Intermediate Accounting Reporting and Analysis 2nd edition Wahlen Solutions Manual

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CHAPTER 2

Financial Reporting: Its Conceptual Framework

CONTENT ANALYSIS OF END-OF-CHAPTER ASSIGNMENTS

NUMBER	TOPIC	CONTENT	LO	ADAPTED	DIFFICULTY	TIME EST.	AACSB	AICPA	BLOOM'S
2-1	Conceptual Framework	Titles of Statement of Concepts	1		Easy	5	Analytic	Measurement	Comprehension
2-2	Conceptual Framework	Purpose of conceptual framework	1		Easy	5	Analytic	Measurement	Comprehension
2-3	Accounting Concepts, Principles, Standards and Rules	Differences among concepts, principles, standards and rules	1		Easy	5	Analytic	Measurement	Comprehension
2-4	Conceptual Framework	What the FASB Concepts Statements establish	1		Easy	5	Analytic	Measurement	Comprehension
2-5	Objective of Financial Reports	Financial reporting and users of financial reporting	2		Easy	5	Analytic	Measurement	Comprehension
2-6	Objective of Financial Reports	Useful information about expected returns	2		Easy	5	Analytic	Measurement	Comprehension
2-7	Objective of Financial Reports	Useful information about net cash inflows	2		Easy	5	Analytic	Measurement	Comprehension
2-8	External Stakeholders Information Needs	Information available in financial reports for external stakeholders	2		Easy	5	Analytic	Measurement	Comprehension
2-9	Financial Reporting and Management Stewardship	Use of financial reporting to assess management stewardship of company	2		Easy	5	Analytic	Measurement	Comprehension
2-10	Financial Reporting Definitions	Define key terms describing users' information needs.	2		Easy	5	Analytic	Measurement	Comprehension

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Number	Topic	Content	LO	Adapted	Difficulty	Time Est.	AACSB	AICPA	Bloom's
2-11	Primary Qualitative Characteristics of Useful Accounting Information	Relevance and faithful representation.	3		Easy	5	Analytic	Measurement	Comprehension
2-12	Relevant Accounting Information	Characteristics of relevant accounting information as defined by *Statement of Financial Accounting Concepts No. 8*	3		Easy	5	Analytic	Measurement	Comprehension
2-13	Materiality	Definition of materiality	3		Easy	5	Analytic	Measurement	Comprehension
2-14	Faithful Representation	Characteristics of faithful representation	3		Easy	5	Analytic	Measurement	Comprehension
2-15	Enhancing Characteristics of Accounting Information	Identify enhancing characteristics of accounting information and explain how they enhance it	3		Easy	5	Analytic	Measurement	Comprehension
2-16	Comparability and Consistency	Compare and contrast comparability and consistency	3		Easy	5	Analytic	Measurement	Comprehension
2-17	Cost Constraint	Cost constraints and financial reporting.	3		Easy	5	Analytic	Measurement	Comprehension
2-18	Reporting Entity Assumption	Reporting entity assumptions in financial reporting	4		Easy	5	Analytic	Measurement	Comprehension
2-19	Going-Concern Assumption	Going concern assumptions and financial reporting	4		Easy	5	Analytic	Measurement	Comprehension
2-20	Period-of-Time Assumption	Periodicity and financial reporting	1		Easy	10	Analytic	Measurement	Application

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Number	Topic	Content	LO	Adapted	Difficulty	Time Est.	AACSB	AICPA	Bloom's
2-21	Mixed Measurement Attributes	The use of mixed measurement attributes in financial reporting	4		Easy	10	Analytic	Measurement	Application
2-22	Interrelationships between attributes	Relating historical cost, relevance, and faithful representation	4		Easy	10	Analytic	Measurement	Application
2-23	Recognition	Definition of recognition as defined by *Statement of Financial Accounting Concepts No. 8*	4		Easy	10	Analytic	Measurement	Application
2-24	Accrual Accounting	Objectives of accrual accounting	4		Easy	10	Analytic	Measurement	Application
2-25	Revenue Recognition	Timing and conditions of revenue recognition	4		Easy	10	Analytic	Measurement	Application
2-26	Expense Recognition	Timing and conditions of expense recognition	4		Easy	10	Analytic	Measurement	Application
2-27	Conservatism	Valuation of financial statement elements when their value is uncertain	4		Easy	10	Analytic	Measurement	Application
2-28	Reporting model in the FASB Conceptual Framework	Sources of useful information identified in the FASB Conceptual Framework	5		Easy	10	Analytic	Measurement	Application
2-29	Primary Sources of Useful Information	The sources of useful information in the reporting model	5		Easy	5	Analytic	Measurement	Comprehension
M2-1	Financial Reporting	Application to individual companies, industries, and economy as a whole	1	AICPA	Easy	5	Analytic	Measurement	Comprehension
M2-2	Constraints of Useful Information	Constraints of useful information as defined by *Statement of Financial Accounting Concepts No. 8*	3	AICPA	Easy	5	Analytic	Measurement	Comprehension

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Number	Topic	Content	LO	Adapted	Difficulty	Time Est.	AACSB	AICPA	Bloom's
M2-3	Relevant Accounting Information	Characteristics of relevant accounting information as defined by *Statement of Financial Accounting Concepts No. 8*	3	AICPA	Easy	5	Analytic	Measurement	Comprehension
M2-4	Qualitative Characteristics of Useful Accounting Information	Characteristics of useful accounting information when qualified individuals arrive at similar conclusions	3	AICPA	Easy	5	Analytic	Measurement	Comprehension
M2-5	Decision-Useful Information	Characteristics of decision-useful information as defined by *Statement of Financial Accounting Concepts No. 8*	3	AICPA	Easy	5	Analytic	Measurement	Comprehension
M2-6	Recognition	Term describing recording and reporting an item in the financial statements as defined by *Statement of Financial Accounting Concepts No. 6*	4	AICPA	Easy	5	Analytic	Measurement	Comprehension
M2-7	Conservatism	Identification of term when firms accrue net losses on obsolete inventory	4	AICPA	Easy	5	Analytic	Measurement	Comprehension
M2-8	Going Concern	Identification of term when firms report cash they expect to receive in the future	4	AICPA	Easy	5	Analytic	Measurement	Comprehension
M2-9	Accrued Expense	Definition of accrued expense	4	AICPA	Easy	5	Analytic	Measurement	Comprehension
M2-10	Expense Recognition	Patent amortization and patent impairment; expense recognition principles	4	AICPA	Easy	10	Analytic	Measurement	Comprehension

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Number	Topic	Content	LO	Adapted	Difficulty	Time Est.	AACSB	AICPA	Bloom's
E2-1	Qualitative Characteristics	Matching of definitions to the qualities of useful accounting information	3		Moderate	15	Analytic	Measurement	Application
E2-2	Accounting Assumptions	Matching of a list of descriptive statements with a list of assumptions	4		Moderate	10	Analytic	Measurement	Application
C2-1	Objectives of Financial Reporting	Identify and explain the objectives of financial reporting	2		Moderate	15	Analytic	Measurement	Application
C2-2	Useful Accounting Information	Describe and explain useful accounting information	3		Moderate	15	Analytic	Measurement	Application
C2-3	Characteristics of Useful Accounting Information	Identify and discuss characteristics of useful accounting information	3		Moderate	15	Analytic	Measurement	Application
C2-4	Characteristics of Useful Accounting Information	Identify and discuss characteristics of useful accounting information	3	CMA	Moderate	20	Analytic	Measurement	Application
C2-5	Cost and Expense Recognition	Identify and discuss rationale for cost and expense recognition	4	AICPA	Moderate	15	Analytic	Measurement	Application
C2-6	Relevance versus Faithful Representation	Identify and discuss characteristics of relevant and reliable information	3	CMA	Moderate	25	Analytic	Measurement	Analysis
C2-7	Conceptual Framework	Define the objective of general purpose external financial reporting; qualitative and enhancing characteristics of useful information, and the constraint	3		Moderate	20	Analytic	Measurement	Analysis

