Solutions Manual for Intermediate Accounting 2nd Gordon

CHAPTER 2
Financial Reporting Theory

Solutions

Questions

Q2-1 The conceptual framework sets forth the theory, concepts, and principles that underlie financial reporting standards. A conceptual framework is designed to ensure that a set of accounting standards is coherent and uniform. Thus, standard setters refer to the framework when developing and revising accounting standards. In this way, the individual standards are consistent and supported by the framework. The conceptual framework includes the objective for financial reporting and the qualitative characteristics associated with high quality financial information. It also provides the elements of the financial reporting system and specifies the recognition and measurement criteria to be used in practice.

Q2-2 Currently, the FASB and the IASB are working separately on the Conceptual Framework. The two Boards were working together to improve and converge the two frameworks until 2010. To date, they have issued one statement that has converged the Objective and Qualitative Characteristics.

Q2-3 A well-developed conceptual framework is needed to ensure that a set of accounting standards is coherent and uniform. Thus, standard setters refer to the framework when developing and revising accounting standards. In this way, the individual standards are consistent and supported by the framework. The conceptual framework includes the objective of financial reporting and the qualitative characteristics associated with high quality financial information. It also provides the elements of the financial reporting system and specifies the recognition and measurement criteria to be used in practice.

Q2-4 The standard setters identify "existing and potential investors, lenders, and other creditors" as the primary financial statement user groups. This information is obtained from the FASB's *Statement of Financial Accounting Concepts No. 8*, paragraph OB2, and the IASB's *Conceptual Framework for Financial Reporting,* paragraph OB2. Financial reporting is aimed at the needs of external financial statements users. The company's managers are internal and have access to detailed accounting information.

Q2-5 Relevance is a fundamental qualitative characteristic of useful financial information. Relevant information is capable of making a difference in decision making because of its *predictive* value, *confirmatory* value and materiality.

Q2-6. Financial information is **relevant** if it is capable of making a difference in decision making by exhibiting the following attributes:

- Predictive value
- Confirmatory value
- Materiality

Q2-7 The concept of *materiality* determines the relevancy of information. Information is material if reporting it inaccurately or omitting it would affect the decisions made by the users of the financial statements. Thus, materiality is an aspect of relevance.

Q2-8 Information has **predictive value** if decision makers can use it as an input into processes that help forecast future outcomes. For example, companies report sales revenue each year. Financial statement users may use the prior year's revenues to predict future revenues.

Q2-9 Information has predictive value if it can be used as an input into processes that help predict future outcomes. For example, users of the financial statements may use the trend in sales growth reported in current and prior years' financial statements to predict future revenue. Information has confirmatory value if it provides feedback about prior evaluations. For example, financial statement users will often compare reported net income to prior earnings forecasts.

Q2-10 Information is understandable when it is classified, characterized, and presented clearly. This does not mean that an uninformed reader of financial statements should be able to understand all information presented. Some transactions are inherently complex and may not be fully understood by uninformed readers of the financial statements. Therefore, understandability implies that financial information is consumed by reasonably informed users.

Q2-11 Period-of-time elements represent the results of events and circumstances that occur between two balance sheet dates, or a period of time. In the conceptual framework, U.S. GAAP identifies seven period-of-time elements: 1. Investments by owners; 2. Distributions to owners; 3. Revenues; 4. Gains; 5. Expenses; 6. Losses; and 7. Comprehensive income. Point-of-time elements represent resources, claims to resources, and interests in resources at a point in time, such as a balance sheet date. U.S. GAAP identifies three point-in-time elements that are assets, liabilities, and equity.

Q2-12 The elements of financial reporting are the building blocks of the financial statements. U.S. GAAP identifies two main groups of elements. We refer to these groups as *point-in-time elements* and *period-of-time elements*. Point–in-time elements represent resources (assets), claims to resources (liabilities), or interests in resources (equity) as of a point in time and appear on the balance sheet. Period-of-time elements describe events and circumstances that affect an entity during a period of time and appear on the income statement, statement of comprehensive income, or statement of shareholders' equity. The period-of-time elements include investments by owners, distributions to owners, revenues, gains, expenses, losses and comprehensive income.

Q2-13 Under U.S. GAAP, an asset is defined as a probable future economic benefit obtained or controlled by a particular entity as a result of past transactions or events. Essential characteristics of an asset are also delineated. Under U.S. GAAP, an asset "embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, a particular entity can obtain the benefit and control others' access to it, and the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred." The future economic benefit from an asset is the cash flows generated from its use. Finally, the asset arises out of an event or transaction that has already occurred.

Q2-14 Recognition is the process of reporting an economic event in the financial statements. If an item is recognized, it is included as a line item on the financial statements (i.e., not just in the notes to the statements). An item is not recognized in the financial statements if it is included in the notes to the statements alone.

Q2-15 The revenue recognition principle is used to guide the timing of revenue recognition. It states that revenue is recognized when it is realized or realizable and earned. An item is considered realized or realizable when a good or service has been exchanged for cash or claims to cash. Revenues are considered earned "when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues." The FASB has developed a new revenue standard. The new revenue standard indicates that the overarching principle of revenue recognition is the notion of the transfer of control of the goods or services.

Q2-16 Expenses are recorded when: (1) they are matched with revenue, (2) in the period incurred, and (3) they are systematically allocated over the period of use. Firms recognize expenses when: (1) the entity's economic benefits are consumed in the process of producing or delivering goods or rendering services and (2) an asset has experienced a reduced future benefit, or when a liability has been incurred or increased, without an associated economic benefit.

Q2-17 Under IFRS, expenses are recognized in the income statement when two criteria are met: (1) a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has occurred and (2) the expense can be measured reliably.

Q2-18 Accrual-basis accounting records revenues according to the revenue recognition principle and records expenses according to the expense recognition principle, regardless of when cash is received or paid. Accrual-basis accounting records revenues when earned and expenses when incurred. U.S. GAAP is based on accrual-basis accounting as opposed to a cash-basis system.

Q2-19 Historical cost is the amount of cash (or equivalent) that was paid to acquire the asset. In the case of a liability, historical cost is the amount of cash (or equivalent) that was received when the obligation was incurred. The historical cost may be adjusted for depreciation or amortization over the life of the asset. The historical cost approach results in the general policy that firms initially record assets (and liabilities) at cost and maintain them at cost until selling, consuming, or otherwise disposing of them.

Q2-20 The going concern concept indicates that accountants will record transactions and prepare financial statements as if the entity will continue to operate for an indefinite period of time, unless there is evidence to the contrary. The going concern concept justifies the use of historical cost by the following rationale. If the business is going to exist for an indefinite period of time, productive assets are not for sale and as a result, market values are not particularly relevant. Of course, if there is evidence that the business will not continue to exist (e.g., bankruptcy) then liquidation values should be used. There are many exceptions in practice. Asset impairments and the increased use of fair value accounting result in many economic resources reported at fair value on the balance sheet.

Brief Exercises

Solution to BE2-1

The following are the conceptual framework components:

- Objective of financial reporting
- Characteristics associated with high-quality financial information
- Elements of the financial reporting system
- Recognition and measurement criteria

Solution to BE2-2

The primary users of the financial statements are investors, lenders, and other creditors *who are not in a position to demand information from the entity.* Those financial statement users who are not in a position to demand information rely on the financial statements to help them assess the amount, timing, and uncertainty of future cash flows of the reporting entity, so that they can form an opinion about future returns that will accrue to them by holding a stake in the entity.

This view applies to both U.S. GAAP and IFRS.

Solution to BE2-3

According to the Conceptual Framework, "The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments, and providing or settling loans and other forms of credit." This objective is obtained from the FASB's *Statement of Financial Accounting Concepts No. 8*, paragraph OB2 and the IASB's *Conceptual Framework for Financial Reporting,* paragraph OB2.

Solution to BE2-4

The items below are characteristics of information that is relevant (REL) or a faithful representation (FR):

FR	Information that is neutral
REL	Information has decision-making implications because of its predictive value
FR	Information that is complete
FR	Information that is free from error
REL	Information has decision-making implications because of its confirmatory value

Solution to BE2-5

Fundamental characteristics are those basic characteristics that distinguish useful financial information from information that is not useful. Enhancing characteristics distinguish more useful information from less useful information.

Solution to BE2-6

Financial reporting information is a faithful representation when it is complete, neutral, and free from error. Complete information includes all information that is necessary for the user to understand the underlying economic event. Neutral means the information is free from bias in both the selection and presentation of financial data. Free from error means the information should not contain errors or omissions in the description of an event.

Solution to BE2-7

Standard setters do consider several types of costs for financial statement preparers and users. Providing information has a cost to the reporting entity, which is ultimately passed along to the investors. The entity consumes a significant amount of resources in collecting, processing, verifying, and communicating their financial results. New standards or significant revisions to existing standards require companies to increase training, update accounting systems, and renegotiate existing contracts based on updated accounting information. Users incur costs in interpreting the financial information. If necessary information is not provided to the users, they incur costs in obtaining or estimating the information.

Solution to BE2-8

The historical cost concept is justified by the conceptual framework because it is considered representationally faithful. The use of historical cost is said to increase the reliability of asset measurement because it is neutral, free from error, and complete, which are key ingredients of the accounting quality of representational faithfulness. A consensus decision can always be reached regarding historical information and this information can be verified or confirmed by tracing it back to source documents. However, historical cost based measures may not always be relevant. This is true for several reasons. First, historical cost data are not timely because they are not updated to provide information needed for decision making, thereby reducing its ability to predict future outcomes and provide feedback of past forecasts (as it does not change from year to year).

Solution to BE2-9

The items below are fundamental characteristics (FC) or enhancing characteristics (EC):

EC Comparable

FC Relevant

EC Timely

EC Understandable

FC Faithful representation

EC Verifiable

Solution to BE2-10

The component of a *faithful representation* is matched with its definition:

Component of a Faithful Representation	Definition
1. Complete	C. Includes all information that is necessary for the user to understand the underlying economic event being depicted
2. Neutral	A. Information is free from bias in both selection and presentation of financial data
3. Free from error	B. Information should not contain errors or omissions in the description of the economic event and there are no errors in the process used to produce the financial information

Solution to BE2-11

The Enhancing Characteristic is matched with its definition:

Enhancing Characteristic	Definition
1. Comparability	C. Users of the financial statements can identify and understand similarities and differences between different entities
2. Verifiability	A. Different knowledgeable parties could reach a consensus that a particular depiction is a faithful representation
3. Timely	D. Information is available to financial statements users soon enough to be useful
4. Understandable	B. Information is classified, characterized and presented clearly

Solution to BE2-12

Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations. Gains are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners.

