CHAPTER 2

Conceptual Framework for Financial Reporting

ASSIGNMENT CLASSIFICATION TABLE (BY TOPIC)

Topics	Questions	Brief Exercises	Exercises	Concepts for Analysis
1. Conceptual framework–general.	1			1, 2
2. Objective of financial reporting.	2, 6		1, 2	3
3. Qualitative characteristics of accounting.	3, 4, 5, 7	1, 2, 3, 4	1, 2, 3, 4	4, 9
4. Elements of financial statements.	8, 9, 21	5, 6	5	
5. Basic assumptions.	10, 11, 12	7, 8, 13	6, 7	
6. Basic principles:				
a. Measurement.	13, 14, 15	9, 10, 13	6, 7, 9, 10	5, 6
b. Revenue recognition.	16, 17, 18, 19,	9	7, 9, 10	5, 6
c. Expense recognition.	20	9, 13	6, 7, 9, 10	5, 6, 7, 8, 10
d. Full disclosure.	22, 23	9, 13	6, 7, 8, 9, 10	
7. International standards–comprehensive.	27, 28, 29		9, 10	
8. Constraints.	24, 25, 26	11, 12, 13, 14	3, 6, 7	11
9. Comprehensive assignments on assumptions, principles, and constraints.	27, 28, 29	14	6, 7, 9, 10	

ASSIGNMENT CLASSIFICATION TABLE (BY LEARNING OBJECTIVE)

Learning Objectives	Brief Exercises	Exercises
1. Describe the usefulness of a conceptual framework.		
2. Describe efforts to construct a conceptual framework.		
3. Understand the objective of financial reporting.		1, 2
4. Identify the qualitative characteristics of accounting information.	1, 2, 3, 4	1, 2, 3, 4
5. Define the basic elements of financial statements.	5, 6	5
6. Describe the basic assumptions of accounting.	7, 8, 13	6, 7
7. Explain the application of the basic principles of accounting.	9, 10, 13	6, 7, 8, 9, 10
8. Describe the impact that constraints have on reporting accounting information.	11, 12, 13, 14	6, 7

ASSIGNMENT CHARACTERISTICS TABLE

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

ANSWERS TO QUESTIONS

1. A conceptual framework is a coherent system of concepts that flow from an objective. The objective identifies the purpose of financial reporting. The other concepts provide guidance on (1) identifying the boundaries of financial reporting, (2) selecting the transactions, other events, and circumstances to be represented, (3) how they should be recognized and measured, and (4) how they should be summarized and reported. A conceptual framework is necessary in financial accounting for the following reasons:

(1) It will enable the IASB 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 objective of financial reporting is as follows:
The objective of general purpose financial reporting is to provide financial information about the reporting entity that is **useful to present and potential equity investors, lenders, and other creditors in making decisions in their capacity as capital providers.** Information that is decision useful to capital providers may also be useful to other users of financial reporting who are not capital providers.

3. "Qualitative characteristics of accounting information" are those characteristics which contribute to the quality or value of the information. The fundamental qualitative characteristics are relevance and faithful representation.

4. Relevance and faithful representation are the two fundamental qualities that make accounting information useful for decision-making. To be **relevant,** accounting information must be capable of making a difference in a decision. Information with no bearing on a decision is irrelevant. Financial information is capable of making a difference when it has predictive value, confirmatory value, or both. **Faithful representation** means that the item is representative of the real-world phenomenon that it purports to represent. Faithful representation is a necessity because most users have neither the time nor the expertise to evaluate the factual content of the information. In other words, faithful representation means that the numbers and descriptions match what really existed or happened. To be a faithful representation, information must be complete, neutral, and free of material error.

5. The enhancing qualitative characteristics are comparability, verifiability, timeliness, and understandability. These characteristics enhance the decision usefulness of financial reporting information that is relevant and faithfully represented. Enhancing qualitative characteristics are complementary to the fundamental qualitative characteristics. Enhancing qualitative characteristics distinguish more-useful information from less-useful information.

6. 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.

7. 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.

Questions Chapter 2 (Continued)

8. 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.

9. The elements are assets, liabilities, and equity (moment in time elements) and income and expenses (period of time elements). The first class (moment in time), affected by elements of the second class (period of time), provides at any time the cumulative result of all changes. This interaction is referred to as "articulation." That is, key figures in one financial statement correspond to balances in another.