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Number	Topic	Content	LO	Adapted	Difficulty	Time Est.	AACSB	AICPA	Bloom's
C2-8	Objectives, Users, and Stewardship	Primary objectives, sophistication level, and stewardship responsibilities of management as defined by *Statement of Financial Accounting Concepts No. 8*	4	CMA	Moderate	20	Analytic	Measurement	Analysis
C2-9	Reporting Entity	Definition of reporting entity; application of reporting entity assumption to various situations	4	AICPA	Moderate	15	Analytic	Measurement	Analysis
C2-10	Accruals and Deferrals	Accruals, deferrals, and the determination of income	4	AICPA	Moderate	15	Analytic	Measurement	Analysis
C2-11	Revenue Recognition	Timing of revenue recognition	4		Moderate	15	Analytic	Measurement	Analysis
C2-12	Violations of Assumptions and Principles	Identification of the violation of various accounting assumptions and principles	4		Moderate	15	Analytic	Measurement	Analysis
C2-13	Ethics and Income Reporting	Ethical perspectives in financial reporting			Moderate	15	Analytic	Measurement	Analysis
C2-14	Inconsistent Statements on Accounting Principles	Fallacies, half-truths, circular reasoning, erroneous comments, or inconsistencies potentially associated with accounting principles	2, 5	AICPA	Moderate	15	Analytic	Measurement	Analysis

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ANSWERS TO GOT IT?QUESTIONS

2-1 The FASB's Conceptual Framework establishes a theoretical foundation of interrelated objectives, concepts, principles, and definitions that lead to the establishment of consistent high-quality financial accounting standards and the appropriate application of those standards in accounting practice. The Conceptual Framework provides a logical structure of objectives, concepts, principles, and definitions that establish the foundation for financial accounting and reporting. The titles of the Statements of Concepts issued by the FASB are: *Statement No. 1* "Objectives of Financial Reporting by Business Enterprises," *Statement No. 2* "Qualitative Characteristics of Accounting Information," *Statement No. 3* "Elements of Financial Statements of Business Enterprises," (replaced by *Statement No. 6* "Elements of Financial Statements"), *Statement No. 4* "Objectives of Financial Reporting by Nonbusiness Organizations," *Statement No. 5* "Recognition and Measurement in Financial Statements of Business Enterprises," *Statement No. 7* "Using Cash Flow Information and Present Value in Accounting Measurements," and *Statement No. 8* "Conceptual Framework for Financial Reporting: Chapter 1: The Objective of General Purpose Financial Reporting and Chapter 3: Qualitative Characteristics of Useful Financial Information."

2-2 The Conceptual Framework is expected to:

- Guide the FASB in establishing accounting standards
- Provide a frame of reference for standard setters, financial statement preparers, and auditors for resolving accounting questions in situations where a standard does not exist
- Establish objectives and conceptual guidelines that form the bounds for judgment in the preparation of financial statements
- Increase users' understanding of and confidence in financial reporting
- Enhance financial statement comparability across firms and over time

2-3 Concepts statements and principles are broad and definitional; standards are applications of concepts and principles to different types of transactions, events, and circumstances; rules are specific implementation procedures.

2-4 To establish the Conceptual Framework, the FASB has issued a number Concepts Statements that establish:

- fundamental principles of accounting
- objectives of financial reporting
- qualities of useful financial accounting information
- definitions of basic elements like assets and liabilities
- types of economic transactions, events, and arrangements to be recognized in financial statements
- measurement attributes to use to measure and report these transactions, events, and arrangements
- how transactions, events, and arrangements should be presented and classified in financial statements

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2-5 The FASB and the IASB state that 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." Investors, lenders and other creditors are external suppliers of financial capital, as opposed to specific internal decision makers, such as management. These external financial statement users do not have the authority to prescribe the financial information they desire from a particular company. Therefore, they must rely on the information that the management of the company communicates to them.

2-6 This objective is to provide useful information for:

- Decisions by existing and potential investors about buying, selling, or holding equity instruments, which depend on the returns that they expect from an investment in those instruments, such as dividends and market price increases.
- Decisions by existing and potential lenders and other creditors about buying, selling, or holding debt instruments or providing or settling loans and other forms of credit, which depend on the principal and interest payments or other returns that they expect.

2-7 This objective is to provide existing and potential investors, lenders, and other creditors with useful information to help them assess the amount, timing, and uncertainty of the prospects for future net cash inflows to the company. This objective is important because investors', lenders', and other creditors' expectations about returns depend on their assessment of the amount, timing, and uncertainty of the prospects for future net cash inflows to the entity.

2-8 a. A specific objective of financial reporting is to provide information about a company's economic resources and the claims on the company. This information is useful to external users for the following reasons:

- To identify the company's resources, its obligations, its financial strengths and weaknesses and to assess its liquidity and solvency
- To specify the types of resources in which the company has invested, as well as the types and timing of the claims on the entity
- To indicate the potential future cash flows from the company's resources and the ability of the resources to satisfy the claims on the company

b. Information about a company's financial performance helps external users assess the return a company has earned on its economic resources and form expectations about its future performance. In particular, information concerning the company's comprehensive income and its components is useful to external users in:

- Evaluating management's performance
- Estimating the company's "earning power," or other amounts that are representative of persistent long-term income-producing ability
- Predicting future income and net cash inflows
- Assessing the risk of investing in or lending to the company

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c. Cash flow information shows how a company obtains and spends cash for its operating, investing, and financing activities, including cash dividends and other distributions of company resources to owners. Investors, lenders, and other creditors use cash flow information about a company to:

- Help understand its operations and the cash-generating ability of the business
- Evaluate its strategic sourcing and use of cash for financing and investing activities
- Assess its liquidity and solvency
- Interpret other information about financial performance

2-9 Financial reporting should provide information about how efficiently and effectively the company's management and governing board have discharged their responsibilities to use the entity's resources. Information about a company's financial performance helps users to understand how well management has discharged its responsibilities to make efficient and effective use of its resources. Information about the variability and components of that financial performance also is important, especially in assessing the uncertainty of future cash flows. Information about a company's past financial performance and how its management discharged its responsibilities is useful for decisions by existing investors, lenders, and other creditors who have the right to vote on or otherwise influence management's actions.

2-10 *Return on investment* provides a measure of overall company performance. *Risk* is the uncertainty or unpredictability of the future results of a company. The greater the variability and uncertainty in a company's future performance, the greater the risk of an investment in or extension of credit to the company. *Financial flexibility* is the ability of a company to use its financial resources to adapt to change and to take advantage of opportunities. *Liquidity* refers to how quickly a company can convert its assets into cash to meet short-term obligations and cover operating costs. *Operating capability* refers to the ability of a company to produce goods and services for customers.

2-11 *Decision usefulness* is the *overall* qualitative characteristic that is the ultimate objective of accounting information. Whether or not financial information is useful depends on the decision to be made, the way in which it is made, the information already available, and the decision maker's ability to process the information. Because the FASB establishes standards for investors, lenders, and other creditors, however, it must consider the quality of decision usefulness for their purposes. This overall goal of decision usefulness can be separated into the fundamental characteristics of relevance and faithful representation.

2-12 Accounting information has *relevance* if it is capable of making a difference in decisions made by financial statement users. Financial information is capable of making a difference if the information is capable of helping users predict future outcomes and/or confirm or correct prior expectations and is material in nature and amount. To have *predictive value*, accounting information should help users form expectations about the future. Financial information can have predictive value if it can be used as an input to a process to predict future outcomes (such as an analyst's forecast). Financial information can have *confirmatory value* if it provides feedback to confirm or correct prior predictions and expectations**.** *Materiality* refers

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to the nature and magnitude of an omission or misstatement of accounting information that would influence the judgment of a reasonable person relying on that information.

