Appendix B

Accounting Principles

Learning Objectives

LO 1 Describe a rules-based and a principles-based approach toward accounting standards.

LO 2 Define the primary objective of financial reporting.

LO 3 Discuss qualitative characteristics of useful accounting information.

LO 4 Describe assumptions underlying useful accounting information.

LO 5 Explain principles of useful accounting information.

LO 6 Describe constraints on useful accounting information.

APPENDIX PREVIEW

For accounting information to be useful, it must possess certain qualitative characteristics. The purpose of this appendix is to provide a conceptual framework for accounting principles that is desirable for accounting information.

Accounting Principles

- **Qualitative Characteristics**
  - Relevance
  - Reliability
  - Comparability
  - Consistency
- **Assumptions**
  - Business entity
  - Periodicity
  - Going concern
  - Monetary unit
- **Principles**
  - Cost
  - Matching
  - Revenue recognition
  - Full disclosure
- **Constraints**
  - Cost-benefit
  - Materiality
  - Conservatism

Rules-Based versus Principles-Based Accounting

LO1 Describe a rules-based and a principles-based approach toward accounting standards.

U.S. accounting practices are often viewed as *rules-based* (as mentioned in Chapter 1). This means that companies are required to apply technical, specific, and detailed rules in preparing financial statements and reports. A *principles-based* approach is sometimes argued as preferable. A principles-based system would develop and apply broad, fundamental concepts for accounting. Companies would have more flexibility in preparing principles-based financial statements to meet the intent of the accounting principle rather than just the specific accounting rule.

For example, a broad accounting principle might be that a company must report all debt it might have to repay. Certain executives of **Enron** were able to mislead investors by not reporting some of its debt. While many of Enron's reports technically followed rules-based standards, the reports failed to adequately disclose all of its debts. As another example, a broad principle might be that a company must report all of its building leases that it is contractually obligated to pay as a liability on its balance sheet. Executives of many retail companies (such as **Wal-Mart** and **Payless Shoe Source**) follow the rules-based standards of accounting for leases. Their balance sheets generally fail to comprehensively report all of the leases that each company is required to pay. In both instances, while the rules are technically followed, the accounting has not achieved the intent of the standards.

Sarbanes-Oxley Act and Principles-Based Accounting

As a result of the Enron scandal and other abuses of rules-based accounting practices, the **Sarbanes-Oxley Act** requires the **Securities and Exchange Commission,** the government group that establishes financial reporting requirements, to study the feasibility of shifting to a more "principles-based" approach. The **Financial Accounting Standards Board,** the private group that sets standards for accounting practice, has also proposed changes designed to create a more principles-based approach to accounting standards. Many accounting experts believe that a change to principles-based standards will force companies preparing financial statements to focus on the intent of accounting standards rather than just technical compliance with the rules. On the other side of the debate, some accounting experts worry that a shift to principles-based standards will lead to lawsuits as shareholders and companies fight over the true intent of the standards.

A principles-based system requires a sound conceptual framework. To more fully understand the principles-based approach, the existing conceptual framework of accounting principles is presented in this appendix.

Objectives of Financial Reporting

LO2 Define the primary objective of financial reporting.

External financial statements users, such as investors and creditors, use accounting information in financial reports to make decisions (such as whether to buy or sell a stock or extend a loan). To assist in decision making, accounting reports must possess useful information.

The primary objective of financial reporting is to provide useful economic information to assist decision makers. There are many elements of accounting information. Exhibit B.1 provides a pyramid detailing the framework of qualitative characteristics, assumptions, principles, and constraints for providing useful accounting information.