10. The five 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.
    (5) Accrual-basis assumption.

11. (a) In accounting it is generally agreed that any measures of the success of a company 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 Euros, Yen, or dollars of different years can be added without any adjustment. When the value of the currency fluctuates greatly over time, the monetary unit assumption loses its validity.

    The IASB indicated that it expects the currency 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 fair 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 the fair value option as the basis for measurement of financial assets and financial liabilities.) The Board believes that fair value measurement for financial assets and financial liabilities 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 assets and financial liabilities. As a result companies now have the option to record fair value in their accounts for most financial assets and financial liabilities, including such items as receivables, investments, and debt securities.

16. Revenue is to be recognized when it is probable that future economic benefits will flow to the entity and reliable measurement of the amount of the revenue is possible.

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.

17. Revenue is to be recognized when it is probable that future economic benefits will flow to the entity and reliable measurement of the amount of the revenue is possible. 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.

18. 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, it is probable that future economic benefits will flows to the entity and reliable measurement of the revenue is possible, and therefore revenue should be recognized.

(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.

19. The president means that the "gain" should be recorded in the books. This item should not be entered in the accounts, however, because a reliable measurement of the revenue is questionable.

20. 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.

21. An item that meets the definition of an element should be recognized if: (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and (b) the item has a cost or value that can be measured with reliability.

22. (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.

23. 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 shares doubled in January of the subsequent reporting period probably should be disclosed because such a situation is of importance to present shareholders. Even though the event occurred after December 31, 2011, it should be disclosed on in the notes to the financial statements as of December 31, 2011, 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.)

24. 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.

25. 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.

26. 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 classifying equipment will be more important than if the misclassification was to the inventory account, compared to misclassifying the same amount to land, because the former error would affect working capital ratios.

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.

27. Both the IASB and FASB have similar measurement principles, based on historical cost and fair value. However U.S. GAAP has a concept statement to guide estimation of fair values when market-related data is not available. (*Statement of Financial Accounting Concepts No. 7,* "Using Cash Flow Information and Present Value in Accounting.") The IASB is considering a proposal to provide expanded guidance on estimating fair values ("Discussion Paper on Fair Value Measurement," (London U.K.: IASB), November 2006).

28. The phases of the conceptual framework project are:
(a) Objective and qualitative characteristics.
(b) Elements and recognition
(c) Measurement
(d) Reporting entity
(e) Presentation and disclosure
(f) Purpose and status
(g) Application to not-for-profit entities
(h) Remaining issues

A final document is expected in 2010 for Phase A and Phase D.

29. 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) Comparability
(b) Timeliness
(c) Predictive value
(d) Relevance
(e) Neutrality

BRIEF EXERCISE 2-2

(a) Faithful representation
(b) Confirmatory value
(c) Free from error
(d) Completeness
(e) Understandability

BRIEF EXERCISE 2-3

(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 a matter of consistency; it is a change in accounting estimate which leads to a change in accounting principles employed or in their method of application. The change would require comment in the auditor's report in an explanatory paragraph.

BRIEF EXERCISE 2-3 (Continued)

(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 2-4

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

BRIEF EXERCISE 2-5

(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; depreciation expense during the life of building will include these costs.

(f) As an expense, as the service has already been received; the contribution to operations occurred in this period.

BRIEF EXERCISE 2-6

(a) Equity
(b) Income
(c) Equity
(d) Assets
(e) Expenses
(f) Expenses
(g) Liabilities
(h) Equity
(i) Income
(j) Equity

BRIEF EXERCISE 2-7

(a) Fair value, or net realizable value, if the land was sold.

(b) Would not be disclosed. Depreciation would be inappropriate if the going concern assumption no longer applies.

(c) Fair value, or selling price less costs to complete.

(d) Fair value (i.e., redeemable value), if the insurance coverage was transferred to another party.

Note: In each of these cases, historical cost or fair value valuation might be abandoned if it can not be assumed that the company will not continue on indefinitely.