Solution to BE2-13

IFRS defines capital maintenance adjustments as revaluations or restatements of reported amounts of assets and liabilities. The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. Upward revaluations are included in equity as capital maintenance adjustments or revaluation reserves. The adjustments are typically reported in other comprehensive income. Downward revaluations are included in net income.

Solution to BE2-14

Expense recognition involves the timing of when an expense is reported on the income statement. There are three approaches used that include: (1) matching expenses such as cost of goods sold with revenues, (2) recording expenses in the period incurred such as wages, and (3) systematically allocating a cost over several years such as depreciation expense or amortization expense. Some expenses are matched with their related revenues. A good example of this is cost of goods sold. This expense is directly matched with the goods that are sold and recognized during the same period. Some expenses are recorded in the period in which they are incurred. For example, the salary of a salesperson is recorded in the period worked. Some expenses are allocated systematically over the periods during which the related asset provides benefit. For example, a building is depreciated (i.e., expensed) over the periods that it will provide a benefit to the entity.

Solution to BE2-15

Element	Definition
Liabilities	Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.
Equity	The net assets are the residual interest in the assets of an entity that remains after deducting its liabilities.
Assets	Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

Solution to BE2-16

Element	U.S. GAAP Definition
1. Gains	E. Increases in equity (net assets) from an entity's peripheral or incidental transactions and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners.
2. Comprehensive income	C. The change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.
3. Losses	F. Decreases in equity (net assets) from an entity's peripheral or incidental transactions and from all other transactions and other events and circumstances affecting the entity except those that result from expenses or distributions to owners.
4. Expenses	A. Outflows or other consumption of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.
5. Revenues	B. Inflows or other enhancements of an entity's assets or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.
6. Distributions to owners	D. Decreases in equity of a particular business enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interest (or equity) in an enterprise.
7. Investments by owners	G. Increases in equity of a particular business enterprise resulting from transfers to it from other entities of something valuable to obtain or increase ownership interests (or equity) in it.

Solution to BE2-17

The elements below are identified as elements under US GAAP, IFRS, or both, and point or period in time.

US GAAP, IFRS, or Both	Point in Time or Period of Time	Element
US GAAP	Period of Time	Investments by owners
IFRS	Period of Time	Income
US GAAP	Period of Time	Losses
Both	Point in Time	Liabilities
Both	Point in Time	Equity
US GAAP	Period of Time	Comprehensive income
Both	Point in Time	Assets
US GAAP	Period of Time	Gains
IFRS	Period of Time	Capital maintenance adjustment
Both	Period of Time	Expenses
US GAAP	Period of Time	Distributions to owners
US GAAP	Period of Time	Revenues
IFRS	Period of Time	Performance

Solution to BE2-18

The items below are identified as part of the general recognition principle under US GAAP, IFRS, or both.

US GAAP, IFRS, or Both	Item
US GAAP	Relevant
Both	Subject to materiality constraint
Both	An element of the financial statements
IFRS	Probable that any future economic benefit associated with the item will flow to or from the company
Both	Measurable
Both	Reliable
Both	Subject to cost-benefit constraint

Solution to BE2-19

The measurement bases are matched with its definition.

Measurement Bases	Definition
1. Historical cost	C. Amount of cash (or equivalent) that is paid to acquire the asset. In the case of a liability, this measurement base is the amount of cash (or equivalent) that is received when the obligation was incurred. This measurement base may change over the life of the asset/liability if it is adjusted for depreciation or amortization.
2. Current cost	A. Amount of cash (or equivalent) that would be required if the asset were acquired currently.
3. Net realizable value	D. Amount of cash (or equivalent) that is expected to be received in exchange for an asset, less the direct costs of the disposal. In the case of a liability, it is the amount of cash (or equivalent) expected to be paid to liquidate the obligation, including any direct costs of liquidation.
4. Present value of future cash flows	E. Discounted net cash flows expected to be received for an asset, or paid out in the case of a liability.
5. Current market value	B. Amount of cash (or equivalent) that would be received by selling the asset in an orderly liquidation. Liabilities may also be measured at current market value.

Solution to BE2-20

Item	Cash-Basis Accounting	Accrual-Basis Accounting
a.	no effect	$2,000 revenue
b.	$1,500 revenue	no effect
c.	$300 expense	$300 expense
d.	no effect	$850 expense
e.	$700 revenue	no effect

Solution to BE2-21

Scenario	Related Assumption or Concept
a. Monro Manufacturing requires that its division managers report to corporate headquarters on a monthly basis.	Periodicity
b. Rainbow Paints, Inc. owns 15% of New Eljam Company. Rainbow does not consolidate this affiliate company because it cannot control its operations.	Business or economic entity
c. Financial analysts at Nelson Corporation use an infinite-growth assumption in building a model to value the company.	Going concern
d. Factory buildings that are reported on Jack Jones Warehousing, Inc.'s balance sheet is the sum of the total cost of two plants; one of the plants was acquired in 1951 and the other was purchased in 2011.	Monetary unit

Exercises

Solution to E2-1

Issue	Component of the Conceptual Framework
1. Noeleen's Controller, Donald Lierni, was surprised to learn that a Form 10-Q was required to satisfy the company's first quarter filing requirements with the SEC. Lierni was concerned that there is insufficient time to develop the "actual" numbers needed to prepare the report. The 10-Q required that significant estimates had to be made before the filing due date.	1. Relevance versus Faithful Representation; timeliness.
2. An additional consideration was the fact that Noeleen now had to satisfy a new group of financial statement users with additional information needs.	2. Multiple user groups, multipurpose financial statements due to unknown decision models--so information has to be complete, understandable, etc.

Issue	Component of the Conceptual Framework
3. Resources had to be expended to meet the new reporting requirements and an assessment had to be made as to what information and disclosures to include and exclude from the financial reports.	3. Cost Constraint and the Materiality Constraint
4. Lierni also learned that privately held companies were subject to less stringent U.S. GAAP requirements than a publicly traded entity. That is, the company now had to follow additional U.S. GAAP standards and was also required to change several accounting methods.	4. Comparability
5. When considering his options, Lierni decided to take a safe approach and report the lowest income possible by adopting income-reducing standards. Here, the Controller proposed taking excessive write-downs for obsolete inventory and potentially impaired assets.	5. Lack of neutrality; expense recognition
6. He also decided to expense the cost of a significant investment in office equipment.	6. Expense recognition concept possibly violated; neutrality.
7. Finally, Noeleen created a separate legal entity to handle its auto financing, Benedict Arnold Credit Company, during the same year it went public. The separate entity is not consolidated with the primary financial statements. Lierni decided to keep this entity off balance sheet and did not see any need for disclosure of Noeleen's relationship with Benedict Arnold Credit Company.	7. Business or economic entity assumption and lack of completeness (lack of full disclosure).

Solution to E2-2

	Use of Accounting Information	Fundamental Characteristic	Attribute
a.	This year's reported earnings per share is $.50 below analysts' forecasts.	Relevance	Confirmatory value
b.	Potential creditors review a company's long-term liabilities footnote to determine that entity's ability to assume additional debt.	Faithful representation	Complete
c.	A corporation discloses both favorable and unfavorable tax settlements.	Faithful representation	Neutral
d.	A company discloses the write-off of an accounts receivable. The receivable due from a major customer accounts for 35% of the company's current assets.	Relevance Faithful representation	Materiality Complete
e.	A financial analyst computes a company's five-year average cost of goods sold in order to forecast next year's gross profit margin.	Relevance	Predictive value

Solution to E2-3

	Scenario	Enhancing Characteristic	Satisfied or Violated
a.	Auditors from two offices of a large public accounting firm agree on the measurement used for a client's plant assets.	Verifiability	Satisfied
b.	The Later Than Sooner Company only reports income every two years.	Timeliness	Violated
c.	Gladys Groceries reports its investments at cost while the other companies in the grocery industry use the fair value option to measure investments.	Comparability	Violated
d.	Grant Company engages in complex business transactions. These events are properly classified, characterized, presented clearly, and fully disclosed.	Understandability	Satisfied

Solution to E2-4

a. None

b. Historical cost concept

c. Business entity concept

d. Full disclosure, materiality, completeness.

e. Expense recognition concept

f. Timeliness.

Solution to E2-5

a. Conceptual framework

b. Predictive value

c. Faithful representation

d. Comparability

e. Verifiability

f. Point-in-time elements

g. Arms-length transaction

h. Going concern concept

i. Periodicity assumption

j. Relevant

Solution to E2-6

a. Correct. This is consistent with the materiality concept. The $4,000 computer is not material to the financial position and results of operations of a multinational corporation. The subsequent accounting (i.e., capitalization and depreciation) is also not justified from a cost-benefit perspective.

b. Correct. This practice is supported by the expense recognition principle of allocating the cost over a period of time because this cost cannot be directly associated with revenues and the economic benefit is not consumed immediately.

c. Incorrect. This violates the expense recognition concept because the benefits from the overhaul cost are not consumed immediately. It may also be incorrect because it violates materiality.

d. Incorrect. This practice violates the business entity concept. The transactions of the business must be kept separate from the personal affairs of the owner.

e. Correct. This practice provides relevant information to its shareholders and is provided on a timely basis. The periodicity assumption is fulfilled.

Solution to E2-7

Since Top Notch paid for the payroll and utilities expenses in the same month it consumed the benefits, there is no difference in the expense recognition of these expenses between the cash basis and accrual basis. The independent contractor's services are expensed in February under accrual-basis accounting but not cash-basis accounting.

Under cash-basis accounting, Top Notch would recognize revenue of $25,000, $12,000, $107,000 ($40,000 + $33,000 + 34,000), in January, February, and March, respectively, since it received cash in those months. However, under the accrual basis, it would recognize $65,000 ($40,000 + $25,000) for services provided in January, $45,000 for services provided in February, and $55,000 ($34,000 + $21,000) for services provided in March.

Monthly net income is the monthly revenues less monthly expenses. Total net income over the three months is $21,000 higher ($121,150 - $100,150) under the accrual basis due to the $21,000 of services provided in March (part d.) for which clients were billed but cash was not yet collected.

