Chapter 1 Environment and Theoretical Structure of Financial Accounting

Question 1–1

Financial accounting is concerned with providing relevant financial information about various kinds of organizations to different types of external users. The primary focus of financial accounting is on the financial information provided by profit-oriented companies to their present and potential investors and creditors.

Question 1–2

Resources are efficiently allocated if they are given to enterprises that will use them to provide goods and services desired by society and not to enterprises that will waste them. The capital markets are the mechanism that fosters this efficient allocation of resources.

Question 1–3

Two extremely important variables that must be considered in any investment decision are the expected rate of return and the uncertainty or risk of that expected return.

Question 1–4

In the long run, a company will be able to provide investors and creditors with a rate of return only if it can generate a profit. That is, it must be able to use the resources provided to it to generate cash receipts from selling a product or service that exceed the cash disbursements necessary to provide that product or service.

Question 1–5

The primary objective of financial accounting is to provide investors and creditors with information that will help them make investment and credit decisions.

Question 1–6

Net operating cash flows are the difference between cash receipts and cash disbursements during a period of time from transactions related to providing goods and services to customers. Net operating cash flows may not be a good indicator of future cash flows because, by ignoring uncompleted transactions, they may not match the accomplishments and sacrifices of the period.

Answers to Questions (continued)

Question 1–7

GAAP (generally accepted accounting principles) are a dynamic set of both broad and specific guidelines that a company should follow in measuring and reporting the information in their financial statements and related notes. It is important that all companies follow GAAP so that investors can compare financial information across companies to make their resource allocation decisions.

Question 1–8

In 1934, Congress created the SEC and gave it the job of setting accounting and reporting standards for companies whose securities are publicly traded. The SEC has retained the power, but has relied on private sector bodies to create the standards. The current private sector body responsible for setting accounting standards is the FASB.

Question 1–9

Auditors are independent, professional accountants who examine financial statements to express an 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 GAAP. The auditor adds credibility to the financial statements, which increases the confidence of capital market participants relying on that information.

Answers to Questions (continued)

Question 1–10

Key provisions included in the text are:

- Creation of the Public Company Accounting Oversight Board
- Regulate types of non-audit audit services
- Require lead audit partner rotation every 5 year
- Corporate executive accountability
- Addresses conflicts of interest for security analysts
- Internal control reporting and auditor opinion about controls

Question 1–11

New accounting standards, or changes in standards, can have significant differential effects on companies, investors and creditors, and other interest groups by causing redistribution of wealth. There also is the possibility that standards could harm the economy as a whole by causing companies to change their behavior.

Question 1–12

The FASB undertakes a series of elaborate information gathering steps before issuing an accounting standard to determine consensus as to the preferred method of accounting, as well as to anticipate adverse economic consequences.

Question 1–13

The purpose of the conceptual framework is to guide the Board in developing accounting standards by providing an underlying foundation and basic reasoning on which to consider merits of alternatives. The framework does not prescribe GAAP.

Answers to Questions (continued)

Question 1–14

Relevance and faithful representation are the primary qualitative characteristics that make information decision-useful. Relevant information will possess predictive and/or confirmatory value. Faithful representation is the extent to which there is agreement between a measure or description and the phenomenon it purports to represent.

Question 1–15

The components of relevant information are predictive value, confirmatory value and materiality. The components of faithful representation are completeness, neutrality, and freedom from error.

Question 1–16

The benefit from providing accounting information is increased decision usefulness. If the information is relevant and possesses faithful representation, it will improve the decisions made by investors and creditors. However, there are costs to providing information that include costs to gather, process, and disseminate that information. There also are costs to users in interpreting the information as well as possible adverse economic consequences that could result from disclosing information. Information should not be provided unless the benefits exceed the costs.

Question 1–17

Information is material if it is deemed to have an effect on a decision made by a user. The threshold for materiality will depend principally on the relative dollar amount of the transaction being considered. One consequence of materiality is that GAAP need not be followed in measuring and reporting a transaction if that transaction is not material. The threshold for materiality has been left to subjective judgment.

Answers to Questions (continued)

Question 1–18

1. Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
2. Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions.
3. Equity is the residual interest in the assets of any entity that remains after deducting its liabilities.
4. Investments by owners are increases in equity resulting from transfers of resources, usually cash, to a company in exchange for ownership interest.
5. Distributions to owners are decreases in equity resulting from transfers to owners.
6. Revenues are inflows of assets or settlements of liabilities from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.
7. Expenses are outflows or other using up of assets or incurrences of liabilities during a period from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.
8. Gains are defined as increases in equity from peripheral or incidental transactions of an entity.
9. Losses represent decreases in equity arising from peripheral or incidental transactions of an entity.
10. Comprehensive income is defined as the change in equity of an entity during a period from nonowner transactions.

Question 1–19

The four basic assumptions underlying GAAP are (1) the economic entity assumption, (2) the going concern assumption, (3) the periodicity assumption, and (4) the monetary unit assumption.

Question 1–20

The going concern assumption means that, in the absence of information to the contrary, it is anticipated that a business entity will continue to operate indefinitely. This assumption is important to many broad and specific accounting principles such as the historical cost principle.

