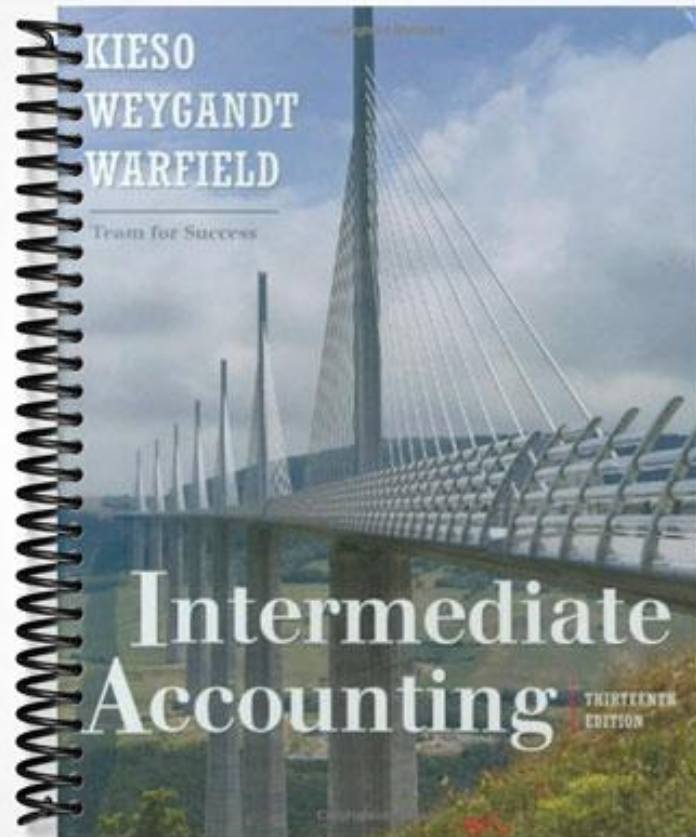


SOLUTIONS MANUAL



CHAPTER 2

Conceptual Framework Underlying Financial Accounting

ASSIGNMENT CLASSIFICATION TABLE (BY TOPIC)

Topics	Questions	Brief Exercises	Exercises	Concepts for Analysis
1. Conceptual framework—general.	1			1, 2
2. Objectives of financial reporting.	2, 5			3
3. Qualitative characteristics of accounting.	3, 4, 6, 24	1, 2	1, 2	4, 10
4. Elements of financial statements.	7, 8, 9	3, 9, 11	3	
5. Basic assumptions.	10, 11, 12	4, 8	4, 5	
6. Basic principles:				
a. Measurement.	13, 14, 15, 16	5, 6, 10	4, 5	5, 6
b. Revenue recognition.	17, 18, 19, 20, 21	5	5	5, 6
c. Expense recognition.	22	5, 10	4, 5	5, 6, 7, 8, 9, 11
d. Full disclosure.	23, 24, 25	5, 10	4, 5, 6	
7. Accounting principles—comprehensive.			7, 8	
8. Constraints.	23, 24, 25, 26	7, 8	1, 4, 5	12
9. Comprehensive assignments on assumptions, principles, and constraints.		9	4, 5	

ASSIGNMENT CLASSIFICATION TABLE (BY LEARNING OBJECTIVE)

Learning Objectives	Brief Exercises	Exercises
1. Describe the usefulness of a conceptual framework.		
2. Describe the FASB's efforts to construct a conceptual framework.		
3. Understand the objectives of financial reporting.		
4. Identify the qualitative characteristics of accounting information.	1, 2	1, 2
5. Define the basic elements of financial statements.	3, 11	3
6. Describe the basic assumptions of accounting.	4, 8, 9, 10	4, 5
7. Explain the application of the basic principles of accounting.	5, 6, 9, 10	4, 5, 6, 7, 8
8. Describe the impact that constraints have on reporting accounting information.	7, 8, 10	1, 4, 5

ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
E2-1	Qualitative characteristics.	Moderate	25–30
E2-2	Qualitative characteristics.	Simple	15–20
E2-3	Elements of financial statements.	Simple	15–20
E2-4	Assumptions, principles, and constraints.	Simple	15–20
E2-5	Assumptions, principles, and constraints.	Moderate	20–25
E2-6	Full disclosure principle.	Complex	20–25
E2-7	Accounting principles—comprehensive.	Moderate	20–25
E2-8	Accounting principles—comprehensive.	Moderate	20–25
CA2-1	Conceptual framework—general.	Simple	20–25
CA2-2	Conceptual framework—general.	Simple	25–35
CA2-3	Objectives of financial reporting.	Moderate	25–35
CA2-4	Qualitative characteristics.	Moderate	30–35
CA2-5	Revenue and expense recognition principles.	Complex	25–30
CA2-6	Revenue and expense recognition principles.	Moderate	30–35
CA2-7	Expense recognition principle.	Complex	20–25
CA2-8	Expense recognition principle.	Moderate	20–25
CA2-9	Expense recognition principle.	Moderate	20–30
CA2-10	Qualitative characteristics.	Moderate	20–30
CA2-11	Expense recognition principle.	Moderate	20–25
CA2-12	Cost/Benefit.	Moderate	30–35

SOLUTION TO CODIFICATION EXERCISES

CE2-1

- (a) The master glossary provides three definitions of fair value that are found in GAAP:

Fair Value—The amount at which an asset (or Liability) could be bought (or incurred) or settled in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

Fair Value—The fair value of an investment is the amount that the plan could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value shall be measured by the market price if there is an active market for the investment. If there is no active market for the investment but there is a market for similar investments, selling prices in that market may be helpful in estimating fair value. If a market price is not available, a forecast of expected cash flows, discounted at a rate commensurate with the risk involved, may be used to estimate fair value. The fair value of an investment shall be reported net of the brokerage commissions and other costs normally incurred in a sale.

Fair Value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

- (b) **Revenue**—Revenue earned by an entity from its direct distribution, exploitation, or licensing of a film, before deduction for any of the entity's direct costs of distribution. For markets and territories in which an entity's fully or jointly-owned films are distributed by third parties, revenue is the net amounts payable to the entity by third party distributors. Revenue is reduced by appropriate allowances, estimated returns, price concessions, or similar adjustments, as applicable.

The glossary references a revenue definition for the SEC: **(Revenue (SEC))**—See paragraph 942-235-S599-1, Regulation S-X Rule 9-05(c)(2), for the definition of revenue for purposes of Regulation S-X Rule 9-05.

This definition relates to segment reporting requirements for public companies.

- (c) **Comprehensive Income** is defined as the change in equity (net assets) of a business entity during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

CE2-2

The FASB Codification's organization is closely aligned with the elements of financial statements, as articulated in the Conceptual Framework. This is apparent in the lay-out of the "Browse" section, which has primary links for Assets, Liabilities, Equity, Revenues, and Expenses.

CE2-3

The Importance of Industry Practices is reflected in the designation of several industries as top level links in the Codification organization. There are separate links to sections for the following industries (section numbers precede each name):

- 905 Agriculture
- 908 Airlines
- 910 Contractors—Construction
- 912 Contractors—Federal Government
- 915 Development Stage entities
- 920 Entertainment—Broadcasters
- 922 Entertainment—Cable Television
- 924 Entertainment—Casinos
- 926 Entertainment—Films
- 928 Entertainment—Music
- 930 Extractive Activities—Mining
- 932 Extractive Activities—Oil and Gas
- 940 Financial Services—Broker and Dealers
- 942 Financial Services—Depository and Lending
- 944 Financial Services—Insurance
- 946 Financial Services—Investment Companies
- 948 Financial Services—Mortgage Banking
- 950 Financial Services—Title Plant
- 952 Franchisors
- 954 Health Care Entities
- 956 Limited Liability Entities
- 958 Not-for-Profit Entities
- 960 Plan Accounting—Defined Benefit Pension Plans
- 962 Plan Accounting—Defined Contribution Pension Plans
- 965 Plan Accounting—Health and Welfare Benefit Plans
- 970 Real Estate—General
- 972 Real Estate—Common Interest Realty Associations
- 974 Real Estate—Real Estate Investment Trusts
- 976 Real Estate—Retail Land
- 978 Real Estate—Time-Sharing Activities
- 980 Regulated Operations
- 985 Software
- 995 U.S. Steamship Entities

ANSWERS TO QUESTIONS

1. A conceptual framework is a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements. A conceptual framework is necessary in financial accounting for the following reasons:
 - (1) It will enable the FASB to issue more useful and consistent standards in the future.
 - (2) New issues will be more quickly solvable by reference to an existing framework of basic theory.
 - (3) It will increase financial statement users' understanding of and confidence in financial reporting.
 - (4) It will enhance comparability among companies' financial statements.
2. The primary objectives of financial reporting are as follows:
 - (1) Provide information useful in investment and credit decisions for individuals who have a reasonable understanding of business.
 - (2) Provide information useful in assessing future cash flows.
 - (3) Provide information about enterprise resources, claims to these resources, and changes in them.
3. "Qualitative characteristics of accounting information" are those characteristics which contribute to the quality or value of the information. The overriding qualitative characteristic of accounting information is usefulness for decision making.
4. Relevance and reliability are the two primary qualities of useful accounting information. For information to be relevant, it should have predictive value or feedback value, and it must be presented on a timely basis. Relevant information has a bearing on a decision and is capable of making a difference in the decision. Relevant information helps users to make predictions about the outcomes of past, present, and future events, or to confirm or correct prior expectations. Reliable information can be depended upon to represent the conditions and events that it is intended to represent. Reliability stems from representational faithfulness, neutrality, and verifiability.
5. In providing information to users of financial statements, the Board relies on general-purpose financial statements. The intent of such statements is to provide the most useful information possible at minimal cost to various user groups. Underlying these objectives is the notion that users need reasonable knowledge of business and financial accounting matters to understand the information contained in financial statements. This point is important: it means that in the preparation of financial statements a level of reasonable competence can be assumed; this has an impact on the way and the extent to which information is reported.
6. Comparability facilitates comparisons between information about two different enterprises at a particular point in time. Consistency facilitates comparisons between information about the same enterprise at two different points in time.
7. At present, the accounting literature contains many terms that have peculiar and specific meanings. Some of these terms have been in use for a long period of time, and their meanings have changed over time. Since the elements of financial statements are the building blocks with which the statements are constructed, it is necessary to develop a basic definitional framework for them.
8. Distributions to owners differ from expenses and losses in that they represent transfers to owners, and they do not arise from activities intended to produce income. Expenses differ from losses in that they arise from the entity's ongoing major or central operations. Losses arise from peripheral or incidental transactions.

