CHAPTER 1

Environment and Theoretical Structure of Financial Accounting

/// OVERVIEW

The primary function of financial accounting is to provide useful financial information to users who are external to the business enterprise, particularly investors and creditors. These users make critical resource allocation decisions that affect the global economy. The primary means of conveying financial information to external users is through financial statements and related notes.

In this chapter you explore important topics, such as the reason why financial accounting is useful, the process by which accounting standards are produced, and the conceptual framework that underlies financial accounting. The perspective you gain in this chapter serves as a foundation for a more detailed study of financial statements, the way the statement elements are measured, and the concepts underlying these measurements and related disclosures.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- **LO1** Describe the function and primary focus of financial accounting. (p. 4)
- **LO2** Explain the difference between cash and accrual accounting. (p. 7)
- **LO3** Define accounting standards and discuss the historical development of accounting standards, including convergence between U.S. and international standards. (pp. 8, 10, and 12)
- **LO4** Explain why the establishment of accounting standards is characterized as a political process. (p. 13)
- **LO5** Explain the purpose of the IASB's conceptual framework. (p. 19)
- **LO6** Identify the objective of financial reporting, the qualitative characteristics of financial reporting information, and the elements of financial statements. (pp. 21 and 24)
- **LO7** Describe the basic assumptions underlying the measurement and reporting of financial statement information. (p. 25)
- **LO8** Describe the recognition, measurement and disclosure concepts that guide accounting practice. (pp. 27, 29, and 32)

FINANCIAL REPORTING CASE

Misguided Marketing Major

During a class break in your investments class, a marketing major tells the following story to you and some friends:

The chief financial officer (CFO) of a large company is interviewing three candidates for the top accounting position with his firm. He asks each the same question:

CFO:	What is two plus two?
First candidate:	Four.
CFO:	What is two plus two?
Second candidate:	Four.
CFO:	What is two plus two?
Third candidate:	What would you like it to be?
CFO:	You're hired.

After you take some good-natured ribbing from the nonaccounting majors, your friend says, "Seriously, though, there must be ways the accounting profession prevents that kind of behavior. Aren't there some laws, or rules, or something? Are they based on some sort of theory, or are they just arbitrary?"

By the time you finish this chapter, you should be able to respond appropriately to the questions posed in this case. Compare your response to the solution provided at the end of the chapter.

QUESTIONS ///

1. What should you tell your friend about the presence of accounting standards and regulations? Who has the authority for standard setting? Who has the responsibility? (pp. 8 and 10)
2. What is the economic and political environment in which standard setting occurs? (p. 13)
3. What is the relationship among management, auditors, investors, and creditors that tends to preclude the "What would you like it to be?" attitude? (p. 15)
4. In general, what is the conceptual framework that underlies accounting principles? (p. 19)

PART A FINANCIAL ACCOUNTING ENVIRONMENT

Have you been on board an Airbus A380, the world's largest passenger airliner? It is a double-decker plane that offers more cabin space, larger windows, bigger overhead compartments, and less cabin noise and air pressure than other passenger airliners. **Singapore Airlines** was the first airline to operate the A380, which made its first commercial flight on 25 October 2007 from Singapore to Sydney. Singapore Airlines' A380 has 12 first-class suites containing one full seat, a full-sized bed and a desk; four of the suites can be converted to two double suites with a double bed.

Singapore Airlines is one of the world's leading air transportation carriers. It has a reputation of providing quality service and introducing various innovations to the airline industry, such as the first global sky telephone service; the first to engage world-renowned chefs to prepare in-flight meals; the first longest direct commercial flight without stopovers between Singapore and Los Angeles, and between Singapore and Newark; and the first to operate the world's largest plane, the A380. Singapore Airlines' flight routes span over 63 destinations in 34 countries around the world. The company's revenues for the financial year ended March 31, 2011 exceeded S$14 billion and profits exceeded S$1 billion. The total value of the company's shares exceeded S$17 billion in 2011.

A key factor contributing to the growth and success of Singapore Airlines was its access to external capital (resources) in that it had the ability to raise external capital from investors and creditors. For example, in the third quarter of 2010, Singapore Airlines' public offering of the company's corporate bonds provided S$300 million in debt financing.

Investors and creditors use information to assess risk and return.

Investors and creditors use many different kinds of information before supplying capital to business enterprises like Singapore Airlines. The information is used to assess the future risk and return of their potential investments in the enterprise.[1] For example, information about the enterprise's products and its management is of vital importance to this assessment. In addition, various kinds of financial information are extremely important to investors and creditors.

● LO1

The primary focus of *financial accounting* is on the information needs of investors and creditors.

You might think of accounting as a special "language" used to communicate financial information about a business to those who wish to use the information to make decisions. **Financial accounting**, in particular, is concerned with providing relevant financial information to various *external* users. The chart in Illustration 1–1 lists a number of financial information supplier groups as well as several external user groups. Of these groups, the primary focus of financial accounting is on the financial information provided by *profit-oriented companies to their present and potential investors and creditors.* The reason for this focus is discussed in a later section of this chapter. One external user group, often referred to as *financial intermediaries*, includes financial analysts, stockbrokers, mutual fund managers, and credit rating organizations. These users provide advice to investors and creditors and/or make investment-credit decisions on their behalf. The collapse of **Enron Corporation** in 2001 and other high profile accounting failures made immensely clear the importance of reporting reliable financial information.

On the other hand, **managerial accounting** deals with the concepts and methods used to provide information to an organization's *internal* users, that is, its managers. You study managerial accounting elsewhere in your curriculum.

Financial statements convey financial information to external users.

The primary means of conveying financial information to investors, creditors, and other external users is through financial statements and related disclosure notes. The financial statements most frequently provided are (1) the statement of financial position or balance sheet, (2) the income statement and/or the statement of comprehensive income, (3) the statement of cash flows, and (4) the statement of changes in equity. Also, starting in 2012, companies must either provide a statement of other comprehensive income immediately following the income statement, or present a combined statement of comprehensive income that includes the information normally contained in both the income statement and the statement of other comprehensive income. As you progress through this text, you

[1] Risk refers to the variability of possible outcomes from an investment. Return is the amount received over and above the investment and usually is expressed as a percentage.

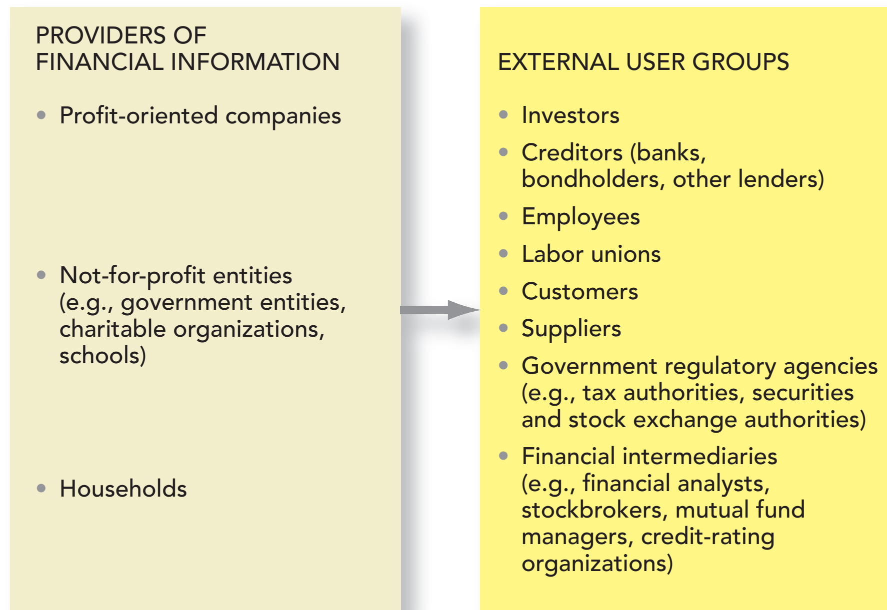


ILLUSTRATION 1–1
Financial Information Supplier Groups and External User Groups

will review and expand your knowledge of the information in these financial statements, the way the elements in these statements are measured, and the concepts underlying these measurements and related disclosures. We use the term **financial reporting** to refer to the process of providing this information to external users. Keep in mind, though, that external users receive important financial information in a variety of other formats as well, including news releases and management forecasts, prospectuses, and reports filed with regulatory agencies.

Singapore Airlines' financial statements and related disclosure notes for the financial year ended March 31, 2011 are provided with all new copies of the text. You can also locate the 2011 statements and notes online at **www.singaporeair.com**. To provide context for our discussions throughout the text, we occasionally refer to these statements and notes. Also, as new topics are introduced in later chapters, you might want to refer to the information to see how Singapore Airlines reported the items being discussed.

The Economic Environment and Financial Reporting

Many countries have a highly developed free-enterprise economy with the majority of productive resources privately owned rather than government owned. It's important in this type of system that a mechanism exists to allocate the scarce resources of our society, both natural resources and labor, in an efficient manner. Resources should be allocated to private enterprises that will use them best to provide goods and services desired by society and not to enterprises that will waste them. The mechanisms that foster this efficient allocation of resources are the **capital markets**. We can think of the capital markets simply as a composite of all investors and creditors.

The *capital markets* provide a mechanism to help our economy allocate resources efficiently.

Businesses go to the capital markets to get the cash necessary for them to function. The three primary forms of business organization are the sole proprietorship, the partnership, and the corporation. In many countries, sole proprietorships and partnerships outnumber corporations. However, the dominant form of business organization, in terms of the ownership of productive resources, is the **corporation**. Investors provide resources, usually cash, to a corporation in exchange for an ownership interest, that is, shares. Creditors lend cash to the corporation, either by making individual loans or by purchasing publicly traded debt such as bonds.

***Corporations* acquire capital from investors in exchange for ownership interest and from creditors by borrowing.**

***Initial market transactions* involve issuance of shares and bonds by the corporation.**

***Secondary market* transactions provide for the transfer of shares and bonds among individuals and institutions.**

Shares and bonds are usually traded on organized security markets such as the New York Stock Exchange and the London Stock Exchange. New cash is provided in **initial market transactions** in which the corporation sells shares or bonds to individuals or other entities that want to invest in it. Subsequent transfers of these shares and bonds between investors and creditors are referred to as **secondary market transactions**. Corporations receive no new cash from secondary market transactions. Nevertheless, secondary market transactions are extremely important to the efficient allocation of resources in our economy. These transactions help establish market prices for additional shares and for bonds that corporations may wish to issue in the future to acquire additional capital. Also, many shareholders and bondholders might be unwilling to initially provide resources to corporations if there were no available mechanism for the future sale of their shares and bonds to others.

What information do investors and creditors need when determining which companies will receive capital? We explore that question next.

The Investment-Credit Decision—A Cash Flow Perspective

Investors and creditors are interested in earning a fair return on the resources provided.

While the decisions made by investors and by creditors are somewhat different, they are similar in at least one important way. They both are concerned with providing resources to companies, usually cash, with the expectation of receiving more cash in return at some time in the future. A corporation's shareholders will receive cash from their investment through the ultimate sale of the ownership shares. In addition, many corporations distribute cash to their shareholders in the form of periodic dividends. For example, if an investor provides a company with $10,000 cash (that is, purchases ownership shares) at the end of 2012, receives $400 in dividends from the company during 2013, and sells the ownership interest (shares) at the end of 2013 for $10,600 ($600 share price appreciation), the investment would have generated a rate of return of 10% for 2013, calculated as follows:

$$\frac{\$400 \text{ dividends} + \$600 \text{ share price appreciation}}{\$10{,}000 \text{ initial investment}} = 10\%$$

The expected *rate of return* and uncertainty, or risk, of that return are key variables in the investment decision.

Investors often face more than one investment opportunity. There are many factors to consider before one of these opportunities is chosen. Two extremely important variables are the *expected rate of return* from each investment option, and the *uncertainty,* or *risk,* of that expected return. For example, consider the following two investment options:

1. Invest $10,000 in a savings account insured by the government that will generate a 5% rate of return.
2. Invest $10,000 in a profit-oriented company.

While the rate of return from option 1 is known with virtual certainty, the return from option 2 is uncertain. The amount and timing of the cash to be received in the future from option 2 are unknown. Investors require information about the company that will help them estimate the unknown return.

A company will be able to provide a return to investors and creditors only if it can generate a profit from selling its products or services.

In the long run, a company will be able to provide investors with a return only if it can generate a profit. That is, it must be able to use the resources provided by investors and creditors to generate cash receipts from selling a product or service that exceed the cash disbursements necessary to provide that product or service. If this excess can be generated, the marketplace is implicitly saying that society's resources have been efficiently allocated. The marketplace is assigning a value to the product or service that exceeds the value assigned to the resources used to produce that product or service.

The objective of financial accounting is to provide investors and creditors with useful information for decision making.

In summary, the primary objective of financial accounting is to provide investors and creditors with information that will help them make investment and credit decisions. More specifically, the information should help investors and creditors evaluate the *amounts*, *timing*, and *uncertainty* of the enterprise's future cash receipts and disbursements. The better this information is, the more efficient will be investor and creditor resource allocation

decisions. But financial accounting doesn't only benefit companies and their investors and creditors. By providing key elements of the information set used by capital market participants, financial accounting plays a vital role by providing information that helps direct society's resources to the companies that utilize those resources most effectively.

Cash versus Accrual Accounting

LO2

Even though predicting future cash flows is the primary goal of many users of financial reporting, the model best able to achieve that goal is the **accrual accounting** model. A competing model is **cash basis accounting**. Each model produces a periodic measure of performance that could be used by investors and creditors for predicting future cash flows.

CASH BASIS ACCOUNTING. Cash basis accounting produces a measure called **net operating cash flow**. This measure is the difference between cash receipts and cash payments from transactions related to providing goods and services to customers during a reporting period.

***Net operating cash flow* is the difference between cash receipts and cash disbursements from providing goods and services.**

Over the life of a company, net operating cash flow definitely is the variable of concern. However, over short periods of time, operating cash flows may not be indicative of the company's long-run cash-generating ability. Sometimes a company pays or receives cash in one period that relates to performance in multiple periods. For example, in one period a company receives cash that relates to prior period sales, or makes advance payments for costs related to future periods. Therefore, net operating cash flow may not be a good predictor of long-run cash-generating ability.

To see this more clearly, consider Carter Company's net operating cash flows during its first three years of operations, shown in Illustration 1–2. Over this three-year period, Carter generated a positive net operating cash flow of $60,000. At the end of this three-year period, Carter has no outstanding debts. Because total sales and cash receipts over the three-year period were each $300,000, nothing is owed to Carter by customers. Also, there are no uncompleted transactions at the end of the three-year period. In that sense, we can view this three-year period as a micro version of the entire life of a company.

At the beginning of the first year, Carter prepaid $60,000 for three years' rent on the facilities. The company also incurred utility costs of $10,000 per year over the period. However, during the first year only $5,000 was actually paid, with the remainder being paid the second year. Employee salary costs of $50,000 were paid in full each year.

Is net operating cash flow for year 1 (negative $65,000) an accurate indicator of future cash-generating ability?[2] Clearly not, given that the next two years show positive net cash flows. Is the three-year pattern of net operating cash flows indicative of the company's year-by-year performance? No, because the years in which Carter paid for rent and utilities are not the same as the years in which Carter actually consumed those resources. Similarly, the amounts collected from customers are not the same as the amount of sales in each period.

ILLUSTRATION 1–2
Cash Basis Accounting

	Year 1	Year 2	Year 3	Total
Sales (on credit)	$100,000	$100,000	$100,000	$300,000
Net Operating Cash Flows				
Cash receipts from customers	$ 50,000	$125,000	$125,000	$300,000
Cash disbursements:				
Prepayment of three years' rent	(60,000)	–0–	–0–	(60,000)
Salaries to employees	(50,000)	(50,000)	(50,000)	(150,000)
Utilities	(5,000)	(15,000)	(10,000)	(30,000)
Net operating cash flow	$ (65,000)	$ 60,000	$ 65,000	$ 60,000

[2] A negative cash flow is possible only if invested capital (i.e., owners contributed cash to the company in exchange for ownership interest) is sufficient to cover the cash deficiency. Otherwise, the company would have to either raise additional external funds or go bankrupt.

Net income **is the difference between** ***revenues*** **and** ***expenses.***

ACCRUAL ACCOUNTING. If we measure Carter's activities by the accrual accounting model, we get a more accurate prediction of future operating cash flows and a more reasonable portrayal of the periodic operating performance of the company. The accrual accounting model doesn't focus only on cash flows. Instead, it also reflects other resources provided and consumed by operations during a period. The accrual accounting model's measure of resources provided by business operations is called revenues, and the measure of resources sacrificed to earn revenues is called expenses. The difference between revenues and expenses is net income, or net loss if expenses are greater than revenues.[3] Illustration 1–3 shows how we would measure revenues and expenses in this very simple situation.

ILLUSTRATION 1–3

Accrual Accounting

The accrual accounting model provides a measure of periodic performance called ***net income,*** **the difference between revenues and expenses.**

CARTER COMPANY
Income Statements

	Year 1	Year 2	Year 3	Total
Revenues	$100,000	$100,000	$100,000	$300,000
Expenses:				
Rent	20,000	20,000	20,000	60,000
Salaries	50,000	50,000	50,000	150,000
Utilities	10,000	10,000	10,000	30,000
Total expenses	80,000	80,000	80,000	240,000
Net Income	$ 20,000	$ 20,000	$ 20,000	$ 60,000

Net income is considered a better ***indicator of future*** **operating cash flows than is current net operating cash flow.**

Revenue for year 1 is the $100,000 sales. Given that sales are eventually collected in cash, the year 1 revenue of $100,000 is a better measure of the inflow of resources from company operations than is the $50,000 cash collected from customers. Also, net income of $20,000 for year 1 appears to be a reasonable predictor of the company's cash-generating ability, as total net operating cash flow for the three-year period is a positive $60,000. Comparing the three-year pattern of net operating cash flows in Illustration 1–2 to the three-year pattern of net income in Illustration 1–3, the net income pattern is more representative of Carter Company's steady operating performance over the three-year period.[4]

While this example is somewhat simplistic, it allows us to see the motivation for using the accrual accounting model. Accrual income attempts to measure the resource inflows and outflows generated by operations during the reporting period, which may not correspond to cash inflows and outflows. Does this mean that information about cash flows from operating activities is not useful? No. Indeed, one of the basic financial statements—the statement of cash flows—reports information about cash flows from operating, investing and financing activities, and provides important information to investors and creditors.[5] The key point is that focusing on accrual accounting as well as cash flows provides a more complete view of a company and its operations.