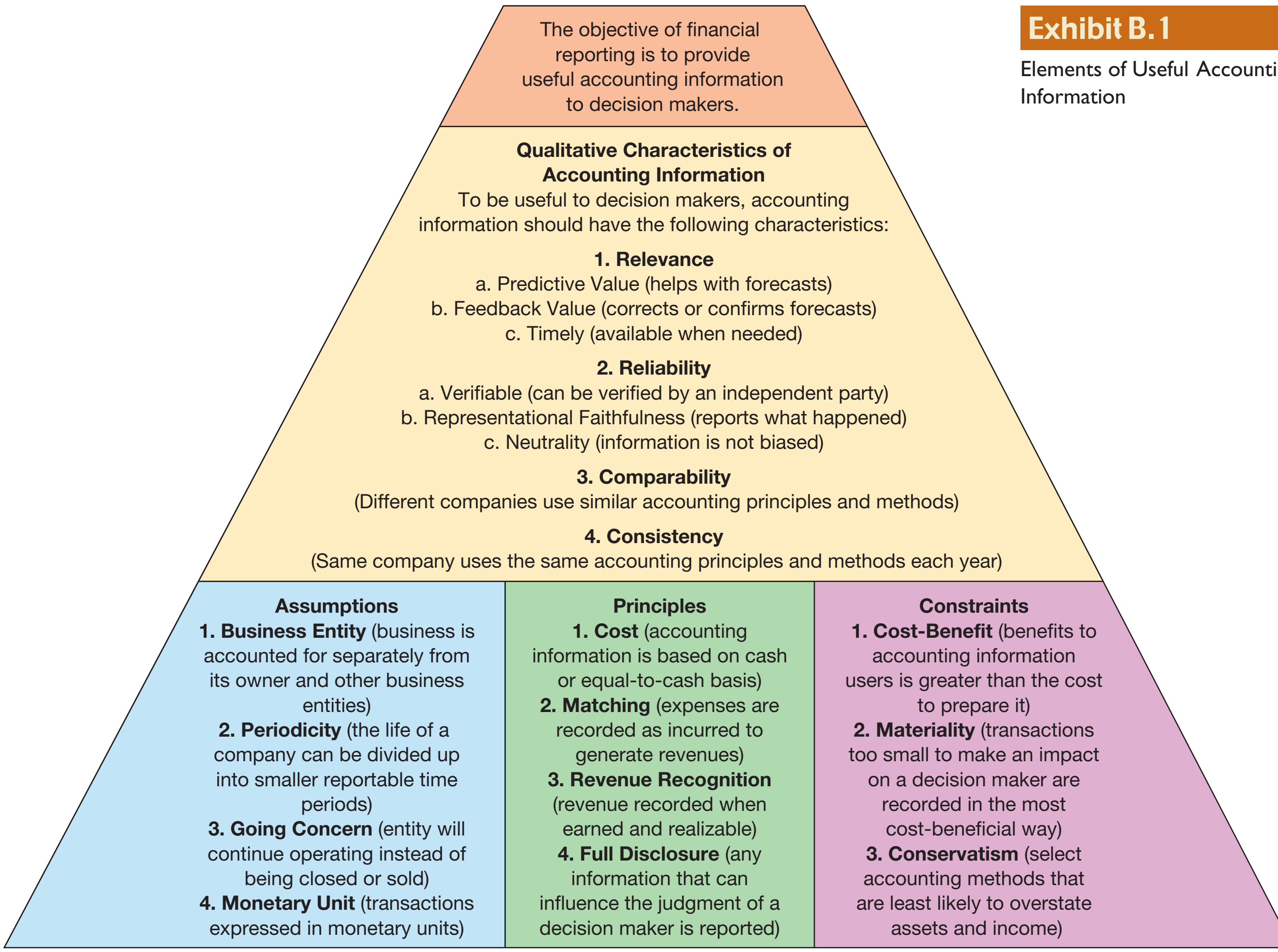


Exhibit B.1
Elements of Useful Accounting Information

Qualitative Characteristics of Useful Accounting Information

As noted in Exhibit B.1, to be useful, accounting information must be relevant, reliable, comparable, and consistent across time. Exhibit B.2 provides an illustration of these qualitative characteristics.

Relevance

LO3 Discuss qualitative characteristics of useful accounting information.

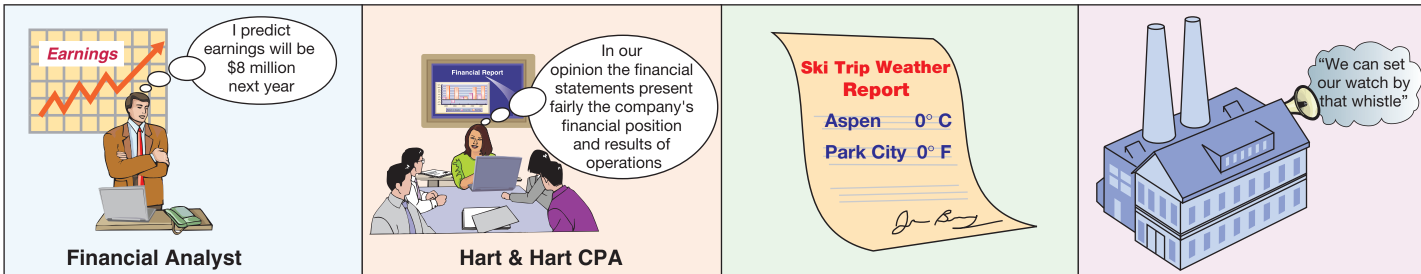
To provide useful information, that information must be **relevant** to the decision maker. Information is relevant if it would make a difference in a business decision. Information is relevant when it helps users predict the future (*predictive value*) or evaluate the past (*feedback value*) and is received in time to affect their decisions (*timeliness*).

