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CHAPTER 1

SOLUTIONS TO B EXERCISES

E 1.1B (15–20 minutes)

(a) True.

(b) False – General-purpose financial reporting helps external users who lack the ability to demand all the financial information they need from an entity and therefore must rely, at least partly, on the information in financial reports.

(c) False – Standard-setting that is based on individual conceptual frameworks will lead to different conclusions about identical or similar issues. As a result, standards will not be consistent with one another, and past decisions may not be indicative of future ones.

(d) False – Information that is decision-useful to capital providers may also be useful to other users of financial reporting, who are not capital providers such as government agencies.

(e) False – An implicit assumption is that users need reasonable knowledge of business and financial accounting matters to understand the information contained in the financial statements.

(f) True.

LO: 1, 2 Bloom: C, Difficulty: Easy, Time: 15-20, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

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E 1.2B (15–20 minutes)

(a) False – The fundamental qualitative characteristics that make accounting information useful are relevance and faithful representation.
(b) True.
(c) False – prudence or conservatism generally is in conflict with the quality of neutrality and may lead to bias in financial reporting.
(d) False – Information that is relevant is characterized as having predictive or confirmatory value.
(e) False – Comparability also refers to comparisons of a firm over time (consistency).
(f) False – Enhancing characteristics relate to both relevance and faithful representation.
(g) True.

LO: 1, 2, Bloom: C, Difficulty: Easy, Time: 15-20, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

E 1.3B (20–30 minutes)

(a) Relevance.
(b) Comparability, Consistency.
(c) Confirmatory value.
(d) Relevance and faithful representation.
(e) Neutrality.
(f) Cost constraint.
(g) Neutrality.
(h) Timeliness.
(i) Verifiability.
(j) Comparability.

LO: 2 Bloom: C, Moderate, Time: 20-30, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

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E 1.4B (15–20 minutes)

(a) Faithful representation.

(b) Neutrality.

(c) Comparability.

(d) Relevance.

(e) Comparability.

(f) Confirmatory value.

(g) Verifiability.

(h) Comparability, verifiability, timeliness, and understandability.

(i) Timeliness.

(j) Relevance and faithful representation.

LO: 2, Bloom: C, Difficulty: Easy, Time: 15-20, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

E 1.5B (15–20 minutes)

(a) Revenues, expenses.
(b) Distribution to owners
(Note: Net effect is to reduce equity and assets).
(c) Gains, losses.
(d) Assets.
(e) Investment by owners, comprehensive income
(also possible to be revenues and gains).
(f) Liabilities.

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E 1.5B (continued)

(g) Comprehensive income

(also possible to be revenues and gains).

(h) Comprehensive income.

(i) Revenues.

(j) Equity.

(k) Comprehensive income.

(l) Distributions to owners.

LO: 2, Bloom: C, Difficulty: Easy, Time: 15-20, AACSB: Communication, AICPA BC: None, AICPA AC: Measurement Analysis and Interpretation, Reporting, AICPA PC: None

E 1.6B (15–20 minutes)

(a) 6. Measurement principle (fair value).

(b) 2. Going concern assumption.

(c) 7. Expense recognition principle.

(d) 1. Economic entity assumption.

(e) 8. Full disclosure principle.

(f) 5. Measurement principle (historical cost).

(g) 4. Periodicity assumption.

(h) 3. Monetary unit assumption.

LO: 3 Bloom: C, Difficulty: Easy, Time: 15-20, AACSB: Communication, AICPA BC: None, AICPA AC: Measurement Analysis and Interpretation, Reporting, AICPA PC: None

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E 1.7B (20–25 minutes)

(a) Full disclosure principle.

(b) Expense recognition principle.

(c) Monetary unit assumption.

(d) Measurement principle (fair value).

(e) Full disclosure principle.

(f) Measurement principle (fair value).

E 1.7B (continued)

(g) Economic entity assumption.

(h) Full disclosure principle.

(i) Revenue recognition principle.

(j) Expense recognition principle.

(k) Measurement principle (fair value).

(l) Periodicity assumption.

(m) Measurement principle (historical cost).

(n) Economic entity assumption.

(o) Expense recognition and revenue recognition principles.

LO: 3 Bloom: C, Moderate, Time: 20-25, AACSB: Communication, AICPA BC: None, AICPA AC: Measurement Analysis and Interpretation, Reporting, AICPA PC: None

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E 1.8B (20-25 minutes)

(a) This event need not be disclosed in the financial statements. The amount of monies involved is relatively small in relation to the net income of the business and should not affect the fairness of the presentation of the financial statements.

(b) According to GAAP, the basis upon which inventory amounts are stated (lower of cost or net realizable value) and the method used in determining cost (LIFO, FIFO, average cost, etc.) should also be reported. The disclosure requirement related to the method used in determining cost should be emphasized, indicating that where possible alternatives exist in financial reporting, disclosure in some format is required.

(c) Comparability requires that disclosure of changes in accounting principles be made in the financial statements. To do otherwise would result in financial statements that are misleading. Financial statements are more useful if they can be compared with similar reports for prior years. Consistency, a type of comparability, occurs when a company applies the same accounting treatment to similar events from period to period.

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E 1.8B (continued)

Changes in accounting method must be disclosed along with the justification for the change.

(d) The proper accounting for this situation is to report the equipment as an asset and the notes payable as a liability on the balance sheet. Offsetting is permitted in only limited situations where certain assets are contractually committed to pay off liabilities.

(e) It is well established in accounting that revenues and cost of goods sold must be disclosed in the reporting of an income statement. It might be noted to students that such was not always the case. At one time, only net income was reported but over time we have evolved to the present reporting format.

LO: 3, Bloom: C, Difficult, Time: 20-25, AACSB: Communication, AICPA BC: None, AICPA AC: Measurement Analysis and Interpretation, Reporting, AICPA PC: None

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E 1.9B (20-25 minutes)

(a) This entry is inappropriate. The expense recognition principle indicates that expenses should be allocated to the appropriate periods involved. In this case, there appears to be a high probability that the company will not have to pay. *FASB ASC 450-20-25* requires that a loss should be accrued only (1) when it is probable that the company would lose the suit and (2) the amount of the loss can be reasonably estimated. (Note to instructor: The student will probably be unfamiliar with *FASB ASC 450-20-25*. The purpose of this question is to develop some decision framework when the probability of a future event must be assumed.)

(b) This entry is inappropriate. At the present time, accountants do not recognize price-level adjustments in the accounts. Hence, it is misleading to deviate from the measurement principle (historical cost) because conjecture or opinion can take place. It should also be noted that depreciation is not so much a matter of valuation as it is a means of cost allocation. Assets are not depreciated on the basis of a decline in their fair market value, but are depreciated on the basis of systematic charges of expired costs against revenues. (Note to instructor: It might be called to the students' attention that the FASB does encourage supplemental disclosure of price-level information.)

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E 1.9B (continued)

(c) This entry is inappropriate. Most accounting methods are based on the assumption that the business enterprise will have a long life. Acceptance of this assumption provides credibility to the historical cost principle, which would be of limited usefulness if liquidation were assumed. Only if we assume some permanence to the enterprise, is the use of depreciation and amortization policies justifiable and appropriate. Therefore, it is incorrect to assume liquidation as Barela, Inc. has done in this situation. It should be noted that only where liquidation appears imminent is the going concern assumption inapplicable.

(d) This entry is inappropriate. The measurement principle (historical cost) indicates that assets and liabilities are accounted for on the basis of cost. If we were to select sales value, for example, we would have an extremely difficult time in attempting to establish a sales value for a given item without selling it. It should further be noted that the revenue recognition principle provides the answer to when revenue should be recognized. Revenue should be recognized when the company satisfies a performance obligation.

(e) This entry is inappropriate. The entry violates the economic entity assumption. This assumption in accounting indicates that economic activity can be identified with a particular unit of accountability. In this situation, the company erred by charging this cost to the wrong economic entity.

(f) The answer to this question is the same as (d).

LO: 3, Bloom: AN, Moderate, Time: 20-25, AACSB: Analytic, AICPA BC: None, AICPA AC: Measurement Analysis and Interpretation, Reporting, AICPA PC: None

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E 1.10B (15–20 minutes)

(a) This is incorrect. Assets should be recorded at the fair market value of what is given up or the fair market value of what is received, whichever is more clearly evident. It should be emphasized that it is not a violation of the measurement principle (historical cost) to use the fair market value of the stock. Recording the asset at the par value of the stock has no conceptual validity. Par value is merely an arbitrary amount usually set at the date of incorporation. The equipment must be recorded at the full $450,000 market value.

(b) This is incorrect. The gain should be recognized when the equipment is delivered to the customer. Deferral of the gain is not permitted, because the company has satisfied the performance obligation. To explore this question at greater length, one might ask what justification other than the controller's might be used to justify the deferral of the gain. For example, the rationale provided in GAAP, non-completion of the earnings process, might be discussed.

(c) This is incorrect. It appears from the information that the sale should be recorded in 2026 instead of 2025. Regardless of whether the terms are f.o.b. shipping point or f.o.b. destination, the point is that the performance obligation was satisfied when the goods were shipped in 2026. It should be noted that if the company is employing a perpetual inventory system in dollars and quantities, a debit to Cost of Goods Sold and a credit to Inventory is also necessary in 2026.

(d) This is incorrect. No gain is allowed due to an increase in inventory valuation. Accountants follow the measurement principle (historical cost) and write-ups of assets are not permitted. It should also be noted that the revenue recognition principle states that revenue should not be recognized until the performance obligation is satisfied.

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E 1.10B (Continued)

(e) This entry is incorrect. Depreciation is an allocation of cost, not an attempt to value assets. As a consequence, even if the value of the building is increasing, costs related to this building should be matched with revenues on the income statement, not as a charge against retained earnings.

LO: 3, Bloom: AN, Moderate, Time: 15-20, AACSB: Analytic, AICPA BC: None, AICPA AC: Measurement Analysis and Interpretation, Reporting, AICPA PC: None

E 1.11B (10-15 minutes)

(a) Many useful nonfinancial measures are not available in the financial statements and are not required to be reported. Companies have concerns about disclosing some information publicly and other information may not be readily gathered, reported and/or auditable.

Many companies disclose additional data of interest to users of financial statements voluntarily. The profession continues to look at the needs of investors and creditors and works to come up with reporting standards

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E 1.11B (Continued)

as the needs of users of financial statements change. A current example would be the focus on sustainability reporting and industry efforts to standardize this reporting.

(b) Timeliness and providing forward–looking information are two challenges facing the profession. There is a tradeoff between the fundamental qualities of relevance and faithful representation with this type of data. With the increased efficiency and effectiveness of automated systems and internal controls, many companies are moving to provide more up to date information to users, but data that is current has rarely been verified.

(c) Reporting of soft assets is a challenge. Internally developed intangible assets are not reported because the data would be highly subjective and not verifiable. The FASB with the help of the profession continues to evaluate flexible reporting that meets the needs of users, builds upon the objective of financial reporting, works within the conceptual framework, and uses the assumptions and principles of accounting to provide the best data.

(d) This statement demonstrates the expectations gap. The cost constraint means companies who produce financial information and those who provide assurance (auditors) make some tradeoffs between the detail level of information provided and its accuracy. Financial statements are meant to be materially correct and focus on prudent investors not being misled.

LO: 4, Bloom: AN, Moderate, Time: 10-15, AACSB: Analytic, AICPA BC: None, AICPA AC: Measurement Analysis and Interpretation, Reporting, AICPA PC: None

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IFRS CONCEPTS AND APPLICATION

IFRS1.1

The two organizations involved in international standard-setting are IOSCO (International Organization of Securities Commissions) and the IASB (International Accounting Standards Board.) The IOSCO does not set accounting standards, but ensures that the global markets can operate in an efficient and effective manner. Conversely, the IASB's mission is to develop a single set of high quality, understandable and international financial reporting standards (IFRSs) for general purpose financial statements.

LO: 5, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Diversity, Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

IFRS1.2

The standards issued by these organizations are sometimes principles-based, rules-based, tax-oriented, or business-based. In other words, they often differ in concept and objective.

LO: 5, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Diversity, Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

IFRS1.3

A single set of high quality accounting standards ensures adequate comparability. Investors are able to make better investment decisions if they receive financial information from a U.S. company that is comparable to an international competitor.

LO: 5, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Diversity, Communication, AICPA BB: None, AICPA FC: Reporting, AICPA PC: Communication

IFRS1.4

While there is some agreement that the role of financial reporting is to assist users in decision-making, the IASB framework has had more of a focus on the objective of providing information on management's performance—often referred to as stewardship. It is likely that there will be much debate regarding the role of stewardship in the conceptual framework. Both Boards have the same objective, and that is to develop a conceptual framework consisting of standards that are principles-based and internally consistent, thereby, leading to the most useful financial reporting. Hopefully, the two Boards will eventually agree on the key components of a common conceptual framework.

LO: 5, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Diversity, Communication, AICPA BB: Global, AICPA FC: Reporting, AICPA PC: Communication

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IFRS1.5

The FASB differentiates gains and losses from revenue and expenses where gains and losses are incidental transactions of the entity. Further, the FASB includes changes in equity as elements: investment by owners, distributions to owners, and comprehensive income.

LO: 5, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Diversity, Communication, AICPA BB: Global, AICPA FC: Reporting, AICPA PC: Communication

IFRS1.6

The IASB and FASB frameworks are strikingly similar. This is not surprising, given that the IASB framework was adopted after the FASB developed its framework (the IASB framework was approved in April 1989). In addition, the IASC, the predecessor to the IASB, was formed to facilitate harmonization of accounting standards across countries. This objective could be aided by adopting a similar conceptual framework.

Specific similarities include that both frameworks adopt similar definitions for assets and liabilities and define equity as the residual of assets minus liabilities.

Some differences with regard to the elements are that the IASB defines just five elements without specific definitions for Investments by and Distributions to Owners or Comprehensive Income. There is also no distinction in the IASB framework between gains and revenues and losses and expenses.

Note to Instructors—These differences may be resolved as the FASB and IASB work on their performance reporting projects.

LO: 2, 5, Bloom: C, Difficulty: Simple, Time: 5-10, AACSB: Diversity l, Communication, AICPA BB: Global, AICPA FC: Reporting, AICPA PC: Communication

IFRS1.7

Search Strings: “materiality”, “completeness”

(a) According to the Framework (QC 11): Information is defined to be material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

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IFRS1.7 (Continued)

(b) According to the Framework (OB 17): Accrual basis
In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognized when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.

LO: 5, Bloom: C, Difficulty: Simple, Time: 5-7, AACSB: Diversity, Communication, Technology, AICPA BB: Global, Technology, AICPA FC: Measurement, Reporting, Technology, AICPA PC: Communication

IFRS1.8

Marks and Spencer plc (per Note 1 – Accounting Policies)

(a) Revenue Recognition
Revenue comprises sales of goods to customers outside the Group less an appropriate deduction for actual and expected returns, discounts and loyalty scheme vouchers, and is stated net of value added tax and other sales taxes. Revenue is recognised when performance obligations are satisfied and goods are delivered to our franchise partners or the customer and the control of goods is transferred to the buyer.