	Revenue Recognition			
Month	**Cash Basis**		**Accrual Basis**	
January			a.	$40,000
	b.	$25,000	b.	25,000
February	c.	12,000	c.	45,000
March	a.	40,000	d.	34,000
	c.	33,000	d.	21,000
	d.	34,000		

	Expense Recognition			
Month	**Cash Basis**		**Accrual Basis**	
January	e.	$12,000	e.	$12,000
	f.	800	f.	800
February	e.	13,000	e.	13,000
	f.	850	f.	850
			g.	1,200
March	e.	15,000	e.	15,000
	f.	1,000	f.	1,000
	g.	1,200		

	Net Income (Revenues less Expenses)	
Month	**Cash Basis**	**Accrual Basis**
January	$ 12,200	$ 52,200
February	($ 1,850)	$ 29,950
March	$ 89,800	$ 39,000
Total	$100,150	$121,150

Solution to E2-8

1. Comparative income statements: Cash versus Accrual Basis of Accounting.

	Accrual Basis		***Cash Basis***	
	2019	***2018***	***2019***	***2018***
Service revenue	$250,000	$185,000		
Cash collected from clients			$80,000	$97,000
Operating expenses:				
Salary expense	12,000	16,500		
Supplies expense	5,500	3,500	4,000	2,500
Depreciation expense	2,000	2,000		
Rent expense	7,000	3,000	7,000	3,000
Insurance expense	- 0 -	- 0 -	5,500	- 0 -
Operating Income	$223,500	$160,000	$63,500	$91,500

2. Cash flow from operations is the same for both methods and is equal to the operating income reported under the cash basis:

Cash Flow from Operations	***2019***	***2018***
Cash collected from clients	$80,000	$97,000
Cash paid for operating expenses:		
Cash paid for supplies	4,000	2,500
Cash paid for rent	7,000	3,000
Cash paid for insurance	5,500	- 0 -
Net cash flow from operations	$63,500	$91,500

2

Financial Reporting Theory

Overview

Chapter 2 is driven by the students' need to understand the conceptual framework for accounting. In order to read and understand financial statements, a student must become familiar with the conceptual framework under which the financial statements were prepared. Therefore, this chapter highlights the ways in which authoritative literature and guidance are grounded in the conceptual framework and discusses how the objective of financial reporting and the elements of financial reporting are part of the conceptual framework.

Learning Objectives

1. Explain what a conceptual framework is and why it is important in accounting standard setting.
2. Define the objective of financial reporting.
3. Describe the qualitative characteristics of financial information, including the fundamental and enhancing characteristics of financial reporting.
4. Identify the elements of financial reporting.
5. Demonstrate an understanding of recognition and measurement in financial reporting including general recognition principles, revenue and expense recognition, and accrual accounting.
6. Explain the assumptions used in financial reporting.

Teaching Outline

Learning Objective 1: Overview of the Conceptual Framework

I. Overview of the Conceptual Framework

A. Conceptual Framework Components

1. *See Exhibit 2.1:* The framework's role in standard setting
2. *See Exhibit 2.2:* Revisions to the conceptual framework, which includes six topics

3. *See Exhibit 2.3:* An overview of the current financial framework

IFRS Breakaway

B. Conceptual Framework: Although qualitative characteristics are identical between U.S. GAAP and IFRS, they differ in many other areas. IFRS is also in the process of revising its framework.

Learning Objective 2: The Objective of Financial Reporting

I. The objective of financial reporting is to provide relevant, useful information to stakeholders. Primary users of financial information are investors, lenders, and other creditors.

Learning Objective 3: The Qualitative Characteristics of Financial Information

I. The conceptual framework divides the qualitative characteristics into:
   - Fundamental characteristics
   - Enhancing characteristics

   A. Fundamental Characteristics: Distinguish useful information from that which is not useful.

      1. Relevance: Capable of making a difference in a decision.
         a. Predictive value: Helps forecast future outcomes.
         b. Confirmatory value: Provides feedback from prior evaluations.
         c. Materiality: If reported inaccurately, would affect financial statement users' decisions.

      2. Faithful Representation: *See Exhibit 2.4.* Indicates whether financial information depicts the substance of an economic event in a manner that is:
         a. Complete: Includes all information, both descriptions and explanations.
         b. Neutral: Is free from bias.
         c. Free from error: Contains no mistakes or omissions.

   B. Enhancing Characteristics: Comparability, verifiability, timeliness, and understandability help distinguish more useful information from less useful information.

      1. Comparability: Allows financial statement users to identify and understand similarities and differences among several entities.

      2. Verifiability: Allows a group of reasonably informed financial statement users to reach a consensus decision.

      3. Timeliness: Available early enough to make a difference in decision making.

      4. Understandability: Classify, characterize, and clearly present all information. *See Exhibit 2.5.*

   C. Cost Constraint: Standard setters should compare the cost of requiring information to the benefits derived from presenting the information.

Learning Objective 4: Elements of Financial Reporting

I. There are two elements of financial reporting: Point-in-time elements and period-of-time elements.

A. Elements: U.S. GAAP

1. Point-in-Time Elements: Represent resources, claims to resources, or interests in resources for a specific point in time. *See Exhibit 2.6*. **Examples:** Accounts receivable and accounts payable
    a. Assets: Probable future economic benefits resulting from some past event.
    b. Liabilities: Probable future sacrifices of economic benefits arising from present obligations.
    c. Equity: Net assets, the difference between assets and liabilities.

2. Period-of-Time Elements: Change point-in-time elements, as they represent events that occur between two balance sheet dates. Elements include, but are not limited to, investments by owners, distribution to owners, revenue, and gains. *See Exhibit 2.7*. **Examples:** Sales revenue, depreciation expense, and dividends declared

IFRS Breakaway

B. Elements

1. Point-in-Time Elements: IFRS identifies the same three point-in-time elements as U.S. GAAP: assets, liabilities, and equity.

2. Period-of-Time Elements: *See Exhibit 2.8*. Capital maintenance adjustments are handled differently between U.S. GAAP and IFRS. IFRS reports changes in equity and comprehensive income substantially differently from U.S. GAAP. These differences stem from IFRS' restatements and revaluations of reported assets and liabilities.

Learning Objective 5: Principles of Recognition and Measurement

I. Three principles underlie accrual accounting:
- General recognition
- Revenue and expense recognition
- Bases of measurement

A. General Recognition Principles

1. Recognition is a multifaceted process that includes four criteria that consider the cost-benefit constraint and the materiality threshold:
    a. The item meets the definition of one of the elements of the financial statements.
    b. The item is measurable (i.e., reliably estimating an amount is important).
    c. The item must be reliable, which is similar to faithful representation.
    d. The item is relevant, which allows financial statement users to make rational economic decisions.

B. Revenue and Expense Recognition

1. Revenue recognition principle:
    e. Realized or realizable: Exchanges goods or services for cash.
    f. Earned: Seller has accomplished what it must do for revenue to be considered earned.

2. Expense recognition principles: *See Exhibit 2.9.* There are three approaches to determine when to report an expense:
    - Match with revenues.
    - Expense in period incurred.
    - Systematically over periods of use.

    a. Firms recognize expenses when economic benefits are consumed.
    b. Firms recognize expenses when an asset has experienced a reduced (or eliminated) future benefit.

C. Bases of Measurement

1. Five aspects of measurement
    a. Historical cost: Amount paid to acquire the asset.
    b. Current cost: Amount for which the firm could acquire the asset currently.
    c. Current market value: Amount for which the firm could sell the asset.
    d. Net realizable value: The amount that could be received in exchange for an asset, less the cost of disposal.
    e. Present value of future cash flows: Discounting net cash flows the firm expects to receive on the exchange of an asset.

2. Arms-length transactions: Involve a buyer and a seller who are independent and unrelated.

3. Fair Value Measurement and the Fair Value Hierarchy: *See Exhibit 2.10.*

IFRS Breakaway

D. Recognition and Measurement: Differentiating between U.S. GAAP and IFRS.

1. General Recognition Principles: *See Exhibit 2.11.*
    a. The item meets the definition of one of the elements: Similar to U.S. GAAP.
    b. The item is measurable: Similar to U.S. GAAP.
    c. The measurement of the item must be reliable: Similar to U.S. GAAP.
    d. It is probable that future economic benefits will flow to or from the company: Used instead of relevance used in U.S. GAAP.

2. Revenue and Expense Recognition
    a. Revenue: 1) An increase in future economic benefits related to an increase in an asset or a decrease of a liability *and* 2) the revenue can be measured reliably.
    b. Expense: 1) A decrease in future economic benefit related to a decrease of an asset or an increase of a liability *and* 2) the expense can be measured reliably.

3. Bases of Measurement
    a. Historical cost
    b. Current cost
    c. Net realizable value

d. Present value of future cash flows

E. Cash versus Accrual Accounting: U.S. GAAP is based on accrual accounting and does not allow for a cash-basis system.

1. Cash-Basis Accounting: Firms recognize revenue when cash is received and an expense when cash is paid.
2. Accrual Accounting: When firms pay or receive cash does not matter.

Learning Objective 6: Assumptions in Financial Reporting

I. Assumptions in Financial Reporting

A. Going Concern Concept: Financial statements are prepared as if the entity will continue for an indefinite period of time.

B. Business or Economic Entity Concept: Business transactions and personal affairs are kept separate.

C. Monetary Unit Assumption: Economic activities are reported in dollars or other monetary units.

D. Periodicity Assumption: An economic entity can divide its life into artificial time periods.

IFRS Breakaway

II. Assumptions in Financial Reporting: IFRS specifically addresses the going concern assumption, while all other assumptions are implied.