Questions Chapter 2 (Continued)

9. Investments by owners differ from revenues and gains in that they represent transfers by owners to the entity, and they do not arise from activities intended to produce income. Revenues differ from gains in that they arise from the entity's ongoing major or central operations. Gains arise from peripheral or incidental transactions.
10. The four basic assumptions that underlie the financial accounting structure are:
- (1) An economic entity assumption.
 - (2) A going concern assumption.
 - (3) A monetary unit assumption.
 - (4) A periodicity assumption.
11. (a) In accounting it is generally agreed that any measures of the success of an enterprise for periods less than its total life are at best provisional in nature and subject to correction. Measurement of progress and status for arbitrary time periods is a practical necessity to serve those who must make decisions. It is not the result of postulating specific time periods as measurable segments of total life.
- (b) The practice of periodic measurement has led to many of the most difficult accounting problems such as inventory pricing, depreciation of long-term assets, and the necessity for revenue recognition tests. The accrual system calls for associating related revenues and expenses. This becomes very difficult for an arbitrary time period with incomplete transactions in process at both the beginning and the end of the period. A number of accounting practices such as adjusting entries or the reporting of corrections of prior periods result directly from efforts to make each period's calculations as accurate as possible and yet recognizing that they are only provisional in nature.
12. The monetary unit assumption assumes that the unit of measure (the dollar) remains reasonably stable so that dollars of different years can be added without any adjustment. When the value of the dollar fluctuates greatly over time, the monetary unit assumption loses its validity.

The FASB in **Concept No. 5** indicated that it expects the dollar unadjusted for inflation or deflation to be used to measure items recognized in financial statements. Only if circumstances change dramatically will the Board consider a more stable measurement unit.

13. Some of the arguments which might be used are outlined below:
- (1) Cost is definite and reliable; other values would have to be determined somewhat arbitrarily and there would be considerable disagreement as to the amounts to be used.
 - (2) Amounts determined by other bases would have to be revised frequently.
 - (3) Comparison with other companies is aided if cost is employed.
 - (4) The costs of obtaining replacement values could outweigh the benefits derived.
14. **Fair value** is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." Fair value is therefore a market-based measure.
15. The fair value option gives companies the option to use fair value (referred to as the fair value option as the basis for measurement of financial assets and financial liabilities.) The Board believes that fair value measurement for financial instruments provides more relevant and understandable information than historical cost. It considers fair value to be more relevant because it reflects the current cash equivalent value of financial instruments. As a result companies now have the option to record fair value in their accounts for most financial instruments, including such items as receivables, investments, and debt securities.

Questions Chapter 2 (Continued)

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

Fair Value Hierarchy

- Level 1:** Observable inputs that reflect quoted prices for identical assets or liabilities in active markets.
- Level 2:** Inputs other than quoted prices included in Level 1 that are observable for the asset or liability either directly or through corroboration with observable data.
- Level 3:** Unobservable inputs (for example, a company's own data or assumptions).

Most Reliable



Least Reliable

As indicated, Level 1 is the most reliable because it is based on quoted prices, like a closing stock price in the *Wall Street Journal*. Level 2 is the next most reliable and would rely on evaluating similar assets or liabilities in active markets. At the least-reliable level, Level 3, much judgment is needed based on the best information available to arrive at a relevant and reliable fair value measurement.

17. Revenue is generally recognized when (1) realized or realizable, and (2) earned.

The adoption of the sale basis is the accountant's practical solution to the extremely difficult problem of measuring revenue under conditions of uncertainty as to the future. The revenue is equal to the amount of cash that will be received due to the operations of the current accounting period, but this amount will not be definitely known until such cash is collected. The accountant, under these circumstances, insists on having "objective evidence," that is, evidence external to the firm itself, on which to base an estimate of the amount of cash that will be received. The sale is considered to be the earliest point at which this evidence is available in the usual case. Until the sale is made, any estimate of the value of inventory is based entirely on the opinion of the management of the firm. When the sale is made, however, an outsider, the buyer, has corroborated the estimate of management and a value can now be assigned based on this transaction. The sale also leads to a valid claim against the buyer and gives the seller the full support of the law in enforcing collection. In a highly developed economy where the probability of collection is high, this gives additional weight to the sale in the determination of the amount to be collected. Ordinarily there is a transfer of control as well as title at the sales point. This not only serves as additional objective evidence but necessitates the recognition of a change in the nature of assets. The sale, then, has been adopted because it provides the accountant with objective evidence as to the amount of revenue that will be collected, subject of course to the bad debts estimated to determine ultimate collectibility.

18. Revenues should be recognized when they are realized or realizable and earned. The most common time at which these two conditions are met is when the product or merchandise is delivered or services are rendered to customers. Therefore, revenue for Selane Eatery should be recognized at the time the luncheon is served.
19. Revenues are realized when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash. Revenues are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash. Readily convertible assets have (1) interchangeable (fungible) units and (2) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.

Questions Chapter 2 (Continued)

20. Each deviation depends on either the existence of earlier objective evidence other than the sale or insufficient evidence of sale. Objective evidence is the key.
- (a) In the case of installment sales the probability of uncollectibility may be great due to the nature of the collection terms. The sale itself, therefore, does not give an accurate basis on which to estimate the amount of cash that will be collected. It is necessary to adopt a basis which will give a reasonably accurate estimate. The installment sales method is a modified cash basis; income is recognized as cash is collected. A cash basis is preferable when no earlier estimate of revenue is sufficiently accurate.
 - (b) The opposite is true in the case of certain agricultural products. Since there is a ready buyer and a quoted price, a sale is not necessary to establish the amount of revenue to be received. In fact, the sale is an insignificant part of the whole operation. As soon as it is harvested, the crop can be valued at its selling price less the cost of transportation to the market and this valuation gives an extremely accurate measure of the amount of revenue for the period without the need of waiting until the sale has been made to measure it. In other words, the sale proceeds are readily realizable and earned, so revenue recognition should occur.
 - (c) In the case of long-term contracts, the use of the “sales basis” would result in a distortion of the periodic income figures. A shift to a “percentage of completion basis” is warranted if objective evidence of the amount of revenue earned in the periods prior to completion is available. The accountant finds such evidence in the existence of a firm contract, from which the ultimate realization can be determined, and estimates of total cost which can be compared with cost incurred to estimate percentage-of-completion for revenue measurement purposes. In general, when estimates of costs to complete and extent of progress toward completion of long-term contracts are reasonably dependable, the percentage-of-completion method is preferable to the completed-contract method.
21. The president means that the “gain” should be recorded in the books. This item should not be entered in the accounts, however, because it has not been realized.
22. The cause and effect relationship can seldom be conclusively demonstrated, but many costs appear to be related to particular revenues and recognizing them as expenses accompanies recognition of the revenue. Examples of expenses that are recognized by associating cause and effect are sales commissions and cost of products sold or services provided.

Systematic and rational allocation means that in the absence of a direct means of associating cause and effect, and where the asset provides benefits for several periods, its cost should be allocated to the periods in a systematic and rational manner. Examples of expenses that are recognized in a systematic and rational manner are depreciation of plant assets, amortization of intangible assets, and allocation of rent and insurance.

Some costs are immediately expensed because the costs have no discernible future benefits or the allocation among several accounting periods is not considered to serve any useful purpose. Examples include officers’ salaries, most selling costs, amounts paid to settle lawsuits, and costs of resources used in unsuccessful efforts.

23. The four characteristics are:
- (1) Definitions—The item meets the definition of an element of financial statements.
 - (2) Measurability—It has a relevant attribute measurable with sufficient reliability.
 - (3) Relevance—The information is capable of making a difference in user decisions.
 - (4) Reliability—The information is representationally faithful, verifiable, and neutral.