BRIEF EXERCISE 2-8

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

BRIEF EXERCISE 2-9

(a) Revenue recognition
(b) Expense recognition
(c) Full disclosure
(d) Cost principle

BRIEF EXERCISE 2-10

Investment 1—Least verifiable.
Investment 2—Most verifiable.
Investment 3—Intermediate verifiability

BRIEF EXERCISE 2-11

(a) Materiality
(b) Cost-benefit relationship
(c) Materiality

BRIEF EXERCISE 2-12

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 in the United States 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 2-13

(a) Accrual basis
(b) Full disclosure
(c) Expense recognition principle
(d) Cost principle

BRIEF EXERCISE 2-14

1. Costs; costs
2. General purpose financial reporting
3. Complete
4. Understandability
5. Comparability
6. Confirmatory value

SOLUTIONS TO EXERCISES

EXERCISE 2-1 (10–15 minutes)

(a) True

(b) False. General purpose financial reporting helps users who lack the ability to demand all the financial information they need from an entity and therefore must rely, at least partly, on the information provided in financial reports. Managers and company insiders generally do not meet these criteria.

(c) False. Accounting standards based on individual conceptual frameworks generally will *not* result in consistent and comparable accounting reports. Rather, standard-setting that is based on personal conceptual frameworks will lead to different conclusions about identical or similar issues than it did previously. As a result, standards will not be consistent with one another and past decisions may not be indicative of future ones.

(d) False. The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions in their capacity as capital providers. However, that information may also be useful to other users of financial reporting who are not capital providers.

(e) False. An implicit assumption is 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 financial statement preparers assume a level of competence on the part of users. This assumption impacts the way and the extent to which companies report information.

(f) True.

EXERCISE 2-2 (10–15 minutes)

(a) False. The fundamental qualitative characteristics that make accounting information useful are relevance and faithful representation.

(b) True.

(c) False. The Framework does not include prudence or conservatism as desirable qualities of financial reporting information. The framework indicates that prudence or conservatism generally is in conflict with the quality of neutrality. This is because by being prudent or conservative likely leads to a bias in the reported financial position and financial performance. In fact, introducing biased understatement of assets (or overstatement of liabilities) in one period frequently leads to overstating financial performance in later periods—a result that cannot be described as prudent. This is inconsistent with neutrality, which encompasses freedom from bias.

(d) False. To be a faithful representation, information must be complete, neutral, and free of material error.

(e) False. While comparability does pertain to the reporting of information in a similar manner for different companies, it also refers to the consistency of information, which is present when a company applies the same accounting treatment to similar events, from period to period. Through such application the company shows consistent use of accounting standards and this permits valid comparisons from one period to the next.

(f) False. Verifiability is an enhancing characteristic for both relevance and faithful representation. Verifiability occurs when independent measurers, using the same methods obtain similar results.

(g) True.

EXERCISE 2-3 (15–20 minutes)

(a) Confirmatory Value.
(b) Cost/Benefit and Materiality.
(c) Neutrality.
(d) Consistency (note the overall qualitative characteristic is comparability; consistency is considered part of comparability).
(e) Neutrality.
(f) Relevance and Faithful Representation.
(g) Timeliness.
(h) Relevance.
(i) Comparability.
(j) Verifiability.

EXERCISE 2-4 (15–20 minutes)

(a) Comparability.
(b) Confirmatory Value.
(c) Comparability.
(d) Neutrality.
(e) Verifiability.
(f) Relevance.
(g) Comparability (Consistency), Verifiability, Timeliness, and Understandability.
(h) Faithful Representation.
(i) Relevance and Faithful Representation.
(j) Timeliness.

EXERCISE 2-5 (10–15 minutes)

(a) Liabilities.
(b) Equity.
(c) Equity.
(d) Income.
(e) Assets.
(f) Income, expenses.
(g) Equity.
(h) Income.
(i) Equity.

EXERCISE 2-6 (15–20 minutes)

(a)	8.	Expense recognition principle.
(b)	6.	Cost principle.
(c)	9.	Full disclosure principle.
(d)	2.	Going concern assumption.
(e)	10.	Revenue recognition principle.
(f)	1.	Economic entity assumption.
(g)	4.	Periodicity assumption.
(h)	7.	Fair value principle.
(i)	12.	Materiality constraint.
(j)	3.	Monetary unit assumption.

