Chapter 1

Financial Accounting and Accounting Standards

# Assignment Classification Table (By Topic)

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **Topics** | **Questions** | **Brief Exercises** | **Exercises** | **Critical Thinking** |
| 1. | Environment of accounting, principles, objectives, standards, accounting theory.  | 1,2, 3,4 | 1 | 1 | 1 |
| 2. | Authoritative pronouncements and rule-making bodies. | 5,6, 7,8 | 2 | 2 | 2 |
| 3. | Conceptual framework- general, objective of financial reporting. | 9, 10 |  | 3 | 3,4 |
| 4. | Qualitative characteristics of accounting. | 11,12, 13, 14, 15, 16,17 | 3,4, 5, 6, 7 | 4,5,6 | 5, 10 |
| 5. | Elements of financial statements. | 18, 19 | 8, 9 | 7 |  |
| 6. | Basic assumptions and principles. | 20, 21, 22, 23, 24, 25, 26, 27, 28, 29, 30,31 | 10, 11, 12, 13, 14 | 4, 8, 9, 10, 11, 12 | 6, 7, 8, 9, 11 |
| 7. | Cost constraint. | 32,33,34 |  |  |  |
| 8. | Role of pressure groups. | 35, 36 |  |  | 12, 14, 15, 16, 17 |
| 9. | Ethical issues. | 37, 38,39,40 |  |  | 13 |

# Assignment Classification Table (By Learning Objective)

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **Learning Objectives** | **Questions** | **Brief Exercises** | **Exercises** | **Critical Thinking** |
| 1. | Describe the financial reporting environment, major standard-setting bodies, and the meaning of generally accepted accounting principles (GAAP). | 1, 2, 3, 4, 5, 6, 7, 8 | 1, 2 | 1, 2 | 1 |
| 2. | Describe the components and usefulness of the conceptual framework. | 9, 10, 11, 12, 13, 14, 15, 16, 17, 18, 19 | 3, 5, 6, 7, 8,9 | 3, 4, 5, 6, 7 | 2,3,4, 5,10 |
| 3. | Discuss the basic assumptions and principles of accounting. | 20, 21, 22, 23,24, 25, 26, 27, 28, 29, 31, 32, 33, 34 | 4, 10, 11, 12, 13, 14 | 8, 9, 10, 11, 12 | 6, 7, 8, 9, 11, 12 |
| 4. | Identify the major challenges in the financial reporting environment. | 30, 35, 36, 37, 38, 39,40 |  | 2 | 11, 13, 14, 15, 16 |

# Assignment Characteristics Table (Time on Task)

|  |  |  |  |
| --- | --- | --- | --- |
|  **Item**  | **Description** | **Level of Difficulty** | **Time (minutes)** |
| E1.1 | Need for GAAP. | Simple | 15-20 |
| E1.2 | Financial reporting and accounting standards. | Simple | 15-20 |
| E1.3 | Usefulness, objective of financial reporting. | Simple | 15-20 |
| E1.4 | Usefulness, objective of financial reporting, qualitative characteristics. | Simple | 15-20 |
| E1.5 | Qualitative characteristics. | Moderate | 20-30 |
| E1.6 | Qualitative characteristics. | Simple | 15-20 |
| E1.7 | Elements of financial statements. | Simple | 15-20 |
| E1.8 | Assumptions, principles, and constraint. | Simple | 15-20 |
| E1.9 | Assumptions, principles, and constraint. | Moderate | 20-25 |
| E1.10 | Full disclosure principle. | Complex | 20-25 |
| E1.11 | Accounting principles and assumptions-comprehensive. | Moderate | 20-25 |
| E1.12 | Accounting principles-comprehensive. | Moderate | 20-25 |
| CT1.1 | Securities and Exchange Commission. | Moderate | 30-40 |
| CT1.2 | Conceptual framework-general. | Simple | 20-25 |
| CT1.3 | Conceptual framework-general. | Simple | 25-35 |
| CT1.4 | Objective of financial reporting. | Moderate | 25-35 |
| CT1.5 | Qualitative characteristics. | Moderate | 30-35 |
| CT1.6 | Revenue recognition principle. | Complex | 25-30 |
| CT1.7 | Expense recognition principle. | Complex | 20-25 |
| CT1.8 | Expense recognition principle. | Moderate | 20-25 |
| CT1.9 | Expense recognition principle. | Moderate | 20-30 |
| CT1.10 | Qualitative characteristics. | Moderate | 20-30 |
| CT1.11 | Expense recognition principle. | Moderate | 20-25 |
| CT1.12 | Cost Constraint. | Moderate | 30-35 |
| CT1.13 | Rule-making Issues. | Complex | 20-25 |
| CT1.14 | Models for setting GAAP. | Simple | 15-20 |
| CT1.15 | Economic consequences. | Moderate | 25-35 |
| CT1.16 | GAAP and economic consequences. | Moderate | 25-35 |

# Answers to Questions

**1.** If a company’s financial performance is measured accurately, fairly, and on a timely basis, the right managers and companies can attract investment capital. Unreliable and irrelevant information leads to poor capital allocation, which adversely affects the efficiency of the securities market.

LO: 1, Bloom:K, Difficulty: Simple, Time: 1-3, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC:Communication

**2.** 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 about providing resources to the entity through equity investments and loans or other forms of credit. Information that is decision-useful to capital providers (investors) may also be useful to other users of financial reporting who are not investors.

LO: 1, Bloom:K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Decision Making

**3.** Investors are interested in financial reporting because it provides information that is useful for making decisions (referred to as the decision-usefulnessapproach). When making these decisions, investors are interested in assessing the company’s (1) ability to generate net cash inflows and (2) management’s ability to protect and enhance the capital providers’ investments. Financial reporting should therefore help investors assess the amounts, timing, and uncertainty of prospective cash inflows from dividends or interest, and the proceeds from the sale, redemption, or maturity of securities or loans. For investors to make these assessments, the economic resources of an enterprise, the claims to those resources, and the changes in them must be understood.

LO: 1, Bloom:K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC:Decision Making

**4.** A common set of financial accounting and reporting standards applied by all businesses and entities should produce financial statements which are reasonably comparable. Without a common set of standards, each enterprise could, and would, develop a theory structure and set of practices, resulting in noncomparability among the financial statements of enterprises.

LO: 1, Bloom:K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC:Communication

**5.** The SEC has the power to prescribe, in whatever detail it desires, the accounting practices and principles to be employed by companies that fall within its jurisdiction. Because the SEC receives audited financial statements from nearly all companies that issue securities to the public or are listed on stock exchanges, it is greatly interested in the content, accuracy, and credibility of the statements. For many years, the SEC relied on the AICPA to regulate the profession and develop and enforce accounting principles. Lately, the SEC has assumed a more active role in the development of accounting standards, especially in the area of disclosure requirements. In December 1973, in ASR No. 150, the SEC said the FASB’s statements would be presumed to carry substantial authoritative support and anything contrary to them to lack such support. It thereby supports the development of accounting principles in the private sector.

LO: 1, Bloom:K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC:Communication

**6.** The explanation should note that generally accepted accounting principles or standards have “substantial authoritative support.” They consist of accounting practices, procedures, concepts, and methods that are recognized by a large majority of practicing accountants as well as other members of the business and financial community. Statements issued by the Financial Accounting Standards Board constitute “substantial authoritative support.”

LO: 1, Bloom:K, Difficulty: Simple, 5-10, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC:Communication

**Questions Chapter 1** **(Continued)**

**7.** The FASB Accounting Standards Codification (Codification) is a compilation of all GAAP in one place. Its purpose is to integrate and synthesize existing GAAP, not to create new GAAP. It creates one level of GAAP which is considered authoritative. The FASB Codification Research Systems (CRS) is an online real-time database that provides easy access to the Codification. The Codification and the related CRS provide a topically organized structure that is subdivided into topics, subtopics, sections, and paragraphs.

LO: 1, Bloom:K, Difficulty: Moderate, Time: 5-7, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC:Communication

**8.** It is hoped that the Codification will help users to better understand what GAAP is. If this occurs, companies will be more likely to comply with GAAP and the time to research accounting issues will be substantially reduced. In addition, through the electronic web-based format, GAAP can be easily updated which will help users stay current.

LO: 1, Bloom:K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC:Communication

**9.** A conceptual framework is a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial account­ing and financial statements. A conceptual framework is necessary for financial accounting for the following reasons:

(1) It enables the FASB to issue more useful and consistent standards in the future.

(2) New issues will be more quickly solvable by reference to an existing framework of basic theory.

(3) It increases financial statement users’ understanding of and confidence in financial reporting.

(4) It enhances comparability among companies’ financial statements.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC:Reporting, AICPA PC: Communication

**10.** The objective of 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 about providing resources to the entity.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC:Reporting, AICPA PC: Communication

**11.** “Qualitative characteristics of accounting information”are those characteristics that contribute to the quality or value of the information. The overriding qualitative characteristic of accounting infor­mation is usefulness for decision-making.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC:Reporting, AICPA PC: Communication

**12.** Relevance and faithful representation are the two fundamental qualities of useful accounting information. For information to be relevant, it should be capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct expectations. Faithful representation rests on whether the numbers and descriptions match what really existed or happened.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC:Reporting, AICPA PC: Communication

**Questions Chapter 1** **(Continued)**

**13.** The concept of materiality refers to the relative significance of an amount, activity, or item to informative disclosure, 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 could affect the decisions of the average informed reader of the financial statements. Financial statements are misleading if they omit a material fact or include so many immaterial matters as to be confusing. In the examination, the auditor concentrates efforts in proportion to degrees of materiality and relative risk and disregards immaterial items.