Questions Chapter 2 (Continued)

24. (a) To be recognized in the main body of financial statements, an item must meet the definition of an element. In addition the item must have been measured, recorded in the books, and passed through the double-entry system of accounting.
- (b) Information provided in the notes to the financial statements amplifies or explains the items presented in the main body of the statements and is essential to an understanding of the performance and position of the enterprise. Information in the notes does not have to be quantifiable, nor does it need to qualify as an element.
- (c) Supplementary information includes information that presents a different perspective from that adopted in the financial statements. It also includes management's explanation of the financial information and a discussion of the significance of that information.
25. The general guide followed with regard to the full disclosure principle is to disclose in the financial statements any facts of sufficient importance to influence the judgment of an informed reader. The fact that the amount of outstanding common stock doubled in January of the subsequent reporting period probably should be disclosed because such a situation is of importance to present stockholders. Even though the event occurred after December 31, 2010, it should be disclosed on the balance sheet as of December 31, 2010, in order to make adequate disclosure. (The major point that should be emphasized throughout the entire discussion on full disclosure is that there is normally no "black" or "white" but varying shades of grey and it takes experience and good judgment to arrive at an appropriate answer.)
26. Accounting information is subject to two constraints: cost/benefit considerations, and materiality. Information is not worth providing unless the benefits it provides exceed the costs of preparing it. Information that is immaterial is irrelevant, and consequently, not useful. If its inclusion or omission would have no impact on a decision maker, the information is immaterial. However, if it is material, it should be reported.
27. The costs of providing accounting information are paid primarily to highly trained accountants who design and implement information systems, retrieve and analyze large amounts of data, prepare financial statements in accordance with authoritative pronouncements, and audit the information presented. These activities are time-consuming and costly. The benefits of providing accounting information are experienced by society in general, since informed financial decisions help allocate scarce resources to the most effective enterprises. Occasionally new accounting standards require presentation of information that is not readily assembled by the accounting systems of most companies. A determination should be made as to whether the incremental or additional costs of providing the proposed information exceed the incremental benefits to be obtained. This determination requires careful judgment since the benefits of the proposed information may not be readily apparent.
28. The concept of materiality refers to the relative significance of an amount, activity, or item to informative disclosure and a proper presentation of financial position and the results of operations. Materiality has qualitative and quantitative aspects; both the nature of the item and its relative size enter into its evaluation.

An accounting misstatement is said to be material if knowledge of the misstatement will affect the decisions of the average informed reader of the financial statements. Financial statements are misleading if they omit a material fact or include so many immaterial matters as to be confusing. In the examination, the auditor concentrates efforts in proportion to degrees of materiality and relative risk and disregards immaterial items.

The relevant criteria for assessing materiality will depend upon the circumstances and the nature of the item and will vary greatly among companies. For example, an error in current assets or current liabilities will be more important for a company with a flow of funds problem than for one with adequate working capital.

Questions Chapter 2 (Continued)

The effect upon net income (or earnings per share) is the most commonly used measure of materiality. This reflects the prime importance attached to net income by investors and other users of the statements. The effects upon assets and equities are also important as are misstatements of individual accounts and subtotals included in the financial statements. The auditor will note the effects of misstatements on key ratios such as gross profit, the current ratio, or the debt/equity ratio and will consider such special circumstances as the effects on debt agreement covenants and the legality of dividend payments.

There are no rigid standards or guidelines for assessing materiality. The lower bound of materiality has been variously estimated at 5% to 20% of net income, but the determination will vary based upon the individual case and might not fall within these limits. Certain items, such as a questionable loan to a company officer, may be considered material even when minor amounts are involved. In contrast a large misclassification among expense accounts may not be deemed material if there is no misstatement of net income.

29. (a) Acceptable if reasonably accurate estimation is possible. To the extent that warranty costs can be estimated accurately, they should be matched against the related sales revenue.
- (b) Not acceptable. Most accounts are collectible or the company will be out of business very soon. Hence sales can be recorded when made. Also, other companies record sales when made rather than when collected, so if accounts for Landowska Co. are to be compared with other companies, they must be kept on a comparable basis. However, estimates for uncollectible accounts should be recorded if there is a reasonably accurate basis for estimating bad debts.
- (c) Not acceptable. A provision for the possible loss can be made through an appropriation of retained earnings but until judgment has been rendered on the suit or it is otherwise settled, entry of the loss usually represents anticipation. Recording it earlier is probably unwise legal strategy as well. For the loss to be recognized at this point, the loss would have to be probable and reasonably estimable. (See FASB ASC 450-10-05 for additional discussion if desired.) Note disclosure is required if the loss is not recorded.
- (d) Acceptable because lower of cost or market is in accordance with generally accepted accounting principles.
30. The IASB framework makes two assumptions. One assumption is that financial statements are prepared on an accrual basis; the other is that the reporting entity is a going concern. The FASB discuss accrual accounting extensively but does not identify it as an assumption. The going concern concept is only briefly discussed. The going concern concept will undoubtedly be debated as to its place in the conceptual framework.
31. While there is some agreement that the role of financial reporting is to assist users in decision-making, the IASB framework has had more of a focus on the objective of providing information on management's performance—often referred to as stewardship. It is likely that there will be much debate regarding the role of stewardship in the conceptual framework.
32. As indicated, the measurement project relates to both initial measurement and subsequent measurement. Thus, the continuing controversy related to historical cost and fair value accounting suggests that this issue will be controversial. The reporting entity project that addresses which entities should be included in consolidated statements and how to implement such consolidations will be a difficult project. Other difficult issues relate to the trade off between highly relevant information that is difficult to verify? Or how do we define control when we are developing a definition of an asset? Or is a liability the future sacrifice itself or the obligation to make the sacrifice?

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 2-1

- (a) If the company changed its method for inventory valuation, the consistency, and therefore the comparability, of the financial statements have been affected by a change in the method of applying the accounting principles employed. The change would require comment in the auditor's report in an explanatory paragraph.**
- (b) If the company disposed of one of its two subsidiaries that had been included in its consolidated statements for prior years, no comment as to consistency needs to be made in the CPA's audit report. The comparability of the financial statements has been affected by a business transaction, but there has been no change in any accounting principle employed or in the method of its application. (The transaction would probably require informative disclosure in the financial statements.)**
- (c) If the company reduced the estimated remaining useful life of plant property because of obsolescence, the comparability of the financial statements has been affected. The change is not a matter of consistency; it is a change in accounting estimate required by altered conditions and involves no change in accounting principles employed or in their method of application. The change would probably be disclosed by a note in the financial statements; if commented upon in the CPA's report, it would be as a matter of disclosure rather than consistency.**
- (d) If the company is using a different inventory valuation method from all other companies in its industry, no comment as to consistency need be made in the CPA's audit report. Consistency refers to a given company following consistent accounting principles from one period to another; it does not refer to a company following the same accounting principles as other companies in the same industry.**

BRIEF EXERCISE 2-2

- (a) Verifiability**
- (b) Comparability**
- (c) Consistency**
- (d) Timeliness**

BRIEF EXERCISE 2-3

- (a) Equity**
- (b) Revenues**
- (c) Equity**
- (d) Assets**
- (e) Expenses**
- (f) Losses**
- (g) Liabilities**
- (h) Distributions to owners**
- (i) Gains**
- (j) Investments by owners**

BRIEF EXERCISE 2-4

- (a) Periodicity**
- (b) Monetary unit**
- (c) Going concern**
- (d) Economic entity**

BRIEF EXERCISE 2-5

- (a) Revenue recognition**
- (b) Expense recognition**
- (c) Full disclosure**
- (d) Historical cost**

BRIEF EXERCISE 2-6

Investment 1—Level 3
Investment 2—Level 1
Investment 3—Level 2

BRIEF EXERCISE 2-7

- (a) Industry practices**
- (b) Conservatism**
- (c) Cost-benefit relationship**
- (d) Materiality**

BRIEF EXERCISE 2-8

Companies and their auditors for the most part have adopted the general rule of thumb that anything under 5% of net income is considered not material. Recently, the SEC has indicated that it is okay to use this percentage for the initial assessment of materiality, but other factors must be considered. For example, companies can no longer fail to record items in order to meet consensus analyst's earnings numbers; preserve a positive earnings trend; convert a loss to a profit or vice versa; increase management compensation, or hide an illegal transaction like a bribe. In other words, both quantitative and qualitative factors must be considered in determining when an item is material.

- (a) Because the change was used to create a positive trend in earnings, the change is considered material.**
- (b) Each item must be considered separately and not netted. Therefore each transaction is considered material.**
- (c) In general, companies that follow an "expense all capital items below a certain amount" policy are not in violation of the materiality concept. Because the same practice has been followed from year to year, Damon's actions are acceptable.**

BRIEF EXERCISE 2-9

- (a) Net realizable value.**
- (b) Would not be disclosed. Liabilities would be disclosed in the order to be paid.**
- (c) Would not be disclosed. Depreciation would be inappropriate if the going concern assumption no longer applies.**
- (d) Net realizable value.**
- (e) Net realizable value (i.e., redeemable value).**

BRIEF EXERCISE 2-10

- (a) Conservatism**
- (b) Full disclosure**
- (c) Expense recognition principle**
- (d) Historical cost**

BRIEF EXERCISE 2-11

- (a) Should be debited to the Land account, as it is a cost incurred in acquiring land.**
- (b) As an asset, preferably to a Land Improvements account. The driveway will last for many years, and therefore it should be capitalized and depreciated.**
- (c) Probably an asset, as it will last for a number of years and therefore will contribute to operations of those years.**
- (d) If the fiscal year ends December 31, this will all be an expense of the current year that can be charged to an expense account. If statements are to be prepared on some date before December 31, part of this cost would be expense and part asset. Depending upon the circumstances, the original entry as well as the adjusting entry for statement purposes should take the statement date into account.**
- (e) Should be debited to the Building account, as it is a part of the cost of that plant asset which will contribute to operations for many years.**
- (f) As an expense, as the service has already been received; the contribution to operations occurred in this period.**

SOLUTIONS TO EXERCISES

EXERCISE 2-1 (20–30 minutes)

- | | |
|-----------------------------------|--------------------------------|
| (a) Feedback Value. | (f) Relevance and Reliability. |
| (b) Cost/Benefit and Materiality. | (g) Timeliness. |
| (c) Neutrality. | (h) Relevance. |
| (d) Consistency. | (i) Comparability. |
| (e) Neutrality. | (j) Verifiability. |

EXERCISE 2-2 (15–20 minutes)

- | | |
|---------------------|------------------------------------|
| (a) Comparability. | (f) Relevance. |
| (b) Feedback Value. | (g) Comparability and Consistency. |
| (c) Consistency. | (h) Reliability. |
| (d) Neutrality. | (i) Relevance and Reliability. |
| (e) Verifiability. | (j) Timeliness. |

EXERCISE 2-3 (15–20 minutes)

- (a) Gains, losses.
- (b) Liabilities.
- (c) Investments by owners, comprehensive income.
(also possible would be revenues and gains).
- (d) Distributions to owners.
(Note to instructor: net effect is to reduce equity and assets).
- (e) Comprehensive income.
(also possible would be revenues and gains).
- (f) Assets.
- (g) Comprehensive income.
- (h) Revenues, expenses.
- (i) Equity.
- (j) Revenues.
- (k) Distributions to owners.
- (l) Comprehensive income.