EXERCISE 2-7 (20–25 minutes)

(a) Historical cost principle.
(b) Accrual-basis assumption.
(c) Full disclosure principle.
(d) Expense recognition principle.
(e) Materiality constraint.
(f) Fair value principle.
(g) Economic entity assumption.
(h) Full disclosure principle.
(i) Revenue recognition principle.
(j) Full disclosure principle.
(k) Revenue and expense recognition principles.
(l) Economic entity assumption.
(m) Periodicity assumption.
(n) Expense recognition principle.
(o) Materiality constraint.
(p) Historical cost principle.
(q) Accrual-basis assumption.
(r) Expense recognition principle.

EXERCISE 2-8

(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 statement of financial position. Offsetting is permitted in only limited situations where certain assets are contractually committed to pay off liabilities, or when a government grant is involved.

EXERCISE 2-8 (Continued)

(c) The basis upon which inventory amounts are stated (net realizable value) and the method used in determining cost (Weighted Average, FIFO, 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) Comparability 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 2-9

(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 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 it is probable that future economic benefits will flow to the entity and reliable measurement of the amount of revenue is possible. In this situation, an earnings process has definitely not taken place.

(c) Probably the company should not record this loss. 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. IAS 37 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 this standard. The purpose of this question is to develop some decision framework when the probability of a future event must be assumed.)

EXERCISE 2-9 (Continued)

(d) At the present time, accountants generally 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 value, but are depreciated on the basis of systematic charges of expired costs against revenues.

(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 2-10

(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 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 the benefits will flow to the company and can be measured reliably.

EXERCISE 2-10 (Continued)

(c) Assets should be recorded at the fair value of what is given up or the fair value of what is received, whichever is more clearly evident. It should be emphasized that it is not a violation of the cost principle to use the fair value of the shares. Recording the asset at the par value of the shares 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. Revenue should be recognized when it is probable that future economic benefits will flow to the entity and reliable measurement of the revenue is possible. 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 IFRS, noncompletion of the earnings process, might be discussed.

(e) It appears from the information that the sale should be recorded in 2012 instead of 2011. 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 2012. 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 2012.

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.

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 the objective of financial reporting. The student is asked to indicate the objective 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 the qualitative characteristics. 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 IFRS 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 20–30 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 2-9 (Time 20–30 minutes)
Purpose—to provide the student with the opportunity to discuss the relevance and faithful representation 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 2-10 (Time 20–25 minutes)
Purpose—to provide the student with the opportunity to discuss the ethical issues related to expense recognition.

CA 2-11 (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 establishes the concepts that underlie financial reporting. A conceptual framework is a coherent system of concepts that flow from an objective. The objective indentifies the purpose of financial reporting. The other concepts provide guidance on (1) identifying the boundaries of financial reporting (2) selecting the transactions, other events, and circumstances to be represented. (3) how they should be recognized and measured, and (4) how they should be summarized and reported.

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 IASB to issue more useful and consistent standards in the future.

(b) 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 solved 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.

CA 2-2

(a) IASB's framework should provide benefits to the accounting community such as:
(1) guiding the IASB 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.

(b) The Framework identifies the most important quality for accounting information as usefulness for decision making. Relevance and faithful representation are the fundamental 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 qualitative characteristics can be distinguished as fundamental or enhancing characteristics, depending on how they affect the usefulness of information. Each quality is described briefly below.

<u>**Fundamental Qualities**</u>

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

Faithful Representation For accounting information to be useful, it must be a faithful representation of the real-world phenomenon that it purports to represent. Faithful representation is a necessity because most users have neither the time nor the expertise to evaluate the factual content of the information. To be a faithful representation, information must be complete, neutral, and free of material error.

CA 2-2 (Continued)

Enhancing Qualities

Comparability. Information that is measured and reported in a similar manner for different companies is considered comparable. Comparability enables users to identify the real similarities and differences in economic events between companies. Another type of comparability, consistency, is present when a company applies the same accounting treatment to similar events, from period to period, the company shows consistent use of accounting standards.

Verifiability. Occurs when independent measurers, using the same methods obtain similar results.

Timeliness. Timeliness means having information available to decision makers before it loses its capacity to influence decisions. Having relevant information available sooner can enhance its capacity to influence decisions, and a lack of timeliness can rob information of its usefulness.