Answers to Questions (continued)

Question 1–21

The periodicity assumption relates to needs of external users to receive timely financial information. This assumption requires that the economic life of a company be divided into artificial periods for financial reporting. Companies usually report to external users at least once a year.

Question 1–22

Four accounting practices, often referred to as principles, that guide accounting practice are (1) revenue recognition, (2) expense recognition, (3) mixed-attribute measurement (including historical cost), and (4) full disclosure.

Question 1–23

Two advantages to basing valuation on historical cost are (1) historical cost provides important cash flow information since it represents the cash or cash equivalent paid for an asset or received in exchange for the assumption of a liability, and (2) historical cost valuation is the result of an exchange transaction between two independent parties and the agreed upon exchange value is, therefore, objective and possesses a high degree of verifiability.

Question 1–24

Companies recognize revenue when goods or services are transferred to customers. However, no revenue is recognized if it isn't probable that the seller will collect the amounts it's entitled to receive. The amount of revenue recognized is the amount the company expects to be entitled to receive in exchange for those goods or services. Revenue is recognized at a point in time or over a period of time, depending on when goods or services are transferred to customers. So, revenue for the sale of most goods is recognized upon delivery, but revenue for services like renting apartments or lending money is recognized over time as those services are provided.

Answers to Questions (continued)

Question 1–25

The four different approaches to implementing expense recognition are:

1. Recognizing an expense based on an exact cause-and-effect relationship between a revenue and expense event. Cost of goods sold is an example of an expense recognized by this approach.
2. Recognizing an expense by identifying the expense with the revenues recognized in a specific time period. Office salaries are an example of an expense recognized by this approach.
3. Recognizing an expense by a systematic and rational allocation to specific time periods. Depreciation is an example of an expense recognized by this approach.
4. Recognizing expenses in the period incurred, without regard to related revenues. Advertising is an example of an expense recognized by this approach.

Question 1–26

In addition to the financial statement elements arrayed in the basic financial statements, information is disclosed by means of parenthetical or modifying comments, notes, and supplemental schedules and tables.

Question 1–27

GAAP prioritizes the inputs companies should use when determining fair value. The highest and most desirable inputs, Level 1, are quoted market prices in active markets for identical assets or liabilities. Level 2 inputs are other than quoted prices that are observable, including quoted prices for similar assets or liabilities in active or inactive markets and inputs that are derived principally from observable related market data. Level 3 inputs, the least desirable, are inputs that reflect the entity's own assumptions about the assumptions market participants would use in pricing the asset or liability based on the best information available in the circumstances.

Question 1–28

Common measurement attributes are historical cost, net realizable value, current cost, present value, and fair value.

Answers to Questions (concluded)

Question 1–29

Under the revenue/expense approach, revenues and expenses are considered primary, and assets, liabilities, and equities are secondary in the sense of being recognized at the time and amount necessary to achieve proper revenue and expense recognition. Under the asset/liability approach, assets and liabilities are considered primary, and revenues and expenses are secondary in the sense of being recognized at the time and amount necessary to allow recognition and measurement of assets and liabilities as required by their definitions.

Question 1–30

Under IFRS, the conceptual framework provides guidance to accounting standard setters but also provides GAAP when more specific accounting standards do not provide guidance.

Question 1–31

The International Accounting Standards Board (IASB) is responsible for determining IFRS. The IASB is funded by the IFRS Foundation. .

BRIEF EXERCISES

Brief Exercise 1–1

Revenues ($340,000 + 60,000)	$400,000
Expenses:	
Rent ($40,000 ÷ 2)	(20,000)
Salaries	(120,000)
Utilities ($50,000 + 2,000)	(52,000)
Net income	**$208,000**

Brief Exercise 1–2

(1) Liabilities
(2) Assets
(3) Revenues
(4) Losses

Brief Exercise 1–3

1. The periodicity assumption
2. The economic entity assumption
3. Revenue recognition
4. Expense recognition

Brief Exercise 1–4

1. Expense recognition
2. The historical cost (original transaction value) principle
3. The economic entity assumption

Brief Exercise 1–5

1. Disagree — The full disclosure principle
2. Agree — The periodicity assumption
3. Disagree — Expense recognition
4. Agree — Revenue recognition

Brief Exercise 1–6

1. Obtains funding for the IFRS standard setting process: IFRS Foundation
2. Determines IFRS: International Accounting Standards Board (IASB)
3. Oversees the IFRS Foundation: Monitoring Board
4. Provides input about the standard setting agenda: IFRS Advisory Council.
5. Provides implementation guidance about relatively narrow issues: IFRS Interpretations Committee.