(b) Historical Cost

1) Property, plant and equipment - The Group's policy is to state property, plant and equipment at cost less accumulated depreciation and any recognised impairment loss. Property is not revalued for accounting purposes.

2) Intangible assets (B. Brands)—Acquired intangible assets include trademarks or brands and customer relationships. These assets are capitalised on acquisition at cost and included in intangible assets. Intangible assets are amortised on a straight-line basis over their estimated useful lives. Acquired intangible assets are tested for impairment as triggering events occur. Any impairment in value is recognised within the income statement.

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IFRS1.8 (Continued)

Fair Value—Trade receivables, trade payables, investments and other financial assets, loan notes, intangible assets (A. Goodwill)—Goodwill arising on consolidation represents the excess of the consideration transferred and the amount of any non-controlling interest in the acquiree over the fair value of the identifiable assets and liabilities (including intangible assets) of the acquired entity at the date of acquisition. Goodwill is recognised as an asset and assessed for impairment annually or as triggering events occurred. Any impairment is recognised immediately in the income statement.

New Accounting Policies
"The Group has applied the following new standards and interpretations for the first time for the annual reporting period commencing 31 March 2019:

- **IFRS 16 Leases.**
- **IFRIC 23 Uncertainty over Income Tax Treatments.**
- **Amendments to IFRS 9 Prepayment Features with Negative Compensation.**
- **Amendments to lAS 28 Long-term Interests in Associates and Joint Ventures.**
- **Amendments to lAS 19 Plan Amendment, Curtailment or Settlement.**
- **Annual Improvements to IFRS Standards 2015–2017 Cycle (Amendments to IFRS 3, IFRS 11, lAS 12 and lAS 23)."**

(c) Critical accounting adjustments and estimation uncertainties related to determining the lease term:

The Group determines the lease term as the non-cancellable term of the lease, together with any periods covered by an option to extend the lease if it is reasonably certain to be exercised, or any periods covered by an option to terminate the lease, if it is reasonably certain not to be exercised. The Group has several lease contracts for land and buildings that include extension and termination options. The Group applies judgement in evaluating whether it is reasonably certain whether or not to exercise the option to renew or terminate the lease.

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IFRS1.8 (Continued)

That is, it considers all relevant factors that create an economic incentive for it to exercise either the renewal or termination, including: whether there are significant penalties to terminate (or not extend); whether any leasehold improvements are expected to have a significant remaining value; historical lease durations; the importance of the underlying asset to the Group's operations; and the costs and business disruption required to replace the leased asset.

Most renewal periods and periods covered by termination options are included as part of the lease term for leases of land and buildings. The Group typically exercises its option to renew (or does not exercise its option to terminate) for these leases because there will be a significant negative effect on trading if a replacement property is not readily available. The lease term is reassessed if a significant event or a significant change in circumstances occurs which affects the assessment of reasonable certainty—for example, if a store is identified to be closed as part of the UK store estate strategic programme.

LO: 5, Bloom: C, Difficulty: Simple, Time: 15-20, AACSB: Diversity, Communication, Technology, AICPA BB: Global, Technology, AICPA FC: Measurement, Reporting, Technology, AICPA PC: Communication

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Chapter 1
Financial Accounting and Accounting Standards

Assignment Classification Table (By Topic)

	Topics	Questions	Brief Exercises	Exercises	Critical Thinking
1.	Environment of accounting, principles, objectives, standards, accounting theory.	1,2,3	1	1	1
2.	Authoritative pronouncements and rule-making bodies.	4,5,6	2	2	2
3.	Conceptual framework-general, objective of financial reporting.	7, 8		3	3,4
4.	Qualitative characteristics of accounting.	9, 10, 11,12, 13, 14, 15	3,4, 5, 6	4,5,6	5, 10
5.	Elements of financial statements, recognition/ derecognition, measurement, presentations, notes.	16, 17, 18, 19	7, 8, 9	7	
6.	Basic assumptions and principles.	20, 21, 22, 23, 24, 25, 26, 27, 28, 29, 30,31	9, 10, 11, 12, 13	4, 8, 9, 10, 11, 12	6, 7, 8, 9, 11
7.	Cost constraint.	32,33			
8.	Role of pressure groups.	34, 35			12, 14, 15, 16, 17
9.	Ethical issues.	36, 37, 38,39			13

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Assignment Classification Table (By Learning Objective)

	Learning Objectives	Questions	Brief Exercises	Exercises	Critical Thinking
1.	Describe the financial reporting environment, major standard-setting bodies, and the meaning of generally accepted accounting principles (GAAP).	1, 2, 3, 4, 5, 6	1, 2	1, 2	1
2.	Describe the components and usefulness of the conceptual framework.	7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17, 18, 19	3, 4, 5, 6, 7, 8	3, 4, 5, 6, 7	2,3,4, 5, 10
3.	Discuss the basic operational concepts of GAAP.	20, 21, 22, 23, 24, 25, 26, 27, 28, 29, 31, 32, 33	9, 10, 11, 12, 13	8, 9, 10, 11, 12	6, 7, 8, 9, 11, 12
4.	Identify the major challenges in the financial reporting environment.	30, 34, 35, 36, 37, 38,39		2	11, 13, 14, 15, 16

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Assignment Characteristics Table (Time on Task)

Item	Description	Level of Difficulty	Time (minutes)
E1.1	Need for GAAP.	Simple	15-20
E1.2	Financial reporting and accounting standards.	Simple	15-20
E1.3	Usefulness, objective of financial reporting.	Simple	15-20
E1.4	Usefulness, objective of financial reporting, qualitative characteristics.	Simple	15-20
E1.5	Qualitative characteristics.	Moderate	20-30
E1.6	Qualitative characteristics.	Simple	15-20
E1.7	Elements of financial statements.	Simple	15-20
E1.8	Assumptions, principles, and constraint.	Simple	15-20
E1.9	Assumptions, principles, and constraint.	Moderate	20-25
E1.10	Full disclosure principle.	Complex	20-25
E1.11	Accounting principles assumptions.	Moderate	20-25
E1.12	Accounting principles-comprehensive.	Moderate	20-25
CT1.1	Securities and Exchange Commission.	Moderate	30-40
CT1.2	Conceptual framework-general.	Simple	20-25
CT1.3	Conceptual framework-general.	Simple	25-35
CT1.4	Objective of financial reporting.	Moderate	25-35
CT1.5	Qualitative characteristics.	Moderate	30-35
CT1.6	Revenue recognition principle.	Complex	25-30
CT1.7	Expense recognition principle.	Complex	20-25
CT1.8	Expense recognition principle.	Moderate	20-25
CT1.9	Expense recognition principle.	Moderate	20-30
CT1.10	Qualitative characteristics.	Moderate	20-30
CT1.11	Expense recognition principle.	Moderate	20-25
CT1.12	Cost Constraint.	Moderate	30-35
CT1.13	Rule-making Issues.	Complex	20-25
CT1.14	Models for setting GAAP.	Simple	15-20
CT1.15	Economic consequences.	Moderate	25-35
CT1.16	GAAP and economic consequences.	Moderate	25-35

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Answers to Questions

1. If a company's financial performance is measured accurately, fairly, and on a timely basis, the right managers and companies can attract investment capital. Unreliable and irrelevant information leads to poor capital allocation, which adversely affects the efficiency of the securities market.

LO: 1, Bloom: K, Difficulty: Simple, Time: 1-3, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Communication

2. Investors are interested in financial reporting because it provides information that is useful for making decisions (referred to as the decision-usefulness approach). When making these decisions, investors are interested in assessing the company's (1) ability to generate net cash inflows and (2) management's ability to protect and enhance the capital providers' investments. Financial reporting should therefore help investors assess the amounts, timing, and uncertainty of prospective cash inflows from dividends or interest, and the proceeds from the sale, redemption, or maturity of securities or loans. For investors to make these assessments, the economic resources of an enterprise, the claims to those resources, and the changes in them must be understood.

LO: 1, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Decision Making

3. A common set of financial accounting and reporting standards applied by all businesses and entities should produce financial statements which are reasonably comparable. Without a common set of standards, each enterprise could, and would, develop a theory structure and set of practices, resulting in noncomparability among the financial statements of enterprises.

LO: 1, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Communication

4. The SEC has the power to prescribe, in whatever detail it desires, the accounting practices and principles to be employed by companies that fall within its jurisdiction. Because the SEC receives audited financial statements from nearly all companies that issue securities to the public or are listed on stock exchanges, it is greatly interested in the content, accuracy, and credibility of the statements. For many years, the SEC relied on the AICPA to regulate the profession and develop and enforce accounting principles. Lately, the SEC has assumed a more active role in the development of accounting standards, especially in the area of disclosure requirements. In December 1973, in ASR No. 150, the SEC said the FASB's statements would be presumed to carry substantial authoritative support and anything contrary to them to lack such support. It thereby supports the development of accounting principles in the private sector.

LO: 1, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Communication

5. The explanation should note that generally accepted accounting principles or standards have "substantial authoritative support." They consist of accounting practices, procedures, concepts, and methods that are recognized by a large majority of practicing accountants as well as other members of the business and financial community. Statements issued by the Financial Accounting Standards Board constitute "substantial authoritative support."

LO: 1, Bloom: K, Difficulty: Simple, 5-10, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Communication

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6. It is hoped that the Codification will help users to better understand what GAAP is. If this occurs, companies will be more likely to comply with GAAP and the time to research accounting issues will be substantially reduced. In addition, through the electronic web-based format, GAAP can be easily updated which will help users stay current.

LO: 1, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Communication

7. A conceptual framework is a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements. A conceptual framework is necessary for financial accounting for the following reasons:
(1) It enables the FASB to issue more useful and consistent standards in the future.
(2) New issues will be more quickly solvable by reference to an existing framework of basic theory.
(3) It increases financial statement users' understanding of and confidence in financial reporting.
(4) It enhances comparability among companies' financial statements.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Communication

8. The objective of financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions about providing resources to the entity.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Communication

9. "Qualitative characteristics of accounting information" are those characteristics that contribute to the quality or value of the information. The overriding qualitative characteristic of accounting information is usefulness for decision-making.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Communication

10. Relevance and faithful representation are the two fundamental qualities of useful accounting information. For information to be relevant, it should be capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct expectations. Faithful representation rests on whether the numbers and descriptions match what really existed or happened.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Communication

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11. The concept of materiality refers to the relative significance of an amount, activity, or item to informative disclosure, proper presentation of financial position, and the results of operations. Materiality has qualitative and quantitative aspects; both the nature of the item and its relative size enter into its evaluation.

An accounting misstatement is said to be material if knowledge of the misstatement could affect the decisions of the average informed reader of the financial statements. Financial statements are misleading if they omit a material fact or include so many immaterial matters as to be confusing.

The relevant criteria for assessing materiality will depend upon the circumstances and the nature of the item and will vary greatly among companies. For example, an error in current assets or current liabilities will be more important for a company with a flow of funds problem than for one with adequate working capital.

The effect upon net income (or earnings per share) is the most commonly used measure of materiality. This reflects the prime importance attached to net income by investors and other users of the statements. The effects upon assets and equities are also important, as are misstatements of individual accounts and subtotals included in the financial statements. Information is material "if it is probable that the judgment of a reasonable person relying upon the financial information would have been changed or influenced by the inclusion or correction of the information."

There are no rigid standards or guidelines for assessing materiality. The lower bound of materiality has been variously estimated at 5% of net income, but the determination will vary based upon the individual case and might not fall within these limits. Certain items, such as a questionable loan to a company officer, may be considered material even when minor amounts are involved. In contrast, a large misclassification among expense accounts may not be deemed material if there is no misstatement of net income.

LO: 2, Bloom: C, Difficulty: Simple, Time: 5-7, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Decision Making

12. The enhancing characteristics are comparability, verifiability, timeliness, and understandability. Enhancing qualities are qualitative characteristics that are complementary to the fundamental qualitative characteristics. These characteristics distinguish more useful information from less useful information.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Communication

13. In providing information to users of financial statements, the FASB relies on general-purpose financial reporting. The intent of financial reporting is to provide the most useful information possible at minimal cost to various user groups. Underlying these objectives is the notion that a user needs a reasonable knowledge of business and financial accounting matters to understand the information contained in financial reporting. This point is important. It means that in the preparation of financial statements, a level of reasonable competence for the user can be assumed; this has an impact on the way and the extent to which information is reported.

LO: 2, Bloom: C, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: AICPA AC: Reporting, AICPA PC: Communication

14. Comparability facilitates comparisons between information about two different enterprises at a particular point in time. Consistency, a type of comparability, facilitates comparisons between information about the same enterprise at two different points in time.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Communication

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15. The accounting literature contains many terms that have specific meanings. Some of these terms have been in use for a long time, and their meanings have changed over time. Since the elements of financial statements are the building blocks with which the statements are constructed, it is necessary to develop a basic definitional framework for them.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Communication

16. Distributions to owners differ from expenses and losses in that they represent transfers to owners, and they do not arise from activities intended to produce income. Expenses differ from losses in that they arise from the entity's ongoing major or central operations. Losses are decreases in equity that are not classified as expenses or distributions to owners.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Communication

17. Investments by owners differ from revenues and gains in that they represent transfers by owners to the entity, and they do not arise from activities intended to produce income. Revenues differ from gains in that they arise from the entity's ongoing major or central operations. Gains are increases in equity that are not classified as revenues or investments by owners.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

18. Recognition refers to when an item should be incorporated into the financial statements. Derecognition refers to when an item should be removed from the financial statements.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

19. Presentation relates to the display of line items, totals, and subtotals on the financial statements. The displays involve the presentation of numbers and words involving the elements of the financial statements.

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

20. The four basic operational concepts of GAAP are: :
(1) The economic entity assumption.
(2) The going concern assumption.
(3) The monetary unit assumption.
(4) The periodicity assumption.

LO: 3, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Communication

21. (a) In accounting, it is generally agreed that any measures of the success of an enterprise for periods less than its total life are at best provisional and subject to correction. Measurement of progress and status for arbitrary time periods is a practical necessity to serve those who must make decisions. It is not the result of postulating specific time periods as measurable segments of total life.

(b) The practice of periodic measurement has led to many of the most difficult accounting problems, such as inventory pricing, depreciation of long-term assets, and the necessity for revenue recognition tests. The accrual system calls for associating related revenues and expenses. This becomes difficult for an arbitrary time period with incomplete transactions in process at both the beginning and the end of the period. Many accounting practices such as adjusting entries or the reporting of corrections of prior periods result directly from efforts to make each period's calculations as accurate as possible and yet recognizing that they are only provisional.