2-13 *Materiality* refers to the nature and magnitude of an omission or misstatement of accounting information that would influence the judgment of a reasonable person relying on that information. Materiality and relevance both relate to how information influences a decision maker, but there is a difference between the two terms. A company may make a decision to disclose certain information because users need that information (it is relevant) *and* because the amount is large enough to make a difference (it is material). Alternatively, a decision not to disclose certain information may be made because the user has no need for the information (it is not relevant) *or* because the amount is too small to make a difference (it is not material).

2-14 Accounting information is a *faithful representation* of the underlying economic transactions, events, and arrangements when the words and numbers accurately depict the economic substance of what they purport to represent. To be a faithful representation, the information must be complete, neutral, and free from error.

- A *complete* representation provides a user with full disclosure of all the information necessary to understand the information being reported, with all necessary facts, descriptions, and explanations.
- A *neutral* representation is not biased, slanted, emphasized, or otherwise manipulated to achieve a predetermined result or to influence users' behavior in a particular direction. However, neutral does not mean that accounting information does not influence human behavior; indeed, accounting information is intended to be useful in decision making, thereby influencing the decision makers' behavior, but not in a predetermined or manipulated direction.
- *Free from error* means the information is presented as accurately as possible, using a process that reflects the best available inputs. It also means the description of the information is appropriate and the amount has been determined with a process that is accurate.

2-15 The FASB and IASB describe four characteristics that enhance the decision usefulness of information that is relevant and faithfully represented: comparability, verifiability, timeliness, and understandability. *Comparability* of accounting information enables users to identify and explain similarities and differences between two or more sets of economic facts. Note that comparability does not mean uniformity. Comparability means similar things look similar and different things look different. Consistency is related to comparability, but it is not the same. *Consistency* means accounting methods and procedures are applied in the same manner from period to period. Accounting information is *verifiable* when different knowledgeable and independent observers can reach consensus (but not necessarily complete agreement) that a particular representation is faithful. Accounting information is *timely* when it is available to decision makers in time to influence their decisions. *Understandability* means that accounting information should be comprehensible to users who have a reasonable knowledge of business and economic activities and who are willing to study the information carefully.

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2-16 *Comparability* of accounting information enables users to identify and explain similarities and differences between two or more sets of economic facts. Note that comparability does not mean uniformity. Comparability means similar things look similar and different things look different. Consistency is related to comparability but it is not the same. *Consistency* means accounting methods and procedures are applied in the same manner from period to period. Consistency, like comparability, is a quality of the accounting process that generates financial information over time rather than a quality of the accounts and amounts themselves. Consistency helps to achieve the goal of comparability across periods, but only if the underlying phenomena being reported remain the same.

2-17 To be reported, accounting information not only must be relevant and faithfully represented but it also must pass an economic test by satisfying the benefit/cost constraint. Accounting information is very beneficial to decision makers, but it is also costly to prepare and use. The preparer (the company) initially incurs the costs of providing financial information. These costs include the cost of collecting, processing, auditing, and communicating the information. The costs might also include the risk of losing a competitive advantage by disclosing the information. The benefits are enjoyed by a diverse group of investors and creditors who use the information and by the company itself because, by providing the information, it can compete for and attract scarce economic resources. The determination of whether the benefits exceed the costs is normally more of a qualitative assessment than a quantitative one.

2-18 In accounting, we assume the reporting entity is distinct from its owners. Each separate reporting entity prepares its own financial records and reports. For companies that are legally distinct entities, such as corporations, the reporting entity is distinct from the common equity shareholders who own the company. In sole proprietorships, in which an individual may both own and operate the business, accounting serves to record and report the transactions and events of the business separately from the proprietor's personal transactions.

2-19 The going-concern assumption (continuity assumption) assumes that the company will continue to operate in the foreseeable future, unless substantial evidence to the contrary exists. If a company is not regarded as a going concern, it is not clear that the company can recognize assets that represent expected future economic benefits, because it is not clear if the company will survive to enjoy those future benefits.

2-20 Financial statement users need timely information to evaluate a company's financial position, profitability, and cash flows on an ongoing basis. In accordance with the period-of-time assumption, companies prepare and report financial statements at the end of each year and include them in an annual report and in annual filings with the SEC. The annual reporting period is sometimes called the accounting period (or fiscal year). By reporting on a periodic basis in order to provide users more timely information, it requires the accountant to measure the assets, liabilities, and owners' equity on the balance sheet as of the last day of each period. In addition, the accountant must measure the financial performance during each period, including the income generated during the period as well as the cash inflows and outflows.

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2-21 In order to provide financial statement users with the most relevant and faithfully represented measures of companies' resources, obligations, and financial performance, accounting uses a mixture of measurement attributes. The *mixed attribute measurement model* seeks to measure assets, liabilities, revenues, expenses, and other elements of the financial statements with the most relevant and faithful measurement available. The types of measurement attributes used include historical costs, allocated historical costs, fair values, present values of future cash flows, net realizable values, and others.

2-22 At the time of most transactions, the *historical cost* (the exchange price) is the most relevant and faithful representation of the value of the exchange. Historical cost provides evidence that independent parties have willingly agreed on the value of the items exchanged at the time of the transaction, and thus historical cost has the qualities of relevance, representational faithfulness (neutrality), and verifiability. Accountants understand that historical cost information can lose relevance for financial decisions if the economic value of the resource or obligation has changed since the time of the original transaction.

2-23 *Recognition* means the process of formally recording and reporting an item in the financial statements of a company. A recognized item is shown in both words and numbers, with the amount included in the financial statement totals. The FASB has identified four fundamental recognition criteria. To be recognized, an item must:

- Meet the definition of an element (such as an asset, liability, revenue, expense, etc.)
- Be measurable
- Be relevant
- Be representationally faithful

2-24 *Accrual accounting* is the process of measuring and reporting the economic effects of transactions, events, and circumstances in the appropriate period when those effects occur, even though the cash consequences may occur in a different period. If a company creates economic resources by generating revenues from selling products to customers in a particular period, accrual accounting will recognize the revenues in that period, even though the customers may have paid cash for the products in an earlier period or will pay cash for the products in a future period. Likewise, when a company consumes resources in order to generate revenues during a period, accrual accounting measures the economic effects of the resources consumed in that period, even though the company may have paid cash for those resources in a prior period or will pay for them in a future period. The objectives of accrual accounting are to appropriately measure financial position and financial performance each period.

2-25 The revenue recognition principle is an application of accrual accounting. It determines the appropriate period in which a company creates economic benefits and can recognize revenues in income. Companies should recognize revenue to depict the transfer of goods or services that reflects the consideration to which the entity expects to be entitled. This occurs when a company satisfies its performance obligations, or promises within the contract, with a customer.

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2-26 The expense recognition principle is also an application of accrual accounting. It determines the appropriate period in which a company has consumed economic resources in conducting business operations. Companies typically recognize expenses in a particular period on the basis of three principles:

- Cause and effect
- Immediate consumption
- Systematic and rational allocation over time

2-27 Conservatism is an approach that accountants use to avoid overstating net assets and net income when these amounts are uncertain. When accounting valuations are uncertain and alternative accounting valuations for assets or liabilities are equally possible, the accountant should select the one that is least likely to overstate the company's assets and income in the current period. The application of conservatism results in the reporting of lower asset values or higher liability values when those values are uncertain. In addition, accountants typically use a lower threshold for the recognition of losses than for gains. Conservatism is not desirable, nor is it a principle of accounting; instead, it is a practical approach accountants take to avoid misleading investors, lenders, and other creditors when valuations are uncertain. Over the years, conservatism gained prominence as a counterweight to balance the optimism of company managers.