The Development of Financial Accounting and Reporting Standards

FINANCIAL Reporting Case

Q1, p. 3

● LO3

Accrual accounting is the financial reporting model used by the majority of profit-oriented companies and by many not-for-profit companies. The fact that companies use the same model is important to investors and creditors, allowing them to compare financial information among companies. To facilitate these comparisons, financial accounting employs a set of accounting standards that provide both broad and specific guidelines that companies should follow when measuring and reporting the information in their financial statements and related

[3] Net income also includes gains and losses, which are discussed later in the chapter.

[4] Empirical evidence that accrual accounting provides a better measure of short-term performance than cash flows is provided by Patricia Dechow, "Accounting Earnings and Cash Flows as Measures of Firm Performance: The Role of Accrual Accounting," *Journal of Accounting and Economics* 18 (1994), pp. 3–42.

[5] The statement of cash flows is discussed in detail in Chapters 4 and 21.

notes. The more important broad principles or standards are discussed in a subsequent section of this chapter and revisited throughout the text in the context of accounting applications for which they provide conceptual support.[6] Specific standards, such as how to measure and report a lease transaction, receive more focused attention in subsequent chapters. Generally, there are two major sets of accounting standards in the world. One set of accounting standards is the International Financial Reporting Standards (IFRS) and the other is the set of standards issued by standard-setting bodies in the United States. Note that in the United States, accounting standards are known as **generally accepted accounting principles**, often abbreviated as **GAAP** (and pronounced as *gap*).

Historical Perspective and Standards

INTERNATIONAL STANDARD SETTING. Most industrialized countries have organizations responsible for determining accounting and reporting standards. In many countries, such as Canada, New Zealand, and the Philippines, accounting standards are set by a private-sector professional accounting body. In a few countries, such as Japan, the United Kingdom, and the United States, the private-sector standard-setting body is independent of the government and of the accounting profession. In many other countries, such as Australia, France, India, and Singapore, the standard-setting organization is a governmental body.

Accounting standards prescribed by these various groups are not the same. Standards differ from country to country due to differences in legal systems, inflation rate, degrees of sophistication and use of capital markets, use of financial reports by tax or government authorities, and political and economic ties with other countries. These differences can cause problems for multinational corporations who may find it difficult to comply with a few different sets of accounting standards. These differences also cause problems for investors who are comparing companies whose financial statements are prepared using different standards. It has also been suggested that different national accounting standards affect comparability in financial information and impair the ability of companies to raise capital in international markets.

Differences among national accounting standards cause problems for multinational corporations and investors.

INTERNATIONAL FINANCIAL REPORTING STANDARDS. In response to this problem, the **International Accounting Standards Committee (IASC)** was formed in 1973 to develop global accounting standards. The IASC consisted of member representatives from countries such as France, Germany, Japan, the United Kingdom, and the United States. The IASC reorganized itself in 2001 and created a new standard-setting body called the **International Accounting Standards Board (IASB)**. The IASB's objectives are to develop, promote, and coordinate the use of a single set of high-quality, understandable, and enforceable global and harmonized accounting standards that help participants in worldwide capital markets and other users to make economic decisions.[7]

***The International Accounting Standards Board (IASB)* is dedicated to developing a single set of global accounting standards.**

The IASC issued 41 **International Accounting Standards (IASs)**, which were endorsed by the IASB when it was formed in 2001. These IASs will continue to be effective until the IASB revises or replaces them. The IASB has revised many IASs and issued new standards of its own, called **International Financial Reporting Standards (IFRS)**. Some of these are new standards, and some may replace the old IASs. The term "IFRS" refers to all the standards issued by the IASB, including the Conceptual Framework, the old IASs, and Interpretations issued by the IFRS Interpretations Committee.

The IASB differs from its predecessor in many ways. There are currently 15 full-time IASB members, compared to the mainly part-time volunteers serving in IASC. Members include representatives from the various constituencies concerned with accounting standards, such as the accounting profession, multinational businesses, financial analysts, academics, regulators, and government. In addition, the IASB is supported financially by the **IFRS Foundation** (formerly known as **International Accounting Standards Committee Foundation (IASCF)**), whose Trustee members are responsible for selecting the IASB

[6] The terms *standards* and *principles* are sometimes used interchangeably.

[7] www.ifrs.org.

members, exercising general oversight of the IASB's activities, and ensuring adequate funding. The Trustees are in turn appointed and monitored by the Monitoring Board, which consists of public capital market authorities such as the chairpersons of the European Commission and the United States' Securities Exchange Commission. The IFRS Foundation also appoints the members of the IFRS Advisory Council and the IFRS Interpretations Committee.

The **IFRS Advisory Council** (formerly known as **Standards Advisory Council (SAC)**) advises the IASB on matters concerning its agenda, projects, and work priorities. The **IFRS Interpretations Committee** (formerly known as **International Financial Reporting Interpretations Committee (IFRIC)**, which was formed in 2001 to replace the **Standing Interpretations Committee (SIC)**) was formed to improve accounting standards by resolving accounting issues that are not specifically addressed by the IFRS, within the framework of existing IFRS, and providing interpretations for the application of existing IFRS. Regulatory oversight of the IASB is provided by the **International Organization of Securities Commissions (IOSCO)**, which includes representatives from securities markets regulators and seeks to facilitate coordination among market regulators in implementing consistent international standards and enforcement against misconduct, thereby developing effective global capital markets.

Illustration 1–4 shows the structure of the IASB and its supporting organizations.

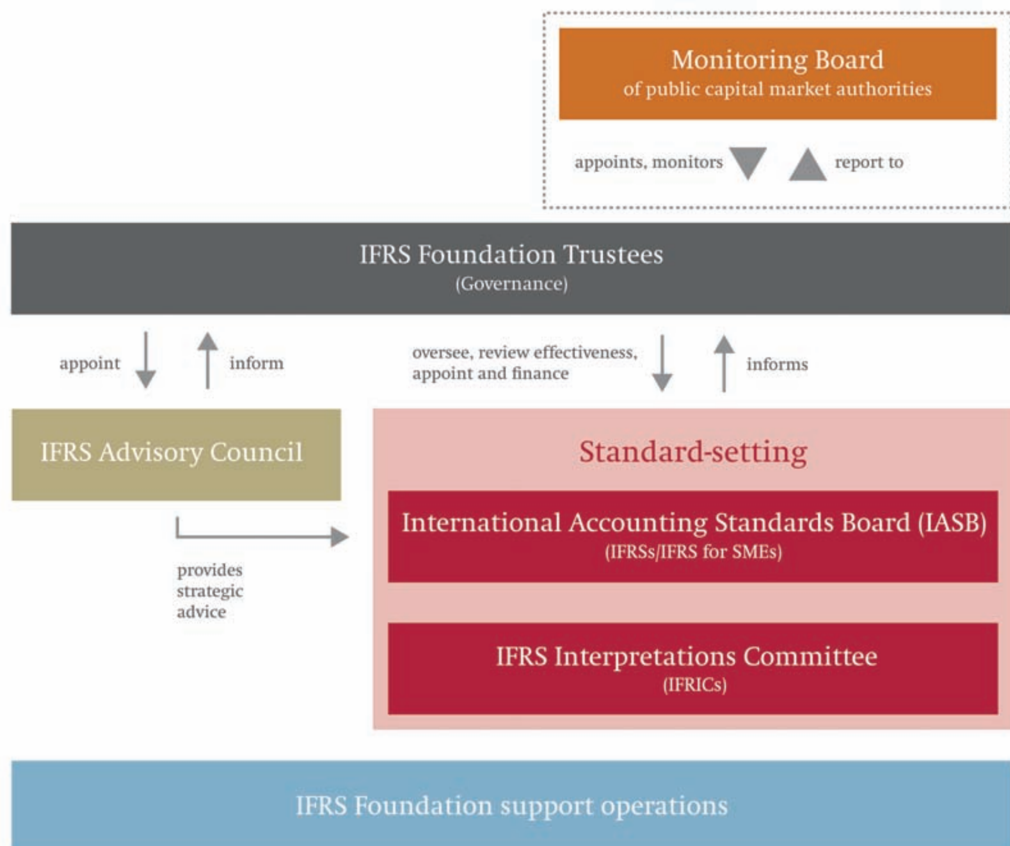
ILLUSTRATION 1–4
Structure of the IASB

FINANCIAL Reporting Case

Q1, p. 3

● LO3

STRUCTURE OF THE INTERNATIONAL ACCOUNTING STANDARDS BOARD[8]



International Financial Reporting Standards are gaining support around the globe.

It is important to note that the IASB is a private and non-governmental standard-setting body and has no authority to enforce the use of IFRS in different jurisdictions. It has to depend on each jurisdiction's regulatory authority to enforce the application of IFRS in that jurisdiction. Nevertheless, more and more countries are basing their national accounting standards on IFRS. By 2011, over 120 jurisdictions, including Australia, Canada, Egypt, and

[8] International Accounting Standards Board and the IFRS Foundation, "Who we are and what we do," (London, U.K.: IASB, 2012).

Hong Kong, and the countries in the European Union (EU), either require or permit the use of IFRS or a local variant of IFRS.[9]

STANDARD SETTING IN THE UNITED STATES. In the 1934 Securities Exchange Act, the United States Congress created the **Securities and Exchange Commission (SEC)** and gave the SEC the authority to set accounting standards for companies whose securities are publicly traded. However, the SEC, a government appointed body, has delegated the task of setting accounting standards to the private sector. Nevertheless, if the SEC does not agree with a particular standard issued by the private sector, it can force a change in the standard, and has done so in the past. The SEC does issue its own accounting standards in the form of *Financial Reporting Releases (FRRs)*, which regulate what information companies must report to it. The SEC also issues Staff Accounting Bulletins as authoritative supplements for reporting issues. The first private-sector standard-setting body was the **Committee on Accounting Procedure (CAP)**. The CAP was formed in 1938 and was a committee of the **American Institute of Certified Public Accountants (AICPA)**, the professional organization for certified public accountants in the United States. In 1959 the **Accounting Principles Board (APB)** replaced the CAP. The APB suffered from a variety of problems. It could not develop a financial reporting conceptual framework that was broadly accepted. Its members also served on a voluntary, part-time basis, so it had difficulty keeping up with the development of financial reporting issues. The most important flaw of the APB was a perceived lack of independence from the accounting profession, because it was composed almost entirely of certified public accountants and supported by the AICPA.

The Securities and Exchange Commission (SEC) in the United States has the authority to set accounting standards for companies, but has delegated the task to the private sector.

Criticism of the APB led to the creation in 1973 of the **Financial Accounting Standards Board (FASB)**. The FASB is an independent, private-sector body with seven full-time members representing the accounting profession, financial analysts, businesses, accounting academics, and government.[10] The FASB is supported financially by the **Financial Accounting Foundation (FAF)**. The FAF is responsible for selecting the members of the FASB and its Advisory Council, and overseeing and raising funds for the FASB's activities.[11] In 1984, the FASB's **Emerging Issues Task Force (EITF)** was formed to address implementation issues and resolve narrowly defined financial accounting issues within the framework of existing U.S. GAAP.

The *FASB* currently sets accounting standards in the United States.

The FASB has issued over 160 accounting standards, called *Statements of Financial Accounting Standards (SFASs)*, a conceptual framework underlying the development of the standards, as well as FASB *Interpretations*, *Staff Positions*, *Technical Bulletins* and *EITF Issue Consensuses*.[12] The SEC has also issued various important pronouncements.

In 2009, the FASB implemented its FASB *Accounting Standards Codification,* which integrates and topically organizes all relevant pronouncements comprising U.S. GAAP in a searchable, online database. It represents the single source of authoritative nongovernmental U.S. GAAP, and also includes portions of SEC guidance relevant to financial reports filed with the SEC. When FASB issues a new standard, it is called an *Accounting Standards Update (ASU)* and becomes authoritative when it is entered into the Codification. The Codification is organized into nine main topics and approximately 90 subtopics, and can be located at **www.fasb.org**.

The *FASB Accounting Standards Codification* is now the only source of authoritative U.S. GAAP, other than rules and interpretative releases of the SEC, which remain as sources of authoritative GAAP.

As shown in Illustration 1–5, the way standard setting is structured in the United States is similar in many respects to the way IFRS standard setting is structured.

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[9] See **www.iasplus.com/country/useias.htm**.

[10] The FASB organization also includes the **Financial Accounting Standards Advisory Council** (FASAC). The major responsibility of the FASAC is to advise the FASB on the priorities of its projects, including the suitability of new projects that might be added to its agenda.

[11] The FAF's primary sources of funding are contributions and the sales of the FASB's publications. The FAF is governed by trustees, the majority of whom are appointed from the membership of eight sponsoring organizations. These organizations represent important constituencies involved with the financial reporting process. For example, one of the funding organizations is the Association of Investment Management and Research (formerly known as the Financial Analysts Federation) which represents financial information users, and another is the Financial Executives International which represents financial information preparers.

[12] For more information, go to the FASB's Internet site at www.fasb.org.

ILLUSTRATION 1–5

Comparison of U.S. GAAP and IFRS Standard-Setting Organizations

● LO3

	U.S. GAAP	IFRS
Regulatory oversight provided by:	Securities Exchange Commission (SEC)	International Organization of Securities Commissions (IOSCO) and the Monitoring Board
Foundation providing oversight, appointing members, raising funds:	Financial Accounting Foundation (FAF): 20 trustees	IFRS Foundation: 21 trustees
Standard-setting board:	Financial Accounting Standards Board (FASB): 7 full-time members	International Accounting Standards Board (IASB): 15 full-time members
Advisory council providing input on agenda and projects:	Financial Accounting Standards Advisory Council (FASAC): 30–40 members	IFRS Advisory Council 40–50 members
Group to deal with emerging issues:	Emerging Issues Task Force (EITF): 15 members	IFRS Interpretations Committee: 14 members

EFFORTS TO CONVERGE U.S. GAAP AND IFRS. The FASB and IASB have been working for several years to converge to one global set of accounting standards, with the goal of eventually enabling the United States to shift to IFRS. In 2002, an important step occurred when the FASB and IASB signed the Norwalk Agreement, formalizing their commitment to convergence and pledging to remove existing differences between U.S. GAAP and IFRS and to coordinate their future standard-setting agendas so that major issues are worked on together. In the spring of 2008, the FASB and IASB agreed to accelerate the convergence process, and the two boards have been working very hard on convergence projects since that time. Already-converged standards that you will encounter later in this textbook deal with topics such as earnings per share, share-based compensation, inventory costs, calculation of fair value, and presentation of comprehensive income.

Whether or not the United States eventually shifts to IFRS will be determined by the SEC. In 2007 the SEC signaled its view that IFRS are of high quality by eliminating the requirement for foreign companies that issue shares in the United States to include in their financial statements a reconciliation of IFRS to U.S. GAAP. Thus, those companies have access to U.S. capital markets with IFRS-based financial statements. Then, in November 2008, the SEC proposed a Roadmap that listed the necessary conditions that must be achieved before the United States will shift to requiring use of IFRS by companies listed on stock exchanges in the United States. The first milestone, "Improvements in accounting standards," refers to the completion of 11 major joint projects intended to improve standards while further aligning U.S. GAAP and IFRS. While several convergence projects have been completed, other important projects are still underway or have been deferred. You will read about these projects in the Where We're Headed boxes throughout the text. At the time this textbook is written, the SEC has not decided whether the United States would report under IFRS. It may be that convergence will take the form of a required whole-scale adoption of IFRS by companies, or a standard-by-standard endorsement of IFRS standards in the United States. On the other hand, convergence is already gradually occurring through cooperation between the FASB and IASB that has resulted in recently issued Accounting Standards Updates in the United States.

The Establishment of Accounting Standards

The IASB undertakes a series of information-gathering steps before issuing a new or revised standard.

DUE PROCESS. When developing accounting standards, the accounting standards board must understand the nuances of the economic transactions the standards address and the views of key constituents concerning how accounting would best capture that economic reality. For example, the IASB undertakes a series of elaborate information-gathering steps

before issuing a new or revised standard. These steps include open hearings, deliberations, and requests for written comments from interested parties. Illustration 1–6 outlines the IASB's standard-setting process.[13]

ILLUSTRATION 1–6

The IASB's Standard-Setting Process

Step	Explanation
1.	**Setting the agenda.** The Board decides whether to add a project to its agenda by considering users' needs and factors such as the availability of existing guidance and resource constraints, and after appropriate consultation with its IASB members, the IFRS Advisory Council, the IFRS Interpretations Committee, other standard setters, and other interested parties.
2.	**Planning the project.** The Board decides whether to conduct the project on its own or jointly with other standard setters, forms a project team, and comes up with a project plan.
3.	**Developing and publishing the discussion paper.** The Board develops and publishes a discussion paper that provides an overview of the issue, possible ways to approach the issue, the preliminary views, and an invitation for public comment. A discussion paper is not mandatory and hence, the Board may decide to omit this step but needs to state the reason for this decision.
4.	**Developing and publishing the exposure draft.** The Board develops and publishes an Exposure Draft, after considering the comments received on the discussion paper and suggestions from the IFRS Advisory Council, the public, and other parties. (In some projects, a second exposure draft may be published to obtain additional public comment.)
5.	**Developing and publishing the standard.** The Board develops and issues the IFRS, after considering the comments received on the exposure draft and resolving the issues arising from the exposure draft.
6.	**After the standard is issued.** The Board holds meetings with interested parties to discuss issues related to the implementation and potential impact of the IFRS, and may organize educational activities and studies related to the application of the IFRS.