Student Supplement to Teaching Outline

Learning Objective 1: Overview of the Conceptual Framework

I. Overview of the Conceptual Framework

   A. Conceptual Framework Components

IFRS Breakaway

   B. Conceptual Framework

Learning Objective 2: The Objective of Financial Reporting

I. The Objective of Financial Reporting

Learning Objective 3: The Qualitative Characteristics of Financial Information

I. The Qualitative Characteristics of Financial Information

   A. Fundamental Characteristics

      1. Relevance

      2. Faithful Representation

   B. Enhancing Characteristics

      1. Comparability

      2. Verifiability

      3. Timeliness

      4. Understandability

   C. Cost Constraint

Learning Objective 4: Elements of Financial Reporting

I. Elements of Financial Reporting

   A. Elements

      1. Point-in-Time Elements

      2. Period-of-Time Elements

IFRS Breakaway

   B. Elements

      1. Point-in-Time Elements

      2. Period-of-Time Elements

Learning Objective 5: Principles of Recognition and Measurement

I. Principles of Recognition and Measurement

A. General Recognition Principles

B. Revenue and Expense Recognition

C. Bases of Measurement

   1. Fair Value Measurement and the Fair Value Hierarchy

IFRS Breakaway

D. Recognition and Measurement

   1. General Recognition Principles
   2. Revenue and Expense Recognition
   3. Bases of Measurement

E. Cash versus Accrual Accounting

   1. Cash-Basis Accounting
   2. Accrual Accounting

Learning Objective 6: Assumptions in Financial Reporting

I. Assumptions in Financial Reporting

A. Going Concern Concept

B. Business or Economic Entity Concept

C. Monetary Unit Assumption

D. Periodicity Assumption

IFRS Breakaway

II. Assumptions in Financial Reporting

Assignment Grid

Assignment	Topic(s)	Learning Objective(s)	Estimated Time in Minutes	Level of Difficulty
Questions				
Q2-1	Conceptual Framework	1	10	Easy
Q2-2	FASB and IASB Conceptual Frameworks	1	10	Easy
Q2-3	Conceptual Framework	1	10	Easy
Q2-4	Users of Financial Statements	2	10	Easy
Q2-5	Relevance	3	10	Easy
Q2-6	Relevance	3	10	Easy
Q2-7	Materiality	3	10	Easy
Q2-8	Predictive Value	3	10	Easy
Q2-9	Predictive Value versus Confirmatory Value	3	10	Easy
Q2-10	Understandability	3	10	Easy
Q2-11	Point-in-Time versus Period-of-Time Elements	4	10	Easy
Q2-12	Elements of Financial Reporting	4	10	Easy
Q2-13	Definition of an Asset	4	10	Easy
Q2-14	Recognition Principle	5	10	Easy
Q2-15	Revenue Recognition Principle	5	10	Easy
Q2-16	Expense Recognition under U.S. GAAP	5	10	Easy
Q2-17	Expense Recognition under IFRS	5	10	Easy
Q2-18	Accrual Accounting Transactions	5	10	Easy
Q2-19	Historical Cost	5	10	Easy
Q2-20	Going Concern	6	10	Easy
Brief Exercises				
BE2-1	Components of the Conceptual Framework	1	5–10	Easy
BE2-2	Users of Financial Information	2	5–10	Easy
BE2-3	Objective of Financial Reporting	2	5–10	Easy
BE2-4	Relevant and Faithful Representation	3	10–15	Easy
BE2-5	Fundamental and Enhancing Characteristics	3	10–15	Easy
BE2-6	Faithful Representation	3	15–20	Medium
BE2-7	Costs and Benefits of Financial Reporting	3	10–15	Easy

Assignment	Topic(s)	Learning Objective(s)	Estimated Time in Minutes	Level of Difficulty
BE2-8	Historical Cost	3, 5	15–20	Medium
BE2-9	Fundamental and Enhancing Characteristics	3	10–15	Easy
BE2-10	Faithful Representation	3	10–15	Easy
BE2-11	Enhancing Characteristics	3	10–15	Easy
BE2-12	Revenues and Gains	4	10–15	Easy
BE2-13	Capital Maintenance Adjustments, IFRS	4	15–20	Medium
BE2-14	Expense Recognition	5	10–15	Easy
BE2-15	Element Definitions	4	10–15	Easy
BE2-16	Element Definitions	4	10–15	Medium
BE2-17	Element Definitions, U.S. GAAP, IFRS	4	15–20	Medium
BE2-18	Recognition, U.S. GAAP, IFRS	5	10–15	Easy
BE2-19	Measurement Bases	5	10–15	Easy
BE2-20	Cash versus Accrual Bases of Accounting	5	15–20	Medium
BE2-21	Assumptions in Financial Reporting	6	15–20	Medium
Brief Exercises				
E2-1	Conceptual Framework	3, 5, 6	15–20	Medium
E2-2	Qualitative Characteristics	3	15–20	Medium
E2-3	Enhancing Characteristics	3	15–20	Medium
E2-4	Concepts	3, 5, 6	15–20	Medium
E2-5	Terms and Concepts	1, 3, 4, 5, 6	15–20	Medium
E2-6	Concepts	3, 5, 6	25–30	Difficult
E2-7	Cash versus Accrual Bases of Accounting	5	15–20	Medium
E2-8	Cash versus Accrual	5	25–30	Difficult

Suggestions for Class Activities

Students should be encouraged to question the differences between U.S. GAAP and IFRS rather than accept these differences on a superficial level. In that way, students can see that some of the IFRS concepts are different from U.S. GAAP for valid reasons. Some IFRS principles and accounts are virtually identical to U.S. GAAP, but nomenclature plays a role. For example, in U.S. GAAP, the concept of equity is very close to the IFRS concept of reserves.

Learning Objective 1

- Start by reviewing Exhibit 2.1, which shows the conceptual framework's role in standard setting. Ask students how and why these aspects are interrelated. Is there one area in the framework that takes precedence over another? If so, why? Have students substantiate their answers.

Learning Objective 2

- Judgment in accounting is a constant characteristic, and students should be reminded that when IFRS is adopted in the United States, there will be more reliance upon use of judgment. Although U.S. GAAP is not completely rules based and IFRS is not completely principles based, there is a tendency to describe these frameworks with these underlying concepts. Even at this stage in the course, we suggest a class discussion of principles versus rules and ask students if they believe U.S. GAAP is more rules based or more principles based and why.
- Use Paul Pacter's interview to begin a discussion of the pros and cons of having a conceptual framework agreed upon before the U.S. convergence with IFRS. Ask students how completely they think agreement should be on a conceptual framework in future accounting standard setting. Another aspect of discussion from this same excerpt could be the critical importance of transparency. Did the Sarbanes-Oxley Act of 2002 sufficiently address the aspect of financial transparency?

Learning Objective 3

- Materiality is a critical aspect in many areas in accounting, taxes, and auditing. Ask students why materiality is important in general, how they understand the concept, and how it relates to this chapter in particular.

Learning Objective 5

- Students in a class of this level understand the basic differences between cash basis and accrual basis; however, they most likely have not yet been exposed to how different the financial results would be between one set of rules and the other. Use Example 2.1 to walk students through the theory and calculations of net income when using the cash basis and when using the accrual basis. The end result is the same, but the results vary drastically in the short run each month.

Learning Objective 6

- Explain the many examples of arms-length transactions. This concept is important in auditing because auditors need to find out if there are related-party transactions. Students benefit greatly when they can see the many interconnections between their courses and different subfields in the accounting discipline. Consider having students role-play being part of the audit team or being part of a small family-run business. Students can decide how they want to communicate to the auditor that all their transactions are or are not related-party transactions. A follow-up could be a discussion of why shareholders would be interested in knowing about possible related-party transactions if the company is publicly held.

- The going concern assumption is often not discussed at length in courses other than those on auditing. To make this topic come alive to students, divide the class into small groups and have them brainstorm all the possible areas of concern from a sample company's financials. Given them approximately 20 minutes to create a list of potential red flags that could lead to a company's demise (e.g., liquidity issues, solvency, inventory buildup or turnover, excess long-term debt, high COGS). Once they have created their lists, have the small groups report to the class about how these areas could be of consequence to the going concern assumption.

Guidance on Incorporating IFRS Material

Students should begin using commonly used IFRS websites, such as IFRS.org, to read about recent developments in the possible convergence with U.S. GAAP. They could be given an assignment to write a summary about some aspects of that website. Another assignment could be to ask them to research some different topics in recent accounting debate from the AICPA website (aicpa.org). Students should be encouraged to join the AICPA at the reduced student rate. This is a great opportunity for students to add credibility to their resumes and to understand that the accounting profession is a highly developed part of the business community.

Numerous topics are introduced in this chapter that will be examined further in subsequent chapters. However, at the end of this chapter students can be assigned a short research project to investigate the IFRS.org website on topics discussed in Chapter 2, primarily revenue recognition.

Some analysts depict IFRS as being more aggressive in their revenue recognition criteria, but some members of the IASB dispute this assessment. The basic difference in revenue recognition is the timing of the revenue recognition: IFRS recognizes revenue earlier than does U.S. GAAP in the reporting cycle. Some analysts have described IFRS as being less conservative in revenue recognition as well as in other areas of financial reporting.

Interview Discussion Questions

1. Discuss several components of the current conceptual framework that provide guidance and direction to accountants when exercising judgment.

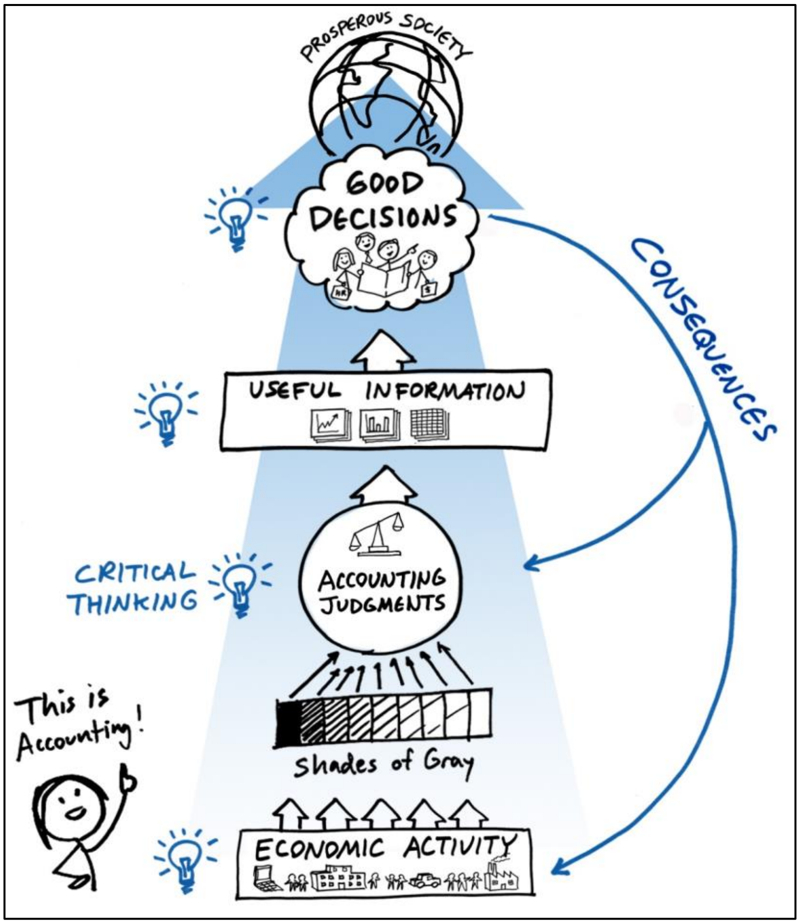
   Suggested Discussion Points: Accountants use judgment on a day-to-day basis when applying accounting concepts, assumptions, and principles. For example, the cost constraint involves determining the expected cost of implementation of a new accounting standard. Materiality is subjective and can be difficult to apply. The measurement of financial statement elements at fair value requires a significant amount of judgment and estimation. How does an accountant know that the information provided is "complete" or "neutral?" Can an accountant be sure that the statements meet the threshold of full disclosure? Judgment plays a major role in implementing the concepts, assumptions, and principles included in the conceptual framework.