LO: 3, Bloom: C, Difficulty: Simple, Time: 5-7, AACSB: Communication, AICPA BC: None, AICPA AC: Measurement, Reporting, AICPA PC: None

22. The monetary unit assumption assumes that the unit of measure (the dollar) remains reasonably stable so that dollars of different years can be added without any adjustment. When the value of the dollar fluctuates greatly over time, the monetary unit assumption loses its validity.

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The FASB indicated that it expects the dollar unadjusted for inflation or deflation to be used to measure items recognized in financial statements. Only if circumstances change dramatically will the FASB consider a more stable measurement unit.

LO: 3, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

23. **Fair value** is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." Fair value is, therefore, a market-based measure.

LO: 3, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Measurement, Reporting, AICPA PC: AICPA PC: None

24. The fair value hierarchy provides insight into the priority of valuation techniques that are used to determine fair value. The fair value hierarchy is divided into three broad levels.

Fair Value Hierarchy

Level 1:	Observable inputs that reflect quoted prices for identical assets or liabilities in active markets.	**Least Subjective**
Level 2:	Inputs other than quoted prices included in Level 1 that are observable for the asset or liability either directly or through corroboration with observable data.	
Level 3:	Unobservable inputs (for example, a company's own data or assumptions).	**Most Subjective**

As indicated, Level 1 is the most reliable because it is based on quoted prices, such as a closing stock price in the *Wall Street Journal*. Level 2 is the next most reliable and would rely on evaluating similar assets or liabilities in active markets. At the least-reliable level, Level 3, much judgment is needed based on the best information available to arrive at a relevant and representationally faithful fair value measurement.

LO: 3, Bloom: K, Difficulty: Simple, Time: 5-7, AACSB: Communication, AICPA BC: None, AICPA AC: Measurement, Reporting, AICPA PC: None

25. The revenue recognition principle requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied. In the case of services, revenue is recognized when the services are performed. In the case of selling a product, the performance obligation is met when the product is delivered. Companies follow a five-step process to analyze revenue arrangements to determine when revenue should be recognized: (1) Identify the contract(s) with the customer; (2) Identify the separate performance obligations in the contract; (3) Determine the transaction price; (4) Allocate the transaction price to separate performance obligations, and; (5) Recognize revenue when each performance obligation is satisfied.

LO: 3, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Measurement, Reporting, AICPA PC: None

26. A performance obligation is a promise to deliver a product or provide a service to a customer. The revenue recognition principle requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied. In the case of services, revenue is recognized when the services are performed. In the case of selling a product, the performance obligation is met when the product is delivered.

LO: 3, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Measurement, Reporting, AICPA PC: None

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27. The five steps in the revenue recognition process are:

Step 1 **Identify the contract(s) with the customer.** A contract is an agreement between two parties that creates enforceable rights or obligations.

Step 2 **Identify the separate performance obligations in the contract.** A performance obligation is either a promise to provide a service or deliver a product, or both.

Step 3. **Determine the transaction price.** The transaction price is the amount of consideration that a company expects to receive from a customer in exchange for transferring a good or service.

Step 4. **Allocate the transaction price to separate performance obligations.** This is usually done by estimating the value of consideration attributable to each product or service.

Step 5. **Recognize revenue when each performance obligation is satisfied**. This occurs when the service is provided or the product is delivered.

Note that many revenue transactions pose few problems because the transaction is initiated and completed at the same time.

LO: 3, Bloom: C, Difficulty: Simple, Time: 5-7, AACSB: Communication, AICPA BC: None, AICPA AC: Measurement, Reporting, AICPA PC: None

28. Revenues are recognized when a performance obligation is satisfied–in the case of services, revenue is recognized when the services are performed. Therefore, revenue for Selane Eatery should be recognized at the time the luncheon is served.

LO: 3, Bloom: AN, Difficulty: Simple, Time: 3-5, Analytic, AICPA BC: None, AICPA AC: Measurement, Reporting, AICPA PC: None

29. The cause and effect relationship can seldom be conclusively demonstrated, but many costs appear to be related to particular revenues, and recognizing them as expenses accompany recognition of the revenue. Examples of expenses that are recognized by associating cause and effect are sales commissions and the cost of products sold or services provided.

Systematic and rational allocation means that in the absence of a direct means of associating cause and effect, and where the asset provides benefits for several periods, its cost should be allocated to the periods in a systematic and rational manner. Examples of expenses that are recognized in a systematic and rational manner are depreciation of plant assets, amortization of intangible assets, and allocation of rent and insurance.

Some costs are immediately expensed because the costs have no discernible future benefits or the allocation among several accounting periods is not considered to serve any useful purpose. Examples include officers' salaries, most selling costs, amounts paid to settle lawsuits, and costs of resources used in unsuccessful efforts.

LO: 3, Bloom: AN, Difficulty: Simple, Time: 5-7, Analytic, AICPA BC: None, AICPA AC: Measurement, Reporting, AICPA PC: None

30. (a) To be recognized in the main body of financial statements, an item must meet the definition of an element. In addition, the item must have been measured, recorded in the books, and passed through the double-entry system of accounting.
(b) Information provided in the notes to the financial statements amplifies or explains the items presented in the main body of the statements and is essential to an understanding of the performance and position of the enterprise. Information in the notes does not have to be quantifiable, nor does it need to qualify as an element.
(c) Supplementary information includes information that presents a different perspective from that adopted in the financial statements. It also includes management's explanation of the financial information and a discussion of the significance of that information.

LO: 4, Bloom: C, Difficulty: Simple, Time: 5-7, AACSB: Communication, AICPA BC: None, AICPA AC: Measurement, Reporting, AICPA PC: None

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31. The general guide followed with regard to the full disclosure principle is to disclose in the financial statements any facts of sufficient importance to influence the judgment of an informed reader. The fact that the amount of outstanding common stock doubled in January of the subsequent reporting period probably should be disclosed because such a situation is of importance to present stockholders. Even though the event occurred after December 31, 2028, it should be disclosed on the balance sheet as of December 31, 2028, in order to make adequate disclosure. (The major point that should be emphasized throughout the entire discussion on full disclosure is that there is normally no "black" or "white" but varying shades of grey and it takes experience and good judgment to arrive at an appropriate answer).

LO: 3, Bloom: AN, Difficulty: Simple, Time: 3-5, Analytic, AICPA BC: None, AICPA AC: Measurement, Reporting, AICPA PC: None

32. Accounting information is subject to the cost constraint. Information should not be provided unless the benefits exceed the costs of preparing it.

LO: 3, Bloom: K, Difficulty: Simple, Time: 3-5, Analytic, AICPA BC: None, AICPA AC: Measurement, Reporting, AICPA PC: None

33. The costs of providing accounting information include costs of collecting and processing, disseminating, auditing, potential litigation, disclosure to competitors, and analysis and interpretation. Benefits to preparers may include greater management control and access to capital at a lower cost. Users may receive better information for allocation of resources, tax assessment, and rate regulation. Occasionally new accounting standards require the presentation of information that is not readily assembled by the accounting systems of most companies. A determination should be made as to whether the incremental or additional costs of providing the proposed information exceed the incremental benefits to be obtained. This determination requires careful judgment since the benefits of the proposed information may not be readily apparent.

LO: 3, Bloom: AN, Difficulty: Simple, Time: 3-5, Analytic, AICPA BC: None, AICPA AC: Measurement, Reporting, AICPA PC: None

34. The sources of pressure are innumerable, but the most intense and continuous pressure to change or influence accounting principles or standards come from individual companies, industry associations, governmental agencies, practicing accountants, academicians, professional accounting organizations, and public opinion.

LO: 4, Bloom: K, Difficulty: Simple, 5-10, AACSB: Communication, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC: Communication

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35. Economic consequences mean the impact of accounting reports on the wealth positions of issuers and users of financial information and the decision-making behavior resulting from that impact. In other words, accounting information impacts various users in many different ways, which leads to wealth transfers among these various groups.

If politics plays an important role in the development of accounting rules, the rules will be subject to manipulation to further whatever policy prevails at the moment. No matter how well-intentioned the rule maker may be, if the information is designed to indicate that investing in a particular enterprise involves less risk than it actually does, or is designed to encourage investment in a particular segment of the economy, financial reporting will suffer an irreplaceable loss of credibility.

LO: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC: Communication

36. Concern exists about fraudulent financial reporting because it can undermine the entire financial reporting process. Failure to provide accurate information to users can lead to inappropriate allocations of resources in our economy. In addition, failure to detect massive fraud can lead to additional governmental oversight of the accounting profession.

LO: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC: Communication

37. The expectations gap is the difference between what people think accountants should be doing and what accountants think they can do. It is a difficult gap to close. The accounting profession recognizes it must play an important role in narrowing this gap. To meet the needs of society, the profession is continuing its efforts in developing accounting standards, such as numerous pronouncements issued by the FASB, to serve as guidelines for recording and processing business transactions in the changing economic environment.

LO: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Communication

38. Some major challenges facing the accounting profession relate to the following items:

Nonfinancial measurement—how to report significant key performance measurements such as customer satisfaction indexes, backlog information and reject rates on goods purchased.

Forward-looking information—how to report more future-oriented information.

Soft assets—how to report on intangible assets, such as market know-how, market dominance, and well-trained employees.

Timeliness—how to report more real-time information.

LO: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Communication

39. Accountants must perceive the ethical dimensions of some situations because GAAP does not define or cover all specific features that are to be reported in financial statements. In these instances, accountants must choose among alternatives. These accounting choices influence whether particular stakeholders may be harmed or benefited. Ethical decision-making involves awareness of potential harm or benefit and taking responsibility for the choices.

LO: 4, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: Ethics, Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Ethical Conduct

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Solutions to Brief Exercises

Brief Exercise 1.1

1. True
2. False. Any company claiming compliance with GAAP must comply with all standards and interpretations, including disclosure requirements.
3. True
4. False. In establishing financial accounting standards, the FASB relies on two basic premises: (1) the FASB should be responsive to the needs and viewpoints of the entire economic community, not just the public accounting profession, and (2) it should operate in full view of the public through a "due process" system that gives interested people ample opportunities to make their view known.

LO: 1, Bloom: K, Difficulty: Simple, Time: 5-10, AACSB: None, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC: None

Brief Exercise 1.2

(a) **AICPA.** American Institute of Certified Public Accountants. The national organization of practicing certified public accountants.

(b) **FAF.** Financial Accounting Foundation. An organization whose purpose is to select members of the FASB and its Advisory Councils, fund their activities, and exercise general oversight.

(c) **FASAC.** Financial Accounting Standards Advisory Council. An organization whose purpose is to consult with the FASB on issues, project priorities, and select task forces.

(d) **GAAP.** Generally Accepted Accounting Principles. A common set of standards, principles, and procedures which have substantial authoritative support and have been accepted as appropriate because of universal application.

(e) **CPA.** Certified Public Accountant. An accountant who has fulfilled certain education and experience requirements and passed a rigorous examination. Most CPAs offer auditing, tax, and management consulting services to the general public.

(f) **FASB.** Financial Accounting Standards Board. The primary body that currently establishes and improves financial accounting and reporting standards for the guidance of issuers, auditors, users, and others.

(g) **SEC.** Securities and Exchange Commission. An independent regulatory agency of the United States government which administers the Securities Acts of 1933 and 1934 and other acts.

(h) **IASB.** International Accounting Standards Board. An international group, formed in 2001 (replacing a predecessor body that was formed in 1973), actively developing and issuing accounting standards that will have international appeal and hopefully support.

LO: 1, Bloom: K, Difficulty: Moderate, Time: 5-10, AACSB: None, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC: None

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Brief Exercise 1.3

(a) 5. Comparability
(b) 8. Timeliness
(c) 3. Predictive value
(d) 1. Relevance
(e) 7. Neutrality

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: None, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Decision Making

Brief Exercise 1.4

(a) 5. Faithful representation
(b) 8. Confirmatory value
(c) 3. Free from error
(d) 2. Completeness
(e) 4. Understandability

LO: 2, Bloom: K, Difficulty: Simple, Time: 3-5, AACSB: None, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC: Decision Making

Brief Exercise 1.5

(a) Verifiability
(b) Comparability
(c) Comparability (consistency)
(d) Timeliness

LO: 2, Bloom: K, Difficulty: Simple, Time: 5-7, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

Brief Exercise 1.6

Companies and their auditors, for the most part, have adopted the general rule of thumb that anything under 5% of net income is considered not material. Recently, the SEC has indicated that it is okay to use this percentage for the initial assessment of materiality, but other factors must be considered. For example, companies can no longer fail to record items to meet consensus analyst's earnings numbers, preserve a positive earnings trend, convert a loss to a profit or vice versa, increase management compensation, or hide an illegal transaction like a bribe. In other words, both quantitative and qualitative factors must be considered in determining when an item is material.

(a) Because the change was used to create a positive trend in earnings, the change is considered material.

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BE 1.6 (Continued)

(b) Each item must be considered separately and not netted. Therefore, each transaction is considered material.

(c) In general, companies that follow an "expense all capital items below a certain amount" policy are not in violation of the materiality concept. Because the same practice has been followed from year to year, Damon's actions are acceptable.

LO: 2, Bloom: K, Difficulty: Moderate, Time: 10-15, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

Brief Exercise 1.7

(a) Equity
(b) Revenues
(c) Equity
(d) Assets
(e) Expenses
(f) Losses
(g) Liabilities
(h) Distributions to owners
(i) Gains
(j) Investments by owners

LO: 2, Bloom: K, Difficulty: Simple, Time: 7-10, AACSB: None, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

Brief Exercise 1.8

(a) Debit to the Land account, as it is a cost incurred in acquiring land.

(b) Debit to an asset account, preferably Land Improvements. The driveway will last for many years, and therefore should be capitalized and depreciated.

(c) Debit to an asset account, preferably Equipment, as the machine will last for a number of years and contribute to the operations of those years.

(d) If the fiscal year ends December 31, this expenditure will be an expense of the current year so will be debited to an expense account. If financial statements are prepared on some date before December 31, part of this cost would be an expense and part would be an asset. Depending upon the circumstances, the original entry, as well as the adjusting entry for statement purposes, should take the financial statement date into account.

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BE 1.8 (Continued)

(e) Debit to the Building account, as it is a part of the cost of that plant asset which will contribute to operations for many years.

(f) Debit to an expense account, as the service has already been received; the contribution to operations occurred in this period.

LO: 2, Bloom: AN, Difficulty: Moderate, Time: 10-15, AACSB: Analytic, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

Brief Exercise 1.9

(a) Periodicity
(b) Monetary unit
(c) Going concern
(d) Economic entity

LO: 3, Bloom: K, Difficulty: Moderate, Time: 5-10, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

Brief Exercise 1.10

(a) Net realizable value.

(b) Would not be disclosed. Depreciation would be inappropriate if the going concern assumption no longer applies.

(c) Net realizable value.

(d) Net realizable value .