These steps are part of the IASB's efforts to consult with and acquire information from various groups such as accountants, financial analysts, the international business community, regulatory authorities, and academics to help determine accounting requirements for recognition, measurement, and disclosures. However, as a practical matter, this information gathering also exposes the IASB to political pressure by various interest groups who want to put in place an accounting treatment that serves their best economic interests.

FINANCIAL Reporting Case

Q2, p. 3

● LO4

POLITICS IN STANDARD SETTING. A change in accounting standards can result in a substantial redistribution of wealth within our economy. Therefore, it is no surprise that there are political pressures on the IASB's standard-setting process. One source of pressure comes from the international business community. Unlike the FASB, which is funded through fees paid by companies listing securities on stock exchanges, the IASB receives much of its funding through voluntary donations by accounting firms and corporations, and there is concern that this financial support may compromise the IASB's independence. In fact, one of the milestones specified by the Securities Exchange Commission for the eventual adoption of IFRS in the United States is that the IASB's independence be increased by creating a funding mechanism more like the FASB's.

Another source of political pressure arises from the fact that politicians from countries that use IFRS lobby for the standards they prefer. The European Union (EU) is a particularly important adopter of IFRS and utilizes a formal evaluation process before determining whether an IFRS standard will be endorsed for use in EU countries. Economic consequences

[13] International Accounting Standards Board and the IFRS Foundation, "Due Process Handbook for the IASB," (London, U.K.: IASB, 2012).

for EU member nations are an important consideration in that process. The EU has been known to apply political pressure on the IASB by rejecting its standards or "carving out" certain unfavorable provisions of the standards, and through the EU members of the IASB Board and Trustees. In addition, EU interest groups directly lobby the IASB. For example, in 2003 and 2004, several EU countries such as France, Italy, and Spain lobbied against some aspects of accounting for financial instruments stridently enough that the EU eventually "carved out" two key provisions relating to portfolio hedging and the fair value option before endorsing the relevant accounting standard (*IAS No. 39*). The EU lobbied the IASB to revise the carved-out provisions, and in 2005, the IASB revised the provision relating to the fair value option. Similarly, in 2005, after the EU stated its intention to reject an IASB Interpretation (*IFRIC No. 3*) regarding the reporting of emissions assets and liabilities, the IASB withdrew *IFRIC No. 3*.[14]

During the financial crisis of 2008–2009, many argued that the use of fair value to measure financial assets and liabilities and the inclusion of fair value changes in net income had exacerbated the financial crisis by forcing financial institutions to take larger than necessary write-downs of financial assets in the illiquid markets that existed at that time. The EU successfully pressured the IASB to suspend its due process and immediately revise its standards to allow reclassification of investments so that EU banks could avoid recognizing huge investment losses.[15] There remains ongoing pressure from lobbyists and politicians for the IASB to reduce the extent to which fair value changes are included in the determination of net income. Presumably, in its endeavors to engage a larger and more diverse group of stakeholders, the IASB on July 1, 2011, appointed a new chairman, Hans Hoogervorst, a securities regulator with extensive diplomatic experience and who is not an accountant. Although the IASB's vice-chairman, Ian Mackintosh, has a long career in accounting and standard setting, the appointment of a non-accountant as IASB's Chairman perhaps signals a new focus on political considerations.

Other standard setters, such as the FASB, has also sometimes changed standards in response to intense political pressure. For example, in the mid 1990s, the FASB proposed that share options paid to employees be recognized as compensation expense. Many companies applied intense political pressure against this proposal, and eventually the FASB backed down and required only disclosure of options-related compensation expense in the disclosure notes. Nearly a decade later, this contentious issue resurfaced in a more amenable political climate, and the FASB issued a standard requiring expense recognition. Another example relates to business combinations which previously could be accounted for using the purchase method or pooling of interest method. Many companies structured their business combinations as a pooling of interests to avoid amortizing (expensing) goodwill, an intangible asset that arises only when the purchase method was used. When the FASB proposed eliminating the pooling method, many companies strongly objected, arguing that they would not undertake business combinations important to economic growth if the purchase method was required, due to the negative impact on earnings caused by goodwill amortization. Eventually the FASB compromised. In the final standard issued in 2001, only the purchase method, now called the acquisition method, is acceptable, but the resulting goodwill is not amortized.[16]

Encouraging High-Quality Financial Reporting

Numerous factors affect the quality of financial reporting. In this section, we discuss the role of the auditor, recent reforms in financial reporting, and the debate about whether accounting standards should emphasize rules or underlying principles.

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[14] Kennard S. Brackney and Philip R. Witmer, "The European Union's Role in International Standards Setting," **www.nysscpa.org/cpajournal/2005/1105/infocus/p20.htm**, *CPA Journal*, November 2005.

[15] Sarah Deans and Dane Mott, "Lowering Standards," **www.morganmarkets.com**, October 14, 2008.

[16] FASB ASC 805: Business Combinations (previously "Business Combinations," *Statement of Financial Accounting Standards No. 141* (revised) (Norwalk, Conn.: FASB, 2007)), and FASB ASC 350: Intangibles—Goodwill and Other (previously "Goodwill and Other Intangible Assets," *Statement of Financial Accounting Standards No. 142* (Norwalk, Conn.: FASB, 2001)).

The Role of the Auditor

FINANCIAL Reporting Case

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It is the responsibility of management to apply accounting standards appropriately. Another group, **auditors**, serves as an independent intermediary to help ensure that management has in fact appropriately applied accounting standards in preparing the company's financial statements. Auditors examine (audit) financial statements to express a professional, independent opinion about whether the statements fairly present the company's financial position, its results of operations, and its cash flows in compliance with accounting standards.

The report of the independent auditors of Singapore Airlines' financial statements is in the annual report information included with the text. The first few paragraphs explain management's responsibility for the financial statements, auditors' responsibility, and the scope of the audit. The last paragraph states the auditors' opinion. After conducting its audit, the accounting firm of **Ernst & Young LLP** stated that "in our opinion, the … financial statements ... are properly drawn up in accordance with the provisions of the (Companies') Act and Singapore Financial Reporting Standards so as to give a true and fair view of the state of affairs of the Group and of the Company …" This is known as a clean opinion. Had there been any material departures from accounting standards or other problems that caused the auditors to question the fairness of the statements, the report would have been modified to inform readers. Normally, companies correct any material misstatements that auditors identify in the course of an audit, so companies usually receive clean opinions. In the United States, the audit report also contains the auditors' opinion on the effectiveness of the company's internal control over financial reporting. We discuss this opinion on internal controls in the next section.

Auditors **express an opinion on the compliance of financial statements with accounting standards.**

The auditor adds credibility to the financial statements, increasing the confidence of capital market participants who rely on the information. Auditors, therefore, play an important role in the resource allocation process.

Auditors offer credibility to financial statements.

In most countries and states, only individuals licensed as **certified public accountants (CPAs)** can represent that the financial statements have been audited in accordance with generally accepted auditing standards. Requirements to be licensed as a CPA vary across different countries and states, but all countries or states would specify education, testing, and experience requirements.

Certified public accountants (CPAs) **are licensed by the country or state to provide audit services.**

Financial Reporting Reform in the United States

Sarbanes-Oxley

In the United States, the dramatic collapse of Enron in 2001 and the dismantling of the international public accounting firm of **Arthur Andersen** in 2002 severely shook U.S. capital markets. The credibility of the accounting profession itself as well as of corporate America was called into question. Public outrage over accounting scandals at high-profile companies like **WorldCom**, **Xerox**, **Merck**, **Adelphia Communications**, and others increased the pressure on lawmakers to pass measures that would restore credibility and investor confidence in the financial reporting process.

PAUL SARBANES—U.S. SENATOR
We confront an increasing crisis of confidence with the public's trust in our markets. If this continues, I think it poses a real threat to our economic health.[17]

Driven by these pressures, Congress acted swiftly and passed the *Public Company Accounting Reform and Investor Protection Act of 2002*, commonly referred to as the *Sarbanes-Oxley Act* or *SOX* for the two congressmen who sponsored the bill. SOX applies to public securities-issuing entities. It provides for the regulation of auditors and the types of services they furnish to clients, increases corporate executives' accountability, addresses conflicts of interest, and has stiff penalties for violators. Illustration 1–7 outlines the key provisions of SOX.

[17] James Kuhnhenn, "Bush Vows to Punish Corporate Lawbreakers," *San Jose Mercury News* (July 9, 2002), p. 8A.

ILLUSTRATION 1–7

Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes-Oxley)

Key Provisions of the Act:

- **Oversight board.** The Public Company Accounting Oversight Board has the authority to establish standards dealing with activities relating to the preparation of audit reports, or can choose to delegate these responsibilities to the AICPA. Prior to the act, the AICPA set auditing standards. The SEC has oversight and enforcement authority.
- **Corporate executive accountability.** Corporate executives must certify the financial statements with severe financial and criminal penalties for fraudulent misstatement.
- **Nonaudit services.** Auditors of public companies are not allowed to perform nonaudit services such as bookkeeping, internal audit outsourcing, and appraisal or valuation services. Other nonaudit services, such as tax services, require pre-approval by the audit committee of the company being audited.
- **Retention of work papers.** Auditors of public companies must retain all audit work papers for seven years or face the threat of a prison term for willful violations.
- **Auditor rotation.** Lead audit partners are required to rotate every five years. Mandatory rotation of audit firms came under consideration.
- **Conflicts of interest.** Audit firms are not allowed to audit public companies whose chief executives worked for the audit firm and participated in that company's audit during the preceding year.
- **Hiring of auditor.** The audit committee, and not company management, hires the audit firm.
- **Internal control (Section 404).** Management has to document and assess the effectiveness of internal control over financial reporting. Auditors express opinions on whether management's internal control assessment is fairly stated and whether the company has maintained effective internal control over financial reporting.

Section 404 of SOX requires that management report on the adequacy of their internal controls. Auditors must also express an opinion on whether the company has maintained effective control over financial reporting. Many argued that the benefits of Section 404 did not justify its compliance costs. There is research evidence that 404 reports affect investors' risk assessments and share prices, indicating these reports are seen as useful by investors.[18] However, the compliance costs are steep. For example, one survey of Fortune 1,000 companies estimated that large companies spent, on average, $8.5 million and $4.8 million (including internal costs and auditor fees) during the first two years of the act to comply with 404 reporting requirements.[19] As expected, the costs dropped significantly in the second year, and would likely to continue to drop as the efficiency of internal control audits increased. Fortunately, many companies now perceive that the benefits of these internal control reports exceed their costs.[20]

Principles-Based or Rules-Based Standards?

The accounting scandals at Enron and other companies involved managers using elaborately structured transactions to try to circumvent specific rules in accounting standards. One consequence of those scandals was a rekindled debate over **principles-based**, or more recently termed **objectives-oriented**, versus **rules-based** accounting standards. In fact, a provision of the Sarbanes-Oxley Act required the SEC to study the issue and provide a report to Congress on its findings. That report, issued in July 2003, recommended that accounting standards be developed using an objectives-oriented approach.[21]

A principles-based, or objectives-oriented, approach to standard setting stresses professional judgment to apply broad principles to various situations, as opposed to following a list of rules.

An objectives-oriented approach to standard setting emphasizes using professional judgment to interpret broad principles and concepts and apply them to various situations, as opposed to following a list of detailed rules, when choosing the accounting treatment for a

[18] Hollis Ashbaugh Skaife, Daniel W. Collins, William R. Kinney, Jr., and Ryan LaFond, "The Effect of SOX Internal Control Deficiencies on Firm Risk and Cost of Equity," *Journal of Accounting Research* 47 (2009): 1–43.

[19] "Sarbanes-Oxley 404 Costs and Implementation Issues: Spring 2006 Survey Update," *CRA International* (April 17, 2006).

[20] Protiviti, Inc., *2011 Sarbanes-Oxley Compliance Survey* (June, 2011).

[21] "Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System," Securities and Exchange Commission (July 2003).

transaction. IFRS is more principles-based or objectives-oriented and provides less precise guidance. In general, the IASB does not provide much guidance such as implementation guidance or discussions of its staff views and positions for its standards. This is because the IFRS emphasizes the general concepts and principles drawn from the IASB's underlying conceptual framework that provides the basis for recognition, measurement, and disclosure of financial statement elements. Hence, the IFRS tends to provide only a limited amount of guidance and fewer illustrative examples and interpretations, and instead encourages the use of professional judgment in applying general principles to specific transactions. In contrast, U.S. GAAP is more rules-based and contains an extremely large amount of detailed and precise guidance. Proponents of an objectives-oriented approach argue that the approach results in a more accurate reflection of the true economic substance of a company's transactions and actual performance in the financial statements, because a focus on professional judgment means a lower likelihood of companies structuring transactions to circumvent the accounting rules, and we are more likely to arrive at an appropriate accounting treatment. Proponents also believe that an objectives-oriented approach will result in shorter and less complex standards. Detractors, on the other hand, argue that the absence of detailed rules opens the door to even more abuse, because management can use the latitude provided by objectives to justify their preferred accounting approach. Even in the absence of intentional misuse, reliance on professional judgment might result in different interpretations for similar transactions, raising concerns about comparability and consistency. Also, detailed rules help auditors withstand pressure from clients who want a more favorable accounting treatment, and help companies ensure that they are complying with accounting standards and avoid litigation. Given ongoing efforts to converge IASB and FASB standards, it is likely that this debate will continue.

Regardless of whether accounting standards are based more on rules or on objectives, prior research highlights that there is some potential for abuse, either by structuring transactions around precise rules or opportunistically interpreting underlying principles.[22] The key is whether management is dedicated to high-quality financial reporting. It appears that poor ethical values on the part of management are at the heart of accounting abuses and scandals like Enron and **Parmalat**, so we now turn to a discussion of ethics in accounting.

Ethics in Accounting

Ethics is a term that refers to a code or moral system that provides criteria for evaluating right and wrong. An ethical dilemma is a situation in which an individual or group is faced with a decision that tests this code. Many of these dilemmas are simple to recognize and resolve. For example, have you ever been tempted to call your professor and ask for an extension on the due date of an assignment by claiming a fictitious illness? Temptation like this will test your personal ethics.

***Ethics* deals with the ability to distinguish right from wrong.**

Accountants, like others operating in the business world, are faced with many ethical dilemmas, some of which are complex and difficult to resolve. For instance, the capital markets' focus on periodic profits may tempt a company's management to bend or even break accounting rules to inflate reported net income. In these situations, technical competence is not enough to resolve the dilemma.

Ethics and Professionalism

One of the elements that many believe distinguishes a profession from other occupations is the acceptance by its members of a responsibility for the interests of those it serves. A high standard of ethical behavior is expected of those engaged in a profession. These standards often are articulated in a code of ethics. For example, law and medicine are professions that have their own codes of professional ethics. These codes provide guidance and rules to members in the performance of their professional responsibilities.

[22] Mark W. Nelson, John A. Elliott, and Robin L. Tarpley, "Evidence From Auditors About Managers' and Auditors" Earnings Management Decisions," *The Accounting Review* 77 (2002): 175–202.

Public accounting has achieved widespread recognition as a profession. In the United States, the AICPA, the U.S. organization of certified public accountants, has its own Code of Professional Conduct which prescribes the ethical conduct members should strive to achieve. Similarly, the Institute of Management Accountants (IMA)—the primary U.S. organization of accountants working in industry and government—has its own code of ethics, as does the Institute of Internal Auditors—the U.S. organization of accountants providing internal auditing services for their own organizations.

Analytical Model for Ethical Decisions

Ethical codes are informative and helpful. However, the motivation to behave ethically must come from within oneself and not just from the fear of penalties for violating professional codes. Presented below is a sequence of steps that provide a framework for analyzing ethical issues. These steps can help you apply your own sense of right and wrong to ethical dilemmas:[23]

Step 1. Determine the facts of the situation. This involves determining the who, what, where, when, and how.

Step 2. Identify the ethical issue and the stakeholders. Stakeholders may include shareholders, creditors, management, employees, and the community.

Step 3. Identify the values related to the situation. For example, in some situations confidentiality may be an important value that may conflict with the right to know.

Step 4. Specify the alternative courses of action.

Step 5. Evaluate the courses of action specified in step 4 in terms of their consistency with the values identified in step 3. This step may or may not lead to a suggested course of action.

Step 6. Identify the consequences of each possible course of action. If step 5 does not provide a course of action, assess the consequences of each possible course of action for all of the stakeholders involved.

Step 7. Make your decision and take any indicated action.

ETHICAL DILEMMA

You have recently been employed by a large retail chain that sells sporting goods. One of your tasks is to help prepare periodic financial statements for external distribution. The chain's largest creditor, National Savings & Loan, requires quarterly financial statements, and you are currently working on the statements for the three-month period ending June 30, 2013.

During the months of May and June, the company spent $1,200,000 on a large radio and TV advertising campaign. The $1,200,000 included the costs of producing the commercials as well as the radio and TV time purchased to run the commercials. All of the costs were charged to advertising expense. The company's chief financial officer (CFO) has asked you to prepare a June 30 adjusting entry to remove the costs from advertising expense and to set up an asset called *prepaid advertising* that will be expensed in July. The CFO explained that "This advertising campaign has produced significant sales in May and June and I think it will continue to bring in customers through the month of July. By recording the ad costs as an asset, we can match the cost of the advertising with the additional July sales. Besides, if we expense the advertising in May and June, we will show an operating loss on our income statement for the quarter. The bank requires that we continue to show quarterly profits in order to maintain our loan in good standing."