2. Discuss the meaning of Paul Pacter's statement, "We accountants must never lose sight of the important public interest in our work."

Suggested Discussion Points: The accounting profession has an obligation to meet the public interest and plays a critical role in our society. The role of accounting in serving the interest of the constituents within the environment in which it operates includes setting standards, ensuring compliance with regulatory requirements, enhancing corporate social responsibility, and monitoring and minimizing the potential for accounting fraud. Taking these steps creates confidence and public trust in the financial system and ensures proper functioning of our capital markets.

The picture below illustrates the accountant's role in society. Starting with economic activity, accountants use their judgment to provide useful information that leads to good decision making and, ultimately, a prosperous society. Thus, the accountant's role in society and serving the public interest is critical.

The Pathways Commission on Accounting Higher Education generated the picture ("Pathways Vision Model") to represent their vision of accounting in society. The Pathways Commission on Accounting Higher Education was created in 2010 by the American Accounting Association (AAA) and the American Institute of Certified Public Accountants (AICPA) to study the future structure of higher education for the accounting profession and develop recommendations for educational pathways to engage and retain the strongest possible community of students, academics, practitioners, and other knowledgeable leaders in the practice and study of accounting.



To learn more, go to www.pathwayscommissin.org

Chapter 2

Financial Reporting Theory

Directed Reading Guide

LO1. Overview of the Conceptual Framework

a) What are the six topics of the FASB conceptual framework project?

i) **Objective and Qualitative Characteristics**

ii) **Elements**

iii) **Measurement**

iv) **Reporting Entity**

v) **Presentation**

vi) **Disclosure**

b) Briefly describe how the IASB's objective and qualitative characteristics differs from those of U.S. GAAP.

They differ in the descriptions of elements of financial reporting and principles of recognition and measurement in financial reporting.

LO2. The Objective of Financial Reporting

a) Briefly describe the objective of financial reporting according to the conceptual framework.

The objective of financial reporting according to the conceptual framework is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit.

LO3. The Qualitative Characteristics of Financial Information

a) List three attributes of relevance.

   i) **Predictive value**

   ii) **Confirmatory value**

   iii) **Materiality**

b) Faithful representation indicates whether financial information depicts the substance of an economic event in a manner that is:

   i) **Complete**

   ii) **Neutral**

   iii) **Free from error**

c) The FASB identifies the following four enhancing characteristics that help distinguish more useful information from less useful information:

   i) **Comparability**

   ii) **Verifiability**

   iii) **Timeliness**

   iv) **Understandability**

LO4. Elements of Financial Reporting

a) The point-in-time elements of financial reporting are:

i) **Assets**

ii) **Liabilities**

iii) **Equity**

b) Draw lines to link each of the U.S. GAAP elements to the appropriate IFRS elements.

U.S. GAAP Elements	IFRS Elements
Revenues	Expenses
Expenses	
Gains	Income
Losses	

LO5. Principles of Recognition and Measurement

a) Briefly describe the revenue recognition principle.

The revenue recognition principle states that a company should recognize revenue when it is realized or realizable and earned.

b) Briefly describe the expense recognition principles.

Expense recognition principles are used to determine the period when a company reports an expense on the income statement.

c) Under U.S. GAAP, what five measurement bases are used in financial reporting?

i) **Historical cost**

ii) **Current cost**

iii) **Current market value**

iv) **Net realizable value**

v) **Present value of future cash flows**

d) U.S. GAAP is based on **__accrual accounting___**; it does not allow a cash-basis system.

LO6. Assumptions in Financial Reporting

a) The **___going concern____** concept indicates that accountants will record transactions and prepare financial statements as if the entity will continue to operate for an indefinite period of time unless there is evidence to the contrary.

b) The **___business or economic entity _____** concept states that all transactions and events relate to the reporting entity and must be kept separate from the personal affairs of the owner.

c) The **_____monetary unit assumption___** stipulates that an entity measure and report its economic activities in dollars (or some other monetary unit).

Chapter 2

Financial Reporting Theory

Directed Reading Guide

LO1. Overview of the Conceptual Framework

a) What are the six topics of the FASB conceptual framework project?

i)

ii)

iii)

iv)

v)

vi)

b) Briefly describe how the IASB's objective and qualitative characteristics differs from those of U.S. GAAP.

LO2. The Objective of Financial Reporting

a) Briefly describe the objective of financial reporting according to the conceptual framework.

LO3. The Qualitative Characteristics of Financial Information

a) List three attributes of relevance.

i)

ii)

iii)

b) Faithful representation indicates whether financial information depicts the substance of an economic event in a manner that is:

i)

ii)

iii)

c) The FASB identifies the following four enhancing characteristics that help distinguish more useful information from less useful information:

i)

ii)

iii)

iv)

LO4. Elements of Financial Reporting

a) The point-in-time elements of financial reporting are:

i)

ii)

iii)

b) Draw lines to link each of the U.S. GAAP elements to the appropriate IFRS elements.

U.S. GAAP Elements	IFRS Elements
Revenues	Expenses
Expenses	
Gains	Income
Losses	

LO5. Principles of Recognition and Measurement

a) Briefly describe the revenue recognition principle.

b) Briefly describe the expense recognition principles.

c) Under U.S. GAAP, what five measurement bases are used in financial reporting?

i)

ii)

iii)

iv)

v)

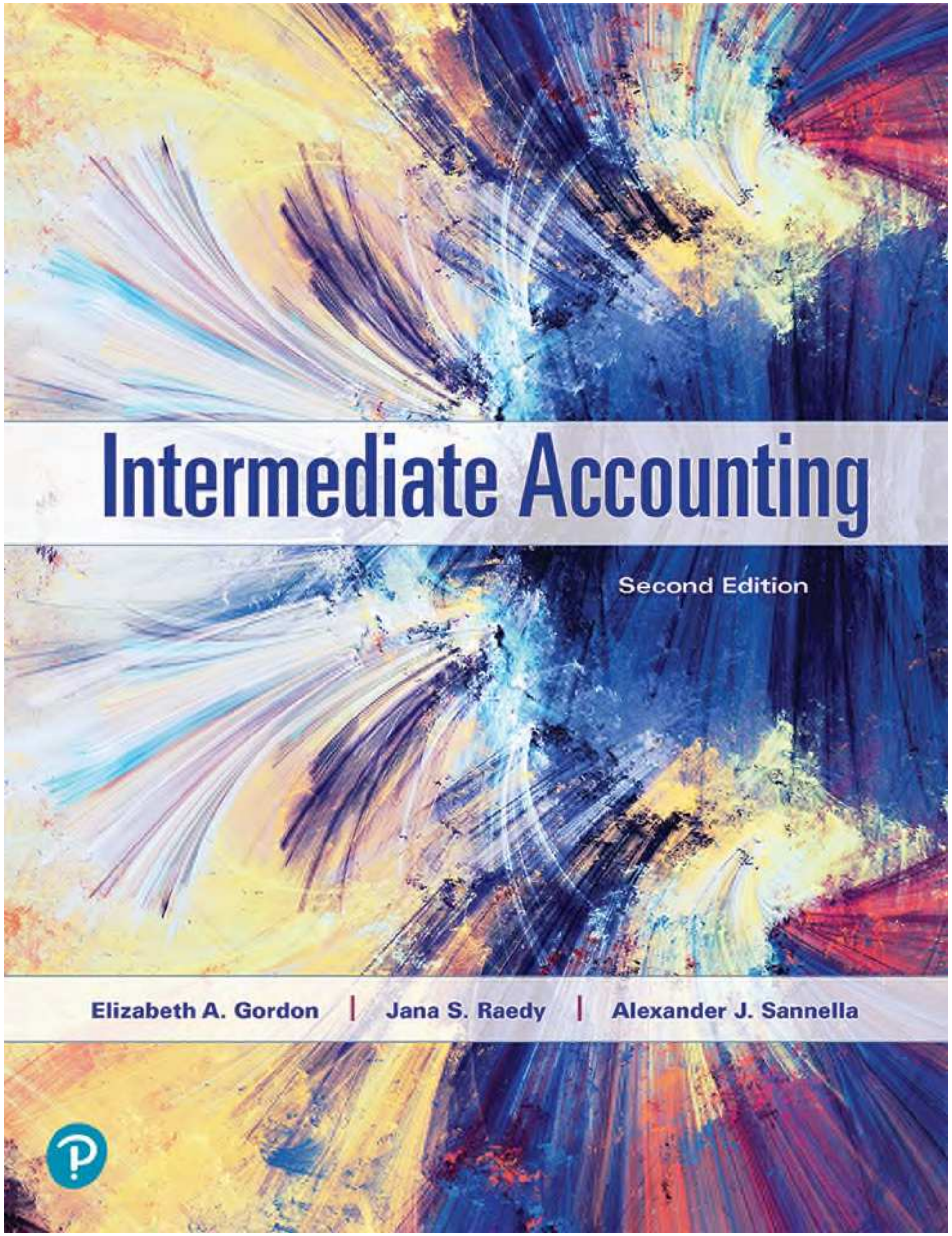
d) U.S. GAAP is based on ______________________; it does not allow a cash-basis system.

LO6. Assumptions in Financial Reporting

a) The _____________________ concept indicates that accountants will record transactions and prepare financial statements as if the entity will continue to operate for an indefinite period of time unless there is evidence to the contrary.

b) The ____________________________ concept states that all transactions and events relate to the reporting entity and must be kept separate from the personal affairs of the owner.

c) The ____________________________ stipulates that an entity measure and report its economic activities in dollars (or some other monetary unit).



CHAPTER 2

FINANCIAL REPORTING THEORY

LEARNING OBJECTIVES

1. Explain what a conceptual framework is and why it is important in accounting standard setting.
2. Define the objective of financial reporting.
3. Describe the qualitative characteristics of financial information, including the fundamental and enhancing characteristics of financial reporting.
4. Identify the elements of financial reporting.
5. Demonstrate an understanding of recognition and measurement in financial reporting, including general recognition principles, revenue and expense recognition, and accrual accounting.
6. Explain the assumptions used in financial reporting.