Reliability

Information is **reliable** if users can depend on it to be free from bias and error. Reliable information is *verifiable* and *faithfully represents* the substance of the underlying economic transaction. If **Best Buy** sold a television for $4,000, it should be reported in its sales revenue as

Exhibit B.2

Qualitative Characteristics of Useful Accounting Information



Relevance	Reliability	Comparability	Consistency
1. Aid forecasting 2. Correct expectations 3. Timely	1. Is verifiable 2. Faithfully reflect reality 3. Unbiased	Different companies use similar accounting methods and principles	Company uses same accounting methods and principles year after year

$4,000. Reliable accounting information is neutral, or free from bias. In other words, accounting information should not be designed to lead accounting information users to accept or reject any specific decision alternative.

Comparability

Information is **comparable** if it helps users to identify differences and similarities between companies. Comparability is possible only if companies follow similar accounting methods and practices. However, even if all companies uniformly follow the same accounting practices, comparable reports do not result if the practices are not appropriate. For example, comparable information would not be provided if all companies were to ignore the useful lives of their assets and depreciate all assets over two years.

Comparability is often harder for cross-country comparisons. Suppose we want to make an investment in an automobile manufacturer such as **Daimler Chrysler**, a German company, or **Toyota**, a Japanese company. Since each of these countries has its own set of accounting rules and methods, a direct comparison will be difficult. The **International Accounting Standards Board** has been established to help harmonize accounting practices across countries.

Consistency

Accounting information users generally look at multiple time periods of a company's financial statements to see if there are any noticeable trends. To make this comparison over multiple periods, the same accounting principles and methods should be used in each period. Otherwise, it is hard to know if changes over time are due to real fundamental changes in financial performance or are simply because the company changed the way it accounted for certain items. Applying the same accounting information methods and practices over time is known as **consistency.**

Underlying Accounting Assumptions

LO4 Describe assumptions underlying useful accounting information.

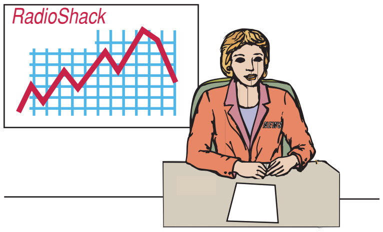
Four assumptions underlie the overall objective of providing useful information to decision makers. These are the business entity assumption, the periodicity assumption, the going concern assumption, and the monetary unit assumption.

Business Entity Assumption

Abuse of the business entity assumption was a main culprit in the collapse of **Enron.**

The **business entity assumption** means that a business is accounted for separately from other business entities, including its owner. The reason for this principle is that separate information about each business is necessary for good decisions. A business entity can take one of three legal forms: *proprietorship, partnership,* or *corporation.*

Periodicity Assumption



"RadioShack announces earnings per share of . . ."

A component of providing relevant and useful information is that it must be timely. Useful information must reach decision makers frequently and promptly. To provide timely information, accounting systems prepare reports at regular intervals. This results in an accounting process impacted by the periodicity (or time period) principle. The **periodicity assumption** is that an organization's activities can be divided into specific time periods such as a month, a three-month quarter, a six-month interval, or a year.

Going-Concern Assumption

The **going-concern assumption** means that accounting information reflects an assumption that the business will continue operating instead of being closed or sold. This implies, for example, that a factory facility is reported at cost instead of, say, liquidation values that assume immediate, involuntary closure.

IN THE NEWS

Principles and Scruples Auditors, directors, and lawyers are using principles to improve accounting reports. Examples include financial restatements at **Delphi**, accounting reviews at **Echostar**, and expense adjustments at **Electronic Data Systems**. Principles-based accounting has led accounting firms to drop clients deemed too risky.

Monetary Unit Assumption

The **monetary unit assumption** means that we can express transactions and events in monetary, or money, units. Money is the common denominator in business. Examples of monetary units are the dollar in the United States, Canada, Australia, and Singapore; the pound sterling in the United Kingdom; and the peso in Mexico, the Philippines, and Chile. The monetary unit assumption also means that financial statement amounts are typically not adjusted for the effects of inflation.

For currency conversion: **www.xe.com**

HOW YOU DOIN'?