[23] Adapted from Harold Q. Langenderfer and Joanne W. Rockness, "Integrating Ethics into the Accounting Curriculum: Issues, Problems, and Solutions," *Issues in Accounting Education* (Spring 1989). These steps are consistent with those provided by the American Accounting Association's Advisory Committee on Professionalism and Ethics in their publication *Ethics in the Accounting Curriculum: Cases and Readings, 1990.*

Ethical dilemmas are presented throughout the text. These dilemmas are designed to raise your consciousness on accounting issues with ethical ramifications. The analytical steps outlined above provide a framework with which to evaluate these situations. In addition, your instructor may assign end-of-chapter ethics cases for further discussion and application.

PART B

THE CONCEPTUAL FRAMEWORK

The increasing complexity of our business world creates growing pressure on accounting standard setters to delicately balance the many constituents of the accounting standard-setting process and to develop a set of accounting standards that are consistent with each other. This task is made less complex if there exists a set of cohesive objectives and fundamental concepts on which financial accounting and reporting can be based. The *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001, provides an underlying foundation for financial reporting standards. In 2010, a revised framework, *The Conceptual Framework for Financial Reporting*, was issued.

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> "The **conceptual framework** deals with (a) the objective of financial reporting; (b) the qualitative characteristics of useful financial information; (c) the definition, recognition, and measurement of the elements from which financial statements are constructed; and (d) concepts of capital and capital maintenance."[24] The purpose of the framework is to assist the board in reviewing existing accounting standards, developing future standards, and promoting harmonization of regulations and standards, and to assist preparers of financial statements, and assist users in interpreting financial statements.[25]

● LO5

The conceptual framework does not prescribe the accounting standards. It provides an underlying foundation for accounting standards.

It is important to realize that the IASB conceptual framework provides structure and direction to financial accounting and reporting and does not directly prescribe the accounting standards.

In the United States, the conceptual framework issued by the FASB is disseminated through seven Statements of Financial Accounting Concepts (*SFACs*). As part of the ongoing efforts to converge U.S. GAAP and IFRS, the FASB and IASB are working together to develop a common and improved conceptual framework that will provide the foundation for developing principles-based, common standards.

The joint conceptual framework project consists of eight phases:

A. Objective and Qualitative Characteristics
B. Definitions of Elements, Recognition, and Derecognition
C. Measurement
D. Reporting Entity Concept
E. Boundaries of Financial Reporting, and Presentation and Disclosure
F. Purpose and Status of the Framework
G. Applicability of the Framework to Not-For-Profit Entities
H. Remaining Issues

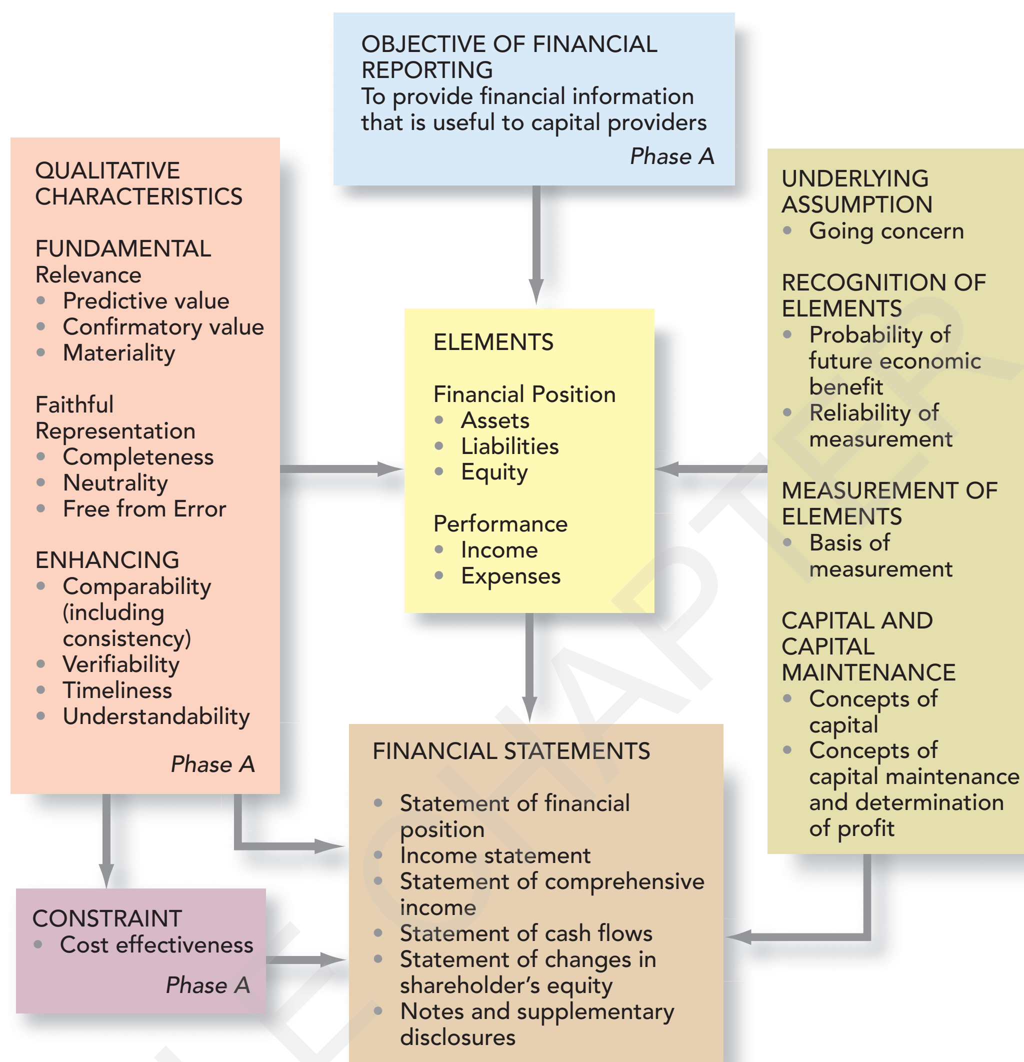
When formulated, this framework will replace the existing IASB conceptual framework. The Boards are currently working on the first four phases of the project and at the time this textbook is written, only Phase A has been completed. Phase A pertains to the objective of financial reporting and the qualitative characteristics of financial information, and that material is incorporated in this and subsequent chapters where applicable. The remaining phases of the project are likely to take several years to be completed.

SAMPLE CHAPTER

[24] "The Conceptual Framework for Financial Reporting," *IASB Conceptual Framework* (London, U.K.: IASB, 2010), p. A25.
[25] Ibid., p. A25.

ILLUSTRATION 1–8

The IASB Conceptual Framework



SAMPLE CHAPTER

In the remainder of this section, we discuss the components of the conceptual framework that influence financial statements as depicted in Illustration 1–8. The financial statements and their elements are most informative when they possess specific qualitative characteristics, subject to certain constraints. Proper recognition and measurement of financial information rely on several assumptions and principles that underlie the financial reporting process.

Our discussions of the objective and qualitative characteristics of financial reporting information are based on the completed first phase of the joint FASB and IASB project (indicated as Phase A in Illustration 1–8), while the remainder of our conceptual framework coverage relies on the existing IASB framework that is still in effect. We discuss and illustrate the financial statements themselves in subsequent chapters.

The conceptual frameworks in U.S. GAAP and IFRS are very similar, and are converging even more with ongoing efforts by the FASB and IASB. However, in U.S. GAAP, the conceptual framework primarily provides guidance to standard setters to help them develop high-quality standards. In IFRS the conceptual framework guides standard setting, but in addition it is supposed to provide a basis for practitioners to make accounting judgments when another IFRS standard does not apply. Also, IFRS emphasizes the overarching concept of the financial statements providing a "true and fair representation" of the company. U.S. GAAP does not include a similar requirement, but U.S. auditing standards require this consideration.

Objective of Financial Reporting

The objective of general purpose financial reporting is to provide financial information about companies that is useful to capital providers in making decisions. For example, investors decide whether to buy, sell, or hold equity or debt securities, and creditors decide whether to provide or settle loans.[26] Information that is useful to capital providers may also be useful to other users of financial reporting information, such as regulators or taxing authorities.

● LO6

The primary objective of financial reporting is to provide useful information to capital providers.

Both investors and creditors are directly interested in the amount, timing, and uncertainty of a company's future cash flows. Information about a company's economic resources (assets) and claims against resources (liabilities) is also useful. Not only does this information about resources and claims provide insight into future cash flows, it also helps decision makers identify the company's financial strengths and weaknesses and assess liquidity and solvency.

Qualitative Characteristics of Financial Reporting Information

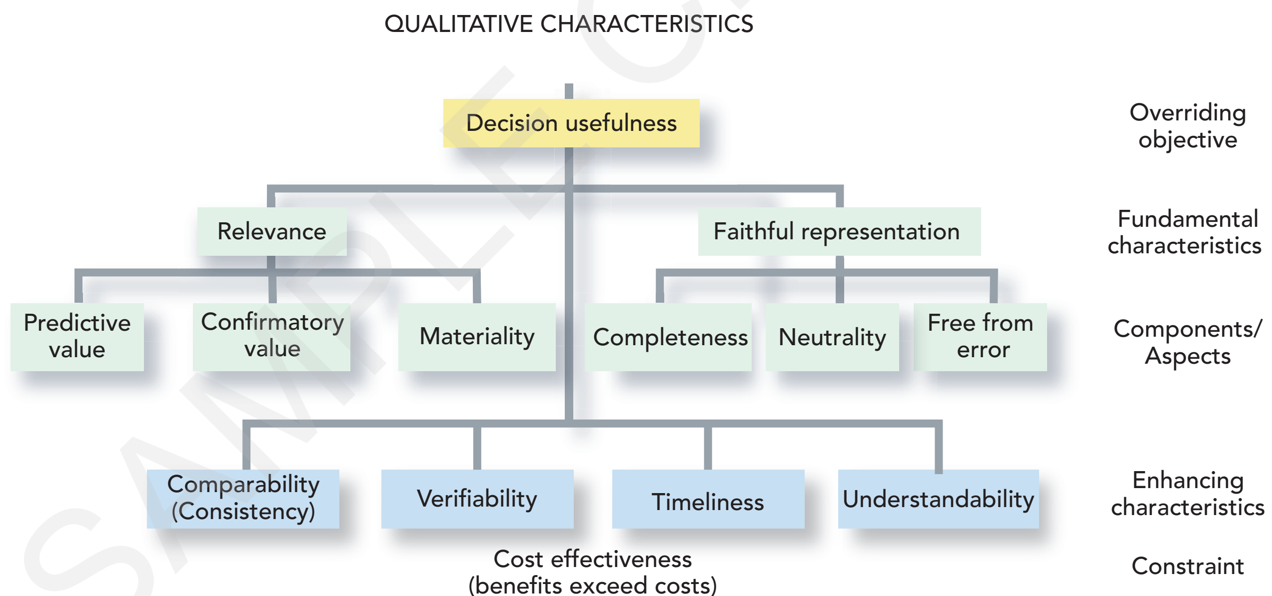
What characteristics should information have to best meet the objective of financial reporting?

● LO6

To be useful, information must make a difference in the decision process.

Illustration 1–9 indicates the desirable qualitative characteristics of financial reporting information, presented in the form of a hierarchy of their perceived importance. Notice that these characteristics are intended to enhance the **decision usefulness** of information.

ILLUSTRATION 1–9 Hierarchy of Desirable Characteristics of Accounting Information



Fundamental Qualitative Characteristics

For financial information to be useful, it should possess the fundamental decision-specific qualities of **relevance** and **faithful representation**. Both are critical. Information is of little value if it's not relevant. And even if information is relevant, it is not as useful if it doesn't faithfully represent the economic phenomenon it purports to represent. Let's look closer at each of these two qualitative characteristics, including the components that

To be useful for decision making, information should possess the qualities of *relevance* and *faithful representation*.

[26] "The Conceptual Framework for Financial Reporting," *IASB Conceptual Framework* (London, U.K.: IASB, 2010), par. OB2.

SAMPLE CHAPTER

make those characteristics desirable. We also consider other characteristics that enhance usefulness.

RELEVANCE. Obviously, to make a difference in the decision process, information must be relevant to the decision. Relevance in the context of financial reporting means that the information must possess **predictive value** and/or **confirmatory value**, typically both. For example, current-period net income has predictive value if it helps users predict a company's future cash flows, and it has confirmatory value if it helps investors confirm or change their prior assessments regarding a company's cash-flow generating ability.

Predictive and confirmatory value are central to the concept of "earnings quality," the ability of reported earnings (income) to predict a company's future earnings. We revisit this concept frequently throughout this textbook in order to explore the impact on earnings quality of various topics under discussion. For instance, in Chapter 4 we discuss the contents of the income statement and certain classifications used in that statement to help analysts separate a company's transitory earnings from its permanent earnings. This separation is critical to a meaningful prediction of future earnings because it's permanent earnings that are likely to recur. In later chapters, we look at how various financial reporting decisions affect earnings quality.

Information is *material* if it has an effect on decisions.

Financial information is material if omitting it or misstating it could affect users' decisions.

Materiality is an aspect of relevance that depends on a company's particular situation and is based on the nature or magnitude of the item that is being reported. If information is immaterial, it's not relevant.

One consequence of considering materiality is that accounting standards need not be followed if an item is immaterial. For example, IFRS requires that receivables be measured at their "net realizable value." If bad debts are anticipated, they should be estimated and subtracted from the principal amount of receivables before the receivables are presented in the statement of financial position. However, if the amount of anticipated bad debts is not considered to be large enough to affect decisions made by users, it's ok to wait and just record the effects of bad debts when the debt has gone bad rather than having to estimate bad debts for existing receivables.

The threshold for materiality often depends on the *relative* dollar amount of the transaction. For example, $10,000 in total anticipated bad debts for a multibillion dollar company like Singapore Airlines would not be considered material. This same $10,000 amount, however, might easily be material for a neighborhood pizza parlor. Because of the context-specific nature of materiality, the IASB has been reluctant to establish any quantitative materiality guidelines. The threshold for materiality has been left to the subjective judgment of the company preparing the financial statements and its auditors.

Professional judgment determines what amount is material in each situation.

Materiality often relates to the nature of the item as well. It depends on qualitative as well as quantitative considerations. For example, an illegal payment of a $10,000 bribe to an official of a foreign government to secure a valuable contract probably would be considered material qualitatively even if the amount is small relative to the size of the company. Similarly, a small dollar amount that changes a net loss to a net income for the reporting period could be viewed as material to financial statement users for qualitative reasons.[27]

***Faithful representation* means agreement between a measure and a real-world phenomenon that the measure is supposed to represent.**

FAITHFUL REPRESENTATION. Faithful representation exists when there is agreement between a measure or description and the phenomenon it purports to represent. For example, assume that the term inventory in the statement of financial position of a retail company is understood by external users to represent items that are intended for sale in the ordinary course of business. If inventory includes, say, machines used to produce inventory, then it lacks faithful representation.

[27] FASB ASC 250–10–S99–1, SAB Topic 1.M: Assessing Materiality (originally "Materiality," Staff Accounting Bulletin No. 99 (Washington, D.C.: SEC, August 1999)).

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To break it down further, faithful representation requires that information be *complete*, *neutral*, and *free from error*. A depiction of an economic phenomenon is **complete** if it includes all the information necessary for faithful representation of the economic phenomena that it purports to represent.[28] Omitting a portion of that information can cause it to be false or misleading and thus not helpful.

A depiction is *complete* if it includes all information necessary for faithful representation.

A financial accounting standard, and the standard-setting process, is "neutral" if it is free from bias. You learned earlier that changes in accounting standards can lead to adverse economic consequences for certain companies and that political pressure is sometimes brought to bear on the standard-setting process in hopes of achieving particular outcomes. Accounting standards should be established with the goal of providing high-quality information, and should try not to achieve particular social outcomes or favor particular groups or companies. The IASB faces a difficult task in maintaining **neutrality** in the face of economic consequences and resulting political pressures.

***Neutrality* implies freedom from bias.**

Representational faithfulness is also enhanced if information is **free from error**, meaning that there are no errors or omissions in the description of the amount or the process used to report the amount. Uncertainty is a fact of life when we measure many items of financial information included in financial statements. Estimates are common, and some inaccuracy is likely. An estimate is represented faithfully if it is described clearly and accurately as being an estimate, and financial statement users are given enough information to understand the potential for inaccuracy that exists.

Representational faithfulness is enhanced if information is *free from error*.

Many accountants have recommended that we deal with the potential for error by employing **conservatism**. Conservatism means that accountants require greater verification before recognizing good news than bad news. The result is that losses are reflected in net income more quickly than are gains, and net assets tend to be biased downwards.

***Conservatism* is inconsistent with neutrality.**

The conceptual framework does not provide any support for conservatism as a desirable characteristic of accounting information. Nevertheless, some accounting practices, such as the lower-of-cost-or-market method for measuring inventory (Chapter 9), appear to be generated by a desire to be conservative. One justification for these practices is that investors and creditors who lose money on their investments are less likely to sue the company if bad news has been exaggerated and good news underestimated. Another justification is that conservative accounting can trigger debt covenants that allow creditors to protect themselves from bad management. So, despite the lack of support for conservatism in the conceptual framework, it is likely to persist as an important consideration in accounting practice and in the application of some accounting standards.

Enhancing Qualitative Characteristics

Illustration 1–9 identifies four enhancing qualitative characteristics, *comparability (including consistency), verifiability, timeliness, and understandability*.