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

CA 2-3

(a) The objective of general purpose financial reporting is to provide financial information about the reporting entity that is **useful to present and potential equity investors, lenders, and other creditors in making decisions in their capacity as capital providers.** Information that is decision useful to capital providers may also be useful to other users of financial reporting who are not capital providers. However, an implicit assumption is 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 financial statement preparers assume a level of competence on the part of users. This assumption impacts the way and the extent to which companies report information.

(b) The purpose of Framework is to set forth fundamentals on which financial accounting and reporting standards may be based. Without an objective 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 fundamental 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.

(2) **Faithful representation** is one of the two fundamental decision-specific characteristics of useful accounting information. Faithfully represented information can be depended upon to represent the conditions and events that it is intended to represent. Faithful representation stems from completeness, neutrality, and lack of error.

(3) **Understandability** is an enhancing 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 companies has been prepared and presented in a similar manner. Comparability enhances comparisons between information about two different companies at a particular point in time.

(5) **Neutrality** means that a company cannot select information to favor one set of parties over another. Reporting unbiased information must be the overriding consideration. If financial reporting is biased, financial reports will lose their credibility.

(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 representationally faithful 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 company'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 companies, 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.

In general, an item that meets the definition of an element should be recognized if: (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and (b) the item has a cost or value that can be measured with reliability. With respect to revenue, it is recognized when it is probable that future economic benefits will flow to the company and reliable measurement of the amount of revenue is possible.

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 amortized cost or fair 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.

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, 2011, 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 international financial reporting standards.

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 as the expense recognition principle, or in this case as "associating cause and effect" ("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) 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 2-8 (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 uncertainty of measurement. 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.

CA 2-9

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 a faithful presentation.

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 have predictive value, confirmatory value, or both. Being timely is also important. 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.

As indicated, one element of relevance is predictive value. 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 confirmatory value. These financial statements do not provide feedback on any strategies which the company may have used to increase profits.

These financial statements also are not faithfully presented. In order to be so, 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 2-10

(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 2-11

1. Information about competitors might be useful for benchmarking the company's results but if management does 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 statement of financial position 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) According to Note 1—Accounting Policies, "Revenue comprises sales of goods to customers outside the Group less an appropriate deduction for actual and expected returns, discounts and loyalty scheme voucher costs, and is stated net of Value Added Tax and other sales taxes. Sales of furniture and online sales are recorded on delivery to the customer."

(b) Most of the information presented in M&S's financial statements is reported on an historical cost basis. Examples are: Property, Plant, and Equipment, Intangible Assets, Investment Properties, and Inventories (subject to net realizable value). Regarding the use of fair value, some investments and other financial assets are reported at fair value. In addition, the fair value of the company's financial instruments and the market value of pension assets are disclosed.

(c) Examination of the auditor's report. Also, M&S discusses a number of new accounting pronouncements issued or effective during the fiscal year (e.g., IFRS 7, IFRIC 11, IFRIC 14). M&S indicates that they have had or are expected to have a material impact on the financial statements.

(d) According to the discussion of "Critical accounting estimates and judgements":

<u>Refunds and loyalty scheme accruals</u>

Accruals for sales returns and loyalty scheme redemption are estimated on the basis of historical returns and redemptions and these are recorded so as to allocate them to the same period as the original revenue is recorded. These provisions are reviewed regularly and updated to reflect management's latest best estimates, however, actual returns and redemptions could vary from these estimates.

Companies include an expanded discussion of items like Refunds and loyalty schemes because the preparation of financial statements requires estimates and assumptions. However, actual results may differ from these estimates and these estimates and assumptions have a significant risk of causing a material adjustment to the carrying amount of assets and liabilities.