Answers—p. B-8

1. Why is it important to have comparable accounting methods between companies?
2. Why is the business entity assumption important?
3. Why is the going-concern assumption important?

Accounting Principles

LO5 Explain principles of useful accounting information.

Accounting relies on four key principles (as illustrated in Exhibit B.1): cost, matching, revenue recognition, and full disclosure.

Cost Principle

The **cost principle** means that accounting information is based on actual cost. Cost is measured on a cash or equal-to-cash basis. This means if cash is given for a service, the transaction's cost is measured as the amount of cash paid. If something besides cash is exchanged (such as a car traded for a truck), the transaction's cost is measured as the cash value of what is given up or received. The cost principle emphasizes reliability, and information based on cost is considered objective. To illustrate, suppose a company pays $5,000 for equipment. The cost principle requires that this purchase be recorded at a cost of $5,000. It makes no difference if the owner thinks this equipment is now worth $7,000.

The cost principle is also called the *historical cost principle.*

Matching Principle

The **matching principle** prescribes that expenses be reported in the same period and on the same income statement as the revenues that were earned as a result of those expenses. To illustrate, suppose a business provides traffic consulting services to a municipal client. All of the expenses (consultant labor, computer use, copies, travel, presentation preparation, use of office space) incurred to complete those consulting services should be recorded in the same period as the consulting services.

Sometimes, it is difficult to match each expense with its related revenue. There are three general guidelines that are used in applying the matching principle (with examples):

Guideline	Example
• Cause and effect	Expenses directly incurred to generate revenue such as consultant labor
• Systematic and rational allocation	Depreciation of office equipment and office space
• Immediate recognition of some costs with uncertain future benefits	Advertising, salary of consultant's supervisor

Revenue Recognition Principle

When a bookstore sells a textbook on credit is its earnings process complete? *Answer:* The bookstore can record sales for these books minus an amount expected for book returns.

Revenue (sales) is the amount received from selling products and services. The **revenue recognition principle** provides guidance on when a company must recognize revenue. To *recognize* revenue means to record it. If revenue is recognized too early, a company would look more profitable than it is. If revenue is recognized too late, a company would look less profitable than it is. The following three concepts are important to revenue recognition. (1) *Revenue is recognized when earned*. The earnings process is normally complete when services are performed or a seller transfers ownership of products to the buyer. (2) *Proceeds from selling products and services need not be in cash*. A common noncash proceed received by a seller is a customer's promise to pay at a future date, called *credit sales*. (3) *Revenue is measured by the cash received plus the cash value of any other items received*.

IN THE NEWS

Revenues for the **New England Patriots** football team include ticket sales, television and cable broadcasts, radio rights, concessions, and advertising. Revenues from ticket sales are earned when the Patriots play each game. Advance ticket sales are not revenues; instead, they represent a liability until the Patriots play the game for which the ticket was sold.

Full Disclosure Principle

Companies have many choices on what information to report. The **full disclosure principle** requires that all accounting information important enough to affect a decision be presented. Such accounting information may be disclosed in the financial statements, footnotes to the financial statements, or as supplementary information. There is always the possibility that too much information or too much detail will overwhelm the user. Therefore, companies try to be clear but concise.

Accounting Constraints

LO6 Describe constraints on useful accounting information.

All of the assumptions and principles discussed thus far help accountants provide useful information to decision makers. However, providing all of this quality information can be too costly to the company. There is a balance between providing sufficient information to the decision maker without being too costly to the company preparing the accounting information. There are three constraints to providing useful information to the decision maker: cost-benefit, materiality, and conservatism.

Cost-Benefit

The benefit to decision makers of receiving accounting information must be worth the cost of providing it. The **cost-benefit** trade-off suggests that information will be provided only if the benefits to users outweigh the costs of preparing and disclosing it.

However, the costs and benefits are not always easy to compute. Moreover, the costs are usually borne by the company, and the benefits are received by a diverse set of decision makers across the world. Still, it is useful to try to carefully consider the costs and benefits before producing or requiring the disclosure of additional accounting information.

Materiality

Materiality asks the question: Is the item big enough to make an impact on the decision maker? If the item is not big enough to make a difference, then **generally accepted accounting principles (GAAP)** do not have to be followed. To illustrate, if **RadioShack** makes a $10 mistake in recording an expense when its overall expenses are $10 billion, the $10 error is most likely not a material item and GAAP need not be followed.

Conservatism

Conservatism suggests that when faced with two equally plausible accounting method choices (or estimates), the company should choose the accounting method (or estimate) that is least likely to overstate assets and income or to understate liabilities and expenses. Managers are generally optimistic, and this constraint offsets that optimism to help present a more conservative view of a company's financial position. The general concept can be summarized in this way: if in doubt, recognize all losses but do not recognize any gains.