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

 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 FASB defines materiality to be consistent with the legal concept of materiality, as established in the securities laws. Specifically, information is material “if there is a substantial likelihood that the omitted or misstated item would have been viewed by a reasonable resource provider as having significantly altered the total mix of information.”

 There are no rigid standards or guidelines for assessing materiality. The lower bound of materiality has been variously estimated at 5% 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.

LO: 2, Bloom: C, Difficulty: Simple, Time: 5-7, AACSB: Communication, AICPA BC: None, AICPA AC:Reporting, AICPA PC: Decision Making

**14.** The enhancing characteristics are comparability, verifiability, timeliness, and understandability.

 Enhancing qualities are qualitative characteristics that are complementary to the fundamental qualitative characteristics. These characteristics distinguish more useful information from less useful information.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC:Reporting, AICPA PC: Communication

**15.** In providing information to users of financial statements, the FASB 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 a user needs a 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 for the user can be assumed; this has an impact on the way and the extent to which information is reported.

LO: 2, Bloom: C, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC:AICPA AC:Reporting, AICPA PC: Communication

**16.** Comparability facilitates comparisons between information about two different enterprises at a particular point in time. Consistency, a type of comparability, facilitates comparisons between information about the same enterprise at two different points in time.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC:Reporting, AICPA PC: Communication

**Questions Chapter 1** **(Continued)**

**17.** The accounting literature contains many terms that have specific meanings. Some of these terms have been in use for a long 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.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC:Reporting, AICPA PC: Communication

**18.** Distributions to owners differ from expenses and losses in that they represent transfers to owners, and they do not arise from activities intended to produce income. Expenses differ from losses in that they arise from the entity’s ongoing major or central operations. Losses arise from peripheral or incidental transactions.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC:Reporting, AICPA PC: Communication

**19.** Investments by owners differ from revenues and gains in that they represent transfers by owners to the entity, and they do not arise from activities intended to produce income. Revenues differ from gains in that they arise from the entity’s ongoing major or central operations. Gains arise from peripheral or incidental transactions.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC:Reporting, AICPA PC: None

**20.** The four basic assumptions that underlie the financial accounting structure are:

 (1) The economic entity assumption.

 (2) The going concern assumption.

 (3) The monetary unit assumption.

 (4) The periodicity assumption.

LO: 3, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC:Reporting, AICPA PC: Communication

**21.** (a) In accounting, it is generally agreed that any measures of the success of an enterprise for periods less than its total life are at best provisional 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 difficult for an arbitrary time period with incomplete transactions in process at both the beginning and the end of the period. Many 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.

LO: 3, Bloom: C, Difficulty: Simple, Time: 5-7, AACSB: Communication, AICPA BC: None, AICPA AC:Measurement, Reporting, AICPA PC: None

**22.** The monetary unit assumption assumes that the unit of measure (the dollar) remains reasonably stable so that dollars of different years can be added without any adjustment. When the value of the dollar fluctuates greatly over time, the monetary unit assumption loses its validity.

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

LO: 3, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC:Reporting, AICPA PC: None

**Questions Chapter 1** **(Continued)**

**23.** **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.

LO: 3, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC:Measurement, Reporting, AICPA PC: AICPA PC: None

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

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

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

LO: 3, Bloom: K, Difficulty: Simple, Time: 5-7, AACSB: Communication, AICPA BC: None, AICPA AC:Measurement, Reporting, AICPA PC: None

**25.** The revenue recognition principle requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied. In the case of services, revenue is recognized when the services are performed. In the case of selling a product, the performance obligation is met when the product is delivered. Companies follow a five-step process to analyze revenue arrangements to determine when revenue should be recognized: (1) Identify the contract(s) 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, and; (5) Recognize revenue when each performance obligation is satisfied.

LO: 3, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC:Measurement, Reporting, AICPA PC: None

**26.** A performance obligation is a promise to deliver a product or provide a service to a customer. The revenue recognition principle requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied. In the case of services, revenue is recognized when the services are performed. In the case of selling a product, the performance obligation is met when the product is delivered.

LO: 3, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC:Measurement, Reporting, AICPA PC: None

**Questions Chapter 1** **(Continued)**

**27.** The five steps in the revenue recognition process are:

**Step 1 Identify the contract(s) with the customer.** A contract is an agreement between two parties that creates enforceable rights or obligations.

**Step 2 Identify the separate performance obligations in the contract.** A performance obligation is either a promise to provide a service or deliver a product, or both.

**Step 3. Determine the transaction price.** The transaction price is the amount of consideration that a company expects to receive from a customer in exchange for transferring a good or service.

**Step 4. Allocate the transaction price to separate performance obligations.** This is usually done by estimating the value of consideration attributable to each product or service.

**Step 5. Recognize revenue when each performance obligation is satisfied**. This occurs when the service is provided or the product is delivered.

 Note that many revenue transactions pose few problems because the transaction is initiated and completed at the same time.

LO: 3, Bloom: C, Difficulty: Simple, Time: 5-7, AACSB: Communication, AICPA BC: None, AICPA AC:Measurement, Reporting, AICPA PC: None

**28.** Revenues are recognized when a performance obligation is satisfied**–**in the case of services, revenue is recognized when the services are performed. Therefore, revenue for Selane Eatery should be recognized at the time the luncheon is served.

LO: 3, Bloom: AN, Difficulty: Simple, Time: 3-5, Analytic, AICPA BC: None, AICPA AC:Measurement, Reporting, AICPA PC: None

**29.** 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 accompany recognition of the revenue. Examples of expenses that are recognized by associating cause and effect are sales commissions and the 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.

LO: 3, Bloom: AN, Difficulty: Simple, Time: 5-7, Analytic, AICPA BC: None, AICPA AC:Measurement, Reporting, AICPA PC: None

**30.** (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.

LO: 4, Bloom: C, Difficulty: Simple, Time: 5-7, AACSB: Communication, AICPA BC: None, AICPA AC: Measurement, Reporting, AICPA PC: None

**Questions Chapter 1** **(Continued)**

**31.** The general guide followed with regard to the full disclosure principle is to disclose in the financial statements any facts of sufficient importance to influence the judgment of an informed reader.
The fact that the amount of outstanding common stock doubled in January of the subsequent reporting period probably should be disclosed because such a situation is of importance to present stockholders. Even though the event occurred after December 31, 2025 (referred to as a subsequent event), it should be disclosed on the balance sheet as of December 31, 2025, 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).

LO: 3, Bloom: AN, Difficulty: Simple, Time: 3-5, Analytic, AICPA BC: None, AICPA AC:Measurement, Reporting, AICPA PC: None

**32.** Accounting information is subject to the cost constraint. Information should not be provided unless the benefits exceed the costs of preparing it.

LO: 3, Bloom: K, Difficulty: Simple, Time: 3-5, Analytic, AICPA BC: None, AICPA AC: Measurement, Reporting, AICPA PC: None

**33.** The costs of providing accounting information include costs of collecting and processing, disseminating, auditing, potential litigation, disclosure to competitors, and analysis and interpretation. Benefits to preparers may include greater management control and access to capital at a lower cost. Users may receive better information for allocation of resources, tax assessment, and rate regulation. Occasionally new accounting standards require the 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.

LO: 3, Bloom: AN, Difficulty: Simple, Time: 3-5, Analytic, AICPA BC: None, AICPA AC: Measurement, Reporting, AICPA PC: None

**34.** In general, conservatism should not be the basis for determining the accounting for transactions because it conflicts with the conceptual framework quality of neutrality.

 (a) Acceptable if reasonably accurate estimation is possible. To the extent that warranty costs can be estimated accurately, they should be recorded when an obligation exists, usually in the period of the sale.

 (b) Not acceptable. Most accounts are collectible, or the company will be out of business very soon. Hence, sales can be recorded when made. Also, other companies record sales when made rather than when collected, so if accounts for Landowska Co. are to be compared with other companies, they must be kept on a comparable basis. However, estimates for uncollectible accounts should be recorded if there is a reasonably accurate basis for estimating bad debts.

 (c) Not acceptable. A provision for the possible loss can be made through an appropriation of retained earnings, but until judgment has been rendered on the suit or it is otherwise settled, entry of the loss usually represents anticipation. Recording it earlier is probably an unwise legal strategy as well. For the loss to be recognized at this point, the loss would have to be probable and reasonably estimable. (See FASB ASC 450-10-05 for additional discussion if desired.) Note disclosure is required if the loss is not recorded.