Learning Objective 1

Explain what a conceptual framework is and why it is important in accounting standard setting.

1 Overview of the Conceptual Framework

- A **conceptual framework** sets forth theory, concepts, and principles to ensure that accounting standards are coherent and uniform.
- The purpose of a conceptual framework is to assist standards setters in developing and revising accounting standards.
- The conceptual framework does *not* override accounting standards.

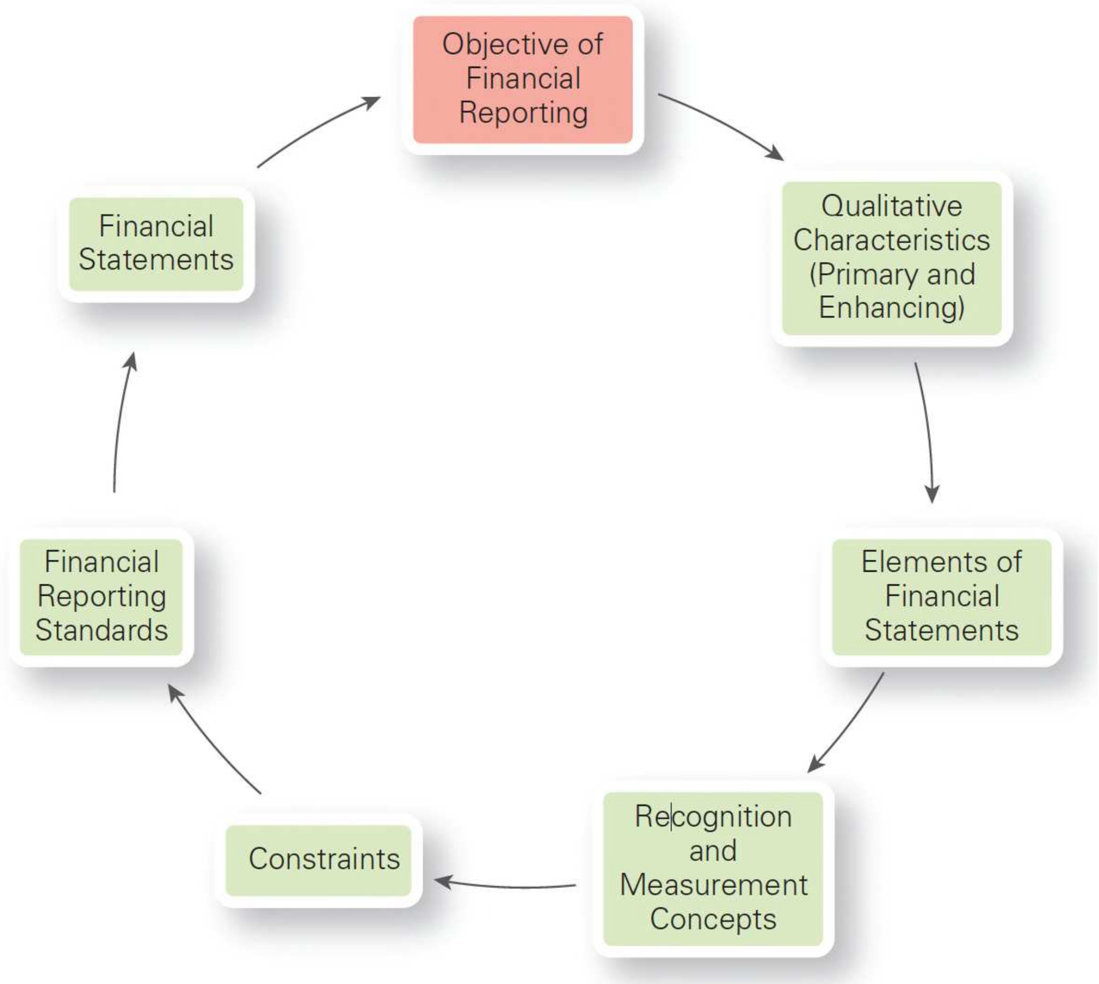
1 Conceptual Framework Components

Conceptual framework components:

- Objectives of financial reporting
- Characteristics associated with high-quality financial information
- Elements of the financial reporting system
- Recognition and measurement criteria

1 Conceptual Framework Components

EXHIBIT 2.1 Conceptual Framework's Role in Standard Setting



1 Conceptual Framework Components

The FASB is currently revising the conceptual framework.

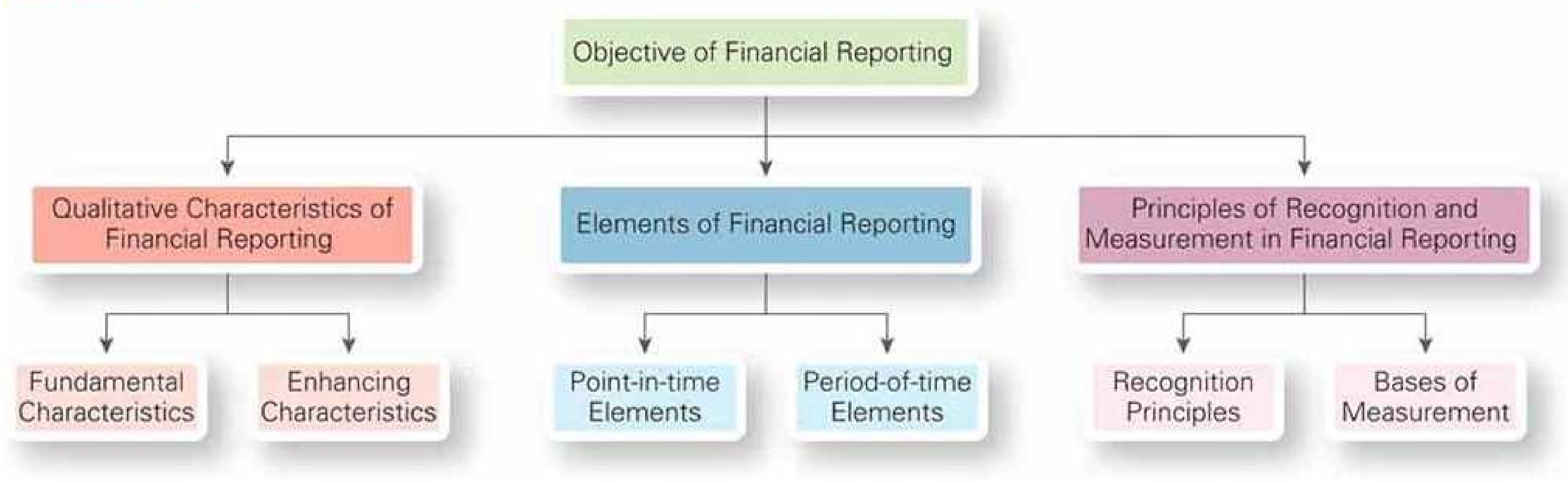
EXHIBIT 2.2 FASB Conceptual Framework Project

Topic	Status
Topic 1: Objective and Qualitative Characteristics	Completed[1]
Topic 2: Elements	Active—No Exposure Draft Issued
Topic 3: Measurement	Active—No Exposure Draft Issued
Topic 4: Reporting Entity	Inactive
Topic 5: Presentation	Active—Exposure Draft Issued
Topic 6: Disclosure	Active—Exposure Draft Issued

Source: http://www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdatePage&cid=900000011090

1 Conceptual Framework Components

EXHIBIT 2.3 Overview of the Conceptual Framework



IFRS
Conceptual Framework

- The IASB's objective and qualitative characteristics are identical to U.S. GAAP.
- They differ in the descriptions of elements of financial reporting and principles of recognition and measurement in financial reporting.
- The IASB is currently revising its framework.

Check Your Understanding: Objective 1

Learning Objective	Check Your Understanding
1 Explain what a conceptual framework is and why it is important in accounting standard setting.	What is a conceptual framework, and what is its purpose?

Learning Objective 2

Define the objective of financial reporting.

2 The Objective of Financial Reporting

- The objective of financial reporting is:

  To provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity (e.g., buying, selling, or holding equity and debt instruments).

- The primary users of financial information are the investors, lenders, and other creditors who cannot demand information from the entity.

Check Your Understanding: Objective 2

Learning Objective	Check Your Understanding
2 Define the objective of financial reporting.	According to the conceptual framework, what type of information should be provided to users of financial information? a) Comprehensive b) Accurate c) Useful d) Detailed

Learning Objective 3

Describe the qualitative characteristics of financial information, including the fundamental and enhancing characteristics of financial reporting.

3 The Qualitative Characteristics of Financial Information

- The conceptual framework divides the qualitative characteristics into *fundamental characteristics* and *enhancing characteristics* and discusses the cost constraint on providing information.
- **Fundamental characteristics** are basic characteristics that distinguish useful financial information from information that is not useful.
  - The FASB identifies two fundamental characteristics: *relevance* and *faithful representation*.

3 Fundamental Characteristics

Financial information is **relevant** if it is capable of making a difference in decision making by exhibiting the following attributes:

- **Predictive value**—Information decision makers can use as an input into processes that help forecast future outcomes.
- **Confirmatory value**—Information that provides feedback about prior evaluations.
- **Materiality**—Information that would affect financial statement users' decisions if it were reported inaccurately or omitted.

3

Fundamental Characteristics

Faithful representation indicates whether financial information depicts the substance of an economic event in a manner that is:

- **Complete**—It includes all information necessary for the financial statement user to understand the underlying economic event.
- **Neutral**—Information is free from bias in both the selection and presentation of financial data.
- **Free from error**—There are no mistakes or omissions in the description of an event or in the process used to produce the financial information.

3 Fundamental Characteristics: Complete

EXHIBIT 2.4 ***Johnson & Johnson*** Property, Plant and Equipment Note Excerpt, January 3, 2016, Financial Statements

NOTE 4: Property, Plant and Equipment

At the end of 2015 and 2014, property, plant and equipment at cost and accumulated depreciation were:

(Dollars in Millions)	**2015**	**2014**
Land and land improvements	$ 780	$ 833
Buildings and building equipment	9,829	10,046
Machinery and equipment	22,511	22,206
Construction in progress	3,528	3,600
Total property, plant and equipment, gross	$ 36,648	$36,685
Less accumulated depreciation	(20,743)	(20,559)
Total property, plant and equipment, net	**$ 15,905**	**$16,126**

The Company capitalizes interest expense as part of the cost of construction of facilities and equipment. Interest expense capitalized in 2015, 2014, and 2013 was $102 million, $115 million, and $105 million, respectively.