2-28 Conceptually, the FASB's financial reporting model identifies the five specific financial statements that are the primary sources of useful financial information. They are the:

- Balance sheet (statement of financial position)
- Income statement
- Comprehensive income statement
- Statement of cash flows
- Statement of shareholders' equity

Under GAAP, the financial statements should also include the notes to explain the policies, methods, and estimates the company used to measure and report the statements, as well as any required supplementary information.

ANSWERS TO MULTIPLE-CHOICE

1. a	3. b	5. a	7. a	9. a
2. a	4. b	6. c	8. c	10. b

ANSWERS TO EXERCISES

E2-1

1. G	4. B	7. E	10. K	13. D
2. L	5. H	8. N	11. J	14. M
3. C	6. I	9. A	12. F	

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E2-2

1. C	3. E	5. B	7. D	9. F
2. I	4. A	6. H	8. J	10. G

ANSWERS TO CASES

C2-1

The objective of general purpose financial reporting is to provide financial information about a company that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the company. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit.

Equity investors include holders of equity securities, holders of partnership interests, and other equity interests. These equity investors generally invest economic resources (usually cash) in order to receive a return on, as well as a return of, the cash they invested. Lenders, including financial institutions and purchasers of traded debt securities (e.g., bonds), provide financial capital to a company by lending it economic resources (usually cash). Lenders generally expect to receive a return on their lending in the form of interest, repayments of borrowings, and increases in the prices of the debt securities they own. Other groups (e.g., suppliers who extend credit to a company) provide resources to the company as a result of their relationship with it even though the relationship is not that of a capital provider. These groups may make decisions relating to providing "capital" to the company, and therefore would also be considered capital providers.

Decisions by existing and potential investors about buying, selling, or holding equity and debt instruments depend on the returns that they expect from an investment in those instruments. For example, dividends, principal and interest payments, or market price increases. Similarly, decisions by existing and potential lenders and other creditors about providing or settling loans and other forms of credit depend on the principal and interest payments or other returns that they expect. Investors', lenders', and other creditors' expectations about returns depend on their assessment of the amount, timing, and uncertainty of (the prospects for) future net cash inflows to the entity. Consequently, existing and potential investors, lenders, and other creditors need information to help them assess the prospects for future net cash inflows to an entity.

A company's management is responsible to the company's capital providers for safely, efficiently, and profitably using its economic resources. Because management's performance in regard to its stewardship responsibilities usually affects the company's ability to generate net cash flows, information about the discharge of these responsibilities is also important to current and potential capital providers.

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C2-2

A company's financial reports should provide useful information about its economic resources (its assets) and the claims on the entity (its liabilities and equity). These financial reports can provide capital providers with information useful in identifying its financial strengths and weaknesses, and in assessing its liquidity and solvency. This financial information indicates the cash flow potentials of some assets (e.g., accounts receivable) and the cash needed to satisfy most claims of lenders and other creditors (e.g., accounts payable). However, many operating cash flows of a company are the result of combining various assets to produce, market, and deliver goods or services to customers. Capital providers need to know the nature and quantity of these resources for the company to use in its operations. Information about the company's financial structure (i.e., its financial position) also helps capital providers evaluate its need for additional borrowing and the likelihood that it will be able to obtain this borrowing. This information is also helpful in predicting the future cash flows to different capital providers.

A company's financial reports should also provide information about the effects of transactions, other events, and circumstances that change the company's economic resources and claims on the entity. This information includes measures and other information about the financial performance of the company as well as cash inflows and outflows. This financial information helps capital providers evaluate the amount, timing, and uncertainty of the company's future cash flows.

A company's financial reports about its financial performance should provide information about the return it has earned on its economic resources because, in the long run, a positive return on its economic resources is needed to generate net cash inflows and thus provide a return to its capital providers. Both the variability of the return and the components of the return are important in evaluating the uncertainty of future cash flows. Capital providers usually find information about a company's past financial performance, under both accrual accounting and cash flow accounting, to be useful in predicting the future returns on its economic resources.

- Under accrual accounting, the company should report the financial effects of its transactions, other events, and circumstances in the period in which the economic effects occur instead of when the cash receipts or payments occur. Financial reports prepared under accrual accounting generally provide better information for assessing past financial performance and future prospects than simply information about cash receipts and payments. Under accrual accounting, information about important economic resources, claims on the entity, and the related changes are included in the company's financial statements. This information is useful in assessing the company's past and future ability to generate net operating cash inflows, rather than by obtaining additional capital from capital providers. It is also useful for evaluating how changes in market prices (fair value) or interest rates have affected the company's economic resources and claims to these resources, thereby affecting the company's ability to generate future net cash inflows.
- Information about a company's cash flows during a period also helps capital providers assess the company's ability to generate future net cash inflows. Information about how a company obtains and spends cash, including information about its borrowing and repayment of borrowing, cash dividends, or other distributions to equity owners may affect the company's liquidity or solvency. Capital providers use information about a company's cash flows to understand its operations, evaluate its investing and financing activities, assess its liquidity and solvency, or interpret other information about its financial performance. Thus, a company should provide cash flow accounting information in addition to accrual accounting information in its financial reports.

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C2-2 (concluded)

A company's financial reports should also provide information about changes in its economic resources and claims to these resources that do *not* result from its financial performance. With this information, capital providers can evaluate to what extent the total change in a company's resources (and related claims) arises from management's ability to protect and enhance the company's economic resources (i.e., discharge its stewardship responsibilities), which will help them in predicting the company's future financial performance.

A company's financial reports should also include management's explanations and other information needed to help capital providers understand the information presented. Management's explanations help capital providers evaluate the company's past performance and help them predict its future performance. Management knows more about the company than external users and can often help explain particular transactions, other events, and circumstances that have affected or may affect the company. Capital providers can also better evaluate the company's financial information when management provides explanations of underlying assumptions, estimates, or methods used, as well as disclosures of significant uncertainties about these assumptions or estimates.

C2-3

The *objective* of general purpose external financial reporting is to provide financial information about a company (including the entities under its control) that is useful to existing and potential equity investors, lenders, and other creditors in making decisions about providing resources to the company. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit.

Relevance and *faithful representation* are the fundamental qualitative characteristics that *must* be present for financial reporting information to be useful. *Relevant* information must be capable of making a difference in the decisions made by external users in their capacity as capital providers. To be relevant, information must have predictive value, confirmatory value, or both. *Predictive value* relates to the ability of the information to help external users (capital providers) evaluate the potential effects of past, present, or future events on future cash flows. *Confirmatory value* relates to the ability of the information to confirm or correct external users' previous evaluations. In addition, materiality is an entity-specific aspect of relevance that information should possess since immaterial information would not affect users' decisions.

Faithful representation of economic phenomena occurs when the related information is complete, neutral, and free from error. *Completeness* means including all information necessary for faithful representation in financial reporting. *Neutral* means that there is an absence of bias to attain a predetermined result or induce a particular behavior. *Free from error* means that the information (including estimates) presented is as accurate as possible, reflecting the best available inputs.

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C2-3 (concluded)

Comparability, verifiability, timeliness, and understandability are the "enhancing" characteristics that distinguish more-useful information from less-useful information and increase the decision usefulness of information. *Comparability* (including consistency) is the quality of accounting information that enables external users to identify similarities and differences between two sets of economic facts. *Consistency* means using the same accounting policies and procedures from period to period or in a single period across companies. *Verifiability* implies that different knowledgeable and independent measurers would reach a consensus that either (a) the information presented is free from material error or bias or (b) an appropriate recognition or measurement method has been applied without material error or bias. *Timeliness* means that information is made available to decision makers before it loses its ability to influence decisions. *Understandability* means that external users who are reasonably knowledgeable about business and financial accounting can comprehend the meaning of the financial information presented.