A common example of conservatism is in the valuation of inventory. Inventories are usually recorded at their cost. However, if the market value of the inventory falls below its cost, conservatism requires that inventories be written down to the market value. To illustrate, consider a company that sells computer systems. Due to the quick technology advances and declining prices of new computer hardware, if a computer does not sell relatively quickly, the market value can fall below the cost to manufacture and sell it. Due to conservatism, the computer is written down to its market value.

HOW YOU DOIN'? Answers—p. B-8

4. Why is the revenue recognition principle important?

5. Do you think a $10 million error would be material in a company with $100 million in sales?

Summary

LO1 Describe a rules-based and a principles-based approach toward accounting standards. The rules-based approach implies that companies are required to apply technical, specific, and detailed rules in preparing financial statements and reports. The principles-based approach develops and applies broad, overarching, and fundamental concepts for accounting.

LO2 Define the primary objective of financial reporting. The primary objective of accounting is to provide useful economic information to assist decision makers to make decisions.

LO3 Discuss qualitative characteristics of useful accounting information. The qualitative characteristics of useful accounting information are that the information must be relevant, reliable, comparable, and consistent. Information is relevant if it would make a difference in a decision. Reliable information is information that can be depended on. Companies can be compared to each other if they use the same accounting methods and principles. Consistency is met when firms apply the same accounting methods and principles year after year.

LO4 Describe assumptions underlying useful accounting information. There are several underlying assumptions to support the overall objective of providing useful information to decision makers including the business entity assumption, the periodicity assumption, the going concern assumption, and the monetary unit assumption.

LO5 Explain principles of useful accounting information. Accounting principles help make accounting information useful to decision makers. They include the cost, matching, revenue recognition, and full disclosure principles.

LO6 Describe constraints on useful accounting information. There are three constraints to providing useful information to decision makers. The benefits of the accounting information must be greater than the costs, the accounting information must be material, and the accounting choices must be conservative.

Guidance Answers to HOW YOU DOIN'?

1. Comparable accounting information provides a similar measuring stick for both companies to assess their relative financial performance. If companies have different accounting methods, there is no way to compare them. It would be like comparing apples to oranges.
2. Users desire information about the performance of a specific entity. If information is mixed between two or more entities, its usefulness decreases.
3. Many of the elements of the financial statements assume that company will continue in operation. This allows them to be valued at cost on the balance sheet rather than being sold at liquidation prices.
4. The revenue recognition principle gives guidelines of when to recognize (record) revenue. This is important; for example, if revenue is recognized too early, the financial statements report revenue sooner than it should and the business looks more profitable than it is. The reverse is also true.
5. Yes, this would be considered to be a material item since it represents 10% of the firm's sales, suggesting it would make a difference on a decision maker's decisions.

Key Terms

Business entity assumption (p. B-4) Concept that assumes a business will be accounted for separately from its owner(s) and any other entity.

Comparability (p. B-4) A qualitative characteristic of accounting information suggesting that information is more useful if it can be related to an industry or competitor benchmark.

Conservatism (p. B-7) Concept that prescribes use of the less optimistic estimate when two estimates are about equally likely.

Consistency (p. B-4) A qualitative characteristic of accounting information that prescribes use of the same accounting method(s) and practice(s) over time so that financial statements are comparable across periods.

Cost-benefit (p. B-7) A constraint of useful accounting information prescribing that information will be provided only if the benefits to users outweigh the costs of preparation.

Cost principle (p. B-5) Accounting principle that prescribes financial statement information to be based on actual costs incurred in business transactions.

Financial Accounting Standards Board (FASB) (p. B-2) Independent group of full-time members responsible for setting accounting rules.

Full disclosure principle (p. B-6) Principle that prescribes financial statements (including notes) to report all relevant information about an entity's operations and financial condition.

Generally Accepted Accounting Principles (GAAP) (p. B-7) Rules that specify acceptable accounting practices.

Going-concern assumption (p. B-5) Concept that prescribes financial statements to reflect the assumption that the business will continue operating indefinitely.

International Accounting Standards Board (IASB) (p. B-4) Group that identifies preferred accounting practices and encourages global acceptance; issues International Financial Reporting Standards (IFRS).

Matching principle (p. B-6) Prescribes expenses to be reported in the same period as the revenues that were earned as a result of the expenses.

Materiality (p. B-7) Prescribes that accounting for items that markedly impact financial statements, and any inferences drawn from them, adhere to GAAP.