LO: 3, Bloom: AN, Difficulty: Simple, Time: 3-5, Analytic, AICPA BC: None, AICPA AC: Measurement, Reporting, AICPA PC: None

**35.** The sources of pressure are innumerable, but the most intense and continuous pressure to change or influence accounting principles or standards come from individual companies, industry associations, governmental agencies, practicing accountants, academicians, professional account-ing organizations, and public opinion.

LO: 4, Bloom:K, Difficulty: Simple, 5-10, AACSB: Communication, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC:Communication

**Questions Chapter 1** **(Continued)**

**36.** Economic consequences mean the impact of accounting reports on the wealth positions of issuers and users of financial information and the decision-making behavior resulting from that impact. In other words, accounting information impacts various users in many different ways, which leads to wealth transfers among these various groups.

If politics plays an important role in the development of accounting rules, the rules will be subject to manipulation to further whatever policy prevails at the moment. No matter how well-intentioned the rule maker may be, if the information is designed to indicate that investing in a particular enterprise involves less risk than it actually does, or is designed to encourage invest­ment in a particular segment of the economy, financial reporting will suffer an irreplaceable loss of credibility.

LO: 4, Bloom:K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC:Communication

**37** Concern exists about fraudulent financial reporting because it can undermine the entire financial reporting process. Failure to provide accurate information to users can lead to inappropriate allocations of resources in our economy. In addition, failure to detect massive fraud can lead to additional governmental oversight of the accounting profession.

LO: 4, Bloom:K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC:Communication

**38.** The expectations gap is the difference between what people think accountants should be doing and what accountants think they can do. It is a difficult gap to close. The accounting profession recognizes it must play an important role in narrowing this gap. To meet the needs of society, the profession is continuing its efforts in developing accounting standards, such as numerous pronouncements issued by the FASB, to serve as guidelines for recording and processing business transactions in the changing economic environment.

LO: 4, Bloom:K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC:Communication

**39.** Some major challenges facing the accounting profession relate to the following items:

Nonfinancial measurement—how to report significant key performance measurements such as customer satisfaction indexes, backlog information and reject rates on goods purchased.

Forward-looking information—how to report more future-oriented information.

Soft assets—how to report on intangible assets, such as market know-how, market dominance, and well-trained employees.

Timeliness—how to report more real-time information.

LO: 4, Bloom:K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC:Communication

**40.** Accountants must perceive the ethical dimensions of some situations because GAAP does not define or cover all specific features that are to be reported in financial statements. In these instances, accountants must choose among alternatives. These accounting choices influence whether par­ticular stakeholders may be harmed or benefited. Ethical decision-making involves awareness of potential harm or benefit and taking responsibility for the choices.

LO: 4, Bloom:K, Difficulty: Simple, Time: 3-5, AACSB: Ethics, Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC:Ethical Conduct

# Solutions to Brief Exercises

**Brief Exercise 1.1**

1. True

2. False. Any company claiming compliance with GAAP must comply with all standards and interpretations, including disclosure requirements.

3. True

4. False. In establishing financial accounting standards, the FASB relies on two basic premises:
(1) the FASB should be responsive to the needs and viewpoints of the entire economic community, not just the public accounting profession, and (2) it should operate in full view of the public through a “due process” system that gives interested people ample opportunities to make their view known.

LO: 1, Bloom:K, Difficulty: Simple, Time: 5-10, AACSB: None, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC:None

**Brief Exercise 1.2**

(a) **AICPA.** American Institute of Certified Public Accountants. The national organization of practicing certified public accountants.

(b) **FAF.** Financial Accounting Foundation. An organization whose purpose is to select members of the FASB and its Advisory Councils, fund their activities, and exercise general oversight.

(c) **FASAC.** Financial Accounting Standards Advisory Council. An organization whose purpose is to consult with the FASB on issues, project priorities, and select task forces.

(d) **GAAP.** Generally Accepted Accounting Principles. A common set of standards, principles, and procedures which have substantial authoritative support and have been accepted as appropriate because of universal application.

(e) **CPA.** Certified Public Accountant. An accountant who has fulfilled certain education and experience requirements and passed a rigorous examination. Most CPAs offer auditing, tax, and management consulting services to the general public.

(f) **FASB.** Financial Accounting Standards Board. The primary body that currently establishes and improves financial accounting and reporting standards for the guidance of issuers, auditors, users, and others.

(g) **SEC.** Securities and Exchange Commission. An independent regulatory agency of the United States government which administers the Securities Acts of 1933 and 1934 and other acts.

(h) **IASB.** International Accounting Standards Board. An international group, formed in 2001 (replacing a predecessor body that was formed in 1973), actively developing and issuing accounting standards that will have international appeal and hopefully support.

LO: 1, Bloom:K, Difficulty: Moderate, Time: 5-10, AACSB: None, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC:None

**Brief Exercise 1.3**

**(a) 5. Comparability**

**(b) 8. Timeliness**

**(c) 3. Predictive value**

**(d) 1. Relevance**

**(e) 7. Neutrality**

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: None, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Decision Making

**Brief Exercise 1.4**

**(a) 5. Faithful representation**

**(b) 8. Confirmatory value**

**(c) 3. Free from error**

**(d) 2. Completeness**

**(e) 4. Understandability**

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: None, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC: Decision Making

**Brief Exercise 1.5**

**(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).**

BE 1.5 (Continued)

**(c) If the company reduced the estimated remaining useful life of plant property because of obsolescence, the comparability of the financial statements has been affected. The change is not a matter of consistency; it is a change in accounting estimate required by altered conditions and involves no change in accounting principles employed or in their method of application. The change might be disclosed by a note in the financial statements if the effect was material. If commented upon in the audit report, it would be a matter of disclosure rather than consistency.**

LO: 2, Bloom: AN, Difficulty: Hard, Time: 10-15, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Communication

**Brief Exercise 1.6**

**(a) Verifiability**

**(b) Comparability**

**(c) Comparability (consistency)**

**(d) Timeliness**

LO: 2, Bloom: K, Difficulty: Simple, Time: 5-7, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

**Brief Exercise 1.7**

Companies and their auditors, for the most part, have adopted the general rule of thumb that anything under 5% of net income is considered not material. Recently, the SEC has indicated that it is okay to use this percentage for the initial assessment of materiality, but other factors must be considered. For example, companies can no longer fail to record items 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.**

BE 1.7 (Continued)

**(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.**

LO: 2, Bloom: K, Difficulty: Moderate, Time: 10-15, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

**Brief Exercise 1.8**

**(a) Equity**

**(b) Revenues**

**(c) Equity**

**(d) Assets**

**(e) Expenses**

**(f) Losses**

**(g) Liabilities**

**(h) Distributions to owners**

**(i) Gains**

**(j) Investments by owners**

LO: 2, Bloom: K, Difficulty: Simple, Time: 7-10, AACSB: None, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

**Brief Exercise 1.9**

**(a) Debit to the Land account, as it is a cost incurred in acquir­ing land.**

**(b) Debit to an asset account, preferably Land Improvements. The driveway will last for many years, and therefore should be capitalized and depreciated.**

**(c) Debit to an asset account, preferably Equipment, as the machine will last for a number of years and contribute to the operations of those years.**

**(d) If the fiscal year ends December 31, this expenditure will be an expense of the current year so will be debited to an expense account. If financial statements are prepared on some date before December 31, part of this cost would be an expense and part would be an asset. Depending upon the circumstances, the original entry, as well as the adjusting entry for statement purposes, should take the financial statement date into account.**

BE 1.9 (Continued)

**(e) Debit to the Building account, as it is a part of the cost of that plant asset which will contribute to operations for many years.**

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

LO: 2, Bloom: AN, Difficulty: Moderate, Time: 10-15, AACSB: Analytic, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

**Brief Exercise 1.10**

**(a) Periodicity**

**(b) Monetary unit**

**(c) Going concern**

**(d) Economic entity**

LO: 3, Bloom: K, Difficulty: Moderate, Time: 5-10, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

**Brief Exercise 1.11**

**(a) Net realizable value.**

**(b) Would not be disclosed.**

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

**(d) Net realizable value.**

**(e) Net realizable value (i.e., redeemable value).**

LO: 3, Bloom: K, Difficulty Moderate, Time: 10-15, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

**Brief Exercise 1.12**

**(a) Revenue recognition**

**(b) Expense recognition**

**(c) Full disclosure**

**(d) Measurement (historical cost)**

LO: 3, Bloom: K, Difficulty: Moderate, Time: 10-15, AACSB: Knowledge, AICPA BC: None, AICPA AC: AICPA AC: Reporting, AICPA PC: None

**Brief Exercise 1.13**

**Investment (1)—Level 3**

**Investment (2)—Level 1**

**Investment (3)—Level 2**

LO: 3, Bloom: AN, Difficulty: Moderate, Time: 5-10, AACSB: Analytic, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

**Brief Exercise 1.14**

**(a) Full disclosure**

**(b) Expense recognition**

**(c) Historical cost**

LO: 3, Bloom: C, Difficulty: Moderate, Time: 5-10, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

# Solutions to Exercises

**Exercise 1.1**

It is not appropriate to abandon mandatory accounting rules and allow each company to voluntarily disclose the type of information it considers important. Without a coherent body of accounting theory and standards, each accountant or enterprise would have to develop its own theory structure and set of practices, and readers of financial statements would have to familiarize themselves with every company’s peculiar accounting and reporting practices. As a result, it would be almost impossible to prepare state-ments that could be compared.