These qualities are subject to one constraint: the cost constraint. The *cost* constraint means that the benefits of better investment, credit, and similar resource allocation decisions are greater than the direct costs (the costs of collecting, processing, verifying, and disseminating) and indirect costs (the costs to external users of analysis and interpretation) of the information.

C2-4 [CMA Adapted]

The financial information that is reported by a company in its financial reports must be useful for existing and potential investors, lenders, and other creditors. To be useful, this information must possess certain qualitative characteristics (or "ingredients"). These qualitative characteristics are classified as primary qualitative characteristics and enhancing qualitative characteristics, depending on how they affect the usefulness of the financial information. There is also a constraint to providing financial information.

PRIMARY QUALITATIVE CHARACTERISTICS

For financial information to be useful, it must possess two primary qualitative characteristics: relevance and faithful representation. Each primary qualitative characteristic also has several components.

1. Relevance

   Financial information is relevant when it can make a difference in the decisions made by external users in their capacity as capital providers. Whether financial information can make a difference is not dependent on whether the information has actually made a difference or will make a difference in the future. What is critical is that the information can make a difference, even if a user chooses not to take advantage of it. To be relevant, financial information has predictive value, confirmatory value, or both, and it must be material.

   - Predictive Value. Financial information has predictive value when it can help capital providers form their expectations about the future. The information itself does not have to be predictable to have predictive value. In addition, financial information does not have to be in the form of a forecast; it only needs to be useful in a predictive process.

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C2-4 (continued)

- Confirmatory Value. Financial information has confirmatory value if it confirms or changes capital providers' previous expectations. Information that confirms previous expectations increases the likelihood that future outcomes or results will be as previously expected. On the other hand, information that changes previous expectations will also change the perceived probabilities of future outcomes or results. Confirmatory value is sometimes referred to as feedback value.

  Financial information that has predictive value usually also has confirmatory value. That is, these values are interrelated. For example, information about a company's economic resources helps capital providers predict the company's ability to take advantage of market opportunities. This information also helps to confirm capital providers' predictions about this ability.

- Materiality. Materiality refers to the nature or magnitude of an omission or misstatement of financial information which could influence the decisions that capital providers make based on this information. In other words, if the dollar amount of an omission or misstatement of financial information would be large enough to influence the judgment of a decision maker, then the information is material. Immaterial information is not relevant since it would not influence a user's decision.

2. Faithful Representation

Financial reports represent economic transactions, events, and arrangements with words and numbers. Accounting information is a *faithful representation* of the underlying economic transactions, events, and arrangements when the words and numbers accurately depict the economic substance of what they purport to represent. To be a faithful representation, the information must be complete, neutral, and free from error.

- Completeness. Financial information is complete when it includes *all* the information that is necessary for the faithful representation of the economic phenomenon that is being reported. An omission can cause information to be false or misleading and, therefore, not useful to the users of financial reports.
- Neutrality. Financial information is neutral when it is not biased to attain a predetermined result or to influence behavior in a particular direction. Neutrality does not mean that financial information has no purpose or does not influence behavior. Financial information is intended to be useful in decision making, thereby influencing the decision makers' behavior, but not in a predetermined direction.
- Free from Error. Financial information is free from error when it is presented as accurately as possible, reflecting the best available inputs. Freedom from error, however, does not imply that financial reports must be 100% accurate. Many financial reporting measures involve estimates that are based on management's judgments. Each estimate must reflect the best available information with some minimum level of accuracy. In addition, sometimes it may be necessary to explicitly disclose the degree of uncertainty in the reported financial information.

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C2-4 (continued)

3. Application of the Primary Qualitative Characteristics

Relevance is concerned with identifying which economic phenomena should be depicted in financial reports to provide decision-useful information to capital providers. Relevance relates to the economic phenomena, not to their predictions, and therefore is considered *before* the other qualitative characteristics. Once financial information is determined to be relevant, then faithful representation is applied to determine whether a depiction of the economic phenomena in words and numbers accurately reflects the economic substance. As primary qualitative characteristics, both relevance and faithful representation work together to contribute to decision usefulness. Either irrelevant economic phenomena or unfaithful representation results in information that is not useful to decision makers.

4. ENHANCING QUALITATIVE CHARACTERISTICS

Enhancing qualitative characteristics distinguish between more-useful information and less-useful information. Enhancing qualitative characteristics increase the decision usefulness of financial information to capital providers and other users, and complement the fundamental qualitative characteristics. There are four enhancing qualitative characteristics: comparability, verifiability, timeliness, and understandability.

a. Comparability

Financial information is comparable when it enables users to identify similarities and differences between two sets of economic phenomena. Decision making involves choosing between alternatives. Thus, financial information about a company is more useful if it can be validly compared with similar information about the company from some other time period or with similar information about other companies. Comparability is not a quality of an individual item of information, but rather between two (or more) items of information. Comparability also includes consistency. *Consistency* means that the same accounting policies and procedures are used, either from period to period within the company or in a single period across companies. Consistency helps to achieve the goal of comparability. Without consistency, it would be difficult for a user to determine whether differences in results were caused by economic differences or simply by differences in accounting methods. While different accounting methods are often allowed by GAAP, permitting alternative accounting methods for the same economic phenomenon reduces comparability.

b. Verifiability

Financial information is verifiable when different knowledgeable and independent measurers would reach a consensus that the economic phenomenon is faithfully represented. Verifiable information can be used with confidence. To be verifiable, financial information does not have to be a single amount. A range of possible amounts and the related probabilities can also be verified. Verification can be either direct or indirect. Under *direct verification*, an amount itself is verified (e.g., counting inventory). Under *indirect verification*, an amount is verified by checking the inputs and recomputing the outputs using the same accounting method (e.g., applying the first-in, first-out inventory method).

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C2-4 (concluded)

c. Timeliness

Financial information is timely when it is available to decision makers before it loses its ability to influence decisions. Timeliness alone cannot make information useful, but a lack of timeliness reduces its potential usefulness. Timeliness does not imply that financial information is only useful in the current accounting period. Some information may continue to be timely because some users may consider it when assessing trends in various items in a company's financial reports.

d. Understandability

Financial information is understandable when capital providers are able to comprehend its meaning. Financial information is more understandable when it is classified and presented clearly and concisely. Capital providers are assumed to have a reasonable knowledge of business and economic activities and to be able to read a financial report. They are also expected to carefully review and analyze the information contained in the financial report. However, some financial information may be particularly complex. In this case, capital providers may seek the aid of an advisor to evaluate the information. Financial information should not be excluded from financial reports solely because it may be too complex for some users to understand without assistance from an advisor.

5. CONSTRAINT TO PROVIDING FINANCIAL INFORMATION

There is one constraint that helps identify what financial information should be disclosed in financial reports—the cost constraint.

Cost Constraint

Financial information is a commodity. Financial reporting of this information imposes costs. Unless the benefit expected from a commodity exceeds its cost, the commodity will not be sought after. This benefit greater than cost relationship is a constraint of providing useful financial information. The determination of whether the benefits of providing (and receiving) financial information justify the related costs is usually more of a qualitative assessment than a quantitative one.

The benefits of financial information are that the information helps capital providers make better decisions, which in turn results in the more efficient functioning of capital markets and a lower cost of capital for the economy as a whole. In addition, individual companies may reap the benefits of financial reporting information through improved access to capital markets, favorable effects on public relations, lower costs of capital, and improved management decisions (i.e., internal decision making).