Monetary unit assumption (p. B-5) Concept that assumes transactions and events can be expressed in money units.

Periodicity assumption (p. B-5) The life of a company can be divided up into smaller, reportable time periods.

Relevance (p. B-3) A qualitative characteristic of accounting information that prescribes that information be useful, understandable, timely, and pertinent for decision making.

Reliability (p. B-3) The principle that information is verifiable and faithfully represents the substance of the underlying economic transaction.

Revenue recognition principle (p. B-6) The principle prescribing that revenue is recognized when earned.

Sarbanes-Oxley Act (p. B-2) Created the *Public Company Accounting Oversight Board,* regulates analyst conflicts, imposes corporate governance requirements, enhances accounting and control disclosures, impacts insider transactions and executive loans, establishes new types of criminal conduct, and expands penalties for violations of federal securities laws.

Securities and Exchange Commission (SEC) (p. B-2) Federal agency Congress has charged to set reporting rules for organizations that sell ownership shares to the public.

Multiple Choice Quiz

Answers on p. B-12 mhhe.com/wildCA2e

Additional Multiple Choice Quizzes are available at the book's Website.

1. The principle that prescribes that a business be accounted for separately and distinctly from its owner or owners is known as the:
   a. Matching principle.
   b. Business entity assumption.
   c. Going-concern assumption.
   d. Revenue recognition principle.
   e. Cost principle.
2. The rule that prescribes financial statements reflect the assumption that the business will continue operating instead of being closed or sold, unless evidence shows that it will not continue, is the:
   a. Going-concern assumption.
   b. Business entity assumption.
   c. Matching principle.
   d. Cost Principle.
   e. Monetary unit assumption.

3. To include the personal assets and transactions of a business's owner in the records and reports of the business would conflict with the:
   a. Matching principle.
   b. Realization principle.
   c. Business entity assumption.
   d. Going-concern assumption.
   e. Revenue recognition principle.

4. The accounting principle that prescribes accounting information be based on actual cost and requires assets and services to be recorded initially at the cash or cash-equivalent amount given in exchange, is the:
   a. Accounting equation.
   b. Cost principle.
   c. Going-concern assumption.
   d. Revenue recognition principle.
   e. Business entity assumption.

5. The qualitative characteristic of reliability:
   a. Means that information is supported by independent, unbiased evidence.
   b. Means that information can be based on what the preparer thinks is true.
   c. Means that financial statements should contain information that is optimistic.
   d. Means that a business may not reorganize revenue until cash is received.
   e. All of the above.

Discussion Questions

1. Describe the four key qualitative characteristics of useful accounting information.

2. Why is the business entity assumption important?

3. Why is the matching principle important?

4. What are the three basic forms of business organization?

5. What does the reliability characteristic imply for information reported in financial statements?

6. A business reports its own office stationery on the balance sheet at its $400 cost, although it cannot be sold for more than $10 as scrap paper. Which accounting principle(s) justifies this treatment?

7. What is **Best Buy**'s revenue recognition policy (as detailed in the footnotes to its financial statements [page A-11])?

8. By examining **RadioShack**'s financial statements in Appendix A, what evidence is there that the company follows the matching principle?

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QUICK STUDY

QS B-1
Identifying characteristics of accounting information LO3

Identify the following characteristics of useful accounting information as being a component of either Relevant (R) or Reliable (L). (*Hint:* Refer to Exhibit B.1.)

1. Timeliness
2. Verifiable
3. Representational Faithfulness
4. Predictive Value
5. Feedback Value
6. Neutrality

QS B-2
Terminology of the characteristics of accounting information LO3

Fill in the blanks with appropriate accounting terminology.

1. Accounting information is ____________ if different companies use similar accounting principles.
2. Information is ____________ if it would make a difference in a business decision.
3. Accounting information is ____________ if the same company uses the same accounting methods year after year.
4. Information is reliable if users can depend on it to be free from ____________ and error.

QS B-3
Assumptions underlying useful accounting information LO4

Identify the appropriate assumption underlying useful accounting information for each description 1 through 4.

1. Hancock Hats reports its sales on a monthly basis.
2. Joann Hancock, owner of Hancock Hats, keeps the accounting records of her business separate from her personal accounts.
3. Hancock Hats reports its financial statements assuming it will continue to be in business for the foreseeable future.
4. Hancock Hats expresses its financial statements using the U.S. dollar.

QS B-4
Principles of useful accounting information LO5

Identify the appropriate accounting principle for each description 1 through 4.