LO: 3, Bloom: K, Difficulty Moderate, Time: 10-15, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

Brief Exercise 1.11

(a) Revenue recognition
(b) Expense recognition
(c) Full disclosure
(d) Measurement (historical cost)

LO: 3, Bloom: K, Difficulty: Moderate, Time: 10-15, AACSB: Knowledge, AICPA BC: None, AICPA AC: AICPA AC: Reporting, AICPA PC: None

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Brief Exercise 1.12

Investment (1)—Level 3
Investment (2)—Level 1
Investment (3)—Level 2

LO: 3, Bloom: AN, Difficulty: Moderate, Time: 5-10, AACSB: Analytic, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

Brief Exercise 1.13

(a) Full disclosure
(b) Expense recognition
(c) Historical cost

LO: 3, Bloom: C, Difficulty: Moderate, Time: 5-10, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

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Solutions to Exercises

Exercise 1.1

It is not appropriate to abandon mandatory accounting rules and allow each company to voluntarily disclose the type of information it considers important. Without a coherent body of accounting theory and standards, each accountant or enterprise would have to develop its own theory structure and set of practices, and readers of financial statements would have to familiarize themselves with every company's peculiar accounting and reporting practices. As a result, it would be almost impossible to prepare statements that could be compared.

In addition, voluntary disclosure may not be an efficient way of disseminating information. A company is likely to disclose less information if it has the discretion to do so. Thus, the company can reduce its cost of assembling and disseminating information. However, an investor wishing additional information has to pay to receive additional information desired. Different investors may be interested in different types of information. Since the company may not be equipped to provide the requested information, it would have to spend additional resources to fulfill such needs; or the company may refuse to furnish such information if it is too costly to do so. As a result, investors may not get the desired information or they may have to pay a significant amount of money for it. Furthermore, redundancy in gathering and distributing information occurs when different investors ask for the same information at different points in time. To society as a whole, this would not be an efficient way of utilizing resources.

LO: 1, 4, Bloom: AN, Difficulty: Simple, Time: 15-20, AACSB: Reflective Thinking, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC: None

Exercise 1.2

1. (d)
2. (d)
3. (d)
4. (a)
5. (a)
6. (b)
7. (d)
8. (b)

LO: 1, 2, Bloom: K, Difficulty: Simple, Time: 15-20, AACSB: Knowledge, AICPA BC: None, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC: None

Exercise 1.3

(a) True.

(b) False – General-purpose financial reports help users who lack the ability to demand all the financial information they need from an entity and, therefore, must rely on, at least partly, the information in financial reports.

(c) False – Standard-setting based on personal conceptual frameworks will lead to different conclusions about identical or similar issues. As a result, standards will not be consistent with one another, and past decisions may not be indicative of future ones.

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Exercise 1.3 (Continued)

(d) False – Information that is decision-useful to capital providers may also be useful to users of financial reporting who are not capital providers.
(e) False – An implicit assumption is that all users need reasonable knowledge of business and financial accounting matters to understand the information contained in the financial statements.
(f) True.

LO: 2 Bloom: C, Difficulty: Simple, Time: 15-20, AACSB: Knowledge, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC: None

Exercise 1.4

(a) False – The fundamental qualitative characteristics that make accounting information useful are relevance and faithful representation.
(b) False – Relevant information must also be material.
(c) False – Information that is relevant is characterized as having predictive or confirmatory value or both.
(d) False – Comparability also refers to comparisons of a firm over time (consistency).
(e) False – Verifiability is an enhancing characteristic that relates to both relevance and faithful representation.
(f) True.

LO: 2, Bloom: C, Difficulty: Simple, Time: 15-20, AACSB: Knowledge, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC: Decision Making

Exercise 1.5

(a) Confirmatory value.
(b) Cost.
(c) Neutrality.
(d) Comparability (Consistency).
(e) Neutrality.
(f) Relevance and Faithful representation.
(g) Timeliness.
(h) Relevance.
(i) Comparability.
(j) Verifiability.

LO: 2, Bloom: C, Difficulty: Moderate, Time: 10-15, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

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Exercise 1.6

(a) Comparability.
(b) Confirmatory value.
(c) Comparability (Consistency).
(d) Neutrality.
(e) Verifiability.
(f) Relevance.
(g) Comparability, Verifiability, Timeliness, and Understandability.
(h) Materiality.
(i) Faithful representation.
(j) Relevance and Faithful representation.
(k) Timeliness.

LO: 2, Bloom: C, Difficulty: Simple, Time: 10-15, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None Bloom:

Exercise 1.7

(a) Losses.
(b) Liabilities.
(c) Investments by owners, comprehensive income. (also, possible would be revenues and gains).
(d) Distributions to owners. (Note to instructor: net effect is to reduce equity and assets).
(e) Comprehensive income (also, possible would be revenues and gains).
(f) Assets.
(g) Comprehensive income.
(h) Revenues, expenses.
(i) Equity.
(j) Revenues.
(k) Comprehensive income.

LO: 2, Bloom: C, Difficulty: Moderate, Time: 15-20, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

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Exercise 1.8

(a)	**7.**	**Expense recognition principle.**
(b)	**5.**	**Measurement principle (historical cost.)**
(c)	**8.**	**Full disclosure principle.**
(d)	**2.**	**Going concern assumption.**
(e)	**1.**	**Economic entity assumption.**
(f)	**4.**	**Periodicity assumption.**
(g)	**3.**	**Monetary unit assumption.**

LO: 3, Bloom: C, Difficulty: Simple, Time: 10-15, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

Exercise 1.9

(a) Measurement principle (historical cost).
(b) Full disclosure principle.
(c) Expense recognition principle.
(d) Measurement (fair value) principle.
(e) Economic entity assumption.
(f) Full disclosure principle.
(g) Revenue recognition principle.
(h) Full disclosure principle.
(i) Expense recognition and revenue recognition principles.
(j) Economic entity assumption.
(k) Periodicity assumption.
(l) Measurement principle, Expense recognition principle.
(m) Measurement principle (historical cost).
(n) Expense recognition principle.

LO: 3, Bloom: C, Moderate, Time: 10-15, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

Exercise 1.10

(a) **It is well established in accounting that revenues, expenses, and cost of goods sold must be disclosed in an income statement. It might be noted to students that such was not always the case. At one time, only net income was reported, but over time, we have evolved to the present reporting format.**

(b) **The proper accounting for this situation is to report the equipment as an asset and the notes payable as a liability on the balance sheet. Offsetting is permitted in only limited situations where certain assets are contractually committed to pay off liabilities.**

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Exercise 1.10 (Continued)

(c) According to GAAP, the basis upon which inventory amounts are stated (lower of cost or market) and the method used in determining cost (LIFO, FIFO, average cost, etc.) should also be reported. The disclosure requirement related to the method used in determining cost should be emphasized, indicating that where possible alternatives exist in financial reporting, disclosure in some format is required.

(d) Consistency requires that disclosure of changes in accounting principles be made in the financial statements. To do otherwise, would result in misleading financial statements. Financial statements are more useful if they can be compared with similar reports for prior years.

LO: 3, Bloom: C, Difficulty: Hard, Time: 20-25, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

Exercise 1.11

(a) This entry violates the economic entity assumption. This assumption in accounting indicates that economic activity can be identified with a particular unit of accountability. In this situation, the company erred by charging this cost to the wrong economic entity.

(b) The historical cost principle indicates that assets and liabilities are accounted for on the basis of cost. If we were to select sales value, for example, we would have an extremely difficult time in attempting to establish a sales value for a given item without selling it. It should further be noted that the revenue recognition principle provides the answer to when revenue should be recognized. Revenue should be recognized when a performance obligation is satisfied. In this case, the obligation is not satisfied until goods are delivered to a customer.

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Exercise 1.11 (Continued)

(c) At present, accountants do not recognize price-level adjustments in the accounts. Hence, it is misleading to deviate from the measurement principle (historical cost) because conjecture or opinion can take place. It should also be noted that depreciation is not so much a matter of valuation as it is a means of cost allocation. Assets are not depreciated on the basis of a decline in their fair value but are depreciated using systematic charges of expired costs against revenues. (Note to instructor: It might be called to the students' attention that the FASB does encourage supplemental disclosure of price-level information.)

(d) The answer to this situation is the same as (b).

LO: 3, Bloom: AN, Difficulty: Moderate, Time: 20-25, AACSB: Analytic, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

Exercise 1.12

(a) Depreciation is an allocation of cost, not an attempt to value assets. As a consequence, even if the fair value of the building increased, costs related to this building should be matched with revenues on the income statement, not as a charge against retained earnings.

(b) Accountants follow the measurement principle (historical cost) approach and write-ups of assets are not permitted. It should also be noted that the revenue recognition principle states that revenue should not be recognized until a performance obligation is satisfied. In this case, revenue (gross profit) would not be recognized until the goods are delivered to the customer. Further, this is not a peripheral transaction so recording a gain is not appropriate.

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Exercise 1.12 (Continued)

(c) Assets should be recorded at the fair value of what is given up or the fair value of what is received, whichever is more clearly evident. It should be emphasized that it is not a violation of the measurement principle (historical cost) to use the fair value of the stock. Recording the asset at the par value of the stock has no conceptual validity. Par value is merely an arbitrary amount usually set at the date of incorporation.

(d) The gain should be recognized when the equipment is delivered to the customer. Deferral of the gain is not permitted, because the company has satisfied the performance obligation.

(e) It appears from the information that the sale should be recorded in 2029 instead of 2028. Revenue should be recognized when a performance obligation is satisfied. In this case, the performance obligation is met when the order is delivered to the buyer. Accounts receivable and Sales revenue should be recorded in 2029. It should be noted that if the company is employing a perpetual inventory system in dollars and quantities, a debit to Cost of Goods Sold and a credit to Inventory is also necessary in 2029.

LO: 3, Bloom: AN, Difficulty: Moderate, Time: 20-25, AACSB: Analytic, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

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Solutions to Using Your Judgement

UYJ 1.1 Financial Reporting Problem

(a) From Note 1 – Summary of Significant Accounting Policies:

Our revenue is primarily generated from the sale of the finished product to customers. Those sales predominantly contain a single performance obligation and revenue is recognized at a single point in time when ownership, risks, and rewards transfer, which can be on the date of shipment or the date of receipt by the customer. A provision for payment discounts and product return allowances is recorded as a reduction of sales in the same period the revenue is recognized. The revenue recorded is presented net of sales and other taxes we collect on behalf of governmental authorities. The revenue includes shipping and handling costs, which generally are included in the list price to the customer.

Trade promotions, consisting primarily of customer pricing allowances, merchandising funds, and consumer coupons, are offered through various programs to customers and consumers. Sales are recorded net of trade promotion spending, which is recognized as incurred at the time of the sale. Most of these arrangements have terms of approximately one year. Accruals for expected payouts under these programs are included as accrued marketing and promotion in the Accrued and other liabilities line item in the Consolidated Balance Sheets.

(b) Historical Cost

Buildings, machinery, and equipment
Property, plant, and equipment is recorded at cost reduced by accumulated depreciation.

Fair Value

Investments (U.S. government securities, corporate bond securities, other investments), derivatives (relating to foreign currency hedges, other foreign currency instruments, interest rates, net investment hedges) are reported at fair value. Certain financial instruments are required to be recorded at fair value.

(c) Accounting Policy Related to Advertising

Advertising makes up a portion of Selling, general and administrative expense (SG&A). Selling, general and administrative expense is primarily comprised of marketing expenses, selling expenses, research and development costs, administrative and other indirect overhead costs, depreciation and amortization expense on non-manufacturing assets, and other miscellaneous operating items. Advertising costs, charged to expense as incurred, include worldwide television, print, radio, internet, and in-store advertising expenses and were $8 billion in 2023, $7.9 billion in 2022, and $8.2 billion in 2021.

LO: 4, Bloom: AN, Difficulty: Moderate, Time: 30-35, AACSB: Analytic, AICPA BC: None, AICPA AC: Measurement, Analysis and Interpretation, Reporting, Research, AICPA PC: Communication

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UYJ 1.2 Comparative Analysis Case

Comparative Analysis

(a) Coca-Cola

Operating Segments (Note 1)

The Company's operating structure is the basis for our internal financial reporting. Our operating structure includes the following operating segments, which are sometimes

referred to as "operating groups" or "groups":

• Europe, Middle East and Africa

• Latin America

• North America

• Asia Pacific

• Global Ventures

• Bottling Investments

Our operating structure also includes Corporate, which consists of two components: (1) a center focused on strategic initiatives, policy and governance; and (2) an enabling services organization focused on both simplifying and standardizing key transactional processes and providing support to business units through global centers of excellence.

They own or license and market numerous nonalcoholic beverage brands, which we group into the following category clusters: sparkling soft drinks; water, enhanced water and sports drinks; juice, dairy and plant-based beverages; tea and coffee; and energy drinks.

They also own and market four of the world's top five nonalcoholic sparkling soft drink brands: Coca-Cola, Diet Coke, Fanta and Sprite.

PepsiCo

Our Divisions (Note 1)

We are organized into seven reportable segments (also referred to as divisions), as follows:

1) FLNA, which includes our branded food and snack businesses in the United States and Canada;
2) QFNA, which includes our cereal, rice, pasta and other branded food businesses in the United States and Canada;
3) PBNA, which includes our beverage businesses in the United States and Canada;
4) LatAm, which includes all of our beverage, food and snack businesses in Latin America;
5) Europe, which includes all of our beverage, food and snack businesses in Europe;

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UYJ 1.2 (Continued)

6) AMESA, which includes all of our beverage, food and snack businesses in Africa, the Middle East and South Asia; and

7) APAC, which includes all of our beverage, food and snack businesses in Asia Pacific, Australia and New Zealand and China region.

Through our operations, authorized bottlers, contract manufacturers and other third parties, we make, market, distribute and sell a wide variety of convenient beverages, foods and snacks, serving customers and consumers in more than 200 countries and territories with our largest operations in the United States, Mexico, Russia, Canada, the United Kingdom, China and South Africa.

(b) Dominant Position - Beverage Sales: Coke or Pepsi

Coca-Cola: Net operating revenues for 2023 were $45,754 million, comprised primarily of beverage sales.

Pepsi: Net revenue for 2023 was $91,471 million, of which beverages are estimated at 35% ($32,015) million.

Coca-Cola has the dominant position for beverage sales.

(c) Inventories, cost allocation method, the effect on comparability. As indicated, the companies use essentially the same inventory valuation method. Therefore, comparability is not affected.

Coca-Cola

Inventories consist primarily of raw materials and packaging (which includes ingredients and supplies) and finished goods (which include concentrates and syrups in our concentrate operations and finished beverages in our finished product operations). Inventories are valued at the lower of cost or net realizable value. We determine cost on the basis of the average cost or first-in, first-out methods.

PepsiCo

Inventory

Inventories are valued at the lower of cost or net realizable value. Cost is determined using the averages; first-in first-out (FIFO); or, in limited instances, last-in, first-out (LIFO) methods.