The costs to a company of providing financial information include the costs of collecting and processing the information, the costs of verifying it, and the costs of disseminating the information. Capital providers also incur the costs of analysis and interpretation of the financial information. Thus, standard-setting regulatory bodies (and companies) must weigh the costs of providing financial information against the benefits of the information. In so doing, they must also consider the costs of *not* providing decision-useful information. If this information is not provided in financial reports, capital providers must obtain or attempt to estimate needed information using incomplete data in financial reports or data available elsewhere.

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C2-5 [AICPA Adapted]

Note to Instructor: Parts of this case may be slightly advanced for students at this point but are included to stimulate discussion.

1. Some costs are recognized as expenses on the basis of a direct association with specific revenue. This presumed direct association has been identified as "associating cause and effect." Direct cause and effect relationships can seldom be conclusively demonstrated, but some costs relate to particular revenues, and recognizing them as expenses accompanies recognition of the revenue. This cause and effect method of expense recognition (often called the matching principle), requires that when revenues are recognized, the specific expenses incurred to produce the revenue be given concurrent periodic recognition in the accounting records. Examples of expenses that are usually recognized by associating cause and effect are sales commissions, freight-out on merchandise sold, and cost of goods sold or services provided.

   However, we do not place much emphasis on the cause and effect method of expense recognition because relatively few expenses actually match to revenues; most expenses are recognized as a function of the period.

2. Some costs are assigned as expenses to the current accounting period because (a) their incurrence during the period provides no discernible future benefits; (b) they are measures of assets recorded in previous periods from which no future benefits are expected or can be discerned; (c) they must be incurred each accounting year, and no build-up of expected future benefits occurs; (d) by their nature they relate to current revenues even though they cannot be directly associated with any specific revenues; (e) the amount of cost to be deferred can be measured only in an arbitrary manner or great uncertainty exists regarding the realization of future benefits, or both; and (f) uncertainty exists regarding whether allocating them to current and future periods will serve any useful purpose. Thus, many costs are called "period costs" and are treated as expenses in the period incurred because they have neither a direct relationship to revenue earned nor can their occurrence be directly shown to give rise to an asset. The application of this principle of expense recognition results in charging many costs to expense in the period in which they are paid or accrued for payment. Examples of costs treated as period expenses would include officers' salaries, advertising, research and development, and auditors' fees.

3. In the absence of a direct basis for associating asset cost with revenue, and if the asset provides benefits for two or more accounting periods, its cost should be allocated to these periods (as an expense) in a systematic and rational manner. Thus, when it is impractical, or impossible, to find a close cause and effect relationship between revenue and cost, this relationship is often assumed to exist. Therefore, the asset cost is allocated to the accounting periods by some method. The allocation method used should appear reasonable to an unbiased observer and should be followed consistently from period to period.

   Examples of systematic and rational allocation of asset cost would include depreciation of fixed assets, amortization of certain intangibles, and allocation of rent and insurance.

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C2-6 [CMA Adapted]

Relevance

Financial information is relevant when it can make a difference in the decisions made by external users in their capacity as capital providers. To be relevant, financial information has predictive value, confirmatory value, or both. In addition, relevant information is material.

- Predictive Value. Financial information has predictive value when it can help capital providers form their expectations about the future. The information itself does not have to be a prediction to have predictive value. To have predictive value, financial information only needs to be useful in a predictive process.
- Confirmatory Value. Financial information has confirmatory value if it confirms or changes capital providers' previous expectations. Information that confirms previous expectations increases the likelihood that future outcomes or results will be as previously expected. On the other hand, information that changes previous expectations will also change the perceived probabilities of future outcomes or results. Confirmatory value is sometimes referred to as feedback value.

  Financial information that has predictive value usually also has confirmatory value. That is, these values are interrelated. For example, information about a company's economic resources helps capital providers predict the company's ability to take advantage of market opportunities. This information also helps to confirm capital providers' predictions about this ability.
- Materiality refers to the nature or magnitude of an omission or misstatement of financial information which could influence the decisions that external users make in the context of an individual company's financial report. In other words, if the dollar amount of an omission or misstatement of financial information would be large enough to influence the judgment of a decision maker, then the information is material. Immaterial information does not affect a user's decision and is, therefore, not relevant.

Faithful Representation

Financial reports represent economic transactions, events, and arrangements with words and numbers. Accounting information is a *faithful representation* of the underlying economic transactions, events, and arrangements when the words and numbers accurately depict the economic substance of what they purport to represent. To be a faithful representation, the information must be complete, neutral, and free from error.

- Completeness. Financial information is complete when it includes *all* the information that is necessary for the faithful representation of the economic phenomenon that is being reported. An omission can cause information to be false or misleading and, therefore, not useful to the users of financial reports.
- Neutrality. Financial information is neutral when it is not biased to attain a predetermined result or to influence behavior in a particular direction. Neutrality does not mean that financial information has no purpose or does not influence behavior. Financial information is intended to be useful in decision making, thereby influencing the decision makers' behavior, but not in a predetermined direction.

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C2-6 (concluded)

- Free from Error. Financial information is free from error when it is presented as accurately as possible, reflecting the best available inputs. Freedom from error, however, does not imply that financial reports must be 100% accurate. Many financial reporting measures involve estimates that are based on management's judgments. Each estimate must reflect the best available information, with some minimum level of accuracy. In addition, sometimes it may be necessary to explicitly disclose the degree of uncertainty in the reported financial information.

Likely Student Response

Relevance is more important. Relevance is concerned with identifying which economic phenomena should be depicted in financial reports to provide decision-useful information to capital providers. Relevance relates to the economic phenomena, not to their predictions, and therefore is considered *before* faithful representation. Once financial information is determined to be relevant, then faithful representation is applied to determine whether a depiction of the economic phenomena in words and numbers accurately reflects the economic substance. As primary qualitative characteristics, both relevance and faithful representation work together to contribute to decision usefulness. Either irrelevant economic phenomena or unfaithful representation results in information that is not useful to decision makers.

C2-7

Note to Instructor: This case is a more general version of C2-4. Unlike C2-4, this case requires students to identify the objectives, primary qualitative characteristics, enhancing characteristics, and the cost constraint.

OBJECTIVES OF FINANCIAL REPORTING

The FASB states that 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."

The FASB further states:

> "Decisions by existing and potential investors about buying, selling, or holding equity and debt instruments depend on the returns that they expect from an investment in those instruments; for example, dividends, principal and interest payments, or market price increases. Similarly, decisions by existing and potential lenders and other creditors about providing or settling loans and other forms of credit depend on the principal and interest payments or other returns that they expect. Investors', lenders', and other creditors' expectations about returns depend on their assessment of the amount, timing, and uncertainty of (the prospects for) future net cash inflows to the entity. Consequently, existing and potential investors, lenders, and other creditors need information to help them assess the prospects for future net cash inflows to an entity."

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C2-7 (continued)

To be useful, this information must possess certain qualitative characteristics (or "ingredients"). These qualitative characteristics are classified as fundamental qualitative characteristics and enhancing qualitative characteristics, depending on how they affect the usefulness of the financial information. There is also a constraint to providing financial information.

PRIMARY QUALITATIVE CHARACTERISTICS

For financial information to be useful, it must possess two primary qualitative characteristics: relevance and faithful representation. Each primary qualitative characteristic also has several components. Also, the primary qualitative characteristics are applied in a certain order.

Relevance

Financial information is relevant when it can make a difference in the decisions made by external users in their capacity as capital providers. To be relevant, financial information has predictive value, confirmatory value, or both, and it must be material.

- Predictive Value. Financial information has predictive value when it can help capital providers form their expectations about the future. The information itself does not have to be a prediction to have predictive value. To have predictive value, financial information only needs to be useful in a predictive process.
- Confirmatory Value. Financial information has confirmatory value if it confirms or changes capital providers' previous expectations. Information that confirms previous expectations increases the likelihood that future outcomes or results will be as previously expected. On the other hand, information that changes previous expectations will also change the perceived probabilities of future outcomes or results. Confirmatory value is sometimes referred to as feedback value.