EXERCISE 2-4 (15–20 minutes)

- (a) 7. Expense recognition principle.
- (b) 5. Historical cost principle.
- (c) 8. Full disclosure principle.
- (d) 2. Going concern assumption.
- (e) 12. Conservatism.
- (f) 1. Economic entity assumption.
- (g) 4. Periodicity assumption.
- (h) 11. Industry practices.
- (i) 10. Materiality.
- (j) 3. Monetary unit assumption.

EXERCISE 2-5 (20–25 minutes)

- | | |
|---|---|
| (a) Historical cost principle. | (k) Revenue and expense recognition principles. |
| (b) Conservatism. | (l) Economic entity assumption. |
| (c) Full disclosure principle. | (m) Periodicity assumption. |
| (d) Expense recognition principle. | (n) Expense recognition principle. |
| (e) Materiality. | (o) Materiality. |
| (f) Industry practices or fair value principle. | (p) Historical cost principle. |
| (g) Economic entity assumption. | (q) Conservatism. |
| (h) Full disclosure principle. | (r) Expense recognition principle. |
| (i) Revenue recognition principle. | |
| (j) Full disclosure principle. | |

EXERCISE 2-6

- (a) It is well established in accounting that revenues, cost of goods sold and expenses must be disclosed in an income statement. It might be noted to students that such was not always the case. At one time, only net income was reported but over time we have evolved to the present reporting format.
- (b) The proper accounting for this situation is to report the equipment as an asset and the notes payable as a liability on the balance sheet. Offsetting is permitted in only limited situations where certain assets are contractually committed to pay off liabilities.

EXERCISE 2-6 (Continued)

- (c) According to GAAP, the basis upon which inventory amounts are stated (lower of cost or market) and the method used in determining cost (LIFO, FIFO, average cost, etc.) should also be reported. The disclosure requirement related to the method used in determining cost should be emphasized, indicating that where possible alternatives exist in financial reporting, disclosure in some format is required.
- (d) Consistency requires that disclosure of changes in accounting principles be made in the financial statements. To do otherwise would result in financial statements that are misleading. Financial statements are more useful if they can be compared with similar reports for prior years.

EXERCISE 2-7

- (a) This entry violates the economic entity assumption. This assumption in accounting indicates that economic activity can be identified with a particular unit of accountability. In this situation, the company erred by charging this cost to the wrong economic entity.
- (b) The historical cost principle indicates that assets and liabilities are accounted for on the basis of cost. If we were to select sales value, for example, we would have an extremely difficult time in attempting to establish a sales value for a given item without selling it. It should further be noted that the revenue recognition principle provides the answer to when revenue should be recognized. Revenue should be recognized when (1) realized or realizable and (2) earned. In this situation, an earnings process has definitely not taken place.
- (c) Probably the company is too conservative in its accounting for this transaction. The matching principle indicates that expenses should be allocated to the appropriate periods involved. In this case, there appears to be a high uncertainty that the company will have to pay. FASB Statement No. 5 requires that a loss should be accrued only (1) when it is probable that the company would lose the suit and (2) the amount of the loss can be reasonably estimated. (Note to instructor: The student will probably be unfamiliar with FASB Statement No. 5. The purpose of this question is to develop some decision framework when the probability of a future event must be assumed.)

EXERCISE 2-7 (Continued)

- (d) **At the present time, accountants do not recognize price-level adjustments in the accounts. Hence, it is misleading to deviate from the cost principle because conjecture or opinion can take place. It should also be noted that depreciation is not so much a matter of valuation as it is a means of cost allocation. Assets are not depreciated on the basis of a decline in their fair market value, but are depreciated on the basis of systematic charges of expired costs against revenues. (Note to instructor: It might be called to the students' attention that the FASB does encourage supplemental disclosure of price-level information.)**
- (e) **Most accounting methods are based on the assumption that the business enterprise will have a long life. Acceptance of this assumption provides credibility to the historical cost principle, which would be of limited usefulness if liquidation were assumed. Only if we assume some permanence to the enterprise is the use of depreciation and amortization policies justifiable and appropriate. Therefore, it is incorrect to assume liquidation as Gonzales, Inc. has done in this situation. It should be noted that only where liquidation appears imminent is the going concern assumption inapplicable.**
- (f) **The answer to this situation is the same as (b).**

EXERCISE 2-8

- (a) **Depreciation is an allocation of cost, not an attempt to value assets. As a consequence, even if the value of the building is increasing, costs related to this building should be matched with revenues on the income statement, not as a charge against retained earnings.**
- (b) **A gain should not be recognized until the inventory is sold. Accountants follow the historical cost approach and write-ups of assets are not permitted. It should also be noted that the revenue recognition principle states that revenue should not be recognized until it is realized or realizable and is earned.**

EXERCISE 2-8 (Continued)

- (c) Assets should be recorded at the fair market value of what is given up or the fair market value of what is received, whichever is more clearly evident. It should be emphasized that it is not a violation of the historical cost principle to use the fair market value of the stock. Recording the asset at the par value of the stock has no conceptual validity. Par value is merely an arbitrary amount usually set at the date of incorporation.**
- (d) The gain should be recognized at the point of sale. Deferral of the gain should not be permitted, as it is realized and is earned. To explore this question at greater length, one might ask what justification other than the controller's might be used to justify the deferral of the gain. For example, the rationale provided in GAAP, noncompletion of the earnings process, might be discussed.**
- (e) It appears from the information that the sale should be recorded in 2011 instead of 2010. Regardless of whether the terms are f.o.b. shipping point or f.o.b. destination, the point is that the inventory was sold in 2011. It should be noted that if the company is employing a perpetual inventory system in dollars and quantities, a debit to Cost of Goods Sold and a credit to Inventory is also necessary in 2011.**

TIME AND PURPOSE OF CONCEPTS FOR ANALYSIS

CA 2-1 (Time 20–25 minutes)

Purpose—to provide the student with the opportunity to comment on the purpose of the conceptual framework. In addition, a discussion of the Concepts Statements issued by the FASB is required.

CA 2-2 (Time 25–35 minutes)

Purpose—to provide the student with the opportunity to identify and discuss the benefits of the conceptual framework. In addition, the most important quality of information must be discussed, as well as other key characteristics of accounting information.

CA 2-3 (Time 25–35 minutes)

Purpose—to provide the student with some familiarity with **Statement of Financial Accounting Concepts No. 1**. The student is asked to indicate the broad objectives of accounting, and to discuss how this statement might help to establish accounting standards.

CA 2-4 (Time 30–35 minutes)

Purpose—to provide the student with some familiarity with **Statement of Financial Accounting Concepts No. 2**. The student is asked to describe various characteristics of useful accounting information and to identify possible trade-offs among these characteristics.

CA 2-5 (Time 25–30 minutes)

Purpose—to provide the student with the opportunity to indicate and discuss different points at which revenues can be recognized. The student is asked to discuss the “crucial event” that triggers revenue recognition.

CA 2-6 (Time 30–35 minutes)

Purpose—to provide the student with familiarity with an economic concept of income as opposed to the GAAP approach. Also, factors to be considered in determining when net revenue should be recognized are emphasized.

CA 2-7 (Time 20–25 minutes)

Purpose—to provide the student with an opportunity to assess different points to report costs as expenses. Direct cause and effect, indirect cause and effect, and rational and systematic approaches are developed.

CA 2-8 (Time 20–25 minutes)

Purpose—to provide the student with familiarity with the expense recognition principle in accounting. Specific items are then presented to indicate how these items might be reported using the expense recognition principle.

CA 2-9 (Time 20–30 minutes)

Purpose—to provide the student with a realistic case involving association of costs with revenues. The advantages of expensing costs as incurred versus spreading costs are examined. Specific guidance is asked on how allocation over time should be reported.

CA 2-10 (Time 20–30 minutes)

Purpose—to provide the student with the opportunity to discuss the relevance and reliability of financial statement information. The student must write a letter on this matter so the case does provide a good writing exercise for the students.

CA 2-11 (Time 20–25 minutes)

Purpose—to provide the student with the opportunity to discuss the ethical issues related to expense recognition.

CA 2-12 (Time 30–35 minutes)

Purpose—to provide the student with the opportunity to discuss the cost/benefit constraint.

SOLUTIONS TO CONCEPTS FOR ANALYSIS

CA 2-1

- (a) A conceptual framework is like a constitution. Its objective is to provide a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements.

A conceptual framework is necessary so that standard setting is useful, i.e., standard setting should build on and relate to an established body of concepts and objectives. A well-developed conceptual framework should enable the FASB to issue more useful and consistent standards in the future.