In addition, voluntary disclosure may not be an efficient way of disseminating information. A company is likely to disclose less information if it has the discretion to do so. Thus, the company can reduce its cost of assembling and disseminating information. However, an investor wishing additional information has to pay to receive additional information desired. Different investors may be interested in different types of information. Since the company may not be equipped to provide the requested information, it would have to spend additional resources to fulfill such needs; or the company may refuse to furnish such information if it is too costly to do so. As a result, investors may not get the desired information or they may have to pay a significant amount of money for it. Furthermore, redundancy in gathering and distributing information occurs when different investors ask for the same information at different points in time. To society as a whole, this would not be an efficient way of utilizing resources.

LO: 1, 4, Bloom:AN, Difficulty: Simple, Time: 15-20, AACSB: Reflective Thinking, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC: None

**Exercise 1.2**

1. (d)

2. (d)

3. (d)

4. (a)

5. (a)

6. (b)

7. (d)

8. (b)

LO: 1, 2, Bloom:K, Difficulty: Simple, Time: 15-20, AACSB: Knowledge, AICPA BC: None, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC:None

**Exercise 1.3**

**(a) True.**

**(b) False – General-purpose financial reports help users who lack the ability to demand all the financial information they need from an entity and, therefore, must rely on, at least partly, the information in financial reports.**

**(c) False – Standard-setting based on personal conceptual frame­works will lead to different conclusions about identical or similar issues. As a result, standards will not be consistent with one another, and past decisions may not be indicative of future ones.**

**Exercise 1.3 (Continued)**

**(d) False – Information that is decision-useful to capital providers may also be useful to users of financial reporting who are not capital providers.**

**(e) False – An implicit assumption is that all users need reasonable knowl­edge of business and financial accounting matters to understand the information contained in the financial statements.**

**(f) True.**

LO: 2 Bloom: C, Difficulty: Simple, Time: 15-20, AACSB: Knowledge, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC: None

**Exercise 1.4**

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

**(b) False – Relevant information must also be material.**

**(c) False – Information that is relevant is characterized as having predictive or confirmatory value or both.**

**(d) False – Comparability also refers to comparisons of a firm over time (consistency).**

**(e) False – Verifiability is an enhancing characteristic that relates to both relevance and faithful representation.**

**(f) True.**

LO: 2, Bloom: C, Difficulty: Simple, Time: 15-20, AACSB: Knowledge, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC: Decision Making

**Exercise 1.5**

|  |  |  |  |
| --- | --- | --- | --- |
| **(a)****(b)** | **Confirmatory value.****Cost.** |  **(g)** **(h)** | **Timeliness.****Relevance.** |
| **(c)** | **Neutrality.** |  **(i)** | **Comparability.** |
| **(d)** | **Comparability (Consistency).** |  **(j)** | **Verifiability.** |
| **(e)** | **Neutrality.** |  |  |
|  **(f)** | **Relevance and Faithful representation.** |  |  |

LO: 2, Bloom: C, Difficulty: Moderate, Time: 10-15, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

**Exercise 1.6**

|  |  |  |  |
| --- | --- | --- | --- |
| **(a)****(b)****(c)** | **Comparability.****Confirmatory value.****Comparability (Consistency).** |  **(h)** **(i)** **(j)** | **Materiality.****Faithful representation.****Relevance and Faithful** |
| **(d)****(e)** | **Neutrality.****Verifiability.** |  **(k)** | **representation.****Timeliness.** |
|  **(f)** | **Relevance.** |  |  |
| **(g)** | **Comparability, Verifiability, Timeliness, and Understandability.** |  |  |

LO: 2, Bloom: C, Difficulty: Simple, Time: 10-15, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None Bloom:

**Exercise 1.7**

**(a) Gains, losses.**

**(b) Liabilities.**

**(c) Investments by owners, comprehensive income.**

 **(also, possible would be revenues and gains).**

**(d) Distributions to owners.**

 **(Note to instructor: net effect is to reduce equity and assets).**

**(e) Comprehensive income**

 **(also, possible would be revenues and gains).**

(f) Assets.

**(g) Comprehensive income.**

**(h) Revenues, expenses.**

**(i) Equity.**

**(j) Revenues.**

**(k) Distributions to owners.**

**(l) Comprehensive income.**

LO: 2, Bloom: C, Difficulty: Moderate, Time: 15-20, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

**Exercise 1.8**

|  |  |  |
| --- | --- | --- |
| **(a)** |  **7.** | **Expense recognition principle.** |
| **(b)** |  **5.** | **Measurement principle (historical cost.)** |
| **(c)** |  **8.** | **Full disclosure principle.** |
| **(d)** |  **2.** | **Going concern assumption.** |
| **(e)** |  **1.** | **Economic entity assumption.** |
|  **(f)** |  **4.** | **Periodicity assumption.** |
| **(g)** |  **3.** | **Monetary unit assumption.** |

LO: 3, Bloom: C, Difficulty: Simple, Time: 10-15, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

**Exercise 1.9**

|  |  |  |  |
| --- | --- | --- | --- |
| **(a)** | **Measurement principle (historical cost).** |  **(i)** | **Expense recognition and revenue recognition principles.** |
| **(b)** | **Full disclosure principle.** |  **(j)** | **Economic entity assumption.** |
| **(c)** | **Expense recognition principle.** |  **(k)** | **Periodicity assumption.** |
| **(d)** | **Measurement (fair value) principle.** |  **(l)** | **Measurement principle, Expense recognition principle.** |
|  **(e)****(f)** | **Economic entity assumption.****Full disclosure principle.** | **(m)** | **Measurement principle (historical cost).** |
| **(g)** | **Revenue recognition principle.** |  **(n)** | **Expense recognition principle.** |
| **(h)** | **Full disclosure principle.** |  |  |

LO: 3, Bloom: C, Moderate, Time: 10-15, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

**Exercise 1.10**

**(a) It is well established in accounting that revenues, expenses, and cost of goods sold must be disclosed in an income statement. It might be noted to students that such was not always the case. At one time, only net income was reported, but over time, we have evolved to the present reporting format.**

**(b) The proper accounting for this situation is to report the equipment as an asset and the notes payable as a liability on the balance sheet. Offsetting is permitted in only limited situations where certain assets are contractually committed to pay off liabilities.**

**Exercise 1.10 (Continued)**

**(c) According to GAAP, the basis upon which inventory amounts are stated (lower of cost or market) and the method used in determining cost (LIFO, FIFO, average cost, etc.) should also be reported. The disclosure requirement related to the method used in determining cost should be emphasized, indicating that where possible alternatives exist in financial reporting, disclosure in some format is required.**

**(d) Consistency requires that disclosure of changes in accounting principles be made in the financial statements. To do otherwise, would result in misleading financial statements. Financial statements are more useful if they can be compared with similar reports for prior years.**

LO: 3, Bloom: C, Difficulty: Hard, Time: 20-25, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

**Exercise 1.11**

**(a) This entry violates the economic entity assumption. This assumption in accounting indicates that economic activity can be identified with a particular unit of accountability. In this situation, the company erred by charging this cost to the wrong economic entity.**

**(b) The historical cost principle indicates that assets and liabilities are accounted for on the basis of cost. If we were to select sales value, for example, we would have an extremely difficult time in attempting to establish a sales value for a given item without selling it. It should further be noted that the revenue recognition principle provides the answer to when revenue should be recognized. Revenue should be recognized when a performance obligation is satisfied. In this case, the obligation is not satisfied until goods are delivered to a customer.**

**(c) The expense recognition principle indicates that expenses should be allocated to the appropriate periods involved. In this case, there appears to be a high degree of uncertainty about whether the company will have to pay. GAAP 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 the guidance (FASB ASC 450; formerly *FASB Statement No. 5*). The purpose of this question is to develop some decision framework when the probability of a future event must be assumed.)**

**Exercise 1.11 (Continued)**

**(d) At present, accountants do not recognize price-level adjustments in the accounts. Hence, it is misleading to deviate from the measurement principle (historical cost) 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 using systematic charges of expired costs against revenues. (Note to instructor: It might be called to the students’ attention that the FASB does encourage supplemental disclosure of price-level information.)**

**(e) The answer to this situation is the same as (b).**

LO: 3, Bloom: AN, Difficulty: Moderate, Time: 20-25, AACSB: Analytic, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

**Exercise 1.12**

**(a) Depreciation is an allocation of cost, not an attempt to value assets. As a consequence, even if the fair value of the building increased, costs related to this building should be matched with revenues on the income statement, not as a charge against retained earnings.**

**(b) Accountants follow the measurement principle (historical cost) approach and write-ups of assets are not permitted. It should also be noted that the revenue recognition principle states that revenue should not be recognized until a performance obligation is satisfied. In this case, revenue (gross profit) would not be recognized until the goods are delivered to the customer. Further, this is not a peripheral transaction so recording a gain is not appropriate.**

**Exercise 1.12 (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 measurement principle (historical cost) to use the fair value of the stock. Recording the asset at the par value of the stock has no conceptual validity. Par value is merely an arbitrary amount usually set at the date of incorporation.**

**(d) The gain should be recognized when the equipment is delivered to the customer. Deferral of the gain is not permitted, because the company has satisfied the performance obligation.**

**(e) It appears from the information that the sale should be recorded in 2026 instead of 2025. Revenue should be recognized when a performance obligation is satisfied. In this case, the performance obligation is met when the order is delivered to the buyer. Accounts receivable and Sales revenue should be recorded in 2026. 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 2026.**

LO: 3, Bloom: AN, Difficulty: Moderate, Time: 20-25, AACSB: Analytic, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

# Solutions to Using Your Judgement

**UYJ 1.1 Financial Reporting Problem**

**(a) From Note 1 – Summary of Significant Accounting Policies:**

Our revenue is primarily generated from the sale of the finished product to customers. Those sales predominantly contain a single performance obligation and revenue is recognized at a single point in time when ownership, risks, and rewards transfer, which can be on the date of shipment or the date of receipt by the customer. A provision for payment discounts and product return allowances is recorded as a reduction of sales in the same period the revenue is recognized. The revenue recorded is presented net of sales and other taxes we collect on behalf of governmental authorities. The revenue includes shipping and handling costs, which generally are included in the list price to the customer.