  Financial information that has predictive value usually also has confirmatory value. For example, information about a company's economic resources helps capital providers predict the company's ability to take advantage of market opportunities. This information also helps to confirm capital providers' predictions about this ability.

- Materiality. Materiality refers to the nature or magnitude of an omission or misstatement of financial information which could influence the decisions that capital providers make based on this information. In other words, if the dollar amount of an omission or misstatement of financial information would be large enough to influence the judgment of a decision maker, then the information is material. Immaterial information is not relevant since it would not influence a user's decision.

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C2-7 (continued)

Faithful Representation

Financial reports represent economic transactions, events, and arrangements with words and numbers. Accounting information is a *faithful representation* of the underlying economic transactions, events, and arrangements when the words and numbers accurately depict the economic substance of what they purport to represent. To be a faithful representation, the information must be complete, neutral, and free from error.

- Completeness. Financial information is complete when it includes *all* the information that is necessary for the faithful representation of the economic phenomenon that is being reported. An omission can cause information to be false or misleading and, therefore, not useful to the users of financial reports.
- Neutrality. Financial information is neutral when it is not biased to attain a predetermined result or to influence behavior in a particular direction. Neutrality does not mean that financial information has no purpose or does not influence behavior. Financial information is intended to be useful in decision making, thereby influencing the decision makers' behavior, but not in a predetermined direction.
- Free from Error. Financial information is free from error when it is presented as accurately as possible, reflecting the best available inputs. Freedom from error, however, does not imply that financial reports must be 100% accurate. Many financial reporting measures involve estimates that are based on management's judgments. Each estimate must reflect the best available information, with some minimum level of accuracy. In addition, sometimes it may be necessary to explicitly disclose the degree of uncertainty in the reported financial information.

Application of the Primary Qualitative Characteristics

Relevance is concerned with identifying which economic phenomena should be depicted in financial reports to provide decision-useful information to capital providers. Relevance relates to the economic phenomena, not to their predictions, and therefore is considered *before* the other qualitative characteristics. Once financial information is determined to be relevant, then faithful representation is applied to determine whether a depiction of the economic phenomena in words and numbers accurately reflects the economic substance. As primary qualitative characteristics, both relevance and faithful representation work together to contribute to decision usefulness. Either irrelevant economic phenomena or unfaithful representation results in information that is not useful to decision makers.

ENHANCING QUALITATIVE CHARACTERISTICS

Enhancing qualitative characteristics distinguish between more-useful information and less-useful information. Enhancing qualitative characteristics increase the decision usefulness of financial information to capital providers and other users, and complement the fundamental qualitative characteristics. There are four enhancing qualitative characteristics: comparability, verifiability, timeliness, and understandability.

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C2-7 (continued)

Comparability

Financial information is comparable when it enables users to identify similarities and differences between two sets of economic phenomena. Decision making involves choosing between alternatives. Thus, financial information about a company is more useful if it can be validly compared with similar information about the company from some other time period or with similar information about other companies. Comparability is not a quality of an individual item of information, but rather between two (or more) items of information. Comparability also includes consistency. *Consistency* means that the same accounting policies and procedures are used, either from period to period within the company or in a single period across companies.

Consistency helps to achieve the goal of comparability. Without consistency, it would be difficult for a user to determine whether differences in results were caused by economic differences or simply by differences in accounting methods. While different accounting methods are often allowed by GAAP, permitting alternative accounting methods for the same economic phenomenon reduces comparability.

Verifiability

Financial information is verifiable when different knowledgeable and independent measurers would reach a consensus that the economic phenomenon is faithfully represented. Verifiable information can be used with confidence. To be verifiable, financial information does not have to be a single amount. A range of possible amounts and the related probabilities can also be verified. Verification can be either direct or indirect. Under direct verification, an amount itself is verified (e.g., counting inventory). Under indirect verification, an amount is verified by checking the inputs and recomputing the outputs using the same accounting method (e.g., applying the first-in, first-out inventory method).

Timeliness

Financial information is timely when it is available to decision makers before it loses its ability to influence decisions. Timeliness alone cannot make information useful, but a lack of timeliness reduces its potential usefulness. Timeliness does not imply that financial information is only useful in the current accounting period. Some information may continue to be timely because some users may consider it when assessing trends in various items in a company's financial reports.

Understandability

Financial information is understandable when capital providers are able to comprehend its meaning. Financial information is more understandable when it is classified and presented clearly and concisely. Capital providers are assumed to have a reasonable knowledge of business and economic activities and to be able to read a financial report. They are also expected to carefully review and analyze the information contained in the financial report. However, some financial information may be particularly complex. In this case, capital providers may seek the aid of an advisor to evaluate the information. Financial information should not be excluded from financial reports solely because it may be too complex for some users to understand without assistance from an advisor.

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C2-7 (concluded)

Application of the Enhancing Qualitative Characteristics

Enhancing qualitative characteristics improve the usefulness of financial information. They should be maximized to the extent possible to increase the relevance and faithful presentation of financial information. However, the enhancing qualitative characteristics either individually or in combination with each other cannot make irrelevant or unfaithfully represented information useful. The application of the enhancing qualitative characteristics does not follow a prescribed order, like the fundamental qualitative characteristics. Sometimes, one or more of the enhancing qualitative characteristics may be sacrificed to varying degrees to maximize another qualitative characteristic. For example, comparability may be temporarily sacrificed to include relevant information based on a new accounting method in a company's financial report.

CONSTRAINT TO PROVIDING FINANCIAL INFORMATION

There is one constraint that helps identify what financial information should be disclosed in financial reports—the cost constraint.

Financial reporting of information imposes costs. The benefit of useful financial information should be greater than the cost of providing the information. The determination of whether the benefits of providing (and receiving) financial information justify the related costs is usually more of a qualitative assessment than a quantitative one.

The benefits of financial information are that the information helps capital providers make better decisions, which in turn results in the more efficient functioning of capital markets and a lower cost of capital for the economy as a whole. In addition, individual companies may reap the benefits of reported financial information through improved access to capital markets, favorable effects on public relations, lower costs of capital, and improved management decisions (i.e., internal decision making).

The costs to a company of providing financial information include the costs of collecting and processing the information, the costs of verifying it, and the costs of disseminating the information. Capital providers also incur the costs of analysis and interpretation of the financial information. Thus, standard-setting regulatory bodies (and companies) must weigh the costs of providing financial information against the benefits of the information. In so doing, they must also consider the costs of *not* providing decision-useful information. If this information is not provided in financial reports, capital providers must obtain or attempt to estimate needed information using incomplete data in financial reports or data available elsewhere.

C2-8 [CMA Adapted]

1. The objective of general purpose external financial reporting is to provide financial information about a company 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. Information that is useful to capital providers may also be useful to other users of financial reporting.

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C2-8 (concluded)

2. Although the level of sophistication related to business and financial accounting matters varies both within and between user groups, users are expected to have a reasonable understanding of business and economic activities and to be able to read a financial report and study the information with reasonable diligence. In some cases, they may seek the aid of an advisor to evaluate the information.

3. Management's *stewardship* responsibility means that the company's management is responsible to the owners for the custody and safekeeping of the resources, their efficient and profitable use, and their protection against unfavorable economic impacts, technological developments, and social changes. Financial reporting should provide information about how efficiently and effectively the company's management and governing board have discharged their responsibilities to use the company's resources.

C2-9 [AICPA Adapted]

1. The *reporting entity* assumption assumes that a business enterprise is a legally and economically distinct entity, so that financial statements can be prepared and reported specifically for that entity. Most of the economic activity in the United States can be directly or indirectly attributed to business enterprises that are distinct reporting entities.