Specific benefits that may arise are:

- (1) A coherent set of standards and rules should result.
 - (2) New and emerging practical problems should be more quickly soluble by reference to an existing framework.
 - (3) It should increase financial statement users' understanding of and confidence in financial reporting.
 - (4) It should enhance comparability among companies' financial statements.
 - (5) It should help determine the bounds for judgment in preparing financial statements.
 - (6) It should provide guidance to the body responsible for establishing accounting standards.
- (b) The FASB has issued six Statements of Financial Accounting Concepts (SFAC) that relate to business enterprises. Their titles and brief description of the focus of each Statement are as follows:
- (1) **SFAC No. 1**, "Objectives of Financial Reporting by Business Enterprises," presents the goals and purposes of accounting.
 - (2) **SFAC No. 2**, "Qualitative Characteristics of Accounting Information," examines the characteristics that make accounting information useful.
 - (3) **SFAC No. 3**, "Elements of Financial Statements of Business Enterprises," provides definitions of the broad classifications of items in financial statements.
 - (4) **SFAC No. 5**, "Recognition and Measurement in Financial Statements," sets forth fundamental recognition and measurement criteria and guidance on what information should be formally incorporated into financial statements and when.
 - (5) **SFAC No. 6**, "Elements of Financial Statements," replaces **SFAC No. 3**, "Elements of Financial Statements of Business Enterprises," and expands its scope to include not-for-profit organizations.
 - (6) **SFAC No. 7**, "Using Cash Flow Information and Present Value in Accounting Measurements," provides a framework for using expected future cash flows and present values as a basis for measurement.

CA 2-2

- (a) FASB's conceptual framework study should provide benefits to the accounting community such as:
- (1) guiding the FASB in establishing accounting standards on a consistent basis.
 - (2) determining bounds for judgment in preparing financial statements by prescribing the nature, functions and limits of financial accounting and reporting.
 - (3) increasing users' understanding of and confidence in financial reporting.

CA 2-2 (Continued)

- (b) **Statement of Financial Accounting Concepts 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.
- (c) The number of key characteristics or 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.
- (1) Understandability—information provided by financial reporting should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence. Financial information is a tool and, like most tools, cannot be of much direct help to those who are unable or unwilling to use it, or who misuse it.
 - (2) Relevance—the accounting information is capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct expectations.
 - (3) 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.

(Note to instructor: Other qualities might be discussed by the student, such as secondary qualities. All of these qualities are defined in the textbook.)

CA 2-3

- (a) The basic objectives in **Statement of Financial Accounting Concepts No. 1** are to:
- (1) provide information useful in investment and credit decisions for individuals who have a reasonable understanding of business.
 - (2) provide information useful in assessing future cash flows.
 - (3) provide information about economic resources, claims to those resources, and changes in them.
- (b) The purpose of this statement is to set forth fundamentals on which financial accounting and reporting standards may be based. Without some basic set of objectives that everyone can agree to, inconsistent standards will be developed. For example, some believe that accountability should be the primary objective of financial reporting. Others argue that prediction of future cash flows is more important. It follows that individuals who believe that accountability is the primary objective may arrive at different financial reporting standards than others who argue for prediction of cash flow. Only by establishing some consistent starting point can accounting ever achieve some underlying consistency in establishing accounting principles.

It should be emphasized to the students that the Board itself is likely to be the major user and thus the most direct beneficiary of the guidance provided by this pronouncement. However, knowledge of the objectives and concepts the Board uses should enable all who are affected by or interested in financial accounting standards to better understand the content and limitations of information provided by financial accounting and reporting, thereby furthering their ability to use that information effectively and enhancing confidence in financial accounting and reporting. That knowledge, if used with care, may also provide guidance in resolving new or emerging problems of financial accounting and reporting in the absence of applicable authoritative pronouncements.

CA 2-4

- (a) (1) Relevance is one of the two primary decision-specific characteristics of useful accounting information. Relevant information is capable of making a difference in a decision. Relevant information helps users to make predictions about the outcomes of past, present, and future events, or to confirm or correct prior expectations. Information must also be timely in order to be considered relevant.
- (2) Reliability is one of the two primary decision-specific characteristics of useful accounting information. Reliable information can be depended upon to represent the conditions and events that it is intended to represent. Reliability stems from representational faithfulness and verifiability. Representational faithfulness is correspondence or agreement between accounting information and the economic phenomena it is intended to represent. Verifiability provides assurance that the information is free from bias.
- (3) Understandability is a user-specific characteristic of information. Information is understandable when it permits reasonably informed users to perceive its significance. Understandability is a link between users, who vary widely in their capacity to comprehend or utilize the information, and the decision-specific qualities of information.
- (4) Comparability means that information about enterprises has been prepared and presented in a similar manner. Comparability enhances comparisons between information about two different enterprises at a particular point in time.
- (5) Consistency means that unchanging policies and procedures have been used by an enterprise from one period to another. Consistency enhances comparisons between information about the same enterprise at two different points in time.
- (b) (**Note to instructor:** There are a multitude of answers possible here. The suggestions below are intended to serve as examples.)
- (1) Forecasts of future operating results and projections of future cash flows may be highly relevant to some decision makers. However, they would not be as reliable as historical cost information about past transactions.
- (2) Proposed new accounting methods may be more relevant to many decision makers than existing methods. However, if adopted, they would impair consistency and make trend comparisons of an enterprise's results over time difficult or impossible.
- (3) There presently exists much diversity among acceptable accounting methods and procedures. In order to facilitate comparability between enterprises, the use of only one accepted accounting method for a particular type of transaction could be required. However, consistency would be impaired for those firms changing to the new required methods.
- (4) Occasionally, relevant information is exceedingly complex. Judgment is required in determining the optimum trade-off between relevance and understandability. Information about the impact of general and specific price changes may be highly relevant but not understandable by all users.
- (c) Although trade-offs result in the sacrifice of some desirable quality of information, the overall result should be information that is more useful for decision making.

CA 2-5

- (a) The various accepted times of recognizing revenue in the accounts are as follows:
- (1) Time of sale. This time is currently acceptable when the costs and expenses related to the particular transaction are reasonably determinable at the time of sale and when the collection of the sales price is reasonably certain.

CA 2-5 (Continued)

- (2) At completion. This time is currently acceptable in extractive industries where the salability of the product at a quoted price is likely and in the agricultural industry where there is a quoted price for the product and only low additional costs of delivery to the market remain.
 - (3) During production. This time is currently acceptable when the revenue is known from the contract and total cost can be estimated to determine percentage of completion.
 - (4) At collection. This time is currently acceptable when collections are received in installments, when there are substantial “after costs” that unless anticipated would have the effect of overstating income on a sales basis in the period of sale, and when collection risks are high.
- (b) (1) The “crucial event”—that is, the most difficult task in the cycle of a complete transaction—in the process of earning revenue may or may not coincide with the rendering of service to the subscriber. The new director suggests that they do not coincide in the magazine business and that revenue from subscription sales and advertising should be recognized in the accounts when the difficult task of selling is accomplished and not when the magazines are published to fill the subscriptions or to carry the advertising.

The director’s view that there is a single crucial event in the process of earning revenue in the magazine business is questionable even though the amount of revenue is determinable when the subscription is sold. Although the firm cannot prosper without good advertising contracts and while advertising rates depend substantially on magazine sales, it also is true that readers will not renew their subscriptions unless the content of the magazine pleases them. Unless subscriptions are obtained at prices that provide for the recovery in the first subscription period of all costs of selling and filling those subscriptions, the editorial and publishing activities are as crucial as the sale in the earning of the revenue. Even if the subscription rate does provide for the recovery of all associated costs within the first period, however, the editorial and publishing activities still would be important since the firm has an obligation (in the amount of the present value of the costs expected to be incurred in connection with the editorial and publication activities) to produce and deliver the magazine. Not until this obligation is fulfilled should the revenue associated with it be recognized in the accounts since the revenue is the result of accomplishing two difficult economic tasks (selling and filling subscriptions) and not just the first one. The director’s view also presumes that the cost of publishing the magazines can be computed accurately at or close to the time of the subscription sale despite uncertainty about possible changes in the prices of the factors of production and variations in efficiency. Hence, only a portion—not most—of the revenue should be recognized in the accounts at the time the subscription is sold.

- (2) Recognizing in the accounts all the revenue in equal portions with the publication of the magazine every month is subject to some of the same criticism from the standpoint of theory as the suggestion that all or most of the revenue be recognized in the accounts at the time the subscription is sold. Although the journalistic efforts of the magazine are important in the process of earning revenue, the firm could not prosper without magazine sales and the advertising that results from paid circulation. Hence, some revenue should be recognized in the accounts at the time of the subscription sale.

This alternative, even though it does not recognize revenue in the accounts quite as fast as it is earned, is preferable to the first alternative because a greater proportion of the process of earning revenue is associated with the monthly publication of the magazine than with the subscription sale. For this reason, and because the task of estimating the amount of revenue associated with the subscription sale often has been considered subjective, recognizing revenue in the accounts with the monthly publication of the magazine has received support even though it does not meet the tests of revenue recognition as well as the next alternative.

CA 2-5 (Continued)

- (3) Recognizing in the accounts a portion of the revenue at the time a cash subscription is obtained and a portion each time an issue is published meets the tests of revenue recognition better than the other two alternatives. A portion of the net income is recognized in the accounts at the time of each major or crucial event. Each crucial event is clearly discernible and is a time of interaction between the publisher and subscriber. A legal sale is transacted before any revenue is recognized in the accounts. Prior to the time the revenue is recognized in the accounts, it already has been received in distributable form. Finally, the total revenue is measurable with more than the usual certainty, and the revenue attributable to each crucial event is determinable using reasonable (although sometimes conceptually unsatisfactory) assumptions about the relationship between revenue and costs when the costs are indirect.

(Note to instructor: CA 2-5 might also be assigned in conjunction with Chapter 18.)