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

(b) Historical Cost

Buildings, machinery, and equipment

Property, plant, and equipment is recorded at cost reduced by accumulated depreciation.

Fair Value

Investments (U.S. government securities, corporate bond securities, other investments), derivatives (relating to foreign currency hedges, other foreign currency instruments, interest rates, net investment hedges) are reported at fair value. Certain financial instruments are required to be recorded at fair value.

1. On July 1, 2019, we adopted ASU 2016-02, "Leases (Topic 842)." The new accounting standard requires the recognition of right-of-use assets and lease liabilities for all long-term leases, including operating leases, on the balance sheet. In January 2017, the FASB issued ASU 2017-04, "Intangibles-Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment." We will adopt the standard effective July 1, 2020. The impact of the new standard will be dependent on the specific facts and circumstances of future individual impairments if any.

(d) Accounting Policy Related to Advertising

Advertising makes up a portion of Selling, general and administrative expense (SG&A). Selling, general and administrative expense is primarily comprised of marketing expenses, selling expenses, research and development costs, administrative and other indirect overhead costs, depreciation and amortization expense on non-manufacturing assets, and other miscellaneous operating items. Advertising costs, charged to expense as incurred, include worldwide television, print, radio, internet, and in-store advertising expenses and were $7.3 billion in 2020, $6.8 billion in 2019, and $7.1 billion in 2018.

LO: 4, Bloom: AN, Difficulty: Moderate, Time: 30-35, AACSB: Analytic, AICPA BC: None, AICPA AC: Measurement, Analysis and Interpretation, Reporting, Research, AICPA PC: Communication

**UYJ 1.2 Comparative Analysis Case**

**(a) *Coca-Cola***

Comparative Analysis

1. Coca-Cola

Operating Segments (Note 1)

The Company's operating structure is the basis for our internal financial reporting. Our operating structure includes the following operating segments, which are sometimes

referred to as "operating groups" or "groups":

• Europe, Middle East and Africa

• Latin America

• North America

• Asia Pacific

• Global Ventures

• Bottling Investments

Our operating structure also includes Corporate, which consists of two components: (1) a center focused on strategic initiatives, policy and governance; and (2) an enabling services organization focused on both simplifying and standardizing key transactional processes and providing support to business units through global centers of excellence.

They own or license and market numerous nonalcoholic beverage brands, which we group into the following category clusters: sparkling soft drinks; water, enhanced water and sports drinks; juice, dairy and plant-based beverages; tea and coffee; and energy drinks.

They also own and market four of the world's top five nonalcoholic sparkling soft drink brands: Coca-Cola, Diet Coke, Fanta and Sprite.

PepsiCo

Our Divisions (Note 1)

We are organized into seven reportable segments (also referred to as divisions), as follows:

1. FLNA, which includes our branded food and snack businesses in the United States and Canada;
2. QFNA, which includes our cereal, rice, pasta and other branded food businesses in the United States and Canada;
3. PBNA, which includes our beverage businesses in the United States and Canada;
4. LatAm, which includes all of our beverage, food and snack businesses in Latin America;
5. Europe, which includes all of our beverage, food and snack businesses in Europe;

**UYJ 1.2 (Continued)**

1. AMESA, which includes all of our beverage, food and snack businesses in Africa, the Middle East and South Asia; and
2. APAC, which includes all of our beverage, food and snack businesses in Asia Pacific, Australia and New Zealand and China region.

Through our operations, authorized bottlers, contract manufacturers and other third parties, we make, market, distribute and sell a wide variety of convenient beverages, foods and snacks, serving customers and consumers in more than 200 countries and territories with our largest operations in the United States, Mexico, Russia, Canada, the United Kingdom, China and South Africa.

(b) Dominant Position - Beverage Sales: Coke or Pepsi

Coca-Cola: Net operating revenues for 2020 were $33,014 million, comprised primarily of beverage sales.

Pepsi: Net revenue for 2020 was $70,372 million, of which beverages are estimated at 45% ($31,667) million.

Coca-Cola has the dominant position for beverage sales.

(c) Inventories, cost allocation method, the effect on comparability. As indicated, the companies use essentially the same inventory valuation method. Therefore, comparability is not affected.

Coca-Cola

Inventories consist primarily of raw materials and packaging (which includes ingredients and supplies) and finished goods (which include concentrates and syrups in our concentrate operations and finished beverages in our finished product operations). Inventories are valued at the lower of cost or net realizable value. We determine cost on the basis of the average cost or first-in, first-out methods.

PepsiCo

Inventory

(c) Inventories – Note 15. Inventories are valued at the lower of cost or net realizable value. Cost is determined using the averages; first-in first-out (FIFO); or, in limited instances, last-in, first-out (LIFO) methods.

**UYJ 1.2 (Continued)**

**(d)** Change in accounting policy

Coca-Cola

 Recently Issued Accounting Pronouncements – Adopted

 In August 2017, the Financial Accounting Standards Board ("FASB") issued ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities ("ASU 2017-12"), which eliminates the requirement to separately measure and report hedge ineffectiveness and requires companies to recognize all elements of hedge accounting that impact earnings in the same line item in the statement of income where the hedged item resides. The amendments in this update include new alternatives for measuring the hedged item for fair value hedges of interest rate risk and ease the requirements for effectiveness testing, hedge documentation and applying the critical terms match method. We adopted ASU 2017-12 effective January 1, 2019 using the modified retrospective method. We recognized a cumulative-effect adjustment to decrease the opening balance of reinvested earnings as of January 1, 2019 by $12 million, net of tax. Refer to Note 5 for additional disclosures required by this ASU.

In February 2018, the FASB issued ASU 2018-02, Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income ("ASU 2018-02"), which permits entities to reclassify the disproportionate income tax effects of the Tax Cuts and Jobs Act of 2017 ("Tax Reform Act") on items within AOCI to reinvested earnings. These disproportionate income tax effect items are referred to as "stranded tax effects." The amendments in this update only relate to the reclassification of the income tax effects of the Tax Reform Act. Other accounting guidance that requires the effect of changes in tax laws or rates to be included in net income is not affected by this update. We adopted ASU 2018-02 effective January 1, 2019. We recognized a cumulative effect adjustment to increase the opening balance of reinvested earnings as of January 1, 2019 by $558 million related to the effect that the change in the income tax rate had on the gross deferred tax amounts of items remaining in AOCI.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers. ASU 2014-09, and its amendments, were primarily included in ASC 606,Revenue from Contracts with Customers, which we adopted effective January 1, 2018 using the modified retrospective method. We recognized a cumulative effect adjustment to decrease the opening balance of reinvested earnings as of January 1, 2018 by $257 million, net of tax.

**UYJ 1.2 (Continued)**

In January 2016, the FASB issued ASU 2016-01, which addresses certain aspects of the recognition, measurement, presentation and disclosure of financial instruments. ASU 2016-01 was effective for the Company beginning January 1, 2018, and we are now recognizing any changes in the fair value of certain equity investments in net income as prescribed by the new standard rather than in other comprehensive income ("OCI"). We recognized a cumulative effect adjustment to increase the opening balance of reinvested earnings as of January 1, 2018 by $409 million, net of tax.

In October 2016, the FASB issued ASU 2016-16, Intra-Entity Transfers of Assets Other Than Inventory ("ASU 2016-16"), which requires the Company to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. ASU 2016-16 was effective for the Company beginning January 1, 2018 and was adopted using a modified retrospective basis. We recorded a $2.9 billion cumulative effect adjustment to increase the opening balance of reinvested earnings as of January 1, 2018, with the majority of the offset being recorded in the line item deferred income tax assets in our consolidated balance sheet.

In March 2018, the FASB issued ASU 2018-05, Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 118. The amendments in this update provide guidance on when to record and disclose provisional amounts for certain income tax effects of the Tax Reform Act. The amendments also require any provisional amounts or subsequent adjustments to be included in net income. Additionally, this ASU discusses required disclosures that an entity must make with regard to the Tax Reform Act. This ASU is effective immediately as new information is available to adjust provisional amounts that were previously recorded. The Company adopted this standard and subsequently finalized the accounting based on the guidance, interpretations and data available as of December 31, 2018.