   In accounting, we assume the reporting entity is distinct from its owners. Each separate reporting entity prepares its own financial records and reports. For companies that are legally distinct entities, such as *corporations*, the reporting entity is distinct from the common equity shareholders who own the company. In *sole proprietorships*, in which an individual may both own and operate the business, accounting serves to record and report the transactions and events of the business separately from the proprietor's personal transactions. Accounting views a *transaction* as an exchange of items of value between the reporting entity and another party (e.g., another company, an employee, a lender, or an individual investor).

   The reporting entity assumption defines the scope of interest and thus narrows the range and establishes the boundaries of the possible transactions, events, and commercial arrangements that may be included in accounting records and reports.

   The applicability of all the other generally accepted assumptions or principles of accounting (such as going concern, monetary unit, and period of time) depends upon the established boundaries and nature of the reporting entity. The other accounting concepts lack significance without reference to an entity. The entity must be defined before the balance of the accounting model can be applied and the accounting can begin. Thus, the reporting entity assumption is so fundamental that it pervades all of accounting.

2. a. Yes, units created by or under law would include corporations, partnerships, and, occasionally, sole proprietorships. Thus, legal units probably are the most common types of reporting entities.

   b. Yes, a product-line operating segment of a company could be a reporting entity for purposes of reporting operating segments.

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c. Yes, most large corporations issue consolidated financial reports for two or more legal entities that constitute a controlled economic entity. Accounting for investments in subsidiary companies by the equity method also is an example of an accounting unit that extends beyond the legal entity. The financial reports for a company that includes two or more product-line operating segments would also be a form of a consolidated report that most commonly would be considered to be the report of a single legal entity.

d. Yes, although the reporting entity often is typically defined in terms of a company that is separate and distinct from other activities of the owner or owners, it is also possible for an owner to comprise a reporting entity. Examples include financial statements for an individual (personal financial statements) and the financial report of a person's estate.

e. No, the reporting entity does not typically apply to an industry. However, financial data are often compiled for an industry by a trade association (industry averages) or by government agencies. Industries typically do not transact as an independent unit but instead represent a group of companies or enterprises producing similar products and services.

f. No, the reporting entity concept cannot be applied to the economy of the United States. The U.S. economy does not act as a separate legal or economic entity engaged in economic transactions. The economy is instead the aggregation of all economic activities by individuals, companies, government agencies, etc. Economy-wide data can be estimated, such as the national income accounts compiled by the U.S. Department of Commerce. The U.S. federal government (and its agencies) can be (and are) treated as accounting entities by the General Accounting Office (GAO).

C2-10 [AICPA Adapted]

Accrual accounting is the process of measuring and reporting the economic effects of transactions, events, and circumstances in the appropriate period when those effects occur, even though the cash consequences may occur in a different period. If a company creates economic resources by generating revenues from selling products to customers in a particular period, accrual accounting will recognize the revenues in that period, even though the customers may have paid cash for the products in an earlier period or will pay cash for the products in a future period. Likewise, when a company consumes resources in order to generate revenues during a period, accrual accounting measures the economic effects of the resources consumed in that period, even though the company may have paid cash for those resources in a prior period or will pay for them in a future period. The objectives of accrual accounting are to appropriately measure financial position and financial performance each period.

When economic effects are recognized in the current period, even though the cash flows will occur in a later period, they are usually referred to as *accruals* (e.g., when a company recognizes an accrued expense and an accrued liability for wages at the end of a period). When cash flows occur in the current period but the economic effects will be recognized in a later period, they are usually referred to as *deferrals* (e.g., when a company recognizes an asset for a prepaid expense, such as prepaid rent, deferring the rent expense to the future period when it is used).

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C2-11

Note to Instructor: These answers are based on what students would be expected to understand from the brief discussion of the revenue recognition methods presented in the chapter.

A. Company A should recognize revenue at the time of sale because it has satisfied its performance obligation when it delivers the merchandise to the customer.

B. Company B should recognize revenue periodically based on the services completed to date. Although payment was received at the time the contracts were signed, revenue cannot be recognized because the performance obligations in the contract with the customer have not been satisfied.

C2-12

A. Violation of the expense recognition principle; cost of goods sold should be recognized as an expense as the resources are consumed. Cost of goods sold should be matched against the revenues when the goods are sold, not purchased.

B. Violation of the historical cost principle; the historical cost (exchange price) of the land should be retained in the accounting records until the land has been sold.

C. Violation of period-of-time assumption; the financial statements should be prepared at least once a year.

D. Violation of the revenue recognition principle; revenue should not be recognized until the company has satisfied its performance obligation by delivering products or services to customers.

E. Violation of the stable monetary unit assumption; the financial statements should not be adjusted for the effects of inflation. (Note: However, in countries that may be experiencing hyperinflation, accounting standards may require inflation-adjusted reporting.)

F. Violation of entity assumption; Thomas should maintain separate records of his personal and business transactions and prepare his company's financial statements based only on the business transactions.

G. Violation of the going-concern assumption and historical cost principle. The economic resources should be reported on an historical cost basis.

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Note to Instructor: This case does not have a definitive answer. From a financial reporting perspective, GAAP is identified and summarized. From an ethical perspective, various issues are raised for discussion purposes.

From a financial reporting perspective, Watson Company is not following GAAP because it recognizes revenues as cash is collected and expenses as cash is paid. This is called cash-basis accounting. Under GAAP, revenues are recognized when a company satisfies its performance obligations to a customer. The expenses involved in conducting business operations and generating revenues are recognized in the period when economic resources are consumed. This is the essence of accrual accounting, which is the process of recognizing the economic effects of transactions, events, and circumstances in the period in which they occur rather than when the cash receipts or payments occur. Use of accrual accounting provides relevant and faithfully represented information about a company's return on investment, risk, financial flexibility, liquidity, and operating capability that helps capital providers in making rational investment and credit decisions.

From an ethical perspective, the issue is whether cash-basis accounting responds to the rights of, and is fair to, all the stakeholders in Watson Company. In this situation, the primary stakeholders are the shareholders, creditors, and Chris. It can be argued that cash-basis accounting does not provide relevant information that has predictive value (for forecasting purposes) and confirmatory value (for evaluating prior expectations). While Chris claims the information under cash-basis accounting is verifiable and conservative, it may not portray a valid description of the company's income-earning activities and may not be neutral. Even though use of cash-basis accounting may be "easy" for Chris, it may not be fair for Watson Company to use this method because shareholders and creditors need accrual-basis financial information for their decision making. Accrual-based accounting makes information comparable across companies. On the other hand, since Watson Company's stock is not publicly traded, there is no requirement that it follow GAAP. Because the company is small and has few shareholders, cash-basis accounting may be acceptable if the shareholders have sufficient access to the company's operating information for their investment decision making. Furthermore, if the creditors are short-term and the amounts owed are small, cash-basis accounting may provide them with enough information to assess the liquidity of the company in regard to paying its short-term debts.

C2-14 [AICPA Adapted]

Statement 1

1. Erroneous conclusion: That the primary accounting function is to provide financial information to management.

2. Accounting is a service activity that provides financial information for making economic decisions. Financial accounting is concerned primarily with providing useful financial information to existing and potential investors, lenders, and other creditors, who are external users of financial statements. Thus, financial accounting information is intended to aid the decision making of external users. A different area of accounting (not the subject of this book), called managerial accounting, is concerned primarily with providing information to management.

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C2-14 (concluded)

Statement 2

1. Fallacy: That financial statements should be prepared with conservatism.

2. Conservatism is not desirable; it is merely a prudent response to uncertainty. Accountants use conservatism as a response to uncertainty in order to avoid overstating net assets and/or net income.

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