CA 2-6

- (a) The economist views business income in terms of wealth of the entity as a whole resulting from an accretion attributable to the whole process of business activity. The accountant must measure the “wealth” of the entity in terms of its component parts, that is, individual assets and liabilities. The events must be identified which cause changes in financial condition of the entity and the resulting changes should be assigned to specific accounting periods. To achieve this identification of such events, accountants employ the revenue recognition principle in the measurement of periodic income.
- (b) Revenue recognition results from the accomplishment of economic activity involving the transfer of goods and services giving rise to a claim. To warrant recognition there must be a change in assets that is capable of being objectively measured and that involves an exchange transaction. This refers to the presence of an arm’s-length transaction with a party external to the entity. The existence and terms of the transaction may be defined by operation of law, by established trade practice, or may be stipulated in a contract. Note that an item should meet four fundamental recognition criteria to be recognized. Those criteria are:
 - (1) Definitions—The item meets the definition of an element of financial statements.
 - (2) Measurability—It has a relevant attribute measurable with sufficient reliability.
 - (3) Relevance—The information is capable of making a difference in user decisions.
 - (4) Reliability—The information is representationally faithful, verifiable, and neutral.

In the context of revenue recognition, recognition involves consideration of two factors, (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration.

Events that can give rise to recognition of revenue are: the completion of a sale; the performance of a service; the production of a standard interchangeable good with a guaranteed market, a determinable market value and only minor costs of marketing, such as precious metals and certain agricultural commodities; and the progress of a construction project, as in shipbuilding. The passing of time may be the “event” that establishes the recognition of revenue, as in the case of interest revenue or rental income.

As a practical consideration, there must be a reasonable degree of certainty in measuring the amount of revenue recognized. Problems of measurement may arise in estimating the degree of completion of a contract, the net realizable value of a receivable or the value of a nonmonetary asset received in an exchange transaction. In some cases, while the revenue may be readily measured, it may be impossible to estimate reasonably the related expenses. In such instances revenue recognition must be deferred until proper periodic income measurement can be achieved through the matching process.

CA 2-6 (Continued)

- (c) No. The factor apparently relied upon by Lopez Associates is that revenue is recognized as the services giving rise to it are performed. The firm has completed the construction of the building, obtained financing for the project, and secured tenants for most of the space. Management of the project is yet to be rendered and Lopez did not accrue revenue for this service. However, another factor must be considered. Since the fee for Lopez's services has as its source the future profits of the project, on May 31, 2010, there is no way to measure objectively the amount of the fee. Setting the amount at the commercial value of the services might be a reasonable approach were it not for the contingent nature of the source of the fees. That an asset, contracts receivable, exists as a result of this activity is outweighed by the inability to measure it objectively. Revenue recognition at this time is unwarranted because of the contingent nature of the revenue and the likelihood of overstating the assets. Thus, revenue recognition at this point would not be in accordance with generally accepted accounting principles.

Because revenue cannot be recognized, the related expenses should be deferred so that they can be amortized over the respective periods of revenue recognition. With a reasonable expectation of future benefit, the deferred costs conform to the accounting concept of assets.

CA 2-7

- (a) Some costs are recognized as expenses on the basis of a presumed direct association with specific revenue. This presumed direct association has been identified both as "associating cause and effect" and as 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 expense recognition principle 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 earnings, have useful significance concerning the efficient utilization of business resources. Thus, applying the expense recognition 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.

- (b) Some costs are assigned as expenses to the current accounting period because
- (1) their incurrence during the period provides no discernible future benefits;
 - (2) they are measures of assets recorded in previous periods from which no future benefits are expected or can be discerned;
 - (3) they must be incurred each accounting year, and no build-up of expected future benefits occurs;
 - (4) by their nature they relate to current revenues even though they cannot be directly associated with any specific revenues;
 - (5) the amount of cost to be deferred can be measured only in an arbitrary manner or great uncertainty exists regarding the realization of future benefits, or both;
 - (6) and uncertainty exists regarding whether allocating them to current and future periods will serve any useful purpose.

Thus, many costs are called "period costs" and are treated as expenses in the period incurred because they have neither a direct relationship with revenue earned nor can their occurrence be directly shown to give rise to an asset. The application of this principle of expense recognition results in charging many costs to expense in the period in which they are paid or accrued for payment. Examples of costs treated as period expenses would include officers' salaries, advertising, research and development, and auditors' fees.

CA 2-7 (Continued)

- (c) A cost should be capitalized, that is, treated as a measure of an asset when it is expected that the asset will produce benefits in future periods. The important concept here is that the incurrence of the cost has resulted in the acquisition of an asset, a future service potential. If a cost is incurred that resulted in the acquisition of an asset from which benefits are not expected beyond the current period, the cost may be expensed as a measure of the service potential that expired in producing the current period's revenues. Not only should the incurrence of the cost result in the acquisition of an asset from which future benefits are expected, but also the cost should be measurable with a reasonable degree of objectivity, and there should be reasonable grounds for associating it with the asset acquired. Examples of costs that should be treated as measures of assets are the costs of merchandise on hand at the end of an accounting period, costs of insurance coverage relating to future periods, and the cost of self-constructed plant or equipment.
- (d) In the absence of a direct basis for associating asset cost with revenue and if the asset provides benefits for two or more accounting periods, its cost should be allocated to these periods (as an expense) in a systematic and rational manner. Thus, when it is impractical, or impossible, to find a close cause-and-effect relationship between revenue and cost, this relationship is often assumed to exist. Therefore, the asset cost is allocated to the accounting periods by some method. The allocation method used should appear reasonable to an unbiased observer and should be followed consistently from period to period. Examples of systematic and rational allocation of asset cost would include depreciation of fixed assets, amortization of intangibles, and allocation of rent and insurance.
- (e) A cost should be treated as a loss when no revenue results. The matching of losses to specific revenue should not be attempted because, by definition, they are expired service potentials not related to revenue produced. That is, losses result from events that are not anticipated as necessary in the process of producing revenue.

There is no simple way of identifying a loss because ascertaining whether a cost should be a loss is often a matter of judgment. The accounting distinction between an asset, expense, loss, and prior period adjustment is not clear-cut. For example, an expense is usually voluntary, planned, and expected as necessary in the generation of revenue. But a loss is a measure of the service potential expired that is considered abnormal, unnecessary, unanticipated, and possibly nonrecurring and is usually not taken into direct consideration in planning the size of the revenue stream.

CA 2-8

- (a) Costs should be recognized as expiring in a given period if they are not chargeable to a prior period and are not applicable to future periods. Recognition in the current period is required when any of the following conditions or criteria are present:
 - (1) A direct identification of association of charges with revenue of the period, such as goods shipped to customers.
 - (2) An indirect association with the revenue of the period, such as fire insurance or rent.
 - (3) A period charge where no association with revenue in the future can be made so the expense is charged this period, such as officers' salaries.
 - (4) A measurable expiration of asset costs during the period, even though not associated with the production of revenue for the current period, such as a fire or casualty loss.

CA 2-8 (Continued)

- (b) (1) Although it is generally agreed that inventory costs should include all costs attributable to placing the goods in a salable state, receiving and handling costs are often treated as cost expirations in the period incurred because they are irregular or are not in uniform proportion to sales.

The portion of the receiving and handling costs attributable to the unsold goods processed during the period should be inventoried. These costs might be more readily apportioned if they are assigned by some device such as an applied rate. Abnormally high receiving and handling costs should be charged off as a period cost.

- (2) The valuation of inventories at the lower of cost or market has been widely adopted as a conservative method of valuing inventories. This method results in recording losses but not gains prior to the sale of the inventory. Where there is not an attendant drop in sales prices, costs and revenues are mismatched to the extent that the present period's reported net income is reduced and the next period's reported net income is increased. Such mismatching has been justified on the grounds that the next period should receive a "fresh start" and its position be the same as though the inventory has been purchased at current market prices. This argument, it might be noted, is contrary to the "going concern" concept.

Where the writedown is of a substantial amount, it has been suggested that the cost of goods sold be reported in terms of original cost. The writedown would be excluded from the cost of goods sold section and shown separately. In addition to matching costs with revenues, this procedure shows normal and abnormal operating results on the income statement for comparative purposes.

- (3) Cash discounts on purchases are treated as "other revenues" in some financial statements in violation of the expense recognition principles (or matching). Revenue is not recognized when goods are purchased or cash disbursed. Furthermore, inventories valued at gross invoice price are recorded at an amount greater than their cash outlay resulting in misstatement of inventory cost in the current period and inventory cost expirations in future periods.

Close adherence to the expense recognition principle (or matching) requires that cash discounts be recorded as a reduction of the cost of purchases and that inventories be priced at net invoice prices. Where inventories are priced at gross invoice prices for expediency, however, there is a slight distortion of the financial statements if the beginning and ending inventories vary little in amount.

CA 2-9

- (a) The preferable treatment of the costs of the sample display houses is expensing them over more than one period. These sample display houses are assets because they represent rights to future service potentials or economic benefits.

According to the expense recognition principle, the costs of service potentials should be amortized as the benefits are received. Thus, costs of the sample display houses should be matched with the revenue from the sale of the houses which is receivable over a period of more than one year. As the sample houses are left on display for three to seven years, Daniel Barenboim apparently expects to benefit from the displays for at least that length of time.

CA 2-9 (Continued)

The alternative of expensing the costs of sample display houses in the period in which the expenditure is made is based primarily upon the concept of conservatism. These costs are of a promotional nature. Promotional costs often are considered expenses of the period in which the expenditures occur due to the uncertainty in determining the time periods benefited. It is likely that no decision is made concerning the life of a sample display house at the time it is erected. Past experience may provide some guidance in determining the probable life. A decision to tear down or alter a house probably is made when sales begin to lag or when a new model with greater potential becomes available.