**Pepsico**

**Recently Issued Accounting Pronouncements - Adopted**

In 2016, the Financial Accounting Standards Board (FASB) issued guidance that changes the impairment model used to measure credit losses for most financial assets. Under the new model we are required to estimate expected credit losses over the life of our trade receivables, certain other receivables and certain other financial instruments. The new model replaced the existing incurred credit loss model and generally results in earlier recognition of allowances for credit losses. We adopted this guidance in the first quarter of 2020 and the adoption did not have a material impact on our consolidated financial statements or disclosures. On initial recognition, we recorded an after-tax cumulative effect decrease to retained earnings of $34 million ($44 million pre-tax) as of the beginning of 2020.

**UYJ 1.2 (Continued)**

**Recently Issued Accounting Pronouncements - Not Yet Adopted**

In 2019, the FASB issued guidance to simplify the accounting for income taxes. The guidance primarily addresses how to (1) recognize a deferred tax liability after we transition to or from the equity method of accounting, (2) evaluate if a step-up in the tax basis of goodwill is related to a business combination or is a separate transaction, (3) recognize all of the effects of a change in tax law in the period of enactment, including adjusting the estimated annual tax rate, and (4) Include the amount of tax based on income in the income tax provision and any incremental amount as a tax not based on income for hybrid tax regimes. The guidance is effective in the first quarter of 2021 with early adoption permitted. We will adopt the guidance when it becomes effective in the first quarter of 2021. The guidance is not expected to have a material impact on our consolidated financial statements or related disclosures.

LO: 4, Bloom: AN, Difficulty: Moderate, Time: 30-35, AACSB: Analytic, Communication, AICPA BC: None, AICPA AC: Measurement Analysis and Interpretation, Reporting, Research, AICPA PC: Communication

**UYJ 1.3 Accounting, Analysis, and Principles**

**Accounting**

Caddie Shack Driving Range

Statement of Financial Position

May 31, 2025

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| *Assets* |  |  | *Liabilities* |  |
| Cash | \*\*\*$15,100 |  | Advertising payable | $ 150 |
| Building | 6,000 |  | Utilities payable | 100 |
| Equipment | 800 |  |  |  |
|  |  |  | *Owners’ Equity* |  |
|  |  |  | Owners’ capital | \*21,650 |
| *Total Assets* |              $21,900 |  | *Total Liabilities & Equity* |              $21,900 |

Accrual income = $4,700 – $1,000 – $750 – $400 – $100 = $2,450\*\*\*\*

Owners’ capital balance = $20,000\*\* + $2,450 – $800 = $21,650\*

Murray might conclude that his business earned a profit of $1,650 ($21,650\* - $20,000\*\*) because of the difference between his ending Owner’s Capital and beginning Owner's Capital. The conclusion that his business lost $4,900 ($20,000\* - $15,100\*\*\*) 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.

**UYJ 1.3 (Continued)**

**Principles**

GAAP income is the accrual income computed above as $2,450 (excluding depreciation expense.) The key concept illustrated in the difference between the loss of $4,900 and profit of $1,650 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).

LO: 2, 3, 4, Bloom: AN, Difficulty, Moderate, Time: 20-25, AACSB: Analytic, Communication, AICPA BC: None, AICPA AC: Measurement Analysis and Interpretation, Reporting, AICPA PC: Communication

# Solutions to Critical Thinking Cases

**CT 1.1**

(a) The Securities and Exchange Commission (SEC) is an independent federal agency that receives its authority from federal legislation enacted by Congress. The Securities and Exchange Act of 1934 created the SEC.

(b) As a result of the Securities and Exchange Act of 1934, the SEC has legal authority relative to accounting practices. The U.S. Congress has given the SEC broad regulatory power to control accounting principles and procedures to fulfill its goal of full and fair disclosure.

(c) There is no direct relationship as the SEC was created by Congress and the Financial Accounting Standards Board (FASB) was created by the private sector. However, the SEC historically has followed a policy of relying on the private sector to establish financial accounting and reporting stan­dards known as generally accepted accounting principles (GAAP). The SEC does not necessarily agree with all of the pronouncements of the FASB. In cases of unresolved differences, the SEC rules take precedence over FASB rules for companies within SEC jurisdiction.

LO: 2, Bloom:K, Difficulty: Moderate, Time: 30-40, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC:Communication

**CT 1.2**

(a) A conceptual framework is a coherent system of concepts that flow from an objective. Some compare it to a constitution. Its objective is to provide a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements.

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

Specific benefits that may arise are:

(1) A coherent set of standards and rules should result.

(2) New and emerging practical problems should be more quickly soluble by reference to an existing framework.

(3) It should increase financial statement users’ understanding of and confidence in financial reporting.

(4) It should enhance comparability among companies’ financial statements.

(5) It should provide guidance on identifying the boundaries of judgment in preparing financial statements.

(6) It should provide guidance to the body responsible for establishing accounting standards.

(b) The FASB has issued eight Statements of Financial Accounting Concepts (SFAC) that relate to business enterprises. Their titles and a brief description of the focus of seven of these Statements are as follows:

(1) **SFAC No. 1,** “Objectives of Financial Reporting by Business Enterprises,” presents the goals and purposes of accounting (superseded by **SFAC No. 8,** Chapter 1.)

(2) **SFAC No. 2,** “Qualitative Characteristics of Accounting Information,” examines the characteristics that make accounting information useful (**SFAC No. 8,** Chapter 3.)

(3) **SFAC No. 3,** “Elements of Financial Statements of Business Enterprises,” provides definitions of items in financial statements such as assets, liabilities, revenues, and expenses.

(4) **SFAC No. 5,** “Recognition and Measurement in Financial Statements of Business Enterprises,” sets forth fundamental recognition and measurement criteria and guidance on what information should be formally incorporated into financial statements and when.

(5) **SFAC No. 6,** “Elements of Financial Statements,” replaces **SFAC No. 3,** “Elements of Financial Statements of Business Enterprises,” and expands its scope to include not-for-profit organizations.

(6) **SFAC No. 7,** “Using Cash Flow Information and Present Value in Accounting Measurements,” provides a framework for using expected future cash flows and present values as a basis for measurement.

(7) **SFAC No. 8,** Chapter 1, “The Objective of General Purpose Financial Reporting,” Chapter 3, “Qualitative Characteristics of Useful Financial Information,” replaces *SFAC No. 1* and *No. 2,* and Chapter 8: *Notes to Financial Statements.*

LO: 2, Bloom: K, Difficulty: Simple, Time: 20-25, AACSB: None, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

**CT 1.3**

(a) FASB’s Conceptual Framework should provide benefits to the accounting community such as:

(1) A coherent set of standards and rules should result.

(2) New and emerging practical problems should be more quickly soluble by reference to an existing framework.

**CT 1.3 (Continued)**

(b) The most important quality of accounting information is its usefulness for decision-making. Relevance and faithful representation are the primary qualities leading to this decision-usefulness. Usefulness is the most important quality because, without usefulness, there would be no benefits from information to set against its costs.

(c) There are a number of key characteristics or qualities that make accounting information useful for decision-making**.** The importance of three of these characteristics or qualities is discussed below.

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

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

(3) Faithful representation—the faithful representation of a measure rests on whether the numbers and descriptions matched what really existed or happened, including completeness, neutrality, and free from error.

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

LO: 2, Bloom: K, Difficulty: Simple, Time: 25-35, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Decision Making

**CT 1.4**

(a) The objective of 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 about providing resources to the entity.

(b) The purpose of this statement is to set forth fundamentals on which financial accounting and reporting standards may be based. Without some basic set of objectives that everyone can agree on, inconsistent standards will be developed. For example, some believe that accountability should be the primary objective of financial reporting. Others argue that the 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 the 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 FASB 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 FASB uses should enable all who are affected by or interested in financial accounting standards to better understand the content and limitations of the 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.

LO: 2, Bloom: C, Difficulty: Simple, Time: 25-35, AACSB: None, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

**CT 1.5**

(a) (1) Relevance is one of the two primary decision-specific characteristics of useful accounting information. Relevant information is capable of making a difference in a decision. Relevant information helps users to make predictions about the outcomes of past, present, and future events, or to confirm or correct prior expectations. ***Only material information is considered to be relevant and therefore, must be disclosed. If the information is not likely to make a difference to a decision-maker, then it need not be disclosed***. Information must also be timely to be relevant.

 (2) Faithful representation is one of the two primary decision-specific characteristics of useful accounting information. ***Faithful representation means that numbers and descriptions match what really existed or happened.*** Representational faithfulness is correspondence or agreement between accounting information and the economic phenomena it is intended to represent stemming from completeness, neutrality, and free from error.

 (3) Understandability is a user-specific characteristic of information. Information is understandable when it permits reasonably informed users to perceive its significance. Understandability is a link between users, who vary widely in their capacity to comprehend or utilize the information, and the decision-specific qualities of information.