EXERCISES

Exercise 1–1

Requirement 1

	Perez Associates	
	Operating Cash Flow	
	Year 1	**Year 2**
Cash collected	$160,000	$190,000
Cash disbursements:		
Salaries	(90,000)	(100,000)
Utilities	(30,000)	(40,000)
Purchase of insurance policy	(60,000)	- 0 -
Net operating cash flow	$(20,000)	$ 50,000

Requirement 2

	Perez Associates	
	Income Statements	
	Year 1	**Year 2**
Revenues	$170,000	$220,000
Expenses:		
Salaries	(90,000)	(100,000)
Utilities	(35,000)	(35,000)
Insurance	(20,000)	(20,000)
Net Income	$ 25,000	$ 65,000

Requirement 3

Year 1:	Amount billed to clients	$170,000
	Less: Cash collected	(160,000)
	Ending accounts receivable	$ 10,000
Year 2:	Beginning accounts receivable	$ 10,000
	Plus: Amounts billed to clients	220,000
		$230,000
	Less: Cash collected	(190,000)
	Ending accounts receivable	$ 40,000

Exercise 1–2

Requirement 1

	Year 2	Year 3
Revenues	$350,000	$450,000
Expenses:		
Rent ($80,000 ÷ 2)	(40,000)	(40,000)
Salaries	(140,000)	(160,000)
Utilities	(30,000)	(40,000)
Advertising	(25,000)	(20,000)*
Net Income	$115,000	$190,000

Requirement 2

Amount owed at the end of year one	$ 5,000
Advertising costs incurred in year two	25,000
	30,000
Amount paid in year two	(15,000)
Liability at the end of year two	**15,000**
Less cash paid in year three	(35,000)
Advertising expense in year three	**$20,000***

Exercise 1–3

Requirement 1

FASB ASC 820: “Fair Value Measurements”

Requirement 2

The specific citation that describes the information that companies must disclose about the use of fair value to measure assets and liabilities for recurring measurements is FASB ASC 820–10–50: “Fair Value Measurements -Overall-Disclosures.”

Exercise 1–4

The *FASB Accounting Standards Codification* represents the single source of authoritative U.S. generally accepted accounting principles. The specific citation for each of the following items is:

1. **The topic number for business combinations:**

   FASB ASC 805: "Business Combinations."

2. **The topic number for related-party disclosures:**

   FASB ASC 850: "Related Party Disclosures."

3. **The topic, subtopic, and section number for the initial measurement of internal-use software:**

   FASB ASC 350–40–30: "Intangibles–Goodwill and Other–Internal–Use Software–Initial Measurement."

4. **The topic, subtopic, and section number for the subsequent measurement of asset retirement obligations:**

   FASB ASC 410–20–35: "Asset Retirement and Environmental Obligations–Asset Retirement Obligations–Subsequent Measurement."

5. **The topic, subtopic, and section number for the recognition of stock compensation:**

   FASB ASC 718–10–25: "Compensation–Stock Compensation–Overall–Recognition."

Exercise 1–5

Organization	Group
1. Securities and Exchange Commission	Users
2. Financial Executives International	Preparers
3. American Institute of Certified Public Accountants	Auditors
4. Institute of Management Accountants	Preparers
5. Association of Investment Management and Research	Users

Exercise 1–6

1. Liability
2. Distribution to owners
3. Revenue
4. Assets, liabilities and equity
5. Comprehensive income
6. Gain
7. Loss
8. Equity
9. Asset
10. Net income
11. Investment by owner
12. Expense

Exercise 1–7

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

Exercise 1–8

1. Materiality
2. Neutrality
3. Consistency
4. Timeliness
5. Predictive value and/or confirmatory value
6. Faithful representation
7. Comparability (Consistency)
8. Cost effectiveness

Exercise 1–9

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

Exercise 1–10

1. The economic entity assumption
2. The periodicity assumption
3. Expense recognition (also the going concern assumption)
4. The historical cost (original transaction value) principle
5. Revenue recognition
6. The going concern assumption
7. Materiality

Exercise 1–11

1. The historical cost (original transaction value) principle
2. The periodicity assumption
3. Revenue recognition
4. The economic entity assumption
5. Expense recognition; materiality
6. The full disclosure principle

Exercise 1–12

1.	Disagree	—	Monetary unit assumption
2.	Disagree	—	Full disclosure principle
3.	Agree	—	Expense recognition
4.	Disagree	—	Historical cost (original transaction value) principle
5.	Agree	—	Revenue recognition
6.	Agree	—	Materiality
7.	Disagree	—	Periodicity assumption

Exercise 1–13

1.	Disagree	—	This is a violation of the historical cost (original transaction value) principle.
2.	Disagree	—	This is a violation of the economic entity assumption.
3.	Disagree	—	This is a violation of appropriate revenue recognition.
4.	Agree	—	The company is conforming to appropriate expense recognition.
5.	Agree	—	The company is conforming to the full disclosure principle.
6.	Disagree	—	This is a violation of the periodicity assumption.

Exercise 1–14

Statement		Concept
1.	d.	Monetary unit assumption
2.	h.	Full-disclosure principle
3.	g.	Expense recognition
4.	e.	Historical cost principle
5.	c.	Periodicity assumption
6.	a.	Economic entity assumption
7.	i.	Cost effectiveness
8.	j.	Materiality
9.	f.	Conservatism
10.	b.	Going concern assumption

Exercise 1–15

1. b
2. d
3. c
4. d
5. b
6. b