Comparability helps users see similarities and differences between events and conditions. We have already discussed the importance of investors and creditors being able to compare information *among companies* to make their resource allocation decisions. Closely related to comparability is the notion that **consistency** of accounting practices over time permits valid comparisons *among different reporting periods*. The predictive and confirmatory value of information is enhanced if users can compare the performance of a company over time.[29] In the Singapore Airlines financial statements and disclosure notes, notice that disclosure Note 2 includes a summary of significant accounting policies. If Singapore Airlines were to change one of these policies, new numbers might not be comparable to numbers measured under a previous policy. To be sure readers are aware of the change, Singapore Airlines would need to provide a full disclosure in the notes to the financial statements.

Accounting information should be *comparable* across different companies and over different time periods.

Accounting information is *consistent* if it is measured and reported the same way in each time period.

[28] "The Conceptual Framework for Financial Reporting," *IASB Conceptual Framework* (London, U.K.: IASB, 2010), par. QC13.

[29] Companies occasionally do change their accounting practices, which makes it difficult for users to make comparisons among different reporting periods. Chapter 4 and Chapter 20 describe the disclosures that a company makes in this situation to restore consistency among periods.

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Information is *verifiable* if different measurers would reach consensus about whether it is representationally faithful.

Verifiability implies that different knowledgeable and independent measurers would reach consensus regarding whether information is a faithful representation of what it is intended to depict. Direct verification involves observing the item being depicted. For example, the historical cost of a parcel of land to be reported in a company's statement of financial position is usually highly verifiable. The cost can be traced to an exchange transaction, the purchase of the land. On the other hand, the fair value of that land is much more difficult to verify. Appraisers could differ in their assessment of fair value. Verification of their estimates would be indirect, involving examination of their valuation models and assessments of the reasonableness of model inputs. The term *objectivity* is often linked to verifiability. The historical cost of the land is objective and easy to verify, but the land's fair value is subjective, and may be influenced by the measurer's past experience and biases. A measurement that is subjective is more difficult to verify, which may make users doubt its representational faithfulness.

Information is *timely* if it is available to users before a decision is made.

Timeliness is also important for information to be useful. Information is timely when it's available to users early enough to allow them to use it in their decision process. The need for timely information requires that companies provide information on a periodic basis. To enhance timeliness, the SEC in the U.S. requires its registrants to submit financial statement information on a quarterly as well as on an annual basis for each financial year. The securities exchanges in other countries also require their listed companies to file their financial statements on a timely basis.

Information is *understandable* if users can comprehend it.

Understandability means that users must be able to comprehend the information within the context of the decision being made. This is a user-specific quality because users will differ in their ability to comprehend any set of information. The overriding objective of financial reporting is to provide comprehensible information to those who have a *reasonable understanding* of business and economic activities and are diligent in studying the information.

Key Constraint: Cost Effectiveness

Information is *cost effective* only if the benefit of increased *decision usefulness* exceeds the costs of providing that information.

Most of us learn early in life that we can't get everything we want. The latest electronic gadget may have all the qualitative characteristics that current technology can provide, but limited resources may lead us to buy a model with fewer bells and whistles. **Cost effectiveness** constrains the accounting choices we make. The benefits of endowing financial information with all the qualitative characteristics we've discussed must exceed the costs of doing so.

The costs of providing financial information include any possible adverse economic consequences of accounting standards.

The costs of providing financial information include those of gathering, processing, and disseminating information. There are also costs to users when interpreting information. In addition, costs include possible adverse economic consequences of implementing accounting standards. For example, consider the requirement that companies that have more than one operating segment must disclose certain disaggregated financial information.[30] In addition to the costs of information gathering, processing, and communicating that information, many companies feel that this reporting requirement imposes what could be called *competitive disadvantage costs*. These companies are concerned that their competitors will gain some advantage from having access to the disaggregated data.

The perceived benefit from this or any accounting standard is increased *decision usefulness* of the information provided, which, ideally, improves the resource allocation process. It is inherently impossible to quantify this benefit. The elaborate information-gathering process undertaken by the IASB in setting accounting standards is an attempt to assess both costs and benefits of a proposed accounting standard, even if in a subjective, nonquantifiable manner.

Elements of Financial Statements

● LO6

The IASB conceptual framework defines the elements of financial statements. These elements are "the financial effects of transactions and other events" that are grouped into "broad classes according to their economic characteristics".[31] They focus directly on items related to reporting financial position and measuring performance.

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[30] "Operating Segments," *International Financial Reporting Standard No. 8* (London, U.K.: IASB, 2009).

[31] "The Conceptual Framework for Financial Reporting," *IASB Conceptual Framework* (London, U.K.: IASB, 2010), par. 4.2.

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ILLUSTRATION 1–10

Elements of Financial Statements

The elements of financial statements defined in the IASB conceptual framework describe financial position and periodic performance.

Elements of Financial Statements	
Asset	Resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
Liability	Present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
Equity (or net assets)	Residual interest in the assets of the entity after deducting all its liabilities.
Income	Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
	Includes revenues (income that arises in the course of the ordinary activities of an entity) and gains (other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity).
Expenses	Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

The *accrual accounting* model is actually embodied in the element definitions. For now, we list and define the elements in Illustration 1–10, as defined in the IASB conceptual framework.[32] You will learn much more about these in subsequent chapters.

Underlying Assumptions

LO7

The IASB conceptual framework states the going concern assumption as the only assumption underlying the preparation and presentation of financial statements.[33]

Going Concern Assumption

A necessary condition underlying IFRS is that, in the absence of information to the contrary, it is anticipated that a business entity will continue to operate indefinitely. Accountants realize that the **going concern assumption** does not always hold since there are certainly many business failures. However, this assumption is crucial to many broad and specific accounting principles. For example, the assumption provides justification for measuring many assets based on their historical costs. If it were known that an enterprise would cease operations in the near future, assets and liabilities would be measured at their current liquidation values. Similarly, when we depreciate a building over an estimated life of 40 years, we assume the business will operate that long.

Financial statements of a company presume the business is a *going concern.*

Other Useful Assumptions

We also include three other assumptions that are useful in guiding the measurement and reporting of financial statement information.

ECONOMIC ENTITY ASSUMPTION. An essential assumption is that all economic events can be identified with a particular *economic entity*. Investors desire information about an economic entity that corresponds to their ownership interest. For example, if you were considering buying some shares in **Cable & Wireless Worldwide (CW)**, you would want

The *economic entity assumption* presumes that economic events can be identified specifically with an economic entity.

[32] "The Conceptual Framework for Financial Reporting," *IASB Conceptual Framework* (London, U.K.: IASB, 2010), pars. 4.4, 4.25, 4.29, and 4.30. The FASB and IASB are currently working on the definitions of the elements of financial statements, as part of the efforts to develop a common and improved conceptual framework. These definitions will be finalized only after Phase B (Definitions of Elements, Recognition, and Derecognition) of the joint conceptual framework project has been concluded.

[33] "The Conceptual Framework for Financial Reporting," *IASB Conceptual Framework* (London, U.K.: IASB, 2010), par. 4.1.

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information on the various operating units that constitute Cable & Wireless. You would need information not only about their United Kingdom operations but also about their European and other international operations. Also, you would not want the information about CW combined with that of **BT Group**, another global telecommunications services company. These would be two separate *economic entities*. The financial information for the various companies (subsidiaries) in which CW owns a controlling interest (greater than 50% ownership of voting shares) should be combined with that of CW (the parent). The parent and its subsidiaries are separate *legal* entities but one *accounting* entity.

Another key aspect of this assumption is the distinction between the economic activities of owners and those of the company. For example, the economic activities of a sole proprietorship, Uncle Jim's Restaurant, should be separated from the activities of its owner, Uncle Jim. Uncle Jim's personal residence, for instance, is not an asset of the business.

The *periodicity assumption* allows the life of a company to be divided into artificial time periods to provide timely information.

PERIODICITY ASSUMPTION. The **periodicity assumption** relates to the qualitative characteristic of *timeliness*. External users need *periodic* information to make decisions. This need for periodic information requires that the economic life of an enterprise (presumed to be indefinite) be divided into artificial time periods for financial reporting. Corporations whose securities are publicly traded in the United States are required to provide financial information to the SEC on a quarterly and annual basis.[34] Many of the securities exchanges in other countries also require their listed companies to file their financial statements on a quarterly and annual basis. Financial statements are often prepared on a monthly basis for banks and others that might need more timely information.

For many companies, the annual time period (the financial year) is the calendar year. However, other companies have chosen a **financial year** (also referred to as "fiscal year") that does not correspond to the calendar year. The accounting profession and the securities exchanges advocate that companies adopt a financial year that corresponds to their natural business year. A natural business year is the 12-month period that ends when the business activities of a company reach their lowest point in the annual cycle. For example, many retailers have financial years ending in January or February because business activity is generally quite slow in January and February following the very busy Christmas period. **Wal-Mart Stores, Inc.**'s financial year ends in January, and **Tesco plc**'s financial year ends in February. Many companies in the United Kingdom such as **Marks and Spencer Group**, Cable & Wireless, and **Burberry Group** have financial years that end in March because the U.K. government's financial year ends on the last day of March. We can see from the Singapore Airlines financial statements that the company's financial year also ends on March 31. **Dixons Retail**'s financial year ends in May; the **Qantas Group**'s in June; and **Siemens AG**'s in September.

The *monetary unit assumption* states that financial statement elements should be measured in a particular monetary unit (in the United States, the U.S. dollar).

MONETARY UNIT ASSUMPTION. Recall that to *measure* financial statement elements, a unit or scale of measurement must be chosen. Information would be difficult to use if, for example, assets were listed as "three machines, two trucks, and a building." A common denominator is needed to measure all elements. The *monetary unit* or measurement scale used in financial statements is nominal units of money, without any adjustment for changes in purchasing power. In the United States, the U.S. dollar is the monetary unit used in financial statements. In the EU, the euro is the monetary unit. Other countries use other currencies as their monetary units.

One problem with the use of a monetary unit like the dollar or the euro is that it is presumed to be stable over time. That is, the value of the dollar or the euro, in terms of its ability to purchase certain goods and services, is assumed to be constant over time. This assumption obviously does not strictly hold. The economy has experienced periods of rapidly changing prices. To the extent that prices are unstable, and those machines, trucks, and buildings were purchased at different times, the monetary unit used to measure them is not the same. The effect of changing prices on financial information is generally discussed elsewhere in your accounting curriculum, often in an advanced accounting course.

[34] The report that must be filed for the first three quarters of each financial year is Form 10-Q and the annual report is Form 10-K.

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ILLUSTRATION 1–11
Summary of Accounting Assumptions and Principles

Assumptions	Description
Going concern	In the absence of information to the contrary, it is anticipated that a business entity will continue to operate indefinitely.
Economic entity	All economic events can be identified with a particular economic entity.
Periodicity	The life of a company can be divided into artificial time periods to provide timely information to external users.
Monetary unit	Financial statement elements should be measured in terms of a particularly monetary unit.

Illustration 1–11 summarizes the assumptions and principles that guide the recognition and measurement of accounting information.

Recognition and Measurement Concepts

Now that we have identified the various elements and underlying assumptions of financial statements, we discuss when the elements should be recognized (recorded) and how they should be measured and disclosed. For example, an asset was previously defined as a probable future economic benefit controlled by a company as a result of past transactions or events. But *when* should the asset be recorded, at *what* amount, and what other important information about the asset should be provided in the financial statements?

The IASB conceptual framework addresses these issues. **Recognition** refers to the process of incorporating information into the basic financial statements. **Measurement** is the process of associating numerical amounts with the elements. **Disclosure** refers to the process of including additional pertinent information in the financial statements and accompanying notes.

Recognition of the Elements of Financial Statements

Recognition criteria

GENERAL RECOGNITION CRITERIA. According to the conceptual framework, an item should be recognized in the basic financial statements if it meets the following two conditions, subject to a cost effectiveness constraint and materiality considerations:

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1. *Probability of future economic benefit*. "It is probable that any future economic benefit associated with the item will flow to or from the entity".
2. *Measurability*. "The item has a cost or value that can be measured with reliability", meaning that the measurement is "complete, neutral, and free from error".[35]

More specifically, the framework states that an asset is recognized in the statement of financial position when its cost or value can be measured reliably and there is a probable inflow of future economic benefits, while a liability is recognized when there is a probable outflow of economic benefits resulting "from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably". "Income is recognized in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably", and expenses are recognized when "a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably". The framework also states that the "recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities", and the "recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets".[36]

[35] "The Conceptual Framework for Financial Reporting," *IASB Conceptual Framework* (London, U.K.: IASB, 2010), par. 4.38 and QC 12.
[36] Ibid., pars. 4.44, 4.46, 4.47, and 4.49.

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REVENUE RECOGNITION. **Revenues** are inflows of assets resulting from providing a product or service to a customer. An income statement should report the results of these activities only for the time period specified in the financial statements. Therefore, the timing of revenue recognition is a key element of earnings measurement. Not adhering to revenue recognition criteria could result in overstating revenue and hence net income in one reporting period and, consequently, understating revenue and net income in another period.

According to IFRS, revenue should be recognized when it can be measured reliably, it is probable that economic benefits flow to the seller, and risks and rewards of ownership have been transferred.

IFRS requires the following criteria to be satisfied before revenue can be recognized:

a. The amount of revenue, associated costs, and stage of completion (for sales of services) can be measured reliably,
b. It is probable that economic benefits will flow to the seller, and
c. The seller has transferred to the buyer the risks and rewards of ownership (for sales of goods).

These criteria help ensure that a company doesn't record revenue until it has performed all or most of its earnings activities for a financially capable buyer. Notice that these criteria allow for the implementation of the accrual accounting model. Revenue should be recognized in the period it is earned, *not necessarily in the period in which cash is received*.

The timing of revenue recognition also affects the timing of asset recognition. When revenue is recognized by crediting a revenue account, the corresponding debit typically increases some asset, usually cash or an account receivable.

The revenue recognition criteria are usually met at the *point-of-sale*.

The primary earnings activity that triggers the recognition of revenue is known as the *critical event*. The critical event for many businesses occurs at the **point-of-sale**. This usually occurs when the goods or services sold to the buyer are *delivered* (i.e., title is transferred).

However, some revenue-producing activities require revenue recognition over time, rather than at one particular point in time. For example, banks earn interest revenue associated with loans outstanding with the passage of time. We discuss revenue recognition in considerable depth in Chapter 5, and discuss upcoming changes to revenue recognition requirements in the Chapter 5 supplement.

EXPENSE RECOGNITION: MATCHING. **Expenses** were defined earlier in the chapter as outflows or using up of assets or incurrences of liabilities. When are expenses recognized? In practice, expense recognition often matches revenues and expenses that arise from the same transactions or other events. There is a cause-and-effect relationship between revenue and expense recognition implicit in this approach. In a given period, revenue is recognized according to the revenue recognition criteria, and the **matching principle** then requires that all expenses incurred in generating that revenue also be recognized.[37] The net result is a measure—net income—that identifies the amount of profit or loss for the period provided by operations.

According to the *matching principle*, expenses should be recognized in the period in which they produce revenues.

Although these concepts are straightforward, their implementation can be difficult, because many expenses are not incurred *directly* to produce a particular amount of revenue. Instead, the association between revenue and many expenses is indirect. Therefore, expense recognition is implemented by one of four different approaches, depending on the nature of the specific expense:

- **Based on an exact cause-and-effect relationship.** This approach is appropriate for *cost of goods sold,* as one example. There is a definite cause-and-effect relationship between **Lenovo**'s revenue from the sale of personal computers and the costs to produce those computers. Commissions paid to salespersons for obtaining revenues is also an example of an expense recognized based on this approach.
- **By associating an expense with the revenues recognized in a specific time period.** Many expenses can be related only to periods of time during which revenue is earned. For example, the monthly salary paid to an office worker is not directly related to any

[37] The matching principle is mentioned in the IASB Conceptual Framework. However, the IASB also notes that applying the matching principle should not result in the recognition of items that do not meet the definitions of assets and liabilities ("The Conceptual Framework for Financial Reporting," *IASB Conceptual Framework* (London, U.K.: IASB, 2010), par. 4.50). We discuss this topic more in the "Evolution of Accounting Principles" section at the end of this chapter.

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specific revenue event. Instead, the employee provides benefits to the company for that one month that indirectly relate to the revenue recognized in that same period.

- **By a systematic and rational allocation to specific time periods.** Some costs are incurred to acquire assets that provide benefits to the company for more than one reporting period, so we recognize expenses over those time periods. For example, straight-line depreciation is a systematic and rational way to allocate the cost of equipment to the periods in which that equipment is used to produce revenue.
- **In the period incurred, without regard to related revenues.** Sometimes costs are incurred, but it is impossible to determine in which period or periods, if any, related revenues will occur. For example, let's say Singapore Airlines spends $1 million for a series of television commercials. It's difficult to determine when, how much, or even whether additional revenues occur as a result of that particular series of ads. As a result, we recognize advertising expenditures as expenses in the period incurred.

The timing of expense recognition also affects the timing of asset and liability recognition and derecognition. When we debit an expense, the corresponding credit usually either decreases an asset (for example, decreasing cash because it was used to pay an employee's salary) or increases a liability (for example, increasing salaries payable to accrue wages that will be paid at a later date).

Measurement of the Elements of Financial Statements

LO8

If an amount is to be recognized, it must also be measured. The IASB acknowledges in their conceptual framework that elements in the financial statements are currently measured by different measurement attributes. If you look at a statement of financial position, for instance, you might see property, plant, and equipment measured at historical cost, accounts receivable measured at net realizable value, long-term liabilities, such as bonds, measured at the present value of future cash payments, and investments measured at fair value. The attribute chosen to measure a particular item should be the one that maximizes the combination of relevance and faithful representation.