 (4) Comparability means that information about enterprises has been prepared and presented in a similar manner. Comparability enhances comparisons between information about two different enterprises at a particular point in time.

 (5) Consistency means that unchanging policies and procedures have been used by an enterprise from one period to another. Consistency enhances comparisons between information about the same enterprise at two different points in time.

(b) (**Note to instructor:** Many answers are 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 free from error as historical cost information about past transactions.

 (2) Proposed new accounting methods may be more relevant to many decision-makers than existing methods. However, if adopted, they would impair consistency and make trend comparisons of an enterprise’s results over time difficult or impossible.

 (3) There presently exists much diversity among acceptable accounting methods and procedures. In order to facilitate comparability between enterprises, the use of only one accepted accounting method for a particular type of transaction could be required. However, consistency would be impaired for those firms changing to the new required methods.

 (4) Occasionally, relevant information is exceedingly complex. Judgment is required in determining the optimum trade-off between relevance and understandability. Information about the impact of general and specific price changes may be highly relevant but not understandable by all users.

(c) Although trade-offs result in the sacrifice of some desirable quality of information, the overall result should be information that is more useful for decision-making.

LO: 2, Bloom: C, Difficulty: Moderate, Time: 30-35, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

**CT 1.6**

(a) Recognition when cash is received is not appropriate unless the magazines are delivered to the customer at the same time. The revenue recognition principle indicates that companies recognize revenue when each performance obligation is satisfied. This occurs when the products are delivered – in this case, the magazines.

(b) Recognition when the magazines are published each month is not appropriate. The revenue recognition principle indicates that companies recognize revenue as each performance obligation is satisfied. This occurs when the product is delivered – publication of the magazines is a necessary step in the process, but until the magazines are delivered, the performance obligation has not been satisfied.

(c) Recognition over time, as the magazines are delivered to customers, is appropriate. The revenue recognition principle indicates that companies recognize revenue as each performance obligation is satisfied. This occurs when the product is delivered, which is the case when the magazines are delivered to customers each month. When the customer pays for the annual subscription, the company has a performance obligation (a liability – Unearned Revenue) that is satisfied over time as magazines are published and delivered to customers.

(**Note to instructor:** CT 1.6 might also be assigned in conjunction with Chapter 17.)

LO: 3, Bloom: AP, Difficulty: Hard, Time: 25-30, AACSB: Analytic, Knowledge, AICPA BC: None, AICPA AC: Measurement Analysis and Interpretation, Reporting, AICPA PC: None

**CT 1.7**

(a) Some costs are recognized as expenses on the basis of a presumed direct association with specific revenue. This presumed direct association has been identified both as “associating cause and effect” and as “matching (expense recognition principle).”

Direct cause-and-effect relationships can seldom be conclusively demonstrated, but many costs appear to be related to particular revenue, and recognition of 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 period recog­nition in the accounting records. Only if the 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 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.

**CT 1.7 (Continued)**

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.

(c) A cost should be capitalized, that is, recorded as an asset when it is expected that the expenditure 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 with 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.

LO: 3, Bloom: AN, Difficulty: Hard, Time: 20-25, AACSB: Analytic, Knowledge, AICPA BC: None, AICPA AC: Measurement Analysis and Interpretation, Reporting, AICPA PC: Decision Making

**CT 1.8**

(a) Costs should be recognized as expiring in a given period if they are not chargeable to a prior period and do not apply to future periods. Recognition in the current period is required when any of the following conditions or criteria are present:

(1) A direct association of charges with revenue of the period, such as goods shipped to customers.

(2) An indirect association with the revenue of the period, such as insurance or rent.

(3) A period charge where no association with revenue in the future can be made, so the expense is charged this period, such as officers’ salaries, or a measurable expiration of asset costs during the period, even though not associated with the production of revenue for the current period, such as a fire or casualty loss.

**CT 1.8 (Continued)**

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

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

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

Close adherence to the expense recognition principle requires that cash dis­counts be recorded as a reduction of the cost of purchases and that inventories be priced at net invoice prices. Where inventories are priced at gross invoice prices for expediency, however, there is a slight distortion of the financial statements if the beginning and ending inventories are not materially different.

LO: 3, Bloom: AP, Difficulty: Hard, Time: 20-25, AACSB: Analytic, Knowledge, AICPA BC: None, AICPA AC: Measurement Analysis and Interpretation, Reporting, AICPA PC: Decision Making

**CT 1.9**

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

 (1) The alternative of expensing the costs of sample display houses in the period in which the expenditure is made is based primarily upon the expense recognition principle. 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 (do they meet the definition of an asset?). 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.

 (2) 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.

(b) 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.

**CT 1.9 (Continued)**

 (1) 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 that 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.

 (2) 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.

LO: 3, Bloom: AP, Difficulty: Moderate, Time: 20-30, AACSB: Analytic,, AICPA BC: Strategic Perspective, AICPA AC: Measurement, Reporting, AICPA PC: Decision Making

**CT 1.10**

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 representationally faithful.

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

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

These financial statements are also not representationally faithful. To be representationally faithful, 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 Ms. 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/Niece

LO: 2, Bloom: C, Difficulty: Moderate, Time: 20-30, AACSB: Knowledge, Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Communication, Decision Making

**CT 1.11**

(a) The stakeholders are investors, creditors, etc.; i.e., users of financial statements, current, and future.

(b) Honesty and integrity of financial reporting, job protection, profit.

(c) Applying the expense recognition principle and recording expense during the plant’s life, or not applying it. That is, record the mothball costs in the future.

(d) The major question may be whether or not the expense of mothballing can be estimated properly so that the integrity of financial reporting is maintained. Applying the expense recognition principle will result in lower profits and possibly higher rates for consumers. Could this cost anyone his or her job? Will investors and creditors have more useful information? On the other hand, failure to apply the expense recognition 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.

LO: 3, Bloom: E, Difficulty, Moderate, Time: 20-25, AACSB: Ethics, Analytic, AICPA BC: Strategic Perspective, AICPA AC: Reporting, AICPA PC: Professional Behavior, Decision Making

**CT 1.12**

1. Information about competitors might be useful for benchmarking the company’s results but if management does not have expertise in providing the information, it could be highly subjective. In addition, it is likely costly for management to gather sufficiently verifiable 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. 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 not be faithful representations, thereby detracting from any potential benefits. In addition, while management’s forecasts of future profitability or balance sheet amounts could be of benefit, companies could be subject to shareholder lawsuits if the amounts in the forecasted statements are not realized.

4. It would be excessively costly for companies to gather and report information that is not used in managing the business.

5. Flexible reporting allows companies to “fine-tune” their financial reporting to meet the information needs of its varied users. In this way, they can avoid the cost of providing information that is not demanded by its users.

6. Similar to number 3, concerning forecasted financial statements, if managers report forward-looking information, the company could be exposed to liability if investors unduly rely on the information in making investment decisions. Thus, if companies get protection from unwarranted lawsuits (called a safe harbor), then they might be willing to provide potentially beneficial forward-looking information.

LO: 3, 4, Bloom: AP, Difficulty: Moderate, Time: 30-35, AACSB: Analytic, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

**CT 1.13**

(a) Inclusion or omission of information that materially affects net income harms particular stakeholders. Accountants must recognize that their decision to implement (or delay) reporting requirements will have immediate consequences for some stakeholders.

(b) Yes. Because the FASB rule results in a fairer representation, it should be implemented as soon as possible—regardless of its impact on net income. SEC Staff Bulletin No. 74 (December 30, 1987) requires a statement as to what the expected impact of the standard will be.

(c) The accountant’s responsibility is to provide financial statements that present fairly the financial condition of the company. By advocating early implementation, Weller fulfills this task.

(d) Potential lenders and investors, who read the financial statements and rely on their fair represen-tation of the financial condition of the company have the most to gain by early implementation. A stockholder who is considering the sale of stock may be harmed by early implementation that lowers net income (and may lower the value of the stock).

LO: 4, Bloom:K, Difficulty: Hard, Time: 20-25, AACSB: Ethics, AICPA BC: Strategic Perspective, AICPA AC: Reporting, AICPA PC**:** Professional Behavior, Decision Making

**CT 1.14**

1. The public/private mixed approach is the way rules are established in the United States. In many respects, the FASB is a quasi-governmental agency in that its pronouncements are required to be followed because the SEC has provided support for this approach. The SEC has the ultimate power to establish GAAP but has chosen to permit the private sector to develop these rules. By accepting the standards established by the FASB as authoritative, it has granted much power to the FASB.

(b) Publicly reported accounting numbers influence the distribution of scarce resources. Resources are channeled where needed at returns commensurate with perceived risk. Thus, reported accounting numbers have economic effects in that resources are transferred among entities and individuals as a consequence of these numbers. It is not surprising then that individuals affected by these numbers will be extremely interested in any proposed changes in the financial reporting environment.

(c) The Accounting Standards Executive Committee (AcSEC of the AICPA), among other groups, has presented a potential challenge to the exclusive right of the FASB to establish accounting principles. Also, Congress has been attempting to legislate certain accounting practices, particularly to help struggling industries.

Some possible reasons why other groups might wish to establish GAAP are:

1. As indicated in the previous answer, these rules have economic effects and therefore certain groups would prefer to make their own rules to ensure that they receive just treatment.