1. Callahan's Castles records expenses incurred to produce revenues in the accounting period.
2. Callahan's Castles discloses all information about pension expenses that can influence the decision maker.
3. Callahan's Castles records sales on its toy castles when they are delivered to the customer.
4. Callahan's Castles records its computer equipment at its acquisition cost.

QS B-5
Constraints of useful accounting information LO6

Fill in the blanks with appropriate accounting terminology.

1. ____________ suggests that transactions that are too small to make an impact on a decision maker are recorded in the most cost beneficial way.

2. Conservatism suggests that accounting methods be selected that are least likely to ______________ assets and income.

3. The _________-benefit constraint suggests that the benefits to receiving accounting information than the costs to prepare it.

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EXERCISES

Exercise B-1
Identifying accounting principles or assumptions LO4 LO5

Identify which general accounting principle best describes each of the following practices.

a. In December 2009, Chavez Landscaping received a customer's order and cash prepayment to install sod at a new house that would not be ready for installation until March 2010. Chavez should record the revenue from the customer order in March 2010, not in December 2009.

b. If \$51,000 cash is paid to buy land, the land is reported on the buyer's balance sheet at \$51,000.

c. Jo Keene owns both Sailing Passions and Dockside Supplies. In preparing financial statements for Dockside Supplies, Keene makes sure that the expense transactions of Sailing Passions are kept separate from Dockside's statements.

Exercise B-2
Rules-based vs. principles-based accounting LO1 LO3

Target Corporation follows accounting rules in reporting its lease obligations. However, the vast majority of Target's obligations for its store leases are not reported as liabilities on Target's balance sheet. Similar to other retail establishments, Target structures its leases to avoid reporting lease liabilities on the balance sheet.

1. Why does Target Corp. wish to avoid reporting its store leases on the balance sheet?

2. Would a principles-based approach continue to allow Target Corp. to avoid reporting its store leases on the balance sheet?

3. Which qualitative characteristic(s) of accounting information is violated when Target Corp. avoids reporting its store leases on the balance sheet?

Exercise B-3
Identifying accounting principles LO4 LO5

Match each of the numbered descriptions with the principle it best reflects. Indicate your answer by writing the letter for the appropriate principle in the blank space next to each description.

A. Cost principle
B. Business entity principle
C. Revenue recognition principle
D. Going-concern principle

______ **1.** Financial statements reflect the assumption that the business continues operating.
______ **2.** Every business is accounted for separately from its owner or owners.
______ **3.** Revenue is recorded only when the earnings process is complete.
______ **4.** Information is based on actual costs incurred in transactions.

Exercise B-4
Identifying accounting principles and assumptions LO4 LO5

You are reviewing the accounting records of Cathy's Antiques, owned by Cathy Miller. You have uncovered the following situations. Cite the appropriate accounting principle or assumption and suggest an action for each separate item.

1. In August, a check for \$500 was written to Wee Day Care Center; this amount represents child care for her son Brandon.

2. Cathy plans a Going Out of Business Sale for May, since she will be closing her business for a month-long vacation in June. She plans to reopen July 1 and will continue operating Cathy's Antiques indefinitely.

3. Cathy received a shipment of pine furniture from Quebec, Canada; the invoice was stated in Canadian dollars.

4. Joseph Clark paid \$1,500 for a dining table; the amount was recorded as revenue. The table will be delivered to Mr. Clark in six weeks.

Exercise B-5
Identifying accounting principles and assumptions
LO3 LO4 LO5

Match each of the numbered transactions to the accounting terms A through E applicable to recording and reporting them.

A. Business entity assumption
B. Reliability
C. Cost principle
D. Monetary unit assumption
E. Revenue recognition principle

_______ **1.** An insurance company receives insurance premiums for six future months' worth of coverage.
_______ **2.** A building is for sale at $480,000; an appraisal is given for $450,000.
_______ **3.** Helen Cho, a sole proprietor, pays for her daughter's preschool out-of-business funds.
_______ **4.** Mayan Imports receives a shipment from Mexico; the invoice is stated in pesos.
_______ **5.** To make the balance sheet look better, Helen Cho added several thousand dollars to the Equipment account that she believed was undervalued.

Exercise B-6
Identifying qualitative characteristics LO3

Fill in the blanks with the appropriate accounting terms or phrases.

1. ______________ means that a company applies the same concept year after year.
2. For information to be relevant, it should have predictive or feedback ______________, and it must be presented in a ______________ manner.
3. ______________ is the quality of information that suggests it can be depended on to represent reality, be verifiable and not be biased.
4. ______________ means that two companies can be assessed relative to each other.