Multiple measurement attributes are employed in IFRS, including:

1. Historical cost
2. Net realizable value
3. Current cost
4. Present (or discounted) value of future cash flows
5. Fair value

These different measurement attributes often indicate the same amount, particularly at initial recognition.

HISTORICAL COST. We often measure assets and liabilities based on their *original transaction value,* that is, their **historical costs**. Some accountants refer to this practice as applying the *historical cost principle*. For an asset, historical cost equals the fair value of what is given in exchange (usually cash) for the asset at its initial acquisition. For liabilities, it is the current cash equivalent received in exchange for assuming the liability. Historical cost for long-lived, revenue-producing assets such as equipment is typically adjusted subsequent to its initial measurement by recognizing depreciation or amortization.

***Historical cost* bases measurements on the amount given or received in the exchange transaction.**

Why base measurement on historical costs? First, historical cost provides important cash flow information as it represents the cash or cash equivalent paid for an asset or received in exchange for the assumption of a liability. Second, because historical cost valuation is the result of an exchange transaction between two independent parties, the agreed-upon exchange value is objective and highly verifiable.

***Net realizable value* bases measurements on the amount of cash into which the asset or liability will be converted in the ordinary course of business.**

NET REALIZABLE VALUE. Some assets are measured at their *net realizable value*, which is the amount of cash into which an asset is expected to be converted in the ordinary course of business. For example, if customers purchased goods or services on account for

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$10,000, and if $2,000 in bad debts were anticipated, net receivables should be valued at $8,000, the net realizable value. Departures from historical cost measurement such as this provide useful information to aid in the prediction of future cash flows.

CURRENT COST. Some inventories are reported at their current replacement cost, which is measured by the cost that would be incurred to purchase or reproduce the goods. This topic is discussed further in Chapter 9.

***Present value* bases measurement on future cash flows discounted for the time value of money.**

PRESENT VALUE. In *IFRS No. 9,* "Financial Instruments,"[38] present value of future cash flows is listed as one of the valuation techniques that are used to approximate the fair value of financial assets and liabilities. We explore the topic of present value in more depth in Chapter 6 and the application of present value in accounting measurement in subsequent chapters.

***Fair value* bases measurements on the price that would be received to sell assets or transfer liabilities in an orderly market transaction.**

FAIR VALUE. We measure many financial assets and liabilities at *fair value* (also referred to as *current market value*). We also use fair values when determining whether the value of nonfinancial assets like property, plant, equipment and intangible assets have been impaired. Given the complexity and growing importance of this measurement attribute, we discuss it in some detail. The IASB has recently issued *IFRS No. 13* which establishes a framework for measuring fair value whenever fair value is called for in applying accounting standards. *IFRS 13* resulted from the joint efforts of the IASB and FASB in developing a common framework for fair value measurement and disclosures in the financial statements that are based on IFRS and U.S. GAAP, and is effective for periods beginning on or after January 1, 2013.

The IASB's framework for measuring fair value doesn't change the number of situations in which fair value is used, but defines fair value and provides improved guidance about how to measure it. 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".[39]

A key aspect of this definition is its focus on the perspective of market participants. For instance, if a company buys a competitor's patent, not intending to use it but merely to keep the competitor from using it, the company will still have to assign a value to the asset because a market participant would find value in using the patent.

Fair value can be measured using:
1. Market approaches
2. Income approaches
3. Cost approaches

In the IASB's framework for measuring fair value, three types of valuation techniques can be used to measure fair value. *Market approaches* base valuation on market information. For example, the value of a share of a company's stock that's not traded actively could be estimated by multiplying the earnings of that company by the P/E (price of shares/earnings) multiples of similar companies. *Income approaches* estimate fair value by first estimating future amounts (for example, earnings or cash flows) and then mathematically converting those amounts to a single present value. You will see how to apply such techniques in Chapter 6 when we discuss time value of money concepts. *Cost approaches* determine value by estimating the amount that would be required to buy or construct an asset of similar quality and condition. A firm can use one or more of these valuation approaches, depending on availability of information, and should try to use them consistently unless changes in circumstances require a change in approach.

To increase consistency and comparability in applying this definition, the IASB provides a "hierarchy" that prioritizes the inputs companies should use when determining fair value.

The priority is based on three broad preference levels. The higher the level (Level 1 is the highest), the more preferable the input. The IASB encourages companies to strive to obtain

[38] "Financial Instruments," *International Financial Reporting Standard No. 9* (London, U.K.: IASB, 2010), par. 5.4.2.
[39] "Fair Value Measurement," *International Financial Reporting Standard No. 13* (London, U.K.: IASB, 2011), par. 9.

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ILLUSTRATION 1–12 Fair Value Hierarchy

Fair Value Hierarchy		
Level	**Inputs**	**Example**
1 **Most Desirable**	Quoted market prices in active markets for identical assets or liabilities.	In Chapter 12 you will learn that certain investments in marketable securities are reported at their *fair values.* Fair value in this case would be measured using the quoted market price from the stock exchange on which the security is traded, such as the London Stock Exchange or the Hong Kong Stock Exchange.
2	Inputs other than quoted prices that are *observable* for the asset or liability. These inputs include quoted prices for *similar* assets or liabilities in active or inactive markets and inputs that are derived principally from or corroborated by observable related market data.	In Chapter 10 we discuss how companies sometimes acquire assets with consideration other than cash. In any noncash transaction, each element of the transaction is recorded at its *fair value.* If one of the assets in the exchange is a building, for instance, then quoted market prices for similar buildings recently sold could be used to value the building or, if there were no similar buildings recently exchanged from which to obtain a comparable market price, valuation could be based on the price per square foot derived from observable market data.
3 **Least Desirable**	*Unobservable* inputs that reflect the entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.	Asset retirement obligations (AROs), discussed in Chapter 10, are measured at *fair value.* Neither Level 1 nor Level 2 inputs would be possible in most ARO valuation situations. Fair value would be estimated using Level 3 inputs to include the present value of expected cash flows estimated using the entity's own data if there is no information that indicates that market participants would use different assumptions.

the highest level input available for each situation. Illustration 1–12 describes the type of inputs and provides an example for each level.

Companies must also provide detailed disclosures about their use of fair value measurements. The disclosures include a description of the inputs used to measure fair value. For recurring fair value measurements that rely on significant *unobservable* inputs (within Level 3 of the fair value hierarchy), companies should disclose the effect of the measurements on earnings (or changes in net assets) for the period.

You are not yet familiar with some of the examples mentioned in Illustration 1–12, but as you progress through the book, you will encounter many instances in which we use fair value for valuation purposes. Refer back to this discussion and speculate on the level of input that would be available to a company in these situations. When a company has the option to measure financial assets or liabilities at fair value (discussed next), we address the choices available to the company in those situations.

The use of the fair value measurement attribute is increasing, both under U.S GAAP and IFRS. This trend, though, is controversial. Proponents of fair value cite its relevance and are convinced that historical cost information may not be useful for many types of decisions. Opponents of fair value counter that estimates of fair value may lack representational faithfulness, particularly when based on inputs from Level 3 in the **fair value hierarchy**, and that managers might be tempted to exploit the unverifiability of such inputs to manipulate earnings. They argue that accounting should emphasize verifiability by recognizing only those gains and other increases in fair value that actually have been realized in transactions or are virtually certain to exist.[40]

[40] Watts, R. L., "Conservatism in Accounting Part I: Explanations and Implications," *Accounting Horizons* (September 2003), pp. 207–21.

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FAIR VALUE OPTION. Usually the measurement attribute we use for a particular financial statement item is not subject to choice. However, IFRS gives a company the option to report some or all of its *financial* assets and liabilities at fair value.[41] For example, in Chapter 14 you will learn that a company normally would report bonds payable at historical cost (adjusted for unamortized premium or discount), but the **fair value option** allows that company to choose instead to report the bonds payable at fair value. If a company chooses the fair value option, future changes in fair value are reported as gains and losses in the income statement.

***IFRS* gives a company the option to value financial assets and liabilities at fair value.**

Why allow the fair value option for financial assets and liabilities, and not for, say, buildings or land? Financial assets and liabilities are cash and other assets and liabilities that convert directly into known amounts of cash. These include investments in shares and bonds of other entities, notes receivable and payable, bonds payable, and derivative securities.[42] Some of these financial assets and liabilities are currently *required* under IFRS to be reported at fair value, and others are not, leading to some potential inconsistencies in how similar or related items are treated. The fair value option provides companies a way to reduce volatility in reported earnings without having to comply with complex hedge accounting standards.

It is not necessary that the company elect the fair value option to report all of its financial instruments at fair value or even all instruments of a particular type at fair value. Companies can "mix and match" on an instrument-by-instrument basis. However, a company is not allowed to switch methods once a method is chosen.

We will revisit the fair value option in subsequent chapters that address the key financial assets and liabilities that now can be measured at fair value. You'll find it easier to understand the concepts introduced in this chapter in the context of the financial assets and liabilities affected: investments (Chapter 12) and bonds payable (Chapter 14).

Disclosure

● LO8

The *full-disclosure principle* requires that any information useful to decision makers be provided in the financial statements, subject to the cost effectiveness constraint.

Remember, the purpose of accounting is to provide information that is useful to decision makers. So, naturally, if there is accounting information not included in the primary financial statements that would benefit users, that information should be provided too. The **full-disclosure principle** means that the financial reports should include any information that could affect the decisions made by external users. Of course, the benefits of that information, as noted earlier, should exceed the costs of providing the information. Such information is disclosed in a variety of ways, including:

1. **Parenthetical comments** or **modifying comments** placed on the face of the financial statements.
2. **Disclosure notes** conveying additional insights about company operations, accounting principles, contractual agreements, and pending litigation.
3. **Supplemental schedules and tables** that report more detailed information than is shown in the primary financial statements.

We find examples of these disclosures in the Singapore Airlines financial statements included with all new copies of the text. The Singapore Airlines financial statements contain several notes disclosing the details of many of the financial statement items. In Marks and Spencer's 2011 statement of changes in shareholders' equity, modifying comments are provided at the bottom of the statement, disclosing details of the company's reserves and retained earnings. The financial statements of U.S. companies often have parenthetical comments provided in the shareholders' equity section of the statement of financial position with disclosure of the number of authorized, issued, and outstanding shares. We discuss and illustrate disclosure requirements as they relate to specific financial statement elements in later chapters as those elements are discussed.

[41] "Financial Instruments," *International Financial Reporting Standard No. 9* (London, U.K.: IASB, 2010), pars. 4.1.5 and 4.2.2.
[42] The fair value option does not apply to certain specified financial instruments, including pension obligations and assets or liabilities arising from leases.

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Capital and Capital Maintenance Concepts

The concepts of capital and capital maintenance determine whether increases or decreases in assets and liabilities are recognized as income or equity.

Concepts of Capital

There are two capital concepts: financial and physical. A financial capital concept focuses on an entity's invested money or invested purchasing power, and capital is defined as the entity's net assets (assets minus liabilities) or equity. A physical capital concept focuses on the entity's operating capability, and hence, capital is defined as the entity's productive capacity or units of output.[43]

Concepts of Capital Maintenance and Determination of Profit

The concept of capital maintenance is linked to the determination of profit because only the increases in net assets that exceed the amounts needed to maintain capital are treated as profits. The primary difference between the financial and physical concepts of capital maintenance is the recognition of the changes in the prices of assets and liabilities as capital maintenance adjustments (equity) or as profits.

Under a financial capital maintenance concept, profit is represented by an increase in the monetary units of net assets, after excluding contributions from and distributions to owners. Hence, price increases in net assets—unrealized gains are treated as profits. Under a physical capital maintenance concept, profit is represented by an increase in physical productive capacity or operating capability during the period. Price changes in net assets are treated as changes in physical productive capacity and are therefore treated as capital maintenance adjustments and not profits. The IASB recommends that management select measurement bases and concepts of capital and capital maintenance by seeking a balance between relevance and reliability.[44]

Evolution of Accounting Principles

Earlier in the chapter you learned that the convergence of accounting standards with international standards is having a profound effect on financial reporting in the United States and many other countries. More broadly, U.S. and international GAAP has been evolving over time from an emphasis on revenues and expenses to an emphasis on assets and liabilities. Of course, you know from introductory accounting that the statement of financial position and income statement are intertwined and must reconcile with each other. For example, the revenues reported in the income statement depict inflows of assets whose balances at a particular point in time are reported in the statement of financial position. But which comes first, identifying revenues and expenses, or identifying assets and liabilities? That emphasis can affect accounting standards in important ways. To help you understand the changes taking place, we start by discussing the revenue/expense approach and then discuss the asset/liability approach.

With the *revenue/expense approach*, recognition and measurement of revenues and expenses are emphasized.

Under the *revenue/expense approach*, we emphasize principles for recognizing revenues and expenses, with some assets and liabilities recognized as necessary to make the statement of financial position reconcile with the income statement. For example, when accounting for a sales transaction our focus would be on whether revenue has been earned, and if we determine that to be the case, we would record an asset (usually cash or accounts receivable) that is associated with the revenue.[45] We would identify the expenses necessary to earn that

[43] "The Conceptual Framework for Financial Reporting," *IASB Conceptual Framework* (London, U.K.: IASB, 2010), par. 4.57.
[44] Ibid., pars. 4.59, 4.60, 4.62, 4.64, and 4.65.
[45] "Some assets and liabilities aren't related to revenue or expense. For example, issuance of shares increases cash as well as shareholders' equity. The treatment of these sorts of transactions is not affected by whether accounting standards emphasize revenues and expenses or assets and liabilities.

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revenue, and then would adjust assets and liabilities accordingly. Much of our accounting for revenues and expenses follows this revenue/expense approach. Key to the revenue/expense approach are the revenue recognition criteria and the matching principle discussed previously in this chapter.

With the *asset/liability approach*, recognition and measurement of assets and liabilities drives revenue and expense recognition.

Under the *asset/liability approach*, on the other hand, we first recognize and measure the assets and liabilities that exist as at the financial year-end and, secondly, recognize and measure the revenues, expenses, gains and losses needed to account for the changes in these assets and liabilities from the previous financial year-end. Proponents of this approach point out that, since revenues and expenses are defined in terms of inflows and outflows of assets and liabilities, the fundamental concepts underlying accounting are assets and liabilities. Therefore, we should try to recognize and measure assets and liabilities appropriately, and as a result will also capture their inflows and outflows in a manner that provides relevant and representationally faithful information about revenues and expenses.

For example, when accounting for a sales transaction, our focus would be on whether a potential accounts receivable meets the definition of an asset (a probable future economic benefit). We would consider such factors as whether the receivable is supported by an enforceable contract and whether the seller has performed its obligations enough to be able to expect receipt of cash flows. The key would be determining if the seller has an asset, and then recognizing whatever amount of revenue is implied by the inflow of that asset. Also, we would not attempt to match expenses to revenues. Rather, we would determine those net assets that had decreased as part of operations during the period, and recognize those decreases as expenses. In subsequent chapters you will see that recent standards involving accounting for revenue, investments, and income taxes follow this asset/liability approach.

These changes are controversial. It may seem like it shouldn't matter whether standard setters use the revenue/expense or asset/liability approach, given that both approaches affect both the income statement and statement of financial position, and it is true that these approaches will often result in the same accounting outcomes. For example, whether matching is a principle used to determine when expenses are recognized, or a result of recognizing that assets were consumed as part of the economic activity that occurred in a particular period in which revenue was also recognized, we will typically still see expenses recognized in the periods in which they are incurred to produce revenues. However, the particular approach used by a standard setter can affect recognition and measurement in important ways. In particular, the asset/liability approach encourages us to focus on accurately measuring assets and liabilities. It is perhaps not surprising, then, that a focus on assets and liabilities has led standard setters to lean more and more toward fair value measurement. The future changes to the conceptual framework discussed in the following "Where We're Headed" box are likely to continue this emphasis on the asset/liability approach.

WHERE WE'RE HEADED

Earlier in the chapter you learned that the FASB and IASB are working together to develop a common and improved conceptual framework. The project has eight phases, and the Boards are currently working on the first four. Phase A, "Objective and Qualitative Characteristics," has been completed and that material is incorporated in this and subsequent chapters where applicable. There is no timetable for the completion of the remaining phases. However, the Boards have reached some tentative conclusions highlighted below.

Phase B: Definitions of Elements, Recognition, and Derecognition. The Boards have tentatively adopted working definitions for assets (present economic resources to which an entity has a right or other access that others do not have) and liabilities (present economic obligations for which the entity is the obligor) that differ from those in the existing framework. Currently, the FASB framework identifies more elements than the IASB framework, and the two frameworks define common elements differently. The Boards are working toward a common set of elements and definitions.

(continued)

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(concluded)

Phase C: Measurement. The objective of Phase C is to provide guidance for selecting measurement bases that satisfy the objective and qualitative characteristics of financial reporting. No tentative conclusions have been reached on this issue.

Phase D: Reporting Entity. The objective of Phase D is to determine what constitutes a reporting entity for the purposes of financial reporting. The Board issued an exposure draft for this phase in March of 2010. The Board's preliminary view is that *control* is a key aspect in determining what constitutes a reporting entity. The Board defines "control" as the ability to direct the activities of the entity to generate benefits for (or limit losses to) itself.