LO: 4, Bloom: AN, Difficulty: Moderate, Time: 30-35, AACSB: Analytic, Communication, AICPA BC: None, AICPA AC: Measurement Analysis and Interpretation, Reporting, Research, AICPA PC: Communication

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UYJ 1.3 Accounting, Analysis, and Principles

Accounting

Caddie Shack Driving Range
Statement of Financial Position
May 31, 2028

Assets		*Liabilities*	
Cash	***$15,100	Advertising payable	$ 150
Building	6,000	Utilities payable	100
Equipment	800		
		Owners' Equity	
		Owners' capital	*21,650
		Total Liabilities & Equity	$21,900
Total Assets	$21,900		

Accrual income = $4,700 – $1,000 – $750 – $400 – $100 = $2,450****
Owners' capital balance = $20,000** + $2,450 – $800 = $21,650*

Murray might conclude that his business earned a profit of $1,650 ($21,650* - $20,000**) because of the difference between his ending Owner's Capital and beginning Owner's Capital. The conclusion that his business lost $4,900 ($20,000* - $15,100***) might come from the change in the business's cash balance, which started at $20,000** and ended the month at $15,100***.

Analysis

The income measure of $2,450**** is most relevant for assessing the future profitability and hence the payoffs to the owners. For example, charging the cost of the building and equipment to expense in the first month of operations understates income in the first month. These costs should be allocated to future periods of benefit through depreciation expense. Similarly, although not paid, the utilities were used to generate revenues, so they should be recognized when incurred, not when paid.

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UYJ 1.3 (Continued)

Principles

GAAP income is the accrual income computed above as $2,450 (excluding depreciation expense.) The key concept illustrated in the difference between the loss of $4,900 and profit of $1,650 is the *expense recognition principle*, which calls for recognition of expenses when incurred, not when paid. Excluding the cash withdrawal from the measurement of income [the difference between income measures in parts (c) and (d)] is an application of the definition of basic elements. Cash withdrawals are distributions to owners, not an element of income (expenses or losses).

LO: 2, 3, 4, Bloom: AN, Difficulty, Moderate, Time: 20-25, AACSB: Analytic, Communication, AICPA BC: None, AICPA AC: Measurement Analysis and Interpretation, Reporting, AICPA PC: Communication

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Solutions to Critical Thinking Cases

CT 1.1

(a) The Securities and Exchange Commission (SEC) is an independent federal agency that receives its authority from federal legislation enacted by Congress. The Securities and Exchange Act of 1934 created the SEC.

(b) As a result of the Securities and Exchange Act of 1934, the SEC has legal authority relative to accounting practices. The U.S. Congress has given the SEC broad regulatory power to control accounting principles and procedures to fulfill its goal of full and fair disclosure.

(c) There is no direct relationship as the SEC was created by Congress and the Financial Accounting Standards Board (FASB) was created by the private sector. However, the SEC historically has followed a policy of relying on the private sector to establish financial accounting and reporting standards known as generally accepted accounting principles (GAAP). The SEC does not necessarily agree with all of the pronouncements of the FASB. In cases of unresolved differences, the SEC rules take precedence over FASB rules for companies within SEC jurisdiction.

LO: 2, Bloom: K, Difficulty: Moderate, Time: 30-40, AACSB: Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Communication

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CT 1.2

(a) A conceptual framework is a coherent system of concepts that flow from an objective. Some compare it to a constitution. Its objective is to provide a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements.

A conceptual framework is necessary so that standard-setting is useful, i.e., standard-setting should build on and relate to an established body of concepts and objectives. A well-developed conceptual framework should enable the FASB to issue more useful and consistent standards in the future.

Specific benefits that may arise are:
(1) A coherent set of standards and rules should result.
(2) New and emerging practical problems should be more quickly soluble by reference to an existing framework.
(3) It should increase financial statement users' understanding of and confidence in financial reporting.
(4) It should enhance comparability among companies' financial statements.
(5) It should provide guidance on identifying the boundaries of judgment in preparing financial statements.
(6) It should provide guidance to the body responsible for establishing accounting standards.

(b) The FASB has issued Statements of Financial Accounting Concepts (SFAC) No. 8 that has eight chapters that relate to business enterprises. Their titles and a brief description of the focus of these eight chapters are as follows:
(1) **SFAC No. 8, Chapter 1,** "The Objective of General Purpose Financial Reporting," presents the goals and purposes of accounting.
(2) **SFAC No. 8, Chapter 2,** "The Reporting Entity," describes the reporting entity.
(3) **SFAC No. 8, Chapter 3,** "Qualitative Characteristics of Useful Financial Information," examines the characteristics that make accounting information useful.
(4) **SFAC No. 8, Chapter 4,** "Elements of Financial Statements," provides definitions of items in financial statements such as assets, liabilities, revenues, and expenses.
(5) **SFAC No. 8, Chapter 5,** "Recognition and Derecognition," sets forth recognition and derecognition criteria to guide when an item should be incorporated into and removed from financial statements.
(6) **SFAC No. 8, Chapter 6,** "Measurement," discusses measurement which is the process of determining relevant numerical depictions of items recognized in the financial statements.
(7) **SFAC No. 8, Chapter 7,** "Presentation," describes the information to be included in general purpose financial reporting and how appropriate presentation can contribute to achieving the objective of financial reporting.
(8) **SFAC No. 8, Chapter 8**, "Notes to Financial Statements," discusses the information that should be considered for inclusion in the notes to financial statements.

LO: 2, Bloom: K, Difficulty: Simple, Time: 20-25, AACSB: None, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

CT 1.3

(a) FASB's Conceptual Framework should provide benefits to the accounting community such as:
(1) A coherent set of standards and rules should result.
(2) New and emerging practical problems should be more quickly soluble by reference to an existing framework.

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CT 1.3 (Continued)

(b) The most important quality of accounting information is its usefulness for decision-making. Relevance and faithful representation are the primary qualities leading to this decision-usefulness. Usefulness is the most important quality because, without usefulness, there would be no benefits from information to set against its costs.

(c) There are a number of key characteristics or qualities that make accounting information useful for decision-making**.** The importance of three of these characteristics or qualities is discussed below.
   (1) Understandability—information provided by financial reporting should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence. Financial information is a tool and, like most tools, cannot be of much direct help to those who are unable or unwilling to use it, or who misuse it.
   (2) Relevance—the accounting information is capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct expectations (including materiality).
   (3) Faithful representation—the faithful representation of a measure rests on whether the numbers and descriptions matched what really existed or happened, including completeness, neutrality, and free from error.

(**Note to instructor:** Other qualities might be discussed by the student, such as enhancing qualities. All of these qualities are defined in the textbook).

LO: 2, Bloom: K, Difficulty: Simple, Time: 25-35, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Decision Making

CT 1.4

(a) The objective of financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions about providing resources to the entity.

(b) The purpose of this statement is to set forth fundamentals on which financial accounting and reporting standards may be based. Without some basic set of objectives that everyone can agree on, inconsistent standards will be developed. For example, some believe that accountability should be the primary objective of financial reporting. Others argue that the prediction of future cash flows is more important. It follows that individuals who believe that accountability is the primary objective may arrive at different financial reporting standards than others who argue for the prediction of cash flow. Only by establishing some consistent starting point can accounting ever achieve some underlying consistency in establishing accounting principles.

It should be emphasized to the students that the FASB itself is likely to be the major user and thus the most direct beneficiary of the guidance provided by this pronouncement. However, knowledge of the objectives and concepts the FASB uses should enable all who are affected by or interested in financial accounting standards to better understand the content and limitations of the information provided by financial accounting and reporting, thereby furthering their ability to use that information effectively and enhancing confidence in financial accounting and reporting. That knowledge, if used with care, may also provide guidance in resolving new or emerging problems of financial accounting and reporting in the absence of applicable authoritative pronouncements.

LO: 2, Bloom: C, Difficulty: Simple, Time: 25-35, AACSB: None, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

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CT 1.5

(a) (1) Relevance is one of the two primary decision-specific characteristics of useful accounting information. Relevant information is capable of making a difference in a decision. Relevant information helps users to make predictions about the outcomes of past, present, and future events, or to confirm or correct prior expectations. ***Only material information is considered to be relevant and therefore, must be disclosed. If the information is not likely to make a difference to a decision-maker, then it need not be disclosed***. Information must also be timely to be relevant.

(2) Faithful representation is one of the two primary decision-specific characteristics of useful accounting information. ***Faithful representation means that numbers and descriptions match what really existed or happened.*** Representational faithfulness is correspondence or agreement between accounting information and the economic phenomena it is intended to represent stemming from completeness, neutrality, and free from error.

(3) Understandability is a user-specific characteristic of information. Information is understandable when it permits reasonably informed users to perceive its significance. Understandability is a link between users, who vary widely in their capacity to comprehend or utilize the information, and the decision-specific qualities of information.

(4) Comparability means that information about enterprises has been prepared and presented in a similar manner. Comparability enhances comparisons between information about two different enterprises at a particular point in time.

(5) Consistency means that unchanging policies and procedures have been used by an enterprise from one period to another. Consistency enhances comparisons between information about the same enterprise at two different points in time.

(b) (**Note to instructor:** Many answers are possible here. The suggestions below are intended to serve as examples).

(1) Forecasts of future operating results and projections of future cash flows may be highly relevant to some decision-makers. However, they would not be as free from error as historical cost information about past transactions.
(2) Proposed new accounting methods may be more relevant to many decision-makers than existing methods. However, if adopted, they would impair consistency and make trend comparisons of an enterprise's results over time difficult or impossible.
(3) There presently exists much diversity among acceptable accounting methods and procedures. In order to facilitate comparability between enterprises, the use of only one accepted accounting method for a particular type of transaction could be required. However, consistency would be impaired for those firms changing to the new required methods.
(4) Occasionally, relevant information is exceedingly complex. Judgment is required in determining the optimum trade-off between relevance and understandability. Information about the impact of general and specific price changes may be highly relevant but not understandable by all users.

(c) Although trade-offs result in the sacrifice of some desirable quality of information, the overall result should be information that is more useful for decision-making.

LO: 2, Bloom: C, Difficulty: Moderate, Time: 30-35, AACSB: Knowledge, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

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CT 1.6

(a) Recognition when cash is received is not appropriate unless the magazines are delivered to the customer at the same time. The revenue recognition principle indicates that companies recognize revenue when each performance obligation is satisfied. This occurs when the products are delivered – in this case, the magazines.

(b) Recognition when the magazines are published each month is not appropriate. The revenue recognition principle indicates that companies recognize revenue as each performance obligation is satisfied. This occurs when the product is delivered – publication of the magazines is a necessary step in the process, but until the magazines are delivered, the performance obligation has not been satisfied.

(c) Recognition over time, as the magazines are delivered to customers, is appropriate. The revenue recognition principle indicates that companies recognize revenue as each performance obligation is satisfied. This occurs when the product is delivered, which is the case when the magazines are delivered to customers each month. When the customer pays for the annual subscription, the company has a performance obligation (a liability – Unearned Revenue) that is satisfied over time as magazines are published and delivered to customers.

(**Note to instructor:** CT 1.6 might also be assigned in conjunction with Chapter 17.)

LO: 3, Bloom: AP, Difficulty: Hard, Time: 25-30, AACSB: Analytic, Knowledge, AICPA BC: None, AICPA AC: Measurement Analysis and Interpretation, Reporting, AICPA PC: None

CT 1.7

(a) Some costs are recognized as expenses on the basis of a presumed direct association with specific revenue. This presumed direct association has been identified both as “associating cause and effect” and as “matching (expense recognition principle).”

Direct cause-and-effect relationships can seldom be conclusively demonstrated, but many costs appear to be related to particular revenue, and recognition of them as expenses accompanies recognition of the revenue. Generally, the expense recognition principle requires that the revenue recognized and the expenses incurred to produce the revenue be given concurrent period recognition in the accounting records. Only if the effort is properly related to accomplishment will the results, called earnings, have useful significance concerning the efficient utilization of business resources. Thus, applying the expense recognition principle is recognition of the cause-and-effect relationship that exists between expense and revenue.

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.

(b) Some costs are assigned as expenses to the current accounting period because:
(1) their incurrence during the period provides no discernible future benefits;
(2) they are measures of assets recorded in previous periods from which no future benefits are expected or can be discerned;
(3) they must be incurred each accounting year, and no build-up of expected future benefits occurs;
(4) by their nature, they relate to current revenues even though they cannot be directly associated with any specific revenues;
(5) 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;
(6) and uncertainty exists regarding whether allocating them to current and future periods will serve any useful purpose.

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CT 1.7 (Continued)

Thus, many costs are called “period costs” and are treated as expenses in the period incurred because they have neither a direct relationship with 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.

(c) A cost should be capitalized, that is, recorded as an asset when it is expected that the expenditure will produce benefits in future periods. The important concept here is that the incurrence of the cost has resulted in the acquisition of an asset with future service potential. If a cost is incurred that resulted in the acquisition of an asset from which benefits are not expected beyond the current period, the cost may be expensed as a measure of the service potential that expired in producing the current period’s revenues. Not only should the incurrence of the cost result in the acquisition of an asset from which future benefits are expected, but also the cost should be measurable with a reasonable degree of objectivity, and there should be reasonable grounds for associating it with the asset acquired. Examples of costs that should be treated as measures of assets are the costs of merchandise on hand at the end of an accounting period, costs of insurance coverage relating to future periods, and the cost of self-constructed plant or equipment.

(d) 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 intangibles, and allocation of rent and insurance.

(e) A cost should be treated as a loss when no revenue results. The matching of losses to specific revenue should not be attempted because, by definition, they are expired service potentials not related to revenue produced. That is, losses result from events that are not anticipated as necessary in the process of producing revenue.

LO: 3, Bloom: AN, Difficulty: Hard, Time: 20-25, AACSB: Analytic, Knowledge, AICPA BC: None, AICPA AC: Measurement Analysis and Interpretation, Reporting, AICPA PC: Decision Making

CT 1.8

(a) Costs should be recognized as expiring in a given period if they are not chargeable to a prior period and do not apply to future periods. Recognition in the current period is required when any of the following conditions or criteria are present:
   (1) A direct association of charges with revenue of the period, such as goods shipped to customers.
   (2) An indirect association with the revenue of the period, such as insurance or rent.
   (3) A period charge where no association with revenue in the future can be made, so the expense is charged this period, such as officers’ salaries, or a measurable expiration of asset costs during the period, even though not associated with the production of revenue for the current period, such as a fire or casualty loss.

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CT 1.8 (Continued)

(b) (1) Although it is generally agreed that inventory costs should include all costs attributable to placing the goods in a salable state, receiving and handling costs are often treated as cost expirations in the period incurred because they are irregular or are not in uniform proportion to sales.

The portion of the receiving and handling costs attributable to the unsold goods processed during the period should be inventoried. These costs might be more readily apportioned if they are assigned by some device such as an applied rate. Abnormally high receiving and handling costs should be charged off as a period cost.