COMPARATIVE ANALYSIS CASE

(a) **Cadbury's financial statements are stated in units of pounds sterling (£—United Kingdom currency). Nestle uses Swiss francs (CHF). Comparability is not a concern when comparing results for each company from one year to the next or when comparing Cadbury (Nestle) to other U.K. (Swiss) companies. There are also no concerns if these companies are compared on the basis of ratios (such as a debt to total assets or return on total assets). This is because the amounts in the numerator and denominator are on the same basis, thereby preserving the relationships. However, when comparing gross amounts, currencies must be translated to provide meaningful comparisons. For example, Nestle reported total 2008 sales of CHF 107,552 million. To compare this to Cadbury, which reported revenue sales of £ 5,384 million, using an exchange rate of 1.56 CHF per £, Cadbury reports CHF 8,399 million (5,384 X 1.56) of revenue in terms of Swiss francs.**

(b) **Following demerger of its beverage businesses in 2008, Cadbury is a focused confectionary business. This business is managed based on four regions—Europe, BIMA (Britain, Ireland, Middle East, Africa), Americas, and Asia Pacific. Nestle reports on the basis of two segment formats—by Management Responsibility and Geographic Area (Europe; Americas; Asia, Oceana, and Africa; Nestle Waters, Nestle Nutrition, and Other Food and Beverages) and Product Group (Beverages; Milk and milk products; Prepared dishes and cooking aids; Confectionery; Petcare; and Pharmaceutical products).**

For Nestle, Confectionery comprises 11.4% (CHF 12,248 million/CHF 107,552 million) of total sales. All of Cadbury's revenues (£ 5,384 million or CHF 8,399 million) are in confectionery. Cadbury indicates it is No. 2 in the world in confectionery sales (apparently behind Nestle).

(c) **For Cadbury, inventories are recorded at the lower of average cost and estimated net realizable value. Cost comprises direct material and labour costs together with the relevant factory overheads (including depreciation) on the basis of normal activity levels. Amounts are removed from inventory based on the average value of the items of inventory removed.**

For Nestle, raw materials and purchased finished goods are valued at purchase cost. Work in progress and manufactured finished goods are valued at production cost. Production cost includes direct production costs and an appropriate proportion of production overheads and factory depreciation. Raw material inventories and purchased finished goods are accounted for using the FIFO (first in, first out) method. The weighted average cost method is used for other inventories. An allowance is established when the net realizable value of any inventory item is lower than the value calculated above.

While both companies value inventory at lower of cost or net realizable value, Nestle values raw materials inventories using FIFO. Depending on the age of inventories, comparisons based on inventory levels may need to be adjusted for this difference.

(d) Both companies (Cadbury in Note 39; Nestle in Note 1 and Note 32) discuss changes in accounting standards that may affect their reports. Cadbury reports no effects in 2008.

For Nestle, it indicates applying new accounting policies from 1 January 2008 onwards:

IFRIC 14–IAS 19—The limit on a defined benefit asset, minimum funding requirements and their interaction. This interpretation requires companies to determine the availability of refunds or reductions in future contributions in accordance with the terms and conditions of the plans and the statutory requirements of the plans of the respective jurisdictions. The retrospective application of IFRIC 14 impacted the 2007 Consolidated Financial Statements (refer to Note 32).

Reclassification of Financial Assets—Amendments to IAS 39—Financial Instruments: Recognition and Measurement and IFRS 7—Financial Instruments: Disclosures. These amendments allow entities to reclassify non-derivative financial assets from the fair value through profit or loss category if the assets are no longer held for the purpose of selling or repurchasing and if the entity has the intention and ability to hold them for the foreseeable future or until maturity. The Group did not reclassify any financial assets out of the fair value through profit or loss category in 2008.

FINANCIAL STATEMENT ANALYSIS CASE—NOKIA

(a) The IASB's framework indicates that revenue is to be recognized when it is probable that future economic benefits will flow to the entity and reliable measurement of the amount of revenue is possible. Based on these fundamental concepts of revenue recognition, criteria are then established for various kinds of revenue transactions through the development of related IFRS.

1. For revenue related to sales, Nokia indicates that the criteria are met when it is probable that economic benefits associated with the transaction will flow to the Group and the costs incurred or to be incurred in respect of the transaction can be measured reliably and when the significant risks and rewards of ownership have transferred to the buyer. Thus, it would appear that sales of products are recognized at point of sale.

2. Revenue from contracts is recognized on the percentage of completion basis, when the outcome of the contract can be estimated reliably. Under this approach Nokia must reassess over the life of the contract whether it is probable that future economic benefits will flow to the entity and reliable measurement of the amount of revenue is possible.