There is uncertainty not only as to the life of a sample display house but also as to whether a sample display house will be torn down or altered. If it is altered rather than torn down, a portion of the cost of the original house may be attributable to the new model.

- (b) If all of the shell houses are to be sold at the same price, it may be appropriate to allocate the costs of the display houses on the basis of the number of shell houses sold. This allocation would be similar to the units-of-production method of depreciation and would result in a good matching of costs with revenues. On the other hand, if the shell houses are to be sold at different prices, it may be preferable to allocate costs on the basis of the revenue contribution of the shell houses sold.

There is uncertainty regarding the number of homes of a particular model which will be sold as a result of the display sample. The success of this amortization method is dependent upon accurate estimates of the number and selling price of shell houses to be sold. The estimate of the number of units of a particular model which will be sold as a result of a display model should include not only units sold while the model is on display but also units sold after the display house is torn down or altered.

Cost amortization solely on the basis of time may be preferable when the life of the models can be estimated with a great deal more accuracy than can the number of units which will be sold. If unit sales and selling prices are uniform over the life of the sample, a satisfactory matching of costs and revenues may be achieved if the straight-line amortization procedure is used.

Date

Dear Uncle Carlos,

I received the information on Neville Corp. and appreciate your interest in sharing this venture with me. However, I think that basing an investment decision on these financial statements would be unwise because they are neither relevant nor reliable.

One of the most important characteristics of accounting information is that it is relevant, i.e., it will make a difference in my decision. To be relevant, this information must be timely. Because Neville's financial statements are a year old, they have lost their ability to influence my decision: a lot could have changed in that one year.

Another element of relevance is predictive value. Once again, Neville's accounting information proves irrelevant. Shown without reference to other years' profitability, it cannot help me predict future profitability because I cannot see any trends developing. Closely related to predictive value is feedback value. These financial statements do not provide feedback on any strategies which the company may have used to increase profits.

These financial statements are also not reliable. In order to be reliable, their assertions must be verifiable by several independent parties. Because no independent auditor has verified these amounts, there is no way of knowing whether or not they are represented faithfully. For instance, I would like to believe that this company earned \$2,424,240, and that it had a very favorable debt-to-equity ratio. However, unaudited financial statements do not give me any reasonable assurance about these claims.

Finally, the fact that Mrs. Neville herself prepared these statements indicates a lack of neutrality. Because she is not a disinterested third party, I cannot be sure that she did not prepare the financial statements in favor of her husband's business.

I do appreciate the trouble you went through to get me this information. Under the circumstances, however, I do not wish to invest in the Neville bonds and would caution you against doing so. Before you make a decision in this matter, please call me.

Sincerely,

Your Nephew

CA 2-11

- (a) The stakeholders are investors, creditors, etc.; i.e., users of financial statements, current and future.
- (b) Honesty and integrity of financial reporting, job protection, profit.
- (c) Applying the expense recognition principle and recording expense during the plant's life, or not applying it. That is, record the mothball costs in the future.
- (d) The major question may be whether or not the expense of mothballing can be estimated properly so that the integrity of financial reporting is maintained. Applying the expense recognition principle will result in lower profits and possibly higher rates for consumers. Could this cost anyone his or her job? Will investors and creditors have more useful information? On the other hand, failure to apply the matching principle means higher profits, lower rates, and greater potential job security.
- (e) Students' recommendations will vary.

Note: Other stakeholders possibly affected are present and future consumers of electric power. Delay in allocating the expense will benefit today's consumers of electric power at the expense of future consumers.

CA 2-12

1. Information about competitors might be useful for benchmarking the company's results but if management does not have expertise in providing the information, it could lack reliability. In addition, it is likely very costly for management to gather sufficiently reliable information of this nature.
2. While users of financial statements might benefit from receiving internal information, such as company plans and budgets, competitors might also be able to use this information to gain a competitive advantage relative to the disclosing company.
3. In order to produce forecasted financial statements, management would have to make numerous assumptions and estimates, which would be costly in terms of time and data collection. Because of the subjectivity involved, the forecasted statements would lack reliability, thereby detracting from any potential benefits. In addition, while management's forecasts of future profitability or balance sheet amounts could be of benefit, companies could be subject to shareholder lawsuits, if the amounts in the forecasted statements are not realized.
4. It would be excessively costly for companies to gather and report information that is not used in managing the business.
5. Flexible reporting allows companies to "fine-tune" their financial reporting to meet the information needs of its varied users. In this way, they can avoid the cost of providing information that is not demanded by its users.
6. Similar to number 3, concerning forecasted financial statements, if managers report forward-looking information, the company could be exposed to liability if investors unduly rely on the information in making investment decisions. Thus, if companies get protection from unwarranted lawsuits (called a safe harbor), then they might be willing to provide potentially beneficial forward-looking information.

FINANCIAL REPORTING PROBLEM

- (a) **From Note 1. Revenue Recognition—Sales are recognized when revenue is realized or realizable and has been earned. Most revenue transactions represent sales of inventory, and the revenue recorded includes shipping and handling costs, which generally are included in the list price to the customer. The Company’s policy is to recognize revenue when title to the product, ownership and risk of loss transfer to the customer, which generally is on the date of shipment. A provision for payment discounts and product return allowances is recorded as a reduction of sales in the same period that the revenue is recognized.**

Trade promotions, consisting primarily of customer pricing allowances, merchandising funds and consumer coupons, are offered through various programs to customers and consumers. Sales are recorded net of trade promotion spending, which is recognized as incurred, generally at the time of the sale. Most of these arrangements have terms of approximately one year. Accruals for expected payouts under these programs are included as accrued marketing and promotion in the accrued and other current liabilities line in the Consolidated Balance Sheets.

- (b) **Most of the information presented in P&G’s financial statements is reported on an historical cost basis. Examples are: Property, Plant, and Equipment, Inventories (which is not in excess of market), Goodwill, and Intangible Assets. Regarding the use of fair value, all of the company’s marketable investments are reported at fair value (quoted market prices). In addition, the fair value of the company’s financial instruments and the fair value of pension assets are disclosed.**
- (c) **Examination of the auditor’s report, which would indicate an accounting change. Also, P&G indicated that no new accounting pronouncements issued or effective during the fiscal year have had or are expected to have a material impact on the financial statements. Certain reclassifications of prior years’ amounts have been made to conform to the current year presentation.**
- (d) **Selling, general and administrative expense primarily includes marketing expenses, including the cost of media, *advertising and related costs*; selling expenses; research and development costs; administrative and other indirect overhead costs; and other miscellaneous operating items.**

COMPARATIVE ANALYSIS CASE

- (a) **Coca-Cola indicates its business is nonalcoholic beverages, principally soft drinks, but also a variety of noncarbonated beverages. It notes that it is the world's leading manufacturer, marketer and distributor of soft-drink beverage concentrates and syrups as well as the world's largest marketer and distributor of juice and juice-drink products. In its segment supporting note to the financial statements, however, it does not provide a breakdown of beverage drinks into soft drinks and noncarbonated beverages. Rather segments are defined based on the following geographic areas: the North American Group; the Africa Group; the European Union, Eurasia Group, the Pacific Group; the Latin America Group; and Corporate.**

PepsiCo views itself as a leading global snack and beverage company. It manufactures, markets, and sells a variety of salty, sweet and grain-based snacks, carbonated and noncarbonated beverages and foods. It is organized in four divisions:

- **Frito-Lay North America,**
- **PepsiCo Beverages North America,**
- **PepsiCo International, and**
- **Quaker Foods North America.**

The North American divisions operate in the United States and Canada. The international divisions operate in approximately 200 countries, with the largest operations in Mexico and the United Kingdom.

- (b) **Coca-Cola's net operating revenues for 2007 was \$28,857 million which was comprised principally of beverage sales. PepsiCo reported net sales of \$39,474 million of which soft drinks is an estimated \$26,028 (\$15,798 + 10,230) million. The remainder is related to sales in the Frito-Lay and Quaker Foods segments. Based on these amounts, Coca-Cola has the dominant position in beverage sales.**

COMPARATIVE ANALYSIS CASE (Continued)

- (c) **Coca-Cola values inventory at the lower of cost or market. In general, cost is determined on the basis of average cost or first-in first-out methods. PepsiCo also values its inventory at the lower of cost or market. Approximately 14% in 2007 and 19% in 2006 of the inventory cost was computed using the LIFO method. The differences between LIFO and FIFO methods of valuing these inventories are not material.**

Because PepsiCo uses LIFO for part of its inventory, if material, it would be necessary to adjust as best as possible to FIFO. An additional problem is that both use the average cost for some of their inventory, but information related to its percentage use is not provided.

- (d) **Both PepsiCo and Coca-Cola were affected by the promulgation of new accounting standards by the FASB in 2007. Description of these standard adoptions is discussed below.**

Coca-Cola

Recent Accounting Standards and Pronouncements

In December 2007, the FASB issued SFAS No. 141 (revised 2007), “Business Combinations.” SFAS No. 141(R) amends the principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS No. 41(R) also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS No. 41(R) is effective for our Company on January 1, 2009, and the Company will apply prospectively to all business combinations subsequent to the effective date.

In December 2007, the FASB issued SFAS No. 160, “Noncontrolling Interests in Consolidated Financial Statements—an amendment of Accounting Research Bulletin No. 51.” SFAS No. 160 establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary.

