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SKU: 9780132162302-SOLUTIONS

CHAPTER 2
Financial Reporting Theory

Solutions

Questions

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

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

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

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

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

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Q2-6. The concept of *materiality* determines the relevancy of information. Information is material if reporting it inaccurately or omitting it would affect the decisions made by the users of the financial statements. Thus, materiality is an aspect of relevance.

Q2-7 Information has predictive value if it can be used as an input into processes that help predict future outcomes. For example, users of the financial statements may use the trend in sales growth reported in current and prior years' financial statements to predict future revenue. Information has confirmatory value if it provides feedback about prior evaluations. For example, financial statement users will often compare reported net income to prior earnings forecasts.

Q2-8 Information is understandable when it is classified, characterized, and presented clearly. This does not mean that an uninformed reader of financial statements should be able to understand all information presented. Some transactions are inherently complex and may not be fully understood by uninformed readers of the financial statements. Therefore, understandability implies that financial information is consumed by reasonably informed users.

Q2-9 The elements of financial reporting are the building blocks of the financial statements. U.S. GAAP identifies two main groups of elements. We refer to these groups as *point-in-time elements* and *period-of-time elements*. Point–in-time elements represent resources (assets), claims to resources (liabilities), or interests in resources (equity) as of a point in time and appear on the balance sheet. Period-of-time elements describe events and circumstances that affect an entity during a period of time and appear on the income statement, statement of comprehensive income, or statement of shareholders' equity. The period-of-time elements include investments by owners, distributions to owners, revenues, gains, expenses, losses and comprehensive income.

Q2-10 Under U.S. GAAP, an asset is defined as a probable future economic benefit obtained or controlled by a particular entity as a result of past transactions or events. Essential characteristics of an asset are also delineated. Under U.S. GAAP, an asset "embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, a particular entity can obtain the benefit and control others' access to it, and the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred." The future economic benefit from an asset is the cash flows generated from its use. Finally, the asset arises out of an event or transaction that has already occurred.

Q2-11 Recognition is the process of reporting an economic event in the financial statements. If an item is recognized, it is included as a line item on the financial statements (i.e., not just in the notes to the statements). An item is not recognized in the financial statements if it is included in the notes to the statements alone.

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Q2-12 The revenue recognition principle is used to guide the timing of revenue recognition. It states that revenue is recognized when it is realized or realizable and earned. An item is considered realized or realizable when a good or service has been exchanged for cash or claims to cash. Revenues are considered earned "when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues." The FASB has developed a new revenue standard. The new revenue standard indicates that the overarching principle of revenue recognition is the notion of the transfer of control of the goods or services.

Q2-13 Expenses are recorded when: (1) they are matched with revenue, (2) in the period incurred, and (3) they are systematically allocated over the period of use.

Q2-14 Under IFRS, expenses are recognized in the income statement when two criteria are met: (1) a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has occurred and (2) the expense can be measured reliably.

Q2-15 Accrual-basis accounting records revenues according to the revenue recognition principle and records expenses according to the expense recognition principle, regardless of when cash is received or paid. Accrual-basis accounting records revenues when earned and expenses when incurred. GAAP is based on accrual-basis accounting as opposed to a cash-basis system.

Q2-16 Historical cost is the amount of cash (or equivalent) that was paid to acquire the asset. In the case of a liability, historical cost is the amount of cash (or equivalent) that was received when the obligation was incurred. The historical cost may be adjusted for depreciation or amortization over the life of the asset.

Q2-17 The going concern concept indicates that accountants will record transactions and prepare financial statements as if the entity will continue to operate for an indefinite period of time, unless there is evidence to the contrary. The going concern concept justifies the use of historical cost by the following rationale. If the business is going to exist for an indefinite period of time, productive assets are not for sale and as a result, market values are not particularly relevant. Of course, if there is evidence that the business will not continue to exist (e.g., bankruptcy) then liquidation values should be used. There are many exceptions in practice. Asset impairments and the increased use of fair value accounting result in many economic resources reported at fair value on the balance sheet.

Brief Exercises

Solution to BE2-1

The primary users of the financial statements are investors, lenders, and other creditors *who are not in a position to demand information from the entity.* Those financial statement users who are not in a position to demand information rely on the financial statements to help them assess the amount, timing, and uncertainty of future cash

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flows of the reporting entity, so that they can form an opinion about future returns that will accrue to them by holding a stake in the entity.

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

Solution to BE2-2

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

Solution to BE2-3

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

FR Information that is neutral

REL Information has decision-making implications because of its predictive value

FR Information that is complete

FR Information that is free from error

REL Information has decision-making implications because of its confirmatory value

Solution to BE2-4

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

Solution to BE2-5

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

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Solution to BE2-6

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

Solution to BE2-7

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

Solution to BE2-8

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

EC Comparable

FC Relevant

EC Timely

EC Understandable

FC Faithful representation

EC Verifiable

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Solution to BE2-9

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

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

Solution to BE2-10

The Enhancing Characteristic is matched with its definition:

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

Solution to BE2-11

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

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Solution to BE2-12

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

Solution to BE2-13

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

Solution to BE2-14

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

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Solution to BE2-15

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

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Solution to BE2-16

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

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

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Solution to BE2-17

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

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

Solution to BE2-18

The measurement bases are matched with its definition.

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

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Solution to BE2-19

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

Solution to BE2-20

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

Exercises

Solution to E2-1

Issue	Component of the Conceptual Framework
1. Noeleen's Controller, Donald Lierni, was surprised to learn that a Form 10-Q was required to satisfy the company's first quarter filing requirements with the SEC. Lierni was concerned that there is insufficient time to develop the "actual" numbers needed to prepare the report. The 10-Q required that significant estimates had to be made before the filing due date.	1. Relevance versus Faithful Representation; timeliness.

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Issue	Component of the Conceptual Framework
2. An additional consideration was the fact that Noeleen now had to satisfy a new group of financial statement users with additional information needs.	2. Multiple user groups, multipurpose financial statements due to unknown decision models--so information has to be complete, understandable, etc.
3. Resources had to be expended to meet the new reporting requirements and an assessment had to be made as to what information and disclosures to include and exclude from the financial reports.	3. Cost Constraint and the Materiality Constraint
4. Lierni also learned that privately held companies were subject to less stringent GAAP requirements than a publicly traded entity. That is, the company now had to follow additional GAAP standards and was also required to change several accounting methods.	4. Comparability
5. When considering his options, Lierni decided to take a safe approach and report the lowest income possible by adopting income-reducing standards. Here, the Controller proposed taking excessive write-downs for obsolete inventory and potentially impaired assets.	5. Lack of neutrality; expense recognition
6. He also decided to expense the cost of a significant investment in office equipment.	6. Expense recognition concept possibly violated; neutrality.
7. Finally, Noeleen created a separate legal entity to handle its auto financing, Benedict Arnold Credit Company, during the same year it went public. The separate entity is not consolidated with the primary financial statements. Lierni decided to keep this entity off balance sheet and did not see any need for disclosure of Noeleen's relationship with Benedict Arnold Credit Company.	7. Business or economic entity assumption and lack of completeness (lack of full disclosure).

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Solution to E2-2

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

Solution to E2-3

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

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Solution to E2-4

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

Under cash-basis accounting, Top Notch would recognize revenue of $25,000, $12,000, $107,000 ($40,000 + $33,000 + 34,000), in January, February, and March, respectively, since it received cash in those months. However, under the accrual basis, it would recognize $65,000 ($40,000 + $25,000) for services provided in January, $45,000 for services provided in February, and $54,000 ($34,000 + $21,000) for services provided in March.

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

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

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

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

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