(2) Cash discounts on purchases are treated as "other revenues" in some financial statements in violation of the revenue and expense recognition principles. Revenue is not recognized when goods are purchased or cash disbursed. Furthermore, inventories valued at gross invoice price are recorded at an amount greater than their cash outlay resulting in a misstatement of inventory cost in the current period and inventory cost expirations in future periods.

Close adherence to the expense recognition principle requires that cash discounts be recorded as a reduction of the cost of purchases and that inventories be priced at net invoice prices. Where inventories are priced at gross invoice prices for expediency, however, there is a slight distortion of the financial statements if the beginning and ending inventories are not materially different.

LO: 3, Bloom: AP, Difficulty: Hard, Time: 20-25, AACSB: Analytic, Knowledge, AICPA BC: None, AICPA AC: Measurement Analysis and Interpretation, Reporting, AICPA PC: Decision Making

CT 1.9

(a) The preferable treatment of the costs of the sample display houses is expensing them over more than one period. These sample display houses are assets because they represent rights to future service potentials or economic benefits.

(1) The alternative of expensing the costs of sample display houses in the period in which the expenditure is made is based primarily upon the expense recognition principle. These costs are of a promotional nature. Promotional costs often are considered expenses of the period in which the expenditures occur due to the uncertainty in determining the time periods benefited (do they meet the definition of an asset?). It is likely that no decision is made concerning the life of a sample display house at the time it is erected. Past experience may provide some guidance in determining the probable life. A decision to tear down or alter a house probably is made when sales begin to lag or when a new model with greater potential becomes available.

There is uncertainty not only as to the life of a sample display house but also as to whether a sample display house will be torn down or altered. If it is altered rather than torn down, a portion of the cost of the original house may be attributable to the new model.

(2) According to the expense recognition principle, the costs of service potentials should be amortized as the benefits are received. Thus, costs of the sample display houses should be matched with the revenue from the sale of the houses, which is receivable over a period of more than one year. As the sample houses are left on display for three to seven years, Daniel Barenboim apparently expects to benefit from the displays for at least that length of time.

(b) There is uncertainty regarding the number of homes of a particular model which will be sold as a result of the display sample. The success of this amortization method is dependent upon accurate estimates of the number and selling price of shell houses to be sold. The estimate of the number of units of a particular model which will be sold as a result of a display model should include not only units sold while the model is on display but also units sold after the display house is torn down or altered.

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CT 1.9 (Continued)

(1) Cost amortization solely on the basis of time may be preferable when the life of the models can be estimated with a great deal more accuracy than can the number of units that will be sold. If unit sales and selling prices are uniform over the life of the sample, a satisfactory matching of costs and revenues may be achieved if the straight-line amortization procedure is used.

(2) If all of the shell houses are to be sold at the same price, it may be appropriate to allocate the costs of the display houses on the basis of the number of shell houses sold. This allocation would be similar to the units-of-production method of depreciation and would result in a good matching of costs with revenues. On the other hand, if the shell houses are to be sold at different prices, it may be preferable to allocate costs on the basis of the revenue contribution of the shell houses sold.

LO: 3, Bloom: AP, Difficulty: Moderate, Time: 20-30, AACSB: Analytic,, AICPA BC: Strategic Perspective, AICPA AC: Measurement, Reporting, AICPA PC: Decision Making

CT 1.10

Dear Uncle Carlos,

I received the information on Neville Corp. and appreciate your interest in sharing this venture with me. However, I think that basing an investment decision on these financial statements would be unwise because they are neither relevant nor representationally faithful.

One of the most important characteristics of accounting information is that it is relevant, i.e., it will make a difference in my decision. To be relevant, this information must be timely. Because Neville's financial statements are a year old, they have lost their ability to influence my decision: a lot could have changed in that one year.

Another element of relevance is predictive value. Once again, Neville's accounting information proves irrelevant. Shown without reference to other years' profitability, it cannot help me predict future profitability because I cannot see any trends developing. Closely related to predictive value is confirmatory value. These financial statements do not provide feedback on any strategies which the company may have used to increase profits.

These financial statements are also not representationally faithful. To be representationally faithful, their assertions must be verifiable by several independent parties. Because no independent auditor has verified these amounts, there is no way of knowing whether or not they are represented faithfully. For instance, I would like to believe that this company earned $2,424,240 and that it had a very favorable debt-to-equity ratio. However, unaudited financial statements do not give me any reasonable assurance about these claims.

Finally, the fact that Ms. Neville herself prepared these statements indicates a lack of neutrality. Because she is not a disinterested third party, I cannot be sure that she did not prepare the financial statements in favor of her husband's business.

I do appreciate the trouble you went through to get me this information. Under the circumstances, however, I do not wish to invest in the Neville bonds and would caution you against doing so. Before you make a decision in this matter, please call me.

Sincerely,

Your Nephew/Niece

LO: 2, Bloom: C, Difficulty: Moderate, Time: 20-30, AACSB: Knowledge, Communication, AICPA BC: None, AICPA AC: Reporting, AICPA PC: Communication, Decision Making

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CT 1.11

(a) The stakeholders are investors, creditors, etc.; i.e., users of financial statements, current, and future.

(b) Honesty and integrity of financial reporting, job protection, profit.

(c) Applying the expense recognition principle and recording expense during the plant's life, or not applying it. That is, record the mothball costs in the future.

(d) The major question may be whether or not the expense of mothballing can be estimated properly so that the integrity of financial reporting is maintained. Applying the expense recognition principle will result in lower profits and possibly higher rates for consumers. Could this cost anyone his or her job? Will investors and creditors have more useful information? On the other hand, failure to apply the expense recognition principle means higher profits, lower rates, and greater potential job security.

(e) Students' recommendations will vary.

Note: Other stakeholders possibly affected are present and future consumers of electric power. Delay in allocating the expense will benefit today's consumers of electric power at the expense of future consumers.

LO: 3, Bloom: E, Difficulty, Moderate, Time: 20-25, AACSB: Ethics, Analytic, AICPA BC: Strategic Perspective, AICPA AC: Reporting, AICPA PC: Professional Behavior, Decision Making

CT 1.12

1. Information about competitors might be useful for benchmarking the company's results but if management does not have expertise in providing the information, it could be highly subjective. In addition, it is likely costly for management to gather sufficiently verifiable information of this nature.

2. While users of financial statements might benefit from receiving internal information, such as company plans and budgets, competitors might also be able to use this information to gain a competitive advantage relative to the disclosing company.

3. To produce forecasted financial statements, management would have to make numerous assumptions and estimates, which would be costly in terms of time and data collection. Because of the subjectivity involved, the forecasted statements would not be faithful representations, thereby detracting from any potential benefits. In addition, while management's forecasts of future profitability or balance sheet amounts could be of benefit, companies could be subject to shareholder lawsuits if the amounts in the forecasted statements are not realized.

4. It would be excessively costly for companies to gather and report information that is not used in managing the business.

5. Flexible reporting allows companies to "fine-tune" their financial reporting to meet the information needs of its varied users. In this way, they can avoid the cost of providing information that is not demanded by its users.

6. Similar to number 3, concerning forecasted financial statements, if managers report forward-looking information, the company could be exposed to liability if investors unduly rely on the information in making investment decisions. Thus, if companies get protection from unwarranted lawsuits (called a safe harbor), then they might be willing to provide potentially beneficial forward-looking information.

LO: 3, 4, Bloom: AP, Difficulty: Moderate, Time: 30-35, AACSB: Analytic, AICPA BC: None, AICPA AC: Reporting, AICPA PC: None

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CT 1.13

(a) Inclusion or omission of information that materially affects net income harms particular stakeholders. Accountants must recognize that their decision to implement (or delay) reporting requirements will have immediate consequences for some stakeholders.

(b) Yes. Because the FASB rule results in a fairer representation, it should be implemented as soon as possible—regardless of its impact on net income. SEC Staff Bulletin No. 74 (December 30, 1987) requires a statement as to what the expected impact of the standard will be.

(c) The accountant's responsibility is to provide financial statements that present fairly the financial condition of the company. By advocating early implementation, Weller fulfills this task.

(d) Potential lenders and investors, who read the financial statements and rely on their fair representation of the financial condition of the company have the most to gain by early implementation. A stockholder who is considering the sale of stock may be harmed by early implementation that lowers net income (and may lower the value of the stock).

LO: 4, Bloom: K, Difficulty: Hard, Time: 20-25, AACSB: Ethics, AICPA BC: Strategic Perspective, AICPA AC: Reporting, AICPA PC: Professional Behavior, Decision Making

CT 1.14

(a) The public/private mixed approach is the way rules are established in the United States. In many respects, the FASB is a quasi-governmental agency in that its pronouncements are required to be followed because the SEC has provided support for this approach. The SEC has the ultimate power to establish GAAP but has chosen to permit the private sector to develop these rules. By accepting the standards established by the FASB as authoritative, it has granted much power to the FASB.

(b) Publicly reported accounting numbers influence the distribution of scarce resources. Resources are channeled where needed at returns commensurate with perceived risk. Thus, reported accounting numbers have economic effects in that resources are transferred among entities and individuals as a consequence of these numbers. It is not surprising then that individuals affected by these numbers will be extremely interested in any proposed changes in the financial reporting environment.

(c) The Accounting Standards Executive Committee (AcSEC of the AICPA), among other groups, has presented a potential challenge to the exclusive right of the FASB to establish accounting principles. Also, Congress has been attempting to legislate certain accounting practices, particularly to help struggling industries.

Some possible reasons why other groups might wish to establish GAAP are:

1. As indicated in the previous answer, these rules have economic effects and therefore certain groups would prefer to make their own rules to ensure that they receive just treatment.
2. Some believe the FASB does not act quickly to resolve accounting matters, either because it is not that interested in the subject area or because it lacks the resources to do so.
3. Some argue that the FASB does not have the competence to legislate GAAP in certain areas. For example, many have argued that the FASB should not legislate GAAP for not-for-profit enterprises because the problems are unique and not well understood by the FASB.

LO: 2, 4 Bloom: C, Difficulty: Simple, Time: 15-20, AACSB: Knowledge, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC: None

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CT 1.15

(a) Considering the economic consequences of GAAP, it is not surprising that special interest groups become vocal and critical (some supporting, some opposing) when rules are being formulated. The FASB's derivative accounting pronouncement is no exception. Many from the banking industry, for example, criticized the rule as too complex and leading to unnecessary earnings volatility. They also indicated that the proposal may discourage prudent risk management activities and in some cases could present misleading financial information.

As a result, Congress is often approached to put pressure on the FASB to change its rulings. In the stock option controversy, industry was quite effective in going to Congress to force the FASB to change its conclusions. In the derivative controversy, Rep. Richard Baker introduced a bill that would force the SEC to formally approve each standard issued by the FASB. Not only would this process delay adoption, but could lead to additional politicization of the rule-making process. Dingell commented that Congress should stay out of the rule-making process and defended the FASB's approach to establishing GAAP.

(b) Attempting to set GAAP by a political process will probably lead to the following consequences:
(a) Too many alternatives.
(b) Lack of clarity that will lead to inconsistent application.
(c) Lack of disclosure that reduces transparency.
(d) Not comprehensive in scope.

Without an independent process, GAAP will be based on political compromise. A classic illustration is what happened in the savings and loan industry. Applying generally accepted accounting principles to the S&L industry would have forced regulators to restrict activities of many S&Ls. Unfortunately, accounting principles were overridden by regulatory rules and the resulting lack of transparency masked the problems. William Siedman, former FDIC Chairman noted later that it was "the worst mistake in the history of government."

Another indication of the problem of government intervention is shown in the accounting standards used by some countries around the world. Completeness and transparency of information needed by investors and creditors are not available in order to meet or achieve other objectives.

LO: 4, Bloom: C, Difficulty: Moderate, Time: 25-30, AACSB: None, AICPA BC: Governance Perspective, AICPA AC: Reporting, Research, AICPA PC: None

CT 1.16

(a) The "due process" system involves the following:
1. Identifying topics and placing them on the FASB's agenda.
2. Research and analysis are conducted and preliminary views of pros and cons are issued.
3. A public hearing is often held.
4. The FASB evaluates research and public responses and issues exposure draft.
5. The FASB evaluates responses and changes the exposure draft if necessary. The final statement is then issued.

(b) Economic consequences mean the impact of accounting reports on the wealth positions of issuers and users of financial information and the decision-making behavior resulting from that impact.

(c) Economic consequences indicated in the letter are (1) concerns related to the potential impact on the capital markets, (2) the weakening of companies' ability to manage risk, and (3) the adverse control implications of implementing costly and complex new rules imposed at the same time as other major initiatives, including the Year 2000 issues and a single European currency.

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CT 1.16 (Continued)

(d) The principal point of this letter is to delay the finalization of the derivatives standard. As indicated in the letter, the authors of this letter urge the FASB to expose its new proposal for public comment, following the established due process procedures that are essential to acceptance of its standards and providing sufficient time for affected parties to understand and assess the new approach. (Authors note: The FASB indicated in a follow-up letter that all due process procedures had been followed and all affected parties had more than ample time to comment. In addition, the FASB issued a follow-up standard, which delayed the effective date of the standard, in part to give companies more time to develop the information systems needed for implementation of the standard).

(e) The reason why the letter was sent to Congress was to put additional pressure on the FASB to delay or drop the issuance of a rule on derivatives. Unfortunately, in too many cases, when the business community does not like the answer proposed by the FASB, it resorts to lobbying members of Congress. The lobbying efforts usually involve developing some type of legislation that will negate the rule. In some cases, efforts involve challenging the FASB's authority to develop rules in certain areas with additional Congressional oversight.

LO: 4, Bloom: E, Difficulty: Moderate, Time: 25-30, AACSB: Communication, AICPA BC: Governance Perspective, AICPA AC: Reporting, AICPA PC: Communication

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Solutions to Codification Exercises

CE1.1

The information at this link describes the elements offered in The FASB Accounting Standards Codification. As indicated, the website offers several resources to enhance your working knowledge of the Codification and the Codification Research System. This page includes links to help pages that describe specific functions and features of the Codification. Links to frequently asked questions, the FASB Learning Guide, and the Notice to Constituents are also available on this page.

Help pages

FAQ

Learning Guide

About the Codification—Notice of Constituents

LO: 3, Bloom: K, Difficulty: Simple, Time: 5-10, AACSB: Technology, AICPA BC: None, AICPA AC: Research, Reporting, Technology and Tools, AICPA PC: Communication

CE1.2

The following information is provided at the Providing Feedback link:

The Codification includes a feature that can be used to submit content-related feedback or general, system-related comments. The feedback system is not designed for comments on proposed Accounting Standards Updates.

Content-related feedback

As a registered user of the FASB Accounting Standards Codification Research System website, you are able and are encouraged to provide feedback, at the paragraph level, to the FASB about any content-related matters. For specific information about the Codification and the feedback process, please read the Notice to Constituents.

To provide content-related feedback:

Click the Submit feedback button beneath the paragraph for which you want to provide feedback. Enter or copy/paste your comments in the text box. Note that formatting (lists, bold, etc.) is not retained and there is a 4,000 character limit on feedback submissions.