COMPARATIVE ANALYSIS CASE (Continued)

PepsiCo

Recent Accounting Pronouncements

In September 2006, the SEC issued SAB 108 to address diversity in practice in quantifying financial statement misstatements. SAB 108 requires that we quantify misstatements based on their impact on each of our financial statements and related disclosure. On December 30, 2006, we adopted SAB 108. Our adoption of SAB 108 did not impact our financial statements.

In September 2006, the FASB issued SFAS 157 which defines fair value, establishes a framework for measuring fair value, and expands disclosure about fair value measurements. The provisions of SFAS 157 are effective as of the beginning of our 2008 fiscal year. However, the FASB has deferred the effective date of SFAS 157, until the beginning of our 2009 fiscal year, as it relates to fair value measurement requirements for nonfinancial assets and liabilities that are not remeasured at fair value on a recurring basis. We are currently evaluating the impact of adopting SFAS 157 on our financial statements. We do not expect our adoption to have a material impact on our financial statements.

In February 2007, the FASB issued SFAS 159 which permits entities to choose to measure many financial instruments and certain other items at fair value. The provisions of SFAS 159 are effective as of the beginning of our 2008 fiscal year. Our adoption of SFAS 159 will not impact our financial statements.

In December 2007, the FASB issued SFAS 141R and SFAS 160 to improve, simplify, and converge internationally the accounting for business combinations and the reporting of noncontrolling interests in consolidated financial statements. The provisions of SFAS 141R and SFAS 160 are effective as of the beginning of our 2009 fiscal year. We are currently evaluating the impact of adopting SFAS 141R and SFAS 160 on our financial statements.

FINANCIAL STATEMENT ANALYSIS CASE—WAL-MART

- (a)
 - (1) In the year of the change, Wal-Mart will reverse the revenue recognized in prior periods for layaway sales that are not complete. This will reduce income in the year of the change.
 - (2) In subsequent years, after the adjustment in the year of the change, as long as Wal-Mart continues to make layaway sales at the same levels, income levels should return to prior levels (except for growth). That is, the accounting change only changes the timing of the recognition, not the overall amount recognized.
- (b) By recognizing the revenue before delivery, Wal-Mart was recognizing revenue before the earnings process was complete. In addition, if customers did not pay the remaining balance owed, the realizability criterion is not met either. While Wal-Mart likely could estimate expected deliveries and payments, it is not apparent that this was done.
- (c) Even if all retailers used the same policy, it still might be difficult to compare the results for layaway transactions. For example what if retailers have different policies as to how much customers have to put down in order for the retailer to set aside the merchandise. Note that the higher (lower) the amount put down, the more (less) likely the customer will complete the transaction. The concern under the prior rules is that retailers might give very generous layaway terms in order to accelerate revenue recognition. Investors would be in for a surprise if customers do not complete the transactions and the revenue recorded earlier must be reversed, thereby lowering reported income.

INTERNATIONAL REPORTING CASE

The IASB and FASB frameworks are strikingly similar. This is not surprising, given that the IASB framework was adopted after the FASB developed its framework (the IASB framework was approved in April 1989). In addition, the IASC, the predecessor to the IASB, was formed to facilitate harmonization of accounting standards across countries. This objective could be aided by adopting a similar conceptual framework.

Specific similarities include:

- (a) **Primary Components**—Both frameworks include elements addressing objectives, assumptions, qualitative characteristics, elements of financial statements, and constraints.
- (b) The objectives for both frameworks focus on information about financial position, performance and changes in performance that is decision-useful.
- (c) Relevance and reliability are identified as key qualitative characteristics of useful information.
- (d) Both frameworks adopt similar definitions for assets and liabilities and define equity as the residual of assets minus liabilities.
- (e) Both frameworks assume some level of understandability by users of financial statements.

Some differences include:

- (a) **Terminology**—The IASB framework contains some terms not found in the FASB's. For example, prudence, listed under reliability in the IASB framework corresponds to the notion of conservatism in the FASB framework.
- (b) **Assumptions**—The IASB does not specifically address assumptions about the monetary unit or economic entity. Note that the accrual basis assumption, in combination with the timeliness constraint can be viewed as subsuming the periodicity assumption in the FASB framework.

INTERNATIONAL REPORTING CASE (Continued)

- (c) **Elements—The IASB defines just five elements without specific definitions for Investments by and Distributions to Owners or Comprehensive Income. There is no distinction in the IASB framework between gains and revenues and losses and expenses.**

Note to Instructors—These differences may be resolved as the FASB and IASB work on their performance reporting projects.

- (d) **Qualitative Characteristics—The IASB does not make a distinction between primary (relevance and reliability) and secondary qualitative factors (comparability), although many of the same qualitative factors are apparent in each framework.**

Recognition and Measurement Principles—The IASB Framework, as presented in the Overview does not address measurement principles related to Historical Cost, Revenue Recognition and Expense Recognition. These likely are discussed in the context of Accrual Basis and True and Fair Presentation.

PROFESSIONAL RESEARCH

Search Strings: concept statement, “materiality”, “articulation”

- (a) According to Concepts Statement 2 (CON 2): Qualitative Characteristics of Accounting Information, “Glossary”:

“Materiality is defined as the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.”

- (b) CON 2, Appendix C—See Table 1—refers to several SEC cases which apply materiality. Students might also research SEC literature (e.g. Staff Accounting Bulletin No. 99), although SEC literature is not in the FARS database.

SFAC No. 2, 128. provides the following examples of screens that might be used to determine materiality:

- “ a. An accounting change in circumstances that puts an enterprise in danger of being in breach of covenant regarding its financial condition may justify a lower materiality threshold than if its position were stronger.
- b. A failure to disclose separately a nonrecurrent item of revenue may be material at a lower threshold than would otherwise be the case if the revenue turns a loss into a profit or reverses the trend of earnings from a downward to an upward trend.
- c. A misclassification of assets that would not be material in amount if it affected two categories of plant or equipment might be material if it changed the classification between a noncurrent and a current asset category.
- d. Amounts too small to warrant disclosure or correction in normal circumstances may be considered material if they arise from abnormal or unusual transactions or events.”

However, according to CON 2, Pars. 129, 131 the FASB notes that more than magnitude must be considered in evaluating materiality:

Almost always, the relative rather than the absolute size of a judgment item determines whether it should be considered material in a given situation. Losses from bad debts or pilferage that could be shrugged off as routine by a large business may threaten the continued existence of a small one. An error in inventory valuation may be material in a small enterprise for which it cut earnings in half but immaterial in an enterprise for which it might make a barely perceptible ripple in the earnings. Some of the empirical investigations referred to in Appendix C throw light on the considerations that enter into materiality judgments.

SFAC No. 2, Par. 131. Some hold the view that the Board should promulgate a set of quantitative materiality guides or criteria covering a wide variety of situations that preparers could look to for authoritative support. That appears to be a minority view, however, on the basis of representations made to the Board in response to the Discussion Memorandum, Criteria for Determining Materiality. The predominant view is that materiality judgments can properly be made only by those who have all the facts. The Board’s present position is that no general standards of materiality could be formulated to take into account all the considerations that enter into an experienced human judgment.

PROFESSIONAL RESEARCH (Continued)

- (c) SFAC No. 3, Par. 15. The two classes of elements are related in such a way that (a) assets, liabilities, and equity are changed by elements of the other class and at any time are their cumulative result and (b) an increase (decrease) in an asset cannot occur without a corresponding decrease (increase) in another asset or a corresponding increase (decrease) in a liability or equity. Those relationships are sometimes collectively referred to as “articulation.” They result in financial statements that are fundamentally interrelated so that statements that show elements of the second class depend on statements that show elements of the first class and vice versa.

PROFESSIONAL SIMULATION

Explanation

1. Most accounting methods are based on the assumption that the business enterprise will have a long life. Acceptance of this assumption provides credibility to the historical cost principle, which would be of limited usefulness if liquidation were assumed. Only if we assume some permanence to the enterprise is the use of depreciation and amortization policies justifiable and appropriate. Therefore, it is incorrect to assume liquidation as the company has done in this situation. It should be noted that only where liquidation appears imminent is the going concern assumption inapplicable.
2. Probably the company is too conservative in its accounting for this transaction. The expense recognition principle indicates that expenses should be allocated to the appropriate periods involved. In this case, there appears to be a high uncertainty that the company will have to pay. FASB Statement No. 5 requires that a loss should be accrued only (1) when it is probable that the company would lose the suit and (2) the amount of the loss can be reasonably estimated. (Note to instructor: The student will probably be unfamiliar with FASB Statement No. 5. The purpose of this question is to develop some decision framework when the probability of a future event must be assumed.)
3. This entry violates the economic entity assumption. This assumption in accounting indicates that economic activity can be identified with a particular unit of accountability. In this situation, the company erred by charging this cost to the wrong economic entity.

Research

According to Concepts Statement 2 (CON 2): Qualitative Characteristics of Accounting Information, “Glossary”:

“Materiality is defined as the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.”

PROFESSIONAL SIMULATION (Continued)

According to the “SUMMARY OF PRINCIPAL CONCLUSIONS”:

“Materiality is a pervasive concept that relates to the qualitative characteristics, especially relevance and reliability. Materiality and relevance are both defined in terms of what influences or makes a difference to a decision maker, but the two terms can be distinguished. A decision not to disclose certain information may be made, say, because investors have no need for that kind of information (it is not relevant) or because the amounts involved are too small to make a difference (they are not material). Magnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment. The Board’s present position is that no general standards of materiality can be formulated to take into account all the considerations that enter into an experienced human judgment. Quantitative materiality criteria may be given by the Board in specific standards in the future, as in the past, as appropriate.”

Expanded discussion of materiality is found at paragraphs 123–132 and in Appendix C of CON 2.