FINANCIAL REPORTING CASE SOLUTION

1. **What should you tell your friend about the presence of accounting standards and regulations? Who has the authority for standard setting? Who has the responsibility?** *(pp. 8 and 10)* Most industrialized countries have organizations responsible for determining accounting and reporting standards. In a few countries, such as Japan, the United Kingdom, and the United States, the private-sector standard-setting body is independent of the government and of the accounting profession. In many other countries, such as Australia, France, India, and Singapore, the standard-setting organization is a governmental body. Because differences in national accounting standards create problems for multinational companies and investors, the International Accounting Standards Board (IASB) was formed to develop global accounting standards known as International Financial Reporting Standards (IFRS). The IASB is a private and non-governmental standard-setting body without authority to enforce the use of IFRS and has to depend on each jurisdiction's regulatory authority to enforce the application of IFRS in that jurisdiction. Nevertheless, more and more countries are basing their national accounting standards on IFRS.

2. **What is the economic and political environment in which standard setting occurs?** *(p. 13)* The setting of accounting and reporting standards often has been characterized as a *political process.* Standards, particularly changes in standards, can have significant differential effects on companies, investors and creditors, and other interest groups. A change in an accounting standard or the introduction of a new standard can result in a substantial redistribution of wealth within our economy. The standard-setting board must consider potential economic consequences of a change in an accounting standard or the introduction of a new standard. The IASB's due process is designed to obtain information from all interested parties to help determine the appropriate accounting approach, but standards are supposed to be neutral with respect to the interests of various parties. Nonetheless, the IASB and other standard setters sometimes come under political pressure that sways the results of the standard-setting process.

3. **What is the relationship among management, auditors, investors, and creditors that tends to preclude the "What would you like it to be?" attitude?** *(p. 15)* It is the responsibility of management to apply accounting standards when communicating with investors and creditors through financial statements. Auditors serve as independent intermediaries to help ensure that the management-prepared statements are presented fairly in accordance with accounting standards. In providing this assurance, the auditor precludes the "What would you like it to be?" attitude.

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4. **In general, what is the conceptual framework that underlies accounting principles?** *(p. 19)* The conceptual framework is a set of cohesive objectives and fundamental concepts on which financial accounting and reporting can be based. It does not prescribe the accounting standards but provides an underlying foundation for accounting standards. The conceptual framework deals with the objective of financial reporting, the qualitative characteristics of useful financial information, the definition, recognition, and measurement of the elements of financial statements, and concepts of capital and capital maintenance.

THE BOTTOM LINE

- **LO1** Financial accounting is concerned with providing relevant financial information to various external users. However, the primary focus is on the financial information provided by profit-oriented companies to their present and potential investors and creditors. (p. 4)
- **LO2** Cash basis accounting provides a measure of periodic performance called *net operating cash flow*, which is the difference between cash receipts and cash disbursements from transactions related to providing goods and services to customers. Accrual accounting provides a measure of performance called *net income,* which is the difference between revenues and expenses. Periodic net income is considered a better indicator of future operating cash flows than is current net operating cash flows. (p. 7)
- **LO3** Accounting standards provide both the broad and specific guidelines that companies should follow when measuring and reporting the information in their financial statements and related notes. In a few countries, such as Japan, the United Kingdom, and the United States, the standard-setting body is independent of government and the accounting profession. In many other countries, such as Australia, France, India, and Singapore, the standard-setting body is a governmental body. The International Accounting Standards Board (IASB) sets a single set of global accounting standards known as International Financial Reporting Standards (IFRS), and works with national accounting standard setters to achieve convergence in accounting standards around the world. The IASB does not have authority to enforce the use of IFRS and depends on each jurisdiction's regulatory authority to enforce the application of IFRS. (pp. 8, 10, and 12)
- **LO4** Accounting standards can have significant differential effects on companies, investors, creditors, and other interest groups. Various interested parties sometimes lobby standard setters for their preferred outcomes. For this reason, the setting of accounting standards often has been characterized as a political process. (p. 13)
- **LO5** The IASB's conceptual framework is a set of cohesive objectives and fundamental concepts on which financial accounting and reporting standards can be based. The framework deals with the objective of financial reporting, qualitative characteristics of useful financial information, recognition and measurement of financial statement elements, and capital and capital maintenance concepts. The purpose of the framework is to assist the IASB in reviewing existing standards, developing future standards, and promoting harmonization of standards, and to assist preparers and users of financial statements. (p. 19)
- **LO6** The objective of financial reporting is to provide useful financial information to capital providers. The fundamental decision-specific qualities that make financial information useful are relevance and faithful representation. To be relevant, information must possess predictive value and/or confirmatory value, and all material information should be included. Completeness, neutrality, and freedom from error enhance faithful representation. The elements of financial statements are assets, liabilities, equity, income, and expenses. (pp. 21 and 24)
- **LO7** The basic assumptions underlying the measurement and reporting of financial statement information are the going concern assumption, the economic entity assumption, the periodicity assumption, and the monetary unit assumption. (p. 25)
- **LO8** Recognition determines whether an item is reflected in the financial statements and depends on the two conditions of probability of future economic benefit and measurability. Measurement determines the amount of the item and involves the choice of a monetary unit such as the dollar or euro, and the choice of a measurement attribute such as historical cost, present value, or fair value. Disclosure refers to the process of including additional pertinent information in the financial statements and accompanying notes. (pp. 27, 29, and 32)

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QUESTIONS FOR REVIEW OF KEY TOPICS

Q 1–1 What is the function and primary focus of financial accounting?

Q 1–2 What is meant by the phrase *efficient allocation of resources*? What mechanism fosters the efficient allocation of resources?

Q 1–3 Identify two important variables to be considered when making an investment decision.

Q 1–4 What must a company do in the long run to be able to provide a return to investors and creditors?

Q 1–5 What is the primary objective of financial accounting?

Q 1–6 Define net operating cash flows. Briefly explain why periodic net operating cash flows may not be a good indicator of future operating cash flows.

Q 1–7 What is meant by accounting standards? Why should all companies follow accounting standards in reporting to external users?

Q 1–8 What is the standard-setting body responsible for determining IFRS? How does it obtain its funding?

Q 1–9 Explain the role of the auditor in the financial reporting process.

Q 1–10 List three key provisions of the Sarbanes-Oxley Act of 2002. Order your list from most important to least important in terms of the likely long-term impact on the accounting profession and financial reporting.

Q 1–11 Explain what is meant by *adverse economic consequences* of new or changed accounting standards.

Q 1–12 Why do the accounting standard setters undertake a series of elaborate information-gathering steps before issuing an accounting standards update?

Q 1–13 What is the purpose of the IASB's conceptual framework?

Q 1–14 Discuss the terms *relevance* and *faithful representation* as they relate to financial accounting information.

Q 1–15 What are the components of relevant information? What are the components of faithful representation?

Q 1–16 Explain what is meant by: The benefits of accounting information must exceed the costs.

Q 1–17 What is meant by the term *materiality* in financial reporting?

Q 1–18 Briefly define the financial statement elements: (1) assets, (2) liabilities, (3) equity, (4) income, and (5) expenses.

Q 1–19 What are the basic assumptions underlying the measurement and reporting of financial statement information?

Q 1–20 What is the going concern assumption?

Q 1–21 Explain the periodicity assumption.

Q 1–22 What measurement attributes are commonly used in financial reporting?

Q 1–23 What are two important reasons to base the valuation of assets and liabilities on their historical cost?

Q 1–24 Describe the criteria that must be satisfied before revenue can be recognized.

Q 1–25 What are the four different approaches to implementing the matching principle? Give an example of an expense that is recognized under each approach.

Q 1–26 In addition to the financial statement elements arrayed in the basic financial statements, what are some other ways to disclose financial information to external users?

Q 1–27 Briefly describe the inputs that companies should use when determining fair value. Organize your answer according to preference levels, from highest to lowest priority.

Q 1–28 Distinguish between the revenue/expense and the asset/liability approaches to setting financial reporting standards.

SAMPLE CHAPTER

BRIEF EXERCISES

BE 1–1
Accrual accounting
● LO2

Cash flows during the first year of operations for the Harman-Kardon Consulting Company were as follows: Cash collected from customers, $340,000; Cash paid for rent, $40,000; Cash paid to employees for services rendered during the year, $120,000; Cash paid for utilities, $50,000.

In addition, you determine that customers owed the company $60,000 at the end of the year and no bad debts were anticipated. Also, the company owed the gas and electric company $2,000 at year-end, and the rent payment was for a two-year period. Calculate accrual net income for the year.

BE 1–2
Financial statement elements
● LO6

For each of the following items, identify the appropriate financial statement element or elements: (1) probable future sacrifices of economic benefits; (2) probable future economic benefits owned by the company; (3) inflows of assets resulting in increase in equity; (4) decrease in equity from incurrences of liabilites.

BE 1–3
Basic assumptions and principles
● LO6 through LO8

Listed below are several statements that relate to financial accounting and reporting. Identify the basic assumption, broad accounting principle, or pervasive constraint that applies to each statement.

1. **Fujitsu Limited** files its annual and quarterly financial statements with the Tokyo Stock Exchange.
2. The president of **Applebee's International, Inc.** travels on the corporate jet for business purposes only and does not use the jet for personal use.
3. Jackson Manufacturing does not recognize revenue for unshipped merchandise even though the merchandise has been manufactured according to customer specifications.
4. Lady Jane Cosmetics depreciates the cost of equipment over their useful lives.

BE 1–4
Basic assumptions and principles
● LO6 through LO8

Identify the basic assumption or broad accounting principle that was violated in each of the following situations.

1. Astro Turf Company recognizes an expense, cost of goods sold, in the period the product is manufactured.
2. McCloud Drug Company purchased inventory for $2 million. The controller recently revalued the inventory to its approximate market value of $8 million.
3. Philips Company pays the monthly mortgage on the home of its president, Larry Crosswhite, and charges the expenditure to miscellaneous expense.

BE 1–5
Basic assumptions and principles
● LO6 through LO8

For each of the following situations, (1) indicate whether you agree or disagree with the financial reporting practice employed and (2) state the basic assumption, pervasive constraint, or accounting principle that is applied (if you agree), or violated (if you disagree).

1. Winderl Corporation did not disclose that it was the defendant in a material lawsuit because the trial was still in progress.
2. Alliant Semiconductor Corporation files quarterly and annual financial statements with the London Stock Exchange.
3. Reliant Pharmaceutical paid rent on its office building for the next two years and charged the entire expenditure to rent expense.
4. Rockville Engineering records revenue only after products have been shipped, even though customers pay Rockville 50% of the sales price in advance.

BE 1–6
Participants in IFRS standard setting
● LO3

Indicate the organization related to IFRS that performs each of the following functions:

1. Obtains funding for the IFRS standard-setting process.
2. Determines IFRS.
3. Encourages cooperation among securities regulators to promote effective and efficient capital markets.
4. Provides input about the standard-setting agenda.
5. Provides implementation guidance about specific issues.

EXERCISES

E 1–1
Accrual accounting
● LO2

Listed below are several transactions that took place during the first two years of operations for the law firm of Pete, Pete, and Roy.

	Year 1	Year 2
Amounts billed to customers for services rendered	$170,000	$220,000
Cash collected from customers	160,000	190,000
Cash disbursements:		
Salaries paid to employees for services rendered during the year	90,000	100,000
Utilities	30,000	40,000
Purchase of insurance policy	60,000	–0–

In addition, you learn that the company incurred utility costs of $35,000 in year one, that there were no liabilities at the end of year two, no anticipated bad debts on receivables, and that the insurance policy covers a three-year period.

Required:

1. Calculate the net operating cash flow for years 1 and 2.
2. Prepare an income statement for each year similar to Illustration 1–3 on page 8 according to the accrual accounting model.
3. Determine the amount of receivables from customers that the company would show in its year 1 and year 2 statements of financial position prepared according to the accrual accounting model.

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E 1–2
Accrual accounting
● LO2

Listed below are several transactions that took place during the second two years of operations for RPG Consulting.

	Year 2	Year 3
Amounts billed to customers for services rendered	$350,000	$450,000
Cash collected from credit customers	260,000	400,000
Cash disbursements:		
Payment of rent	80,000	–0–
Salaries paid to employees for services rendered during the year	140,000	160,000
Travel and entertainment	30,000	40,000
Advertising	15,000	35,000

In addition, you learn that the company incurred advertising costs of $25,000 in year 2, owed the advertising agency $5,000 at the end of year 1, and there were no liabilities at the end of year 3. Also, there were no anticipated bad debts on receivables, and the rent payment was for a two-year period, year 2 and year 3.

Required:

1. Calculate accrual net income for both years.
2. Determine the amount due to the advertising agency that would be shown as a liability on the RPG's statement of financial position at the end of year 2.

E 1–3
Financial statement elements
● LO6

For each of the items listed below, identify the appropriate financial statement element or elements.

1. Obligation to transfer cash or other resources as a result of a past transaction.
2. Dividends paid by a corporation to its shareholders.
3. Inflow of an asset from providing a good or service.
4. The financial position of a company.
5. Increase in equity from ongoing business transactions.
6. Increase in equity not from ongoing business activities but peripheral transactions.
7. Sale of an asset used in the operations of a business for less than the asset's book value.
8. The owners' residual interest in the assets of a company.
9. An item owned by the company representing probable future benefits.
10. Revenues plus gains less expenses and losses.
11. An owner's contribution of cash to a corporation in exchange for ownership shares.
12. Outflow of an asset related to the production of revenue.

E 1–4
Concepts; terminology; conceptual framework
● LO6

Listed below are several terms and phrases associated with the conceptual framework. Pair each item from List A (by letter) with the item from List B that is most appropriately associated with it.

List A	List B
____ 1. Predictive value	a. Decreases in equity resulting from transfers to owners.
____ 2. Relevance	b. Requires consideration of the costs and value of information.
____ 3. Timeliness	c. Important for making interfirm comparisons.
____ 4. Distribution to owners	d. Applying the same accounting practices over time.
____ 5. Confirmatory value	e. Users understand the information in the context of the decision being made.
____ 6. Understandability	f. Agreement between a measure and the phenomenon it purports to represent.
____ 7. Gain	g. Information is available prior to the decision.
____ 8. Faithful representation	h. Pertinent to the decision at hand.
____ 9. Expenses	i. Implies consensus among different measurers.
____ 10. Materiality	j. Information confirms expectations.
____ 11. Comparability	k. Decreases in equity from depletions of assets.
____ 12. Neutrality	l. The process of admitting information into financial statements.
____ 13. Recognition	m. The absence of bias.
____ 14. Consistency	n. Results if an asset is sold for more than its book value.
____ 15. Cost effectiveness	o. Information is useful in predicting the future.
____ 16. Verifiability	p. Concerns the relative size of an item and its effect on decisions.

E 1–5
Qualitative characteristics
● LO6

Phase A of the joint FASB and IASB conceptual framework project stipulates the desired fundamental and enhancing qualitative characteristics of accounting information. Several constraints impede achieving these desired characteristics. Answer each of the following questions related to these characteristics and constraints.

1. Which constraint would allow a company to record the purchase of a $120 printer as an expense rather than capitalizing the printer as an asset?

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2. Donald Kirk, former chairman of the FASB, once noted that " . . . there must be public confidence that the standard-setting system is credible, that selection of board members is based on merit and not the influence of special interests . . ." Which characteristic is implicit in Mr. Kirk's statement?
3. Allied Appliances Ltd changed its revenue recognition policies. Which characteristic is jeopardized by this change?
4. National Bancorp, a publicly traded company, files quarterly and annual financial statements with the Toronto Stock Exchange. Which characteristic is relevant to the timing of these periodic filings?
5. In general, relevant information possesses which qualities?
6. When there is agreement between a measure or description and the phenomenon it purports to represent, information possesses which characteristic?
7. Jeff Brown is evaluating two companies for future investment potential. Jeff's task is made easier because both companies use the same accounting methods when preparing their financial statements. Which characteristic does the information Jeff will be using possess?
8. A company should disclose information only if the perceived benefits of the disclosure exceed the costs of providing the information. Which constraint does this statement describe?

E 1–6
Basic assumptions, principles, and constraints
● LO6 through LO8

Listed below are several terms and phrases associated with basic assumptions, underlying principles, and constraints. Pair each item from List A (by letter) with the item from List B that is most appropriately associated with it.

List A	List B
____ 1. Matching principle	a. The enterprise is separate from its owners and other entities.
____ 2. Periodicity	b. A common denominator is the dollar.
____ 3. Historical cost principle	c. The entity will continue indefinitely.
____ 4. Materiality	d. Record expenses in the period the related revenue is recognized.
____ 5. Revenue recognition	e. The original transaction value upon acquisition.
____ 6. Going concern assumption	f. All information that could affect decisions should be reported.
____ 7. Monetary unit assumption	g. The life of an enterprise can be divided into artificial time periods.
____ 8. Economic entity assumption	h. Criteria usually satisfied at point of sale.
____ 9. Full-disclosure principle	i. Concerns the relative size of an item and its effect on decisions.

E 1–7
Basic assumptions and principles
● LO6 through LO8

Listed below are several statements that relate to financial accounting and reporting. Identify the basic assumption, broad accounting principle, or pervasive constraint that applies to each statement.

1. Jim Marley is the sole owner of Marley's Appliances. Jim borrowed $100,000 to buy a new home to be used as his personal residence. This liability was not recorded in the records of Marley's Appliances.
2. Siemens AG distributes an annual report to its shareholders.
3. **Nokia Corporation** depreciates machinery and equipment over their useful lives.
4. Crosby Company lists land on its statement of financial position at $120,000, its original purchase price, even though the land has a current market value of $200,000.
5. **Nestlé S. A.** records revenue when products are delivered to customers, even though the cash has not yet been received.
6. Liquidation values are not normally reported in financial statements even though many companies do go out of business.
7. **Mitsubishi Corporation**, a multibillion dollar company, purchased some small tools at a cost of $800. Even though the tools will be used for a number of years, the company recorded the purchase as an expense.

E 1–8
Basic assumptions and principles
● LO7 LO8

Identify the basic assumption or broad accounting principle that was violated in each of the following situations.