Depreciation expense, including the amortization of capitalized interest in 2015, 2014, and 2013, was $2.5 billion, $2.5 billion, and $2.7 billion, respectively.

Upon retirement or other disposal of property, plant and equipment, the costs and related amounts of accumulated depreciation or amortization are eliminated from the asset and accumulated depreciation accounts, respectively. The difference, if any, between the net asset value and the proceeds are recorded in earnings.

Source: Annual Report, 2015 Johnson and Johnson

3 Enhancing Characteristics

The FASB identifies four **enhancing characteristics** that help distinguish more useful information from less useful information. The first two are:

- **Comparability**—Financial statements users should be able to identify and understand similarities and differences among several entities.
- **Verifiability**—A group of reasonably informed financial statement users should be able to reach a consensus decision that reported information is a faithful representation of an underlying economic event.

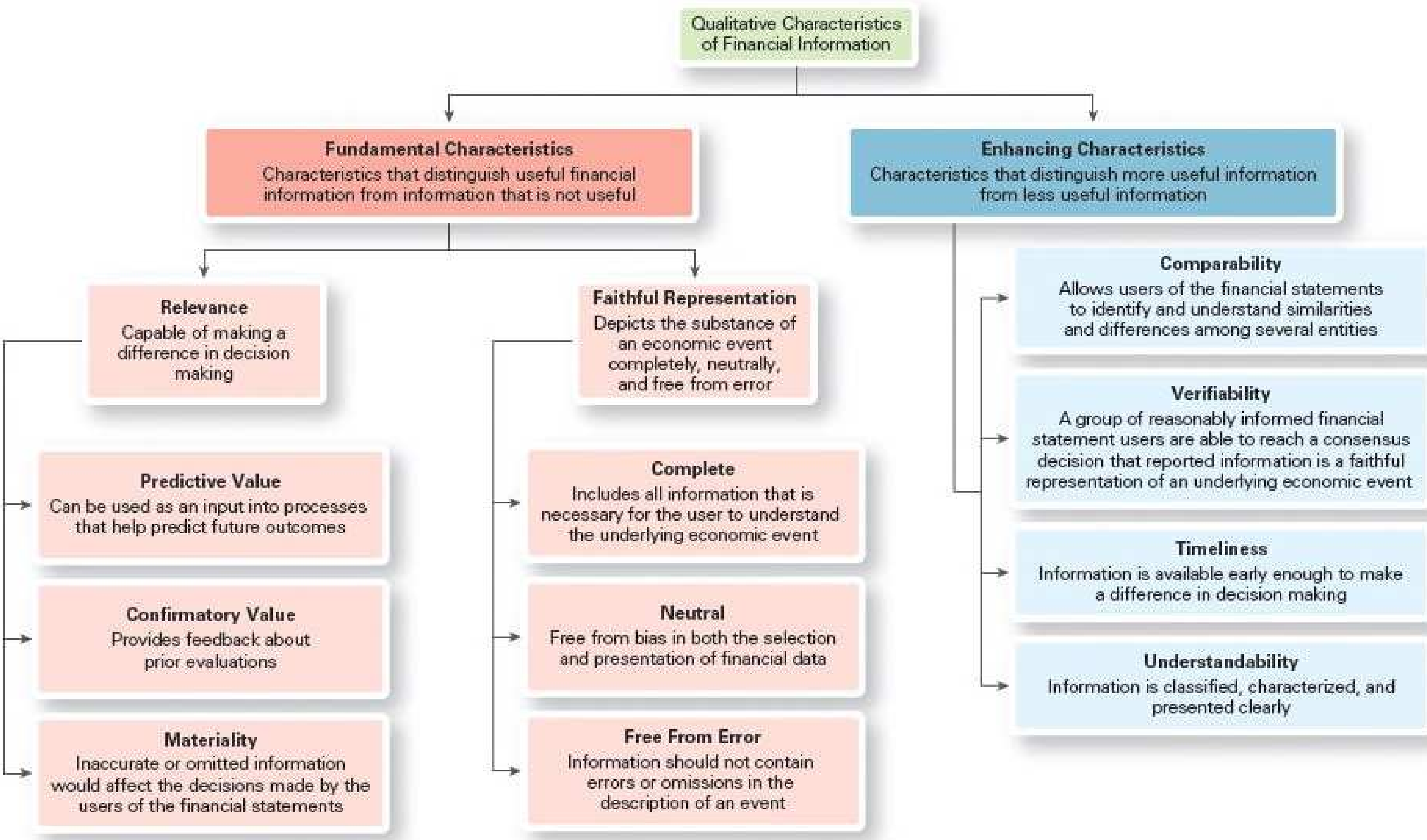
3

Enhancing Characteristics

The third and fourth enhancing characteristics are:

- **Timeliness**—**Timely information** is available to financial statement users early enough to make a difference in decision making.
- **Understandability**—Information is **understandable** to reasonably informed financial statement users when financial statements classify, characterize, and clearly present all information.

EXHIBIT 2.5 Qualitative Characteristics of Financial Information



3

Cost Constraint

- Providing all relevant and representationally faithful information available is costly.
- Standard setters should compare the cost of requiring information to the benefits derived from presenting this information.
- Standard setters consider costs for both financial statement reporters and users.

Check Your Understanding: Objective 3

Learning Objective	Check Your Understanding
3 Describe the qualitative characteristics of financial information, including the fundamental and enhancing characteristics of financial reporting.	Name the four enhancing characteristics identified by FASB.

Learning Objective 4

Identify the elements of financial reporting.

4 Elements of Financial Reporting

The **second phase** of the conceptual framework project focuses on the elements of financial reporting:

- **Point-in-time elements**—Represent resources, claims to resources, or interests in resources as of a specific point in time and appear on the balance sheet (statement of financial position).
- **Period-of-time elements**—Represent the results of events and circumstances that affect an entity during a period of time and appear on the income statement, statement of comprehensive income, or statement of shareholders' equity.

4 Elements of Financial Reporting

The three point-in-time elements are assets, liabilities, and equity.

EXHIBIT 2.6 Definitions of Point-in-Time Elements

Element	Definition
Assets	Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events
Liabilities	Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events
Equity	The net assets or residual interest in the assets of an entity that remains after deducting its liabilities.

Source: FASB, *Statement of Financial Accounting Concepts No. 6*, "Elements of Financial Statements," Paragraphs 25, 35, 49

4 Elements of Financial Reporting

U.S. GAAP identifies seven period-of-time elements, as defined in Exhibit 2.7.

EXHIBIT 2.7 Period-of-Time Elements

Element	Definition
Investments by Owners	Increases in equity of a particular business enterprise resulting from transfers to it from other entities of something valuable to obtain or increase ownership interests (or equity) in it. Assets are most commonly received as investments by owners, but that which is received may also include services or satisfaction or conversion of liabilities of the enterprise.
Distributions to Owners	Decreases in equity of a particular business enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interest (or equity) in an enterprise.
Revenues	Inflows or other enhancements of an entity's assets or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.
Gains	Increases in equity (net assets) from an entity's peripheral or incidental transactions and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners.
Expenses	Outflows or other consumption of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.
Losses	Decreases in equity (net assets) from an entity's peripheral or incidental transactions and from all other transactions and other events and circumstances affecting the entity except those that result from expenses or distributions to owners.
Comprehensive Income	The change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

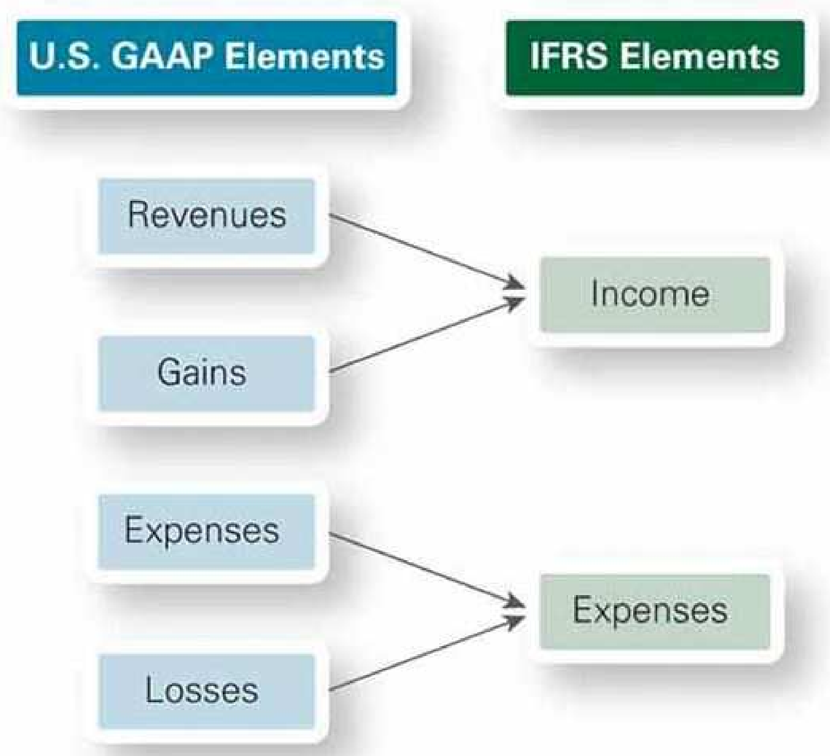
Source: FASB, *Statement of Financial Accounting Concepts No. 6*, "Elements of Financial Statements"

IFRS
Elements

- IFRS identifies the same three point-in-time elements as U.S. GAAP:
  - **Assets**
  - **Liabilities**
  - **Equity**
- IFRS identifies four period-of-time elements:
  - **Performance** (e.g., profit)
  - **Income** (includes both revenues and gains)
  - **Expenses** (includes both expenses and losses)
  - **Capital maintenance adjustments**

IFRS Elements

EXHIBIT 2.8 Links between Revenues, Gains, Income, Expenses, and Losses under U.S. GAAP and IFRS



IFRS
Elements

- IFRS defines **capital maintenance adjustments** as restatements or revaluations of reported amounts of assets and liabilities that companies usually report in other comprehensive income.
- Under the concept of **financial capital maintenance,** capital is viewed as the financial amount, or money amount, invested in a company.
- Under the concept of **physical capital maintenance,** capital is viewed as the productive capacity of a company, such as units of output per day.