(b) A number of estimates are required in applying these revenue recognition policies. For example, sales may materially change if management's assessment of such criteria was determined to be inaccurate. Specifically, Nokia makes price protection adjustments based on estimates of future price reductions and certain agreed customer inventories at the date of the price adjustment. Possible changes in these estimates could result in revisions to the sales in future periods. In this case, the revenue amounts will not be faithful representations and they will lack predictive value (not relevant).

With respect to revenue from contracts, recognized revenues and profits are subject to revisions during the project in the event that the assumptions regarding the overall project outcome are revised. Current sales and profit estimates for projects may materially change due to the early stage of a long-term project, new technology, changes in the project scope, changes in costs, changes in timing, changes in customers' plans, realization of penalties, and other corresponding factors. Again, the revenue amounts will not be faithful representations and they will lack predictive value (not relevant).

(c) Even if all phone-makers use the same policy, it still might be difficult to compare their revenue numbers. As indicated in (b), management makes a number of judgments and estimates in determining whether the criteria have been met. For example, if one company's management is more optimistic in estimating the costs to complete a contract, it will recognize more revenue from a contract and it will recognize the revenue earlier. This will result in revenue numbers that are not comparable to another company with a similar contract but whose management used less optimistic estimates.

ACCOUNTING, ANALYSIS AND PRINCIPLES

ACCOUNTING

CADDIE SHACK COMPANY
Statement of Financial Position
May 31, 2010

Assets		**Owners' equity**	
Building	$ 6,000	Contributed capital	$20,000
Equipment	800	Retained earnings	1,650
Cash	15,100		
Total assets	$21,900	Liabilities	
		Advertising payable	150
		Utilities payable	100
		Total liabilities & equity	$21,900

Accrual income = $4,700 – $1,000 – $750 – $400 – $100 = $2,450
Retained Earnings balance = $0 + $2,450 – $800 = $1,650

Murray's might conclude that his business earned a profit of $2,450 because that is his accrual income for the month. The conclusion that his business lost $4,900 might come from the change in the business's cash balance, which started at $20,000 and ended the month at $15,100.

ANALYSIS

The income measure of $2,450 is most relevant for assessing the future profitability and hence the payoffs to the owners. For example, charging the cost of the building and equipment to expense in the first month of operations understates income in the first month. These costs should be allocated to future periods of benefit through depreciation expense. Similarly, although not paid, the utilities were used to generate revenues so they should be recognized when incurred, not when paid.

ACCOUNTING, ANALYSIS AND PRINCIPLES (Continued)

PRINCIPLES

IFRS income is the accrual income computed above as $2,450. The key concept illustrated in the difference between the loss of $4,900 and profit of $2,450 is the *expense recognition principle,* which calls for recognition of expenses when incurred, not when paid. Excluding the cash withdrawal from the measurement of income (the difference between income measures in parts c and d) is an application of the definition of basic elements. Cash withdrawals are distributions to owners, not an element of income (expenses or losses).

PROFESSIONAL RESEARCH

<u>Search Strings</u>: **"materiality", "completeness"**

(a) According to the Framework (para. 30): Information is defined to be material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

(b) (1) According to the Framework, (para. 29–30):

29 The relevance of information is affected by its nature and materiality. In some cases, the nature of information alone is sufficient to determine its relevance. For example, the reporting of a new segment may affect the assessment of the risks and opportunities facing the entity irrespective of the materiality of the results achieved by the new segment in the reporting period. In other cases, both the nature and materiality are important, for example, the amounts of inventories held in each of the main categories that are appropriate to the business.

30 Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

(2) With respect to Completeness (para. 30):

To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

This statement indicates that excluding immaterial items will not affect the completeness of the financial statements.

(c) According to the Framework (para. 22):

Accrual basis

In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognized when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.

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. International Accounting Standard No. 37 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 this IAS. 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 the Framework (para. 30): Information is defined to be material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

PROFESSIONAL SIMULATION (Continued)

Furthermore, a context for understanding Materiality is provided in para. 29:

> **29 The relevance of information is affected by its nature and materiality. In some cases, the nature of information alone is sufficient to determine its relevance. For example, the reporting of a new segment may affect the assessment of the risks and opportunities facing the entity irrespective of the materiality of the results achieved by the new segment in the reporting period. In other cases, both the nature and materiality are important, for example, the amounts of inventories held in each of the main categories that are appropriate to the business.**