2. Some believe the FASB does not act quickly to resolve accounting matters, either because it is not that interested in the subject area or because it lacks the resources to do so.

3. Some argue that the FASB does not have the competence to legislate GAAP in certain areas. For example, many have argued that the FASB should not legislate GAAP for not-for-profit enterprises because the problems are unique and not well understood by the FASB.

LO: 2, 4 Bloom:C, Difficulty: Simple, Time: 15-20, AACSB: Knowledge, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC:None

**CT 1.15**

(a) Considering the economic consequences of GAAP, it is not surprising that special interest groups become vocal and critical (some supporting, some opposing) when rules are being formulated. The FASB’s derivative accounting pronouncement is no exception. Many from the banking industry, for example, criticized the rule as too complex and leading to unnecessary earnings volatility. They also indicated that the proposal may discourage prudent risk management activities and in some cases could present misleading financial information.

As a result, Congress is often approached to put pressure on the FASB to change its rulings. In the stock option controversy, industry was quite effective in going to Congress to force the FASB to change its conclusions. In the derivative controversy, Rep. Richard Baker introduced a bill that would force the SEC to formally approve each standard issued by the FASB. Not only would this process delay adoption, but could lead to additional politicization of the rule-making process. Dingell commented that Congress should stay out of the rule-making process and defended the FASB’s approach to establishing GAAP.

(b) Attempting to set GAAP by a political process will probably lead to the following consequences:

(a) Too many alternatives.

(b) Lack of clarity that will lead to inconsistent application.

(c) Lack of disclosure that reduces transparency.

(d) Not comprehensive in scope.

Without an independent process, GAAP will be based on political compromise. A classic illustration is what happened in the savings and loan industry. Applying generally accepted accounting principles to the S&L industry would have forced regulators to restrict activities of many S&Ls. Unfortunately, accounting principles were overridden by regulatory rules and the resulting lack of transparency masked the problems. William Siedman, former FDIC Chairman noted later that it was “the worst mistake in the history of government.”

Another indication of the problem of government intervention is shown in the accounting standards used by some countries around the world. Completeness and transparency of information needed by investors and creditors are not available in order to meet or achieve other objectives.

LO: 4, Bloom:C, Difficulty: Moderate, Time: 25-30, AACSB: None, AICPA BC: Governance Perspective, AICPA AC: Reporting, Research, AICPA PC:None

**CT 1.16**

(a) The “due process” system involves the following:

1. Identifying topics and placing them on the FASB’s agenda.

2. Research and analysis are conducted and preliminary views of pros and cons are issued.

3. A public hearing is often held.

4. The FASB evaluates research and public responses and issues exposure draft.

5. The FASB evaluates responses and changes the exposure draft if necessary. The final statement is then issued.

(b) Economic consequences mean the impact of accounting reports on the wealth positions of issuers and users of financial information and the decision-making behavior resulting from that impact.

(c) Economic consequences indicated in the letter are (1) concerns related to the potential impact on the capital markets, (2) the weakening of companies’ ability to manage risk, and (3) the adverse control implications of implementing costly and complex new rules imposed at the same time as other major initiatives, including the Year 2000 issues and a single European currency.

**CT 1.16 (Continued)**

(d) The principal point of this letter is to delay the finalization of the derivatives standard. As indicated in the letter, the authors of this letter urge the FASB to expose its new proposal for public comment, following the established due process procedures that are essential to acceptance of its standards and providing sufficient time for affected parties to understand and assess the new approach. (Authors note: The FASB indicated in a follow-up letter that all due process procedures had been followed and all affected parties had more than ample time to comment. In addition, the FASB issued a follow-up standard, which delayed the effective date of the standard, in part to give companies more time to develop the information systems needed for implementation of the standard).

(e) The reason why the letter was sent to Congress was to put additional pressure on the FASB to delay or drop the issuance of a rule on derivatives. Unfortunately, in too many cases, when the business community does not like the answer proposed by the FASB, it resorts to lobbying members of Congress. The lobbying efforts usually involve developing some type of legislation that will negate the rule. In some cases, efforts involve challenging the FASB’s authority to develop rules in certain areas with additional Congressional oversight.

LO: 4, Bloom:E, Difficulty: Moderate, Time: 25-30, AACSB: Communication, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC:Communication

# Solutions to Codification Exercises

**CE1.1**

The information at this link describes the elements offered in The FASB Accounting Standards Codification. As indicated, the website offers several resources to enhance your working knowledge of the Codification and the Codification Research System. This page includes links to help pages that describe specific functions and features of the Codification. Links to frequently asked questions, the FASB Learning Guide, and the Notice to Constituents are also available on this page.

 Help pages

 FAQ

 Learning Guide

 About the Codification—Notice of Constituents

LO: 3, Bloom:K, Difficulty: Simple, Time: 5-10, AACSB: Technology, AICPA BC: None, AICPA AC: Research, Reporting, Technology and Tools, AICPA PC:Communication

**CE1.2**

The following information is provided at the Providing Feedback link:

The Codification includes a feature that can be used to submit content-related feedback or general, system-related comments. The feedback system is not designed for comments on proposed Accounting Standards Updates.

**Content-related feedback**

As a registered user of the FASB Accounting Standards Codification Research System website, you are able and are encouraged to provide feedback, at the paragraph level, to the FASB about any content-related matters. For specific information about the Codification and the feedback process, please read the Notice to Constituents.

**To provide content-related feedback:**

Click the Submit feedback button beneath the paragraph for which you want to provide feedback. Enter or copy/paste your comments in the text box. Note that formatting (lists, bold, etc.) is not retained and there is a 4,000 character limit on feedback submissions.

Click SUBMIT. Your comments are sent to the FASB and reviewed by FASB staff. You can also submit multiple comments for any given paragraph, if, for example, you determine that more information would be useful to the FASB staff.

**General feedback**

Click here to provide general feedback on the Codification in general, the Codification Research System website, and other system-related items that are not content-specific.

LO: 3, Bloom:K, Difficulty: Simple, Time: 10-15, AACSB: Communication, Technology, AICPA BC: None, AICPA AC: Research, Reporting, Technology and Tools, AICPA PC:Communication

**CE1.3**

The “What’s New” page provides links to Codification content that has been recently issued. During the verification phase, updates may result from either the issuance of Codification update instructions that accompany new Standards or from changes to the Codification due to incorporation of constituent feedback.

LO: 3, Bloom:K, Difficulty: Simple, Time: 5-10, AACSB: Communication, Technology, AICPA BC: None, AICPA AC: Research, Reporting, Technology and Tools, AICPA PC:Communication

**CE1.4**

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

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

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

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

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

 This definition relates to segment reporting requirements for public companies.

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

LO: 2, 3, Bloom: K, Difficulty: Simple, Time: 10-15, AACSB: Communication, Technology, AICPA BC: None, AICPA AC:Research, Reporting, Technology and Tools, AICPA PC: Communication

**CE1.5**

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

LO: 2, Bloom: K, Difficulty: Simple, Time: 5, AACSB: Communication, Technology, AICPA BC: None, AICPA AC:Reporting,Research, Technology and Tools, AICPA PC: Communication

# Solutions to Codification Research Case

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

**(a) According to Concepts Statement 8 (CON 8, Chapter 3): Qualitative Characteristics of Accounting Information, “Glossary”:**

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

**(b) CON 8 refers to several SEC cases which apply materiality. Students might also research SEC literature (e.g. Staff Accounting Bulletin No. 99), although SEC literature is not in the FARS database.**

**CON 8, Chapter 3. provides the following examples of screens that might be used to determine materiality:**

 **a. An accounting change in circumstances that puts an enterprise in danger of being in breach of a covenant regarding its financial condition may justify a lower materiality threshold than if its position were stronger.**

 **b. A failure to disclose separately a nonrecurrent item of revenue may be material at a lower threshold than would otherwise be the case if the revenue turns a loss into a profit or reverses the trend of earnings from a downward to an upward trend.**

 **c. A misclassification of assets that would not be material in amount if it affected two categories of plant or equipment might be material if it changed the classification between a noncurrent and a current asset category.**

 **d. Amounts too small to warrant disclosure or correction in normal circumstances may be considered material if they arise from abnormal or unusual transactions or events.**

**Codification Research Case (Continued)**

**However, the FASB notes that more than magnitude must be considered in evaluating materiality:**

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

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

**(c) SFAC No. 6, Paras. 20-21. The two classes of elements are related in such a way that (a) assets, liabilities, and equity are changed by elements of the other class and at any time are their cumulative result and (b) an increase (decrease) in an asset cannot occur without a corresponding decrease (increase) in another asset or a corresponding increase (decrease) in a liability or equity. Those relationships are sometimes collectively referred to as “articulation.” They result in financial statements that are fundamentally interrelated so that statements that show elements of the second class depend on statements that show elements of the first class and vice versa.**

LO: 3, Bloom: C, Moderate, Time: 25-30, AACSB: Communication, AICPA BC: None, AICPA AC: Measurement Analysis and Interpretation, Reporting, Research, Technology and Tools, AICPA PC: Communication