1. Pastel Paint Company purchased inventory at a price of $250,000. Because the value of the inventory has appreciated to $400,000, the company has valued the inventory at $400,000 in its most recent statement of financial position.
2. Atwell Corporation has not prepared financial statements for external users for over three years.
3. The Klingon Company sells farm machinery. Revenue from a large order of machinery from a new buyer was recorded the day the order was received.
4. Don Smith is the sole owner of a company called Hardware City. The company recently paid a $150 utility bill for Smith's personal residence and recorded a $150 expense.
5. Golden Book Company purchased a large printing machine for $1,000,000 (a material amount) and recorded the purchase as an expense.
6. Ace Appliance Company is involved in a major lawsuit involving injuries sustained by some of its employees in the manufacturing plant. The company is being sued for $2,000,000, a material amount, and is not insured. The suit was not disclosed in the most recent financial statements because no settlement had been reached.

SAMPLE CHAPTER

E 1–9
Basic assumptions and principles
● LO6 through LO8

For each of the following situations, indicate whether you agree or disagree with the financial reporting practice employed and state the basic assumption, pervasive constraint, or accounting principle that is applied (if you agree) or violated (if you disagree).

1. Wagner Corporation adjusted the valuation of all assets and liabilities to reflect changes in the purchasing power of the dollar.
2. Spooner Oil Company changed its method of accounting for oil and gas exploration costs from successful efforts to full cost. No mention of the change was included in the financial statements. The change had a material effect on Spooner's financial statements.
3. Cypress Manufacturing Company purchased machinery having a five-year life. The cost of the machinery is being expensed over the life of the machinery.
4. Rudeen Corporation purchased inventory for $180,000 at a liquidation sale of a competitor. Because the inventory was worth $230,000, Rudeen valued the inventory in its subsequent statement of financial position at $230,000.
5. Davis Bicycle Company received a large order for the sale of 1,000 bicycles at $100 each. The customer paid Davis the entire amount of $100,000 on March 15. However, Davis did not record any revenue until April 17, the date the bicycles were delivered to the customer.
6. Gigantic Corporation purchased two small calculators at a cost of $32. The cost of the calculators was expensed even though they had a three-year estimated useful life.
7. Esquire Company provides financial statements to external users every three years.

E 1–10
Basic assumptions, principles, and constraints
● LO6 through LO8

For each of the following situations, state whether you agree or disagree with the financial reporting practice employed, and briefly explain the reason for your answer.

1. The controller of the Dumars Corporation increased the carrying value of land from its original cost of $2 million to its recently appraised value of $3.5 million.
2. The president of Vosburgh Industries asked the company controller to charge miscellaneous expense for the purchase of an automobile to be used solely for personal use.
3. At the end of its 2013 financial year, Dower Ltd received an order from a customer for $45,350. The merchandise will ship early in 2014. Because the sale was made to a long-time customer, the controller recorded the sale in 2013.
4. At the beginning of its 2013 financial year, Rossi Imports paid $48,000 for a two-year lease on warehouse space. Rossi recorded the expenditure as an asset to be expensed equally over the two-year period of the lease.
5. The Reliable Tire Company included a note in its financial statements that described a pending lawsuit against the company.
6. The Hughes Corporation, a company whose securities are publicly traded, prepares monthly, quarterly, and annual financial statement for internal use but disseminates to external users only the annual financial statements.

E 1–11
Basic assumptions, principles, and constraints
● LO6 through LO8

Listed below are the basic assumptions, underlying principles, and constraints discussed in this chapter.

a. Economic entity assumption	f. Revenue recognition
b. Going concern assumption	g. Matching principle
c. Periodicity assumption	h. Full-disclosure principle
d. Monetary unit assumption	i. Cost effectiveness
e. Historical cost principle	j. Materiality

Identify by letter the assumption, principle, or constraint that relates to each statement or phrase below.

____ 1. Revenue is recognized only after certain criteria are satisfied.
____ 2. Information that could affect decision making should be reported.
____ 3. Cause-and-effect relationship between revenues and expenses.
____ 4. The basis for measurement of many assets and liabilities.
____ 5. Relates to the qualitative characteristic of timeliness.
____ 6. All economic events can be identified with a particular entity.
____ 7. The benefits of providing accounting information should exceed the cost of doing so.
____ 8. A consequence is that accounting standards need not be followed in all situations.
____ 9. Assumes the entity will continue indefinitely.
____10. Inflation causes a violation of this assumption.

SAMPLE CHAPTER

E 1–12
Multiple choice; basic assumptions, and principles
● LO5 through LO8

Determine the response that best completes the following statements or questions.

1. The primary objective of financial reporting is to provide information
   a. About a firm's management team.
   b. Useful to capital providers.
   c. Concerning the changes in financial position resulting from the income-producing efforts of the entity.
   d. About a firm's financing and investing activities.
2. In general, revenue is recognized as earned when the risks and rewards of ownership are transferred from the seller to the buyer and
   a. The sales price has been collected.
   b. A purchase order has been received.
   c. It is probable that economic benefits flow to the seller.
   d. A contract has been signed.
3. In depreciating the cost of an asset, accountants are most concerned with
   a. Conservatism.
   b. Revenue recognition.
   c. Full disclosure.
   d. The matching principle.
4. The primary objective of the matching principle is to
   a. Provide full disclosure.
   b. Record expenses in the period that related revenues are recognized.
   c. Provide timely information to decision makers.
   d. Promote comparability between financial statements of different periods.
5. The separate entity assumption states that, in the absence of contrary evidence, all entities will survive indefinitely.
   a. True
   b. False

BROADEN YOUR PERSPECTIVE

Apply your critical-thinking ability to the knowledge you've gained. These cases will provide you an opportunity to develop your research, analysis, judgment, and communication skills. You also will work with other students, integrate what you've learned, apply it in real world situations, and consider its global and ethical ramifications. This practice will broaden your knowledge and further develop your decision-making abilities.

Research Case 1–1
The development of accounting standards
● LO3

Most industrialized countries have organizations responsible for setting accounting standards. The International Accounting Standards Committee (IASC) was formed in 1973 and reorganized in 2001 to form the International Accounting Standards Board (IASB) with the objective of developing global accounting standards known as International Financial Reporting Standards (IFRS).

Required:

1. What are the types of organizations that set accounting standards?
2. Explain why it was necessary to form the IASC/IASB to develop global accounting standards.
3. Who has the authority to enforce the use of IFRS?

Research Case 1–2
IASB structure and standard-setting process
● LO3

The International Accounting Standards Board (IASB) is an independent private-sector organization that issues global accounting standards known as International Financial Reporting Standards (IFRS).

Required:

1. Describe the structure of the IASB and its relationship with its supporting organizations.
2. What are the types of standards issued by the IASB?
3. Briefly describe the process that the IASB undertakes before issuing a new or revised standard.

Research Case 1–3
Accessing IASB information through the Internet
● LO3

The purpose of this case is to introduce you to the information available on the website of the International Accounting Standards Board (IASB).

Required:

Access the IASB home page on the Internet. The web address is www.ifrs.org. Answer the following questions.

1. Describe the mission of the IASB.
2. Who are the current Board members? Briefly describe their backgrounds.
3. Where is the IASB located?

SAMPLE CHAPTER

Research Case 1–4
Accessing FASB information through the Internet
● LO3

The purpose of this case is to introduce you to the information available on the website of the Financial Accounting Standards Board (FASB).

Required:

Access the FASB home page on the Internet. The web address is www.fasb.org. Answer the following questions.

1. Describe the mission of the FASB.
2. The FASB has how many board members?
3. Who is the current chairman of the FASB?

Research Case 1–5
Accounting standards in China
● LO3 LO4

Economic reforms in the People's Republic of China are moving that nation toward a market-driven economy. China's accounting practices must also change to accommodate the needs of potential investors. In an article entitled "Institutional Factors Influencing China's Accounting Reforms and Standards," Professor Bing Xiang analyzes the changes in the accounting environment of China during the recent economic reforms and their implications for the development of accounting reforms.

Required:

1. In your library or from some other source, locate the indicated article in *Accounting Horizons*, June 1998.
2. Briefly describe the economic reforms that led to the need for increased external financial reporting in China.
3. Conformity with International Financial Reporting Standards was specified as an overriding objective in formulating China's accounting standards. What is the author's opinion of this objective?

Communication Case 1–6
Relevance and faithful representation
● LO6

Some theorists contend that companies that create pollution should report the social cost of that pollution in income statements. They argue that such companies are indirectly subsidized as the cost of pollution is borne by society while only production costs (and perhaps minimal pollution fines) are shown in the income statement. Thus, the product sells for less than would be necessary if all costs were included.

Assume that the IASB is considering a standard to include the social costs of pollution in the income statement. The process would require considering both relevance and faithful representation of the information provided by the new standard. Your instructor will divide the class into two to six groups depending on the size of the class. The mission of your group is to explain how the concepts of relevance and faithful representation relate to this issue.

Required:

Each group member should consider the question independently and draft a tentative answer prior to the class session for which the case is assigned.

In class, each group will meet for 10 to 15 minutes in different areas of the classroom. During that meeting, group members will take turns sharing their suggestions for the purpose of arriving at a single group treatment.

After the allotted time, a spokesperson for each group (selected during the group meetings) will share the group's solution with the class. The goal of the class is to incorporate the views of each group into a consensus answer to the question.

Communication Case 1–7
Accounting standard setting
● LO4

One of your friends is a financial analyst for a major stock brokerage firm. Recently she indicated to you that she had read an article in a weekly business magazine that alluded to the political process of establishing accounting standards. She had always assumed that accounting standards were established by determining the approach that conceptually best reflected the economics of a transaction.

Required:

Write a one to two-page article for a business journal explaining what is meant by the political process for establishing accounting standards. Be sure to include in your article a discussion of the need for the standards-setting board to balance accounting considerations and economic consequences.

Ethics Case 1–8
The auditors' responsibility
● LO4

It is the responsibility of management to apply accounting standards when communicating with investors and creditors through financial statements. Another group, auditors, serves as an independent intermediary to help ensure that management has in fact appropriately applied accounting standards in preparing the company's financial statements. Auditors examine (audit) financial statements to express a professional, independent opinion. The opinion reflects the auditors' assessment of the statements' fairness, which is determined by the extent to which they are prepared in compliance with accounting standards.

Some feel that it is impossible for an auditor to give an independent opinion on a company's financial statements because the auditors' fees for performing the audit are paid by the company. In addition to the audit fee, quite often the auditor performs other services for the company such as preparing the company's income tax returns.

Required:

How might an auditor's ethics be challenged while performing an audit?

SAMPLE CHAPTER

Judgment Case 1–9
Qualitative characteristics
● LO6

Accounting standards do not require companies to disclose forecasts of any financial variables to external users. A friend, who is a finance major, is puzzled by this and asks you to explain why such relevant information is not provided to investors and creditors to help them predict future cash flows.

Required:

Explain to your friend why this information is not routinely provided to investors and creditors.

Judgment Case 1–10
Comparability, and the role of the auditor
● LO4 LO6

Mary McQuire is trying to decide how to invest her money. A friend recommended that she buy the shares of one of two corporations and suggested that she should compare the financial statements of the two companies before making a decision.

Required:

1. Do you agree that Mary will be able to compare the financial statements of the two companies?
2. What role does the auditor play in ensuring comparability of financial statements between companies?

Judgment Case 1–11
Cost effectiveness
● LO6

Phase A of the joint FASB and IASB conceptual framework project includes a discussion of the constraint of cost effectiveness. Assume that the IASB is considering revising an important accounting standard.

Required:

1. What is the desired benefit from revising an accounting standard?
2. What are some of the possible costs that could result from a revision of an accounting standard?
3. What does the IASB do in order to assess possible benefits and costs of a proposed revision of an accounting standard?

Judgment Case 1–12
Revenue recognition
● LO8

A new client, the Wolf Company, asks your advice concerning the point in time that the company should recognize revenue from the rental of its office buildings. Renters usually pay rent on a quarterly basis at the beginning of the quarter. The owners contend that the critical event that motivates revenue recognition should be the date the cash is received from renters. After all, the money is in hand and is very seldom returned.

Required:

1. Describe the criteria that must be satisfied before revenue can be recognized.
2. Do you agree or disagree with the position of the owners of Wolf Company? Support your answer.

Analysis Case 1–13
The matching principle
● LO8

Revenues measure the accomplishments of a company during the period. Expenses are then matched with revenues to produce a periodic measure of performance called *net income.*

Required:

1. Explain what is meant by the phrase *matched with revenues.*
2. Describe the four approaches used to implement the matching principle and label them 1 through 4.
3. For each of the following, identify which matching approach should be used to recognize the cost as expense.
   a. The cost of producing a product.
   b. The cost of advertising.
   c. The cost of monthly rent on the office building.
   d. The salary of an office employee.
   e. Depreciation on an office building.

Judgment Case 1–14
Capitalize or expense?
● LO8

When a company makes an expenditure that is neither a payment to a creditor nor a distribution to an owner, management must decide if the expenditure should be capitalized (recorded as an increase in an asset) or expensed (recorded as an expense thereby decreasing owners' equity).

Required:

1. Which factor or factors should the company consider when making this decision?
2. Which key accounting principle is involved?
3. Are there any constraints that could cause the company to alter its decision?

Real World Case 1–15
Elements; disclosures; Hewlett-Packard
● LO6 LO8

Real World Financials

Selected financial statements from a recent annual report of **Hewlett-Packard Company (HP)** follow on pages 45 and 46. Use these statements to answer the following questions.

Required:

1. The company's financial year ends on what date?
2. What amounts did HP report for the following items for the financial year 2011?
   a. Total net revenues
   b. Total operating expenses
   c. Net income (earnings)
   d. Total assets
   e. Total shareholders' equity

SAMPLE CHAPTER

3. How many ordinary shares or shares of common stock did the company have issued as of the 2011 financial year end?
4. Why do you think HP reports more than one year of data in its financial statements?

HEWLETT-PACKARD COMPANY AND SUBSIDIARIES

Consolidated Balance Sheets

	October 31	
	2011	2010
	In millions, except par value	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 8,043	$ 10,929
Accounts receivable	18,224	18,481
Financing receivables	3,162	2,986
Inventory	7,490	6,466
Other current assets	14,102	15,322
Total current assets	51,021	54,184
Property, plant and equipment	12,292	11,763
Long-term financing receivables and other assets	10,755	12,225
Goodwill	44,551	38,483
Purchased intangible assets	10,898	7,848
Total assets	$129,517	$124,503
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Notes payable and short-term borrowings	$ 8,083	$ 7,046
Accounts payable	14,750	14,365
Employee compensation and benefits	3,999	4,256
Taxes on earnings	1,048	802
Deferred revenue	7,449	6,727
Accrued restructuring	654	911
Other accrued liabilities	14,459	15,296
Total current liabilities	50,442	49,403
Long-term debt	22,551	15,258
Other liabilities	17,520	19,061
Commitments and contingencies		
Stockholders' equity:		
HP stockholders' equity		
Preferred stock, $0.01 par value (300 shares authorized; none issued)	—	—
Common stock, $0.01 par value (9,600 shares authorized; 1,991 and 2,204 shares issued and outstanding, respectively)	20	22
Additional paid-in capital	6,837	11,569
Retained earnings	35,266	32,695
Accumulated other comprehensive loss	(3,498)	(3,837)
Total HP stockholders' equity	38,625	40,449
Non-controlling interests	379	332
Total stockholders' equity	39,004	40,781
Total liabilities and stockholders' equity	$129,517	$124,503

SAMPLE CHAPTER

HEWLETT-PACKARD COMPANY AND SUBSIDIARIES
Consolidated Statements of Earnings

	For the fiscal years ended October 31		
	2011	2010	2009
	In millions, except per share amounts		
Net revenue:			
Products	$ 84,757	$ 84,799	$ 74,051
Services	42,039	40,816	40,124
Financing income	449	418	377
Total net revenue	127,245	126,033	114,552
Costs and expenses:			
Cost of products	65,167	65,064	56,503
Cost of services	32,056	30,590	30,660
Financing interest	306	302	326
Research and development	3,254	2,959	2,819
Selling, general and administrative	13,466	12,718	11,648
Amortization of purchased intangible assets	1,607	1,484	1,578
Impairment of goodwill and purchased intangible assets	885	—	—
Restructuring charges	645	1,144	640
Acquisition-related charges	182	293	242
Total operating expenses	117,568	114,554	104,416
Earnings from operations	9,677	11,479	10,136
Interest and other, net	(695)	(505)	(721)
Earnings before taxes	8,982	10,974	9,415
Provision for taxes	1,908	2,213	1,755
Net earnings	$ 7,074	$ 8,761	$ 7,660
Net earnings per share:			
Basic	$ 3.38	$ 3.78	$ 3.21
Diluted	$ 3.32	$ 3.69	$ 3.14
Weighted-average shares used to compute net earnings per share:			
Basic	2,094	2,319	2,388
Diluted	2,128	2,372	2,437

SAMPLE CHAPTER

Real World Case 1–16
Elements; disclosures; Singapore Airlines
● LO6 LO8
Real World Financials

Singapore Airlines, a Singapore company, prepares its financial statements according to the Singapore Financial Reporting Standards, a local variant of IFRS. Singapore Airlines' annual report for the year ended March 31, 2011, which includes financial statements and disclosure notes, is included with all new textbooks and can be found at www.singaporeair.com.

Required:

1. What amounts did Singapore Airlines report for the following items for the financial year ended March 31, 2011?
   a. Total revenues
   b. Income from operations
   c. Net income
   d. Current assets
   e. Total equity
2. What was Singapore Airlines' basic earnings per share for the 2011 financial year?
3. What is disclosed in Note 2 of Singapore Airlines' annual report? Why is the information in Note 2 important for users of financial statements?