CHECK YOUR UNDERSTANDING: OBJECTIVE 4

Learning Objective	Check Your Understanding
4 Identify the elements of financial reporting.	What are the three point-in-time elements under U.S. GAAP?

Learning Objective 5

Demonstrate an understanding of recognition and measurement in financial reporting, including general recognition principles, revenue and expense recognition, and accrual accounting.

5

Principles of Recognition and Measurement

Financial accounting uses accrual accounting rather than cash accounting. Underlying principles of accrual accounting:

- General recognition
- Revenue and expense recognition
- Bases of measurement

5 General Recognition Principles

Recognition is the process of reporting an economic event in the financial statements.

- Recognized events are included in a line item on the financial statements as opposed to in the notes to the statements.

Recognition occurs only when four criteria are met:

- The item meets the definition of an element of the financial statements.
- The item is measurable.
- The item is reliable.
- The item is relevant.

5 General Recognition Principles

An item may not be recognized due to the *cost-benefit constraint* or a *materiality threshold*.

- The **cost-benefit constraint** requires that the expected benefits from recognition exceed the costs of recognition.
- The **materiality threshold** requires that an item be recognized in the financial statements if its omission or misstatement would significantly influence the judgment of a reasonably informed statement user.

5 Revenue and Expense Recognition

The **revenue recognition principle** in the conceptual framework states that a company should recognize revenue when it is *realized* or *realizable* and *earned*:

- An item is **realized** or **realizable** when a company exchanges a good or service for cash or claims to cash.
- Revenues are considered **earned** when the seller has accomplished what it must do to be entitled to the revenues.

5 Revenue and Expense Recognition

The new revenue standard, which public companies can begin to adopt in 2017, requires five steps for revenue recognition:

1. Identify the contract with the customer.
2. Identify the separate performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to separate performance obligations.
5. Recognize revenue when each performance obligation is satisfied.

5 Revenue and Expense Recognition

- **Expense recognition principles** are used to determine the period when a company reports an expense on the income statement.
- Firms recognize expenses when:
  - The entity's economic benefits are consumed in the process of producing or delivering goods or rendering services.
  - An asset has experienced a reduced (or eliminated) future benefit or when a liability has been incurred or increased without an associated economic benefit.

5 Revenue and Expense Recognition

- There are three main approaches to determine when to report an expense:
  - Match with revenues (e.g., cost of goods sold)
  - Expense in period incurred (e.g., salaries and wages expense)
  - Systematically allocate over periods of use (e.g., depreciation expense)
- The approach used depends on the type of expense.

5 Revenue and Expense Recognition

EXHIBIT 2.9 Examples of Expense Recognition

Income Statement Line Item	Related Balance Sheet Line Item	When to Recognize the Expense on the Income Statement	Approach to Recognize Expense
Cost of goods sold	Inventory	Upon sale of inventory	Match with revenue
Loss on inventory obsolescence	Inventory	When inventory value declines or becomes obsolete	Loss in period incurred
Supplies expense	Supplies	Upon use in operations and consumption of supplies	Expense in period incurred
Depreciation expense	Accumulated depreciation	Over time with use in production and consumption of future economic benefit	Systematically allocate over periods of use
Salary and wages expense	Salaries and wages payable	Recognize in the period services are performed	Expense in period incurred

5 Bases of Measurement

U.S. GAAP identifies five measurement bases:

- **Historical cost** is the amount of cash (or equivalent) that the firm paid to acquire an asset. For liabilities, historical cost is the amount of cash (or equivalent) that the firm received when it incurred the obligation.
  - The historical cost of an asset may be adjusted for depreciation or amortization.
  - An **arms-length transaction** involves a buyer and seller who are independent and unrelated parties
- **Current cost** is the amount of cash (or equivalent) that would be required if the firm acquired the asset currently.

5 Bases of Measurement

- **Current market value** is the amount of cash (or equivalent) that the firm would receive by selling the asset in an orderly liquidation.
- **Net realizable value** is the amount of cash (or equivalent) to be received in exchange for an asset, less the direct costs of disposal.
- **Present value of future cash flows** results from discounting net cash flows the firm expects to receive on the exchange of an asset or to pay to liquidate a liability.

5 Fair Value Measurement and the Fair Value Hierarchy

The FASB requires disclosures that indicate the reliability of the inputs used in all fair value measures reported on the financial statements.

EXHIBIT 2.10 Fair Value Hierarchy

Level	Inputs Used in the Measurement Process
Level 1	Quoted prices in active markets for an identical asset or liability. A publicly traded equity security is classified in this level.
Level 2	Inputs other than the quoted prices included in Level 1 that are observable for the asset or liability. For example, a building could be valued using a price per square foot obtained from transactions in a comparable building in a similar location.
Level 3	Unobservable inputs to value the asset or liability. For example, to measure the fair value of a private equity investment, a company might perform an analysis that relies on the present value of the expected future cash flows of that investment.

Source: FASB, *Statement of Financial Accounting Standards No. 157*, "Fair Value Measurement" (Norwalk, CT: FASB, 2006), Paragraphs 22–31

IFRS Recognition and Measurement
General Recognition Principles

IFRS has four recognition criteria. The first three of them are similar to U.S. GAAP recognition criteria :

- The item meets the definition of one of the elements.
- The item is measurable.
- The measurement of the item must be reliable.
- It is probable that future economic benefits will flow to or from the company.

IFRS Recognition and Measurement
General Recognition Principles

EXHIBIT 2.11 General Recognition Principles

U.S. GAAP	IFRS
An item is recognized in the financial statements if it is:	
An element of the financial statements	Similar under U.S. GAAP and IFRS.
Measurable	Similar under U.S. GAAP and IFRS.
Reliable	Similar under U.S. GAAP and IFRS.
Relevant	Not included in IFRS.
Not included in U.S. GAAP	Probable that any future economic benefit associated with the item will flow to or from the company
Recognition is subject to the:	
Cost-benefit constraint	Similar under U.S. GAAP and IFRS.
Materiality constraint	Similar under U.S. GAAP and IFRS.

IFRS Recognition and Measurement
Revenue and Expense Recognition

- Firms recognize revenue when they meet both of the following criteria:
  - An increase in future economic benefits related to an increase in an asset or a decrease of a liability has occurred.
  - The revenue can be measured reliably.
- Firms recognize expenses in the income statement when both of the following criteria are met:
  - A decrease in future economic benefits related to a decrease in an asset or an increase of a liability has occurred.
  - The expense can be measured reliably.

IFRS Recognition and Measurement
Bases of Measurement

IFRS includes four of the five measurement bases used by U.S. GAAP:

- Historical cost
- Current cost
- Net realizable value
- Present value of future cash flows

IFRS does not include current market value as a separate measurement basis.

5 Cash versus Accrual Accounting

U.S. GAAP requires *accrual accounting*, *not* a *cash-basis system.*

- Under the **cash basis**, firms recognize revenues only when they receive cash and recognize expenses only when they pay cash.
- Under the **accrual basis**, firms recognize revenues when control of a good or service passes to the customer and expenses when incurred.
- The major difference between cash and accrual accounting is the timing of revenue and expense recognition.

Example 2.1 — 5 — The Cash versus the Accrual Basis of Accounting

Problem: Yards, Inc., mows lawns at a fee of $100 per month. In the current year, 200 customers prepaid for the four months in the summer, beginning on May 1. Yards received $80,000 of cash receipts ($100 per month × 200 customers × 4 months) in May. Yards, Inc., provided the required service for four months by mowing lawns throughout May, June, July, and August. During those months, the company incurred expenses of $10,000, $13,000, $12,000, and $10,000, respectively, and paid these expenses during the same month it consumed the economic benefit. Determine net income for each month from May through August under both the cash and the accrual bases of accounting.

Example 2.1 5 The Cash versus the Accrual Basis of Accounting

Solution: Because Yards, Inc., paid for the expenses in the same month it consumed the benefits, there is no difference in expense recognition between the cash basis and accrual basis. However, there is a difference in revenue recognition.

Under cash-basis accounting, Yards would recognize revenue of $80,000 in May because that is when it received cash. However, under the accrual basis, it would recognize $20,000 ($100 per yard × 200 yards) in each of the four months.

Example 2.1 5 The Cash versus the Accrual Basis of Accounting

Solution (continued): Under both systems Yards will ultimately recognize $80,000 revenue, $45,000 in expense, and $35,000 in net income. However, the timing of the revenue recognition differs, as illustrated in the following table.

	Revenue Recognition		Expense Recognition		Net Income	
Month	Cash Basis	Accrual Basis	Cash Basis	Accrual Basis	Cash Basis	Accrual Basis
May	$80,000	$20,000	$10,000	$10,000	$70,000	$10,000
June	- 0 -	20,000	13,000	13,000	(13,000)	7,000
July	- 0 -	20,000	12,000	12,000	(12,000)	8,000
August	- 0 -	20,000	10,000	10,000	(10,000)	10,000
Totals	$80,000	$80,000	$45,000	$45,000	$35,000	$35,000

CHECK YOUR UNDERSTANDING: OBJECTIVE 5

Learning Objective	Check Your Understanding
5 Demonstrate an understanding of recognition and measurement in financial reporting, including general recognition principles, revenue and expense recognition, and accrual accounting.	For which one of the following would an expense *not* be recognized? a) Depreciation of equipment in the third year of its five-year life b) A payment of $1,200 for an advertising campaign that will commence in the next financial year c) A salary amount of $2,400 earned by employees on December 31 that will be deposited into their bank accounts on January 3 d) A payment of $10,500 cash on October 1 for the research and development of a new product that is to be launched on February 2 of next year

Learning Objective 6

Explain the assumptions used in financial reporting.

6 Assumptions in Financial Reporting

The following underlying assumptions are integral to the financial reporting process.

- **Going concern concept**—The entity will continue to operate indefinitely (i.e., not go into liquidation in the near future).
- **Business or economic entity concept**—The owner(s) and the business affairs are separated and reported separately.
- **Monetary unit assumption**—All items are valued according to an accepted currency (e.g., U.S. $), and it is assumed that the currency remains stable over time in terms of purchasing power.
- **Periodicity assumption**—The entity is to divide its life into artificial time periods for the purpose of providing periodic reports (e.g., income statement) on its economic activities. For example, the SEC requires quarterly financial statements.

CHECK YOUR UNDERSTANDING: OBJECTIVE 6

Learning Objective	Check Your Understanding
6 Explain the assumptions used in financial reporting.	What are the four assumptions discussed in this section of the chapter?