Click SUBMIT. Your comments are sent to the FASB and reviewed by FASB staff. You can also submit multiple comments for any given paragraph, if, for example, you determine that more information would be useful to the FASB staff.

General feedback

Click here to provide general feedback on the Codification in general, the Codification Research System website, and other system-related items that are not content-specific.

LO: 3, Bloom: K, Difficulty: Simple, Time: 10-15, AACSB: Communication, Technology, AICPA BC: None, AICPA AC: Research, Reporting, Technology and Tools, AICPA PC: Communication

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CE1.3

The "What's New" page provides links to Codification content that has been recently issued. During the verification phase, updates may result from either the issuance of Codification update instructions that accompany new Standards or from changes to the Codification due to incorporation of constituent feedback.

LO: 3, Bloom: K, Difficulty: Simple, Time: 5-10, AACSB: Communication, Technology, AICPA BC: None, AICPA AC: Research, Reporting, Technology and Tools, AICPA PC: Communication

CE1.4

(a) The master glossary provides three definitions of fair value that are found in GAAP:

Fair Value—The amount at which an asset (or liability) could be bought (or incurred) or settled in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

Fair Value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

(b) Revenue—Revenue earned by an entity from its direct distribution, exploitation, or licensing of a film, before deduction for any of the entity's direct costs of distribution. For markets and territories in which an entity's fully or jointly-owned films are distributed by third parties, revenue is the net amounts payable to the entity by third-party distributors. Revenue is reduced by appropriate allowances, estimated returns, price concessions, or similar adjustments, as applicable.

The glossary references a revenue definition for the SEC: (Revenue (SEC))—See paragraph 942.235-S599-1, Regulation S-X Rule 9-05(c)(2), for the definition of revenue for purposes of Regulation S-X Rule 9-05.

This definition relates to segment reporting requirements for public companies.

(c) Comprehensive Income is defined as the change in equity (net assets) of a business entity 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.

LO: 2, 3, Bloom: K, Difficulty: Simple, Time: 10-15, AACSB: Communication, Technology, AICPA BC: None, AICPA AC: Research, Reporting, Technology and Tools, AICPA PC: Communication

CE1.5

The FASB Codification's organization is closely aligned with the elements of financial statements, as articulated in the Conceptual Framework. This is apparent in the layout of the "Browse" section, which has primary links for Assets, Liabilities, Equity, Revenues, and Expenses.

LO: 2, Bloom: K, Difficulty: Simple, Time: 5, AACSB: Communication, Technology, AICPA BC: None, AICPA AC: Reporting, Research, Technology and Tools, AICPA PC: Communication

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Solutions to Codification Research Case

Search Strings: concept statement, "materiality", "articulation"

(a) According to Concepts Statement 8 (CON 8, Chapter 3): Qualitative Characteristics of Accounting Information, "Glossary":

"Materiality is defined as the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information could have been changed or influenced by the omission or misstatement."

(b) CON 8 refers to several SEC cases which apply materiality. Students might also research SEC literature (e.g. Staff Accounting Bulletin No. 99), although SEC literature is not in the FARS database.

CON 8, Chapter 3. provides the following examples of screens that might be used to determine materiality:

a. An accounting change in circumstances that puts an enterprise in danger of being in breach of a covenant regarding its financial condition may justify a lower materiality threshold than if its position were stronger.
b. A failure to disclose separately a nonrecurrent item of revenue may be material at a lower threshold than would otherwise be the case if the revenue turns a loss into a profit or reverses the trend of earnings from a downward to an upward trend.
c. A misclassification of assets that would not be material in amount if it affected two categories of plant or equipment might be material if it changed the classification between a noncurrent and a current asset category.
d. Amounts too small to warrant disclosure or correction in normal circumstances may be considered material if they arise from abnormal or unusual transactions or events.

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However, the FASB notes that more than magnitude must be considered in evaluating materiality:

The relative rather than the absolute size of a judgment item almost always determines whether it should be considered material in a given situation. Losses from bad debts or pilferage that could be shrugged off as routine by a large business may threaten the continued existence of a small one. An error in inventory valuation may be material in a small enterprise for which it cut earnings in half but immaterial in an enterprise for which it might make a barely perceptible ripple in the earnings. Some of the empirical investigations referred to in Appendix C throw light on the considerations that enter into materiality judgments.

Some hold the view that the Board should promulgate a set of quantitative materiality guides or criteria covering a wide variety of situations that preparers could look to for authoritative support. That appears to be a minority view, however. The predominant view is that materiality judgments can properly be made only by those who have all the facts. The Board's present position is that no general standards of materiality could be formulated to take into account all the considerations that enter into an experienced human judgment.

(c) SFAC No. 6, Paras. 20-21. The two classes of elements are related in such a way that (a) assets, liabilities, and equity are changed by elements of the other class and at any time are their cumulative result and (b) an increase (decrease) in an asset cannot occur without a corresponding decrease (increase) in another asset or a corresponding increase (decrease) in a liability or equity. Those relationships are sometimes collectively referred to as "articulation." They result in financial statements that are fundamentally interrelated so that statements that show elements of the second class depend on statements that show elements of the first class and vice versa.

LO: 3, Bloom: C, Moderate, Time: 25-30, AACSB: Communication, AICPA BC: None, AICPA AC: Measurement Analysis and Interpretation, Reporting, Research, Technology and Tools, AICPA PC: Communication

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CHAPTER 1

The Environment and Conceptual Framework of Financial Reporting

ASSIGNMENT CLASSIFICATION TABLE (By Topic)

Topics		Questions	Brief Exercises	Exercises
1.	Financial reporting environment.	1, 2		1,2
2.	Standards and standard setting bodies.	3, 4, 5, 6	1, 2	2
3.	Conceptual framework.	7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17, 18, 19	3, 4, 5, 6, 7, 8	3,4,5,6,7
4.	Assumptions and principles.	20, 21, 22, 23, 24, 25, 26, 27, 28, 29, 30, 31, 32, 33	9, 10, 11, 12, 13	8,9,10,11,12
5.	Challenges in financial reporting.	34, 35, 36, 37, 38		2
6.	Ethical issues.	39		

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ASSIGNMENT CLASSIFICATION TABLE (BY LEARNING OBJECTIVE)

Learning Objectives	Brief Exercises	Exercises	Critical Thinking Cases
1. Describe the financial reporting environment, major standard-setting bodies, and the meaning of general accepted accounting principles (GAAP).	1, 2	1,2	1
2. Describe the components and usefulness of the conceptual framework.	3,4,5,6,7, 8	3,4,5,6,7	2, 3, 4, 5, 10
3. Discuss the basic operational concepts of GAAP.	9,10,11, 12,13	8,9,10, 11,12	6, 7, 8, 9, 11, 12
4. Identify the major challenges in the financial reporting environment.		2	3, 11, 13, 14, 15, 16

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ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
E1-1	Need for GAAP.	Simple	15–20
E1-2	Financial reporting and accounting standards.	Simple	15–20
E1-3	Usefulness, objectives of financial reporting.	Simple	15–20
E1-4	Usefulness, objectives of financial reporting, qualitative characteristics.	Simple	15–20
E1-5	Qualitative characteristics.	Moderate	20–25
E1-6	Qualitative characteristics.	Simple	15-20
E1-7	Elements of financial statements.	Simple	15–20
E1-8	Assumptions, principles, and constraint.	Simple	15-20
E1-9	Assumptions, principles, and constraint.	Simple	20–25
E1-10	Full disclosure principle.	Complex	30–40
E1-11	Accounting principles and assumptions - comprehensive.	Moderate	20-25
E1-12	Accounting principles - comprehensive.	Moderate	30–40

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LEARNING OBJECTIVES

1. Describe the financial reporting environment, major standard-setting bodies, and the meaning of general accepted accounting principles (GAAP).
2. Describe the components and usefulness of the conceptual framework.
3. Discuss the basic operational concepts of GAAP.
4. Identify the major challenges in the financial reporting environment.

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CHAPTER REVIEW

1. Chapter 1 describes the environment that has influenced both the development and use of the financial accounting process. The chapter traces the development of financial accounting standards, focusing on the groups that have had or currently have the responsibility for developing such standards. Certain groups other than those with direct responsibility for developing financial accounting standards have significantly influenced the standard-setting process. These various pressure groups are also discussed.

Financial Reporting Environment

2. (L.O. 1) The essential characteristics of accounting are (1) the identification, measurement, and communication of financial information about (2) economic entities to (3) interested parties. **Financial accounting** is the process that culminates in the preparation of financial reports on the enterprise for use by both internal and external parties.

3. **Financial statements** are the principal means through which a company communicates its financial information to those outside it. The financial statements most frequently provided are (1) the balance sheet, (2) the income statement, (3) the statement of cash flows, and (4) the statement of owners' or stockholders' equity. Other means of financial reporting include the president's letter or supplementary schedules in the corporate annual report, prospectuses, reports filed with government agencies, news releases, management forecasts, and social or environmental impact statements.

4. **Financial reporting** helps investors to assess the amounts, timing and uncertainty of future cash flows from dividends, interest and the proceeds from the sale or maturity of investments. It also helps to compare income and assets of different companies.

Accounting, Decision-Usefulness, and Capital Allocation

5. Accounting is important for markets, free enterprise, and competition because it assists in providing information that leads to capital allocation. The better the information, the more effective the process of capital allocation and then the healthier the economy.

Need to Develop Standards

6. To enhance the decision-usefulness of accounting information, the accounting profession has developed a set of standards that are generally accepted and universally practiced.

7. This common set of standards and procedures are known as **generally accepted accounting principles (GAAP).** These principles serve as a general guide to the accounting practitioner in accumulating and reporting the financial information of a business enterprise.

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Securities and Exchange Commission (SEC)

8. After the stock market crash in 1929 and the Great Depression, there were calls for increased government regulation and supervision—especially of financial institutions and the stock market. As a result, the federal government established the Securities and Exchange Commission (**SEC**) to help develop and standardize financial information presented to stockholders. The SEC is a federal agency and administers the Securities Exchange Act of 1934 and several other acts. Most companies that issue securities to the public or are listed on a stock exchange are required to file audited financial statements with the SEC. In addition, the SEC has broad powers to prescribe the accounting practices and standards to be employed by companies that fall within its jurisdiction.

9. At the time the SEC was created, it encouraged the creation of a private standards-setting body. As a result, accounting standards have generally been developed in the private sector either through the American Institute of Certified Public Accountants (**AICPA**) or the Financial Accounting Standards Board (**FASB**). The SEC has affirmed its support for the FASB by indicating that financial statements conforming to standards set by the FASB will be presumed to have substantial authoritative support.

10. Over its history, the SEC's involvement in the development of accounting standards has varied. In some cases, the private sector has attempted to establish a standard, but the SEC has refused to accept it. In other cases, the SEC has prodded the private sector into taking quicker action on setting standards.

11. If the SEC believes that an accounting or disclosure irregularity exists regarding a company's financial statements, the SEC sends a deficiency letter to the company. If the company's response to the deficiency letter proves unsatisfactory, the SEC has the power to issue a "stop order," which prevents the registrant from issuing securities or trading securities on the exchanges. Criminal charges may also be brought by the Department of Justice.

Financial Accounting Standards Board (FASB)

12. The FASB represents the current rule-making body within the accounting profession. The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, which includes issuers, auditors, and users of financial information.

    Two basic premises of the FASB are that in establishing financial accounting standards: (a) it should be responsive to the needs and viewpoints of the entire economic community, not just the public accounting profession, and (b) it should operate in full view of the public through a "due process" system that gives interested persons ample opportunity to make their views known.

Due Process

13. The FASB issues two major types of pronouncements:

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a. **Accounting Standards Updates.** The Updates amend the Accounting Standards Codification, which represents the source of authoritative accounting standards, other than standards issued by the SEC. Each Update explains how the Codification has been amended and also includes information to help the reader understand the changes and when those changes will be effective. They are considered GAAP and must be followed in practice.

b. **Financial Accounting Concepts**. The Statements of Financial Accounting Concepts (SFAC) represent an attempt to move away from the problem-by-problem approach to standard setting that has been characteristic of the accounting profession. The Concept Statements are intended to form a cohesive set of interrelated concepts, a conceptual framework that will serve as tools for solving existing and emerging problems in a consistent manner. Unlike FASB statements, the Concept Statements do not establish GAAP.

FASB Codification

14. Generally accepted accounting principles (GAAP) are those principles that have **substantial authoritative support.** Accounting principles that have substantial authoritative support are those found in FASB Statements, Interpretations, and Staff Positions; APB Opinions; and Accounting Research Bulletins (ARBs). If an accounting transaction is not covered in any of these documents, the accountant may look to other authoritative accounting literature for guidance.

15. The FASB developed the Financial Accounting Standards Board Accounting Standards Codification ("**the Codification**") to provide in one place all the authoritative literature related to a particular topic. The Codification changes the way GAAP is documented, presented, and updated.

Conceptual Framework

16. (L.O. 2) **The conceptual framework** in accounting is important because rule-making should be built on and relate to an established body of concepts. The benefits of a soundly developed conceptual framework are as follows: (a) it should be easier to issue a coherent set of standards and rules; and (b) practical problems should be more quickly solved. There are eight chapters in the conceptual framework.

Chapter 1 - The Objective

17. The basic objective of financial reporting is the foundation of the conceptual framework and requires that general-purpose financial reporting provide information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions about providing resources to the entity. To understand general-purpose financial reporting, users need reasonable knowledge of business and financial matters.

Chapter 2 - The Reporting Entity

18. The reporting entity concept refers to companies that prepare general purpose financial reports.

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Chapter 3 - Qualitative Characteristics

19. The fundamental qualities of accounting information are:

    a. **Relevance** – information that is capable of making a difference in a decision. Comprised of

        1. **Predictive value** means that the information can help users form expectations about the future.
        2. **Confirmatory value** means that the information validates or refutes expectations based on previous evaluations.
        3. **Materiality** means that information is material if omitting it or misstating it could influence decisions that users make on the basis of the reported financial information.

    b. **Faithful representation** – numbers and descriptions match what really happened or existed. Comprised of

        1. **Completeness** means that all necessary information is provided.
        2. **Neutrality** means that the information is unbiased.
        3. **Free from error** means that the information is accurate.

Enhancing Qualities

20. Enhancing qualities complement the fundamental qualities and include:

    a. **Comparability** means that companies record and report information in a similar manner. **Consistency** is another type of comparability and means the company uses the same accounting methods from period to period.

    b. **Verifiability** means that independent people using the same methods arrive at similar conclusions.

    c. **Timeliness** means that information is available before it loses its relevance.

    d. **Understandability** means that reasonably informed users should be able to comprehend the information that is clearly classified and presented.

Chapter 4 - Elements

21. An important aspect of developing an accounting theoretical structure is the body of basic elements or definitions. Ten basic elements that are most directly related to measuring the performance and financial status of a business enterprise are formally defined in *SFAC No. 8, Chapter 4*. These elements, as defined below, are further discussed and interpreted throughout the text. Divided into two distinct groups: assets, liabilities and equity (net assets) are described at a point in time while the remaining seven elements describe transactions during a period of time.

    Assets. Present rights of an entity to economic benefits.

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Liabilities. Present obligations of an entity to transfer economic benefits.

Equity or Net Assets. Residual interest in the assets of an entity that remains after deducting its liabilities.

Investments by Owners. Increases in equity of an entity resulting from transfers to the entity from other entities of something of valuable to obtain or increase ownership interests (or equity) in the entity. Assets are most commonly received as investments by owners, but that which is received may include services or satisfaction or conversion of liabilities of the entity.

Distributions to Owners. Decreases in equity of an entity resulting from transferring assets, rendering services, or incurring liabilities by the entity to owners. Distributions to owners decrease ownership interests (or equity) in an entity.

Comprehensive Income. Change in equity (net assets) of an entity 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.

Revenues. 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 carrying out other activities.

Expenses. Outflows or other using up of assets of an entity or incurrences of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities.

Gains. Increases in equity (net assets) from transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners.

Losses. Decreases in equity (net assets) from transactions and other events and circumstances affecting the entity except those that result from expenses or distributions to owners.

Chapter 5 – Recognition and Derecognition

22. This chapter sets forth criteria to guide when an item should be incorporated into, recognition, or removed from, derecognition, the financial statements. For an item to be recognized, it must (1) meet the definition of an element, (2) have a relevant measurement, and (3) meet the requirements of faithful representation.

Chapter 6 – Measurement

23. Measurement is the process of determining the relevant numerical depictions of items recognized in the financial statements.

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Chapter 7 – Presentation

24. Presentation relates to the display of line items, totals, and subtotals on the financial statements.

Chapter 8 – Notes

25. Notes to financial statements generally amplify or explain the items presented in the main body of the financial statements.

Operational Concepts

26. (L.O. 3) In the practice of financial accounting, certain basic assumptions are important to an understanding of the manner in which data are presented. The following four basic assumptions underlie the financial accounting structure:

    Economic Entity Assumption. Economic activity can be identified with a particular unit of accountability in a manner that assumes the company is separate and distinct from its owners or other business units. This assumption and the reporting entity concept identified in the conceptual framework are very similar. The main difference is that the reporting entity concept is limited to general purpose financial reporting whereas the economic entity assumption is broader in scope.

    Going Concern Assumption. In the absence of contrary information, a company is assumed to have a long life. The current relevance of the historical cost principle is dependent on the going-concern assumption.

    Monetary Unit Assumption. Money is the common denominator of economic activity and provides an appropriate basis for accounting measurement and analysis. The monetary unit is assumed to remain relatively stable over the years in terms of purchasing power. In essence, this assumption disregards any inflation or deflation in the economy in which the company operates.

    Periodicity Assumption. The economic activities of a company can be divided into artificial time periods for the purpose of providing the company's periodic reports.

Basic Principles

27. Certain **basic principles** are followed by accountants in recording and reporting the transactions of a business entity. These principles relate to how assets, liabilities, revenues, and expenses are to be **identified, measured,** and **reported.**

    Measurement Principle. A 'mixed-attribute' system permits the use of various measurement bases.

    Historical Cost Principle. Acquisition cost is considered a reliable basis upon which to account for assets and liabilities of a company. Historical cost has an advantage over other valuations, as it is thought to be verifiable.

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Fair Value Principle. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. GAAP has increasingly called for the use of fair value measurements in the financial statements that is divided into three levels: 1) based on independent third party quoted prices: least subjective, 2) evaluate similar assets or liabilities: more subjective, and 3) observable inputs based on company's data or assumptions: most subjective.

Revenue Recognition Principle. Revenue is recognized at the time in which the performance obligation is satisfied.

Expense Recognition Principle (matching principle). Recognition of expenses is related to net changes in assets and earning revenues. The expense recognition principle is implemented in accordance with the definition of expense by matching efforts (expenses) with accomplishment (revenues).

Product costs, such as material, labor, and overhead, attach to the product, and are recognized in the same period the products are sold.

Period costs, such as officers' salaries and other administrative expenses, attach to the period, and are recognized in the period incurred.

Full Disclosure Principle. In the preparation of financial statements, the accountant should include sufficient information to influence the judgment and decision of an informed user. A series of judgmental tradeoffs must occur.

Financial Statements. To be recognized in the main body of the financial statements, an item should meet the definition of a basic element, be measurable with sufficient certainty, and be faithfully represented.

Notes to the Financial Statements. The purpose of the notes is to amplify or explain items presented in the main body of the statements.

Supplementary Information. May include details or amounts that represent a different perspective than those adopted in the financial statements.

Cost Constraint

28. Although accounting theory is based upon certain assumptions and the application of basic principles, there are some exceptions to these assumptions. One exception is often called a constraint, and sometimes justifies departures from basic accounting theory.

    Cost Constraint. The cost constraint (or cost-benefit relationship) relates to the notion that the benefits to be derived from providing certain accounting information should exceed the costs of providing that information. The difficulty in cost-benefit analysis is that the costs and especially the benefits are not always evident or measurable.

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Major Challenges in Financial Reporting

29. User groups (CPA's AICPA, Financial Community, Preparers, etc.) play a significant role in influencing GAAP.

Expectations Gap

30. The expectations gap is the difference between what the public thinks accountants should do versus what accountants think they can do. This issue was formalized due to the Sarbanes-Oxley Act (SOX) that arose due to numerous accounting scandals. Key legislation resulting from SOX are:

    a. Creation of an external oversight board, the (Public Company Accounting Oversight Board (PCAOB).

    b. CEOs and CFOs have to certify the financial statements and will forfeit bonuses and profits when there is an accounting restatement.

    c. Audit committee members must have financial expertise and be independent members of the board of directors.

    d. Large public companies must document and evaluate the effectiveness of their internal controls over financial reporting.

Financial Reporting

31. Some of the challenges facing financial reporting in the future include:

    a. **Nonfinancial measurements,** which include customer satisfaction indexes, backlog information, and reject rates on goods purchased.

    b. **Forward-looking information.**

    c. **Soft assets** include such intangibles as market dominance, expertise in supply chain management, and brand image.

    d. **Timeliness,** including real-time financial statement information.

    e. **Understandability,** including concerns about the complexity and lack of understandability of financial reports raised by investors and market regulators.

32. In accounting, ethical dilemmas are encountered frequently. The whole process of ethical sensitivity and selection among alternatives can be complicated by pressures that may take the form of time pressures, job pressures, client pressures, personal pressures, and peer pressures. Throughout the text, ethical considerations are presented to sensitize you to the type of situations you may encounter in your profession.

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LECTURE OUTLINE

The material in this chapter usually can be covered in one class session. The issues in this chapter can be addressed by organizing a lecture around the following.

A. (L.O. 1) Financial Reporting Environment.

1. **Identification, measurement,** and **communication** of financial information.

    a. Financial statements:

        (1) Income statement.

        (2) Balance sheet.

        (3) Statement of cash flows.

        (4) Statement of owners' or stockholders' equity.

2. About **economic entities.**

3. To **interested parties** (including owner/managers, creditors, stockholders, government agencies, management, employees, consumers, labor unions, etc.).

B. Need for accounting standards.

1. To meet the various needs of users, companies prepare a single set of general-purpose financial reports.

2. Users expect financial statements to present fairly, clearly, and completely the company's financial operations.

3. The accounting profession has developed a set of standards and procedures called **generally accepted accounting principles (GAAP)**.

C. Parties involved in standard-setting.

1. Securities and Exchange Commission (SEC). The role of the SEC, reasons for its establishment, SEC jurisdiction.

2. Delegation of SEC's authority to the FASB.

3. Financial Accounting Standards Board (FASB).

    a. Description of the FASB's "due process" system in setting standards.

    b. Two major types of pronouncements issued by FASB:

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(1) **Accounting Standards Updates** amend the Accounting Standards Codification, which represents the source of authoritative accounting standards, other than standards issued by the SEC.

(2) **Financial Accounting Concepts** represent an attempt to move away from the problem-by-problem approach to standard setting that has been characteristic of the accounting profession. The Concept Statements are intended to form a cohesive set of interrelated concepts, a conceptual framework.

c. The FASB developed the Financial Accounting Standards Board Accounting Standards Codification ("the Codification").

a. The Codification changes the way GAAP is documented, presented and updated.

b. Explains what GAAP is and eliminates nonessential information.

D. (L.O. 2) Need for a Conceptual Framework.

1. Build on and relate to an established body of concepts.
2. Issue more useful and consistent pronouncements over time.
3. Increase financial statement users' understanding of and confidence in financial reporting.
4. Enhance comparability among companies' financial statements.
5. Provide a framework for solving new and emerging practical problems.

E. Chapter 1 - Objective

1. Information that is **useful** to present and potential equity **investors, lenders** and other **creditors** in making decisions in their capacity as capital providers.
2. Information helpful to capital providers may also be helpful to other users who are not capital providers.

F. Chapter 2 – The Reporting Entity – refers to companies that prepare general purpose financial reports.

G. Chapter 3 – Qualitative Characteristics The overriding criterion for evaluating accounting information is that it must be **useful for decision making.**

a. Fundamental qualities of useful accounting information.

(1) **Relevance.** Accounting information is relevant if it is capable of making a difference in a decision. Relevant information has

(a) Predictive value.

(b) Confirmatory value.

(c) Materiality.

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(2) **Faithful Representation.** For accounting information to be useful, the numbers and descriptions contained in the financial statements must faithfully represent what really existed or happened. To be a faithful representation, information must be

(a) Complete.

(b) Neutral.

(c) Free of error.

H. Enhancing qualities of useful accounting information.

(1) **Comparability.** Information that is measured and reported in a similar manner for different companies is considered comparable. **Consistency** exists when a company applies the same accounting treatment to similar events, period to period.

(2) **Verifiability.** When independent measurers, using the same methods, obtain similar results.

(3) **Timeliness.** Having information available to decision-makers before it loses its capacity to influence decisions.

(4) **Understandability.** When information lets reasonably informed users see the connection between their decisions and the information contained in the financial statements.

I. Chapter 4 - Elements. (See text page 1-18 for definitions.) Items a-c are elements at a moment in time. Items d-j are elements during a period of time.

a. Assets.

b. Liabilities.

c. Equity or net assets.

d. Investments by owners.

e. Distributions to owners.

f. Comprehensive income.

g. Revenues.

h. Expenses.

i. Gains.

j. Losses.

J. Chapter 5 – Recognition and Derecognition

(1) To be recognized in the financial statements, an item must

a. meet the definition of an element.

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b. have a relevant measurement.

c. meet the requirement of faithful representation.

(2) To be derecognized in the financial statements, an item ceases to meet the criteria for recognition.

K. Chapter 6 – Measurement – process of determining relevant numerical depictions of items recognized in the financial statements.

L. Chapter 7 – Presentation – relates to the display of line items, totals, and subtotals on the financial statements.

M. Chapter 8 – Notes – amplify or explain the items presented in the main body of the statements.

N. (L.O. 3) Operational Concepts

1. Assumptions.

a. **Economic entity assumption**. Economic activity can be identified with a particular unit of accountability.

b. **Going concern assumption**. Companies will have a long enough life to justify depreciation and amortization.

c. **Monetary unit assumption**. The monetary unit (i.e., the dollar) is the most effective means of expressing to interested parties changes in capital and exchanges of goods and services. A second assumption is that the monetary unit remains reasonably stable.

d. **Periodicity assumption.** Activities of an enterprise can be divided into artificial time periods.

2. Basic Principles.

a. **Measurement principle**. GAAP permits the use of historical cost and fair value bases.

(1) **Historical cost principle.** Generally thought to be verifiable.

(2) **Fair value principle.** Fair value information may be more useful for certain types of assets and liabilities. The three broad levels of the fair value hierarchy are:

a. **Level 1**. Observable inputs that reflect quoted prices for identical assets or liabilities in active markets.
b. **Level 2**. Inputs other than quoted prices included in Level 1 that are observable for the asset or liability either directly or through corroboration with observable data.

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c. **Level 3**. Unobservable inputs such as discounted expected future net cash flows.

b. **Revenue recognition principle.** Revenue is recognized at the time in which the performance obligation is satisfied.

c. **Expense recognition principle (matching principle).** Efforts (expenses) should be matched with accomplishments (revenues) if feasible.

(1) Practical rules for expense recognition: Analyze costs to determine whether a direct relationship exists with revenue.

(a) When a direct relationship exists, expense costs against revenues in the period when the revenue is recognized.

(b) When a direct relationship exists but is difficult to identify, allocate costs rationally and systematically to an expense in the periods benefited.

(c) When little, if any, direct relationship exists, expense as incurred.

d. **Full disclosure principle.** Reveals in financial statements any facts of sufficient importance to influence the judgment and decisions of an informed reader. (Develop concept of reasonably prudent investor.) Discuss use of notes and supplementary information in financial reporting.

3. **Cost constraint.** The benefit to be derived from having accounting information should exceed the cost of providing it. Frequently it is easier to assess the costs than it is to determine the benefits of providing a particular item of information.

O. (L.O. 4) Major challenges in the financial reporting environment.

1. **Politicization** and the impact of various user groups on the development of GAAP.

2. The **expectations gap.**

a. What people think accountants should do vs. what accountants think they can do.

b. Sarbanes-Oxley Act and the Public Company Accounting Oversight Board.

3. Financial reporting challenges:

a. Nonfinancial measurements. Financial reports failed to provide some key performance measures widely used by management.

b. Forward-looking information. Financial reports failed to provide forward-looking information needed by present and potential investors and creditors

c. Soft assets. Financial reports focused on hard assets (inventory, plant assets) but failed to provide much information about a company's soft assets (intangibles).

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d. Timeliness. Generally only historical information is provided with little to no real-time financial statement information available.

e. Understandability. Financial reports are often complex and hard to understand.

P. Ethics and financial accounting.

1. In accounting, companies frequently encounter ethical dilemmas. Some of these dilemmas are easy to resolve but many are not, requiring difficult choices among allowable alternatives.

2. Time, job, client, personal, and peer pressures can complicate the process of ethical sensitivity and selection among alternatives.

3. Decisions are sometimes difficult because a public consensus has not emerged to formulate a comprehensive ethical system that provides guidelines in making ethical judgments.

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Artificial Intelligence Activities

Prepared by Mfon Akpan, DBA, CGMA, Methodist University

Chapter 1: The Environment and Conceptual Framework of Financial Reporting

Disclaimer: Artificial intelligence platforms continuously change with frequent and often unexpected updates. The AI prompts and content in this book were designed and tested with the most current models available at the time of writing. However, as technology advances, instructors are encouraged to verify the accuracy and functionality of the sample prompts with the latest AI tools they are using.