Exercise B-7
Identifying constraints of providing useful information LO6

1. Pagnozzi Properties is trying to decide if it needs to install a new accounting system to keep track of every detailed construction cost. The cost of the system will be $20,000 and the benefits are uncertain.
2. Gary Peters makes a $20 mistake when accounting for travel expenses. He has a question of whether this mistake needs to be corrected since it is relatively small.
3. Manuel Sanchez wants to know which accounting choice to make when accounting for consulting expenses at the end of the year. He decides that when in doubt, it would be better to understate rather than overstate net income.

In each case 1 through 3, identify the constraint that each of these statements addresses.

Exercise B-8
Identifying constraints violated
LO6

1. Inventory is reported at market value when cost is lower.
2. Computers costing less than $1,000 are immediately expensed even though their useful life is three years.
3. The auditors of Dietrich Co. found an error of $50 in its financial statements and decide to restate their financial statements; Dietrich has sales revenue of $15 million.
4. To appropriately account for the pension liability, Ziebart Co. installs an abnormally expensive system to track employees, their health, and their pension status. Ziebart argues that this system is necessary to comply with accounting guidelines.

Indicate the accounting constraint, if any, that is violated by each practice.

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PROBLEM SET A

Problem B-1A
Identify accounting assumptions, principles, or constraints
LO4 LO5 LO6

Identify the accounting assumption, principle, or constraint that best describes the accounting practices at Ben Wallace Company.

1. Land is valued at its original purchase price rather than its appraised value.
2. Ben Wallace Company issues financial statements every three months.
3. Expenses are allocated to the appropriate revenues each accounting period.
4. All relevant financial information is disclosed in the financial reports.

5. Personal computers costing less than $1,000 are expensed in the current period even though their useful life is three years.
6. The CEO's personal business records are kept separate from the company's records.
7. The U.S. dollar is the unit of currency used in financial reports.

Problem B-2A

Identifying assumptions, principles, or constraints violated

LO4 LO5 LO6

Presented below are transactions that occurred during 2010.

1. Susan Scholz, the president of Lake of the Ozarks cabin properties, buys a computer for personal use and charges it to her company's expense account.
2. In preparation of its financial statements, Ettredge Inc. omitted information about its method of accounting for accounts receivable.
3. To make its profits look better, Shanghai Automotive booked sales before its cars were shipped.
4. Jose Martinez reports all of its assets and liabilities at liquidation value, even though the company does not expect to go out of business in the foreseeable future.
5. Tom Hapgood writes up his inventory on the balance sheet since its market value is higher than its cost.

Required

For each of the above transactions, identify the assumption, principle, or constraint that has been violated.

PROBLEM SET B

Problem B-1B

Identify accounting assumptions, principles, or constraints

LO4 LO5 LO6

Identify the accounting assumption, principle, or constraint that best describes the accounting practices at Steve Hill Company.

1. Financial statements are prepared each year.
2. Market value changes after an asset's purchase are not recorded in the accounts.
3. Notes and supplementary information are included with the financial statements.
4. The factory is not reported at liquidation value. (Do not use the cost principle.)
5. Manufactured toys are not recorded as revenues until they have been sold and shipped.
6. Requires that generally accepted accounting principles be followed for all material items.

Problem B-2B

Identifying assumptions, principles, or constraints violated

LO4 LO5 LO6

Danny Manning and Larry Brown are accountants for the Engineering Institute. They disagree over the following transactions that occurred during 2010. Larry disagrees with Danny on each of the transactions below.

1. The Engineering Institute finds a bargain for a commercial-grade plotter and pays $3,000. Danny argues that if they had bought it from the dealer, they would have paid $4,000. Danny suggests they record the plotter for $4,000.
2. Timothy West, president of the Engineering Institute, used his company expense account to purchase a new BMW for his personal use. Danny argues that since the president is also the owner of the Engineering Institute, it really does not matter who paid for it.
3. Depreciation for the year was $114,000. Danny argues that since net income is expected to be lower in the current fiscal year, they should just charge it as an expense next year.
4. Danny suggests that the Engineering Institute value its equipment on its balance sheet at its liquidation value, which is $50,000 less than cost.
5. The Engineering Institute signed a lease on its offices for the next five years. A lease liability is not included on the company's balance sheet. Danny doesn't think such information needs to be disclosed.

Required

For each of the above transactions, identify why Larry disagrees. Also identify the assumption, principle, or constraint that has been violated.

ANSWERS TO MULTIPLE CHOICE QUIZ

1. b
2. a
3. c
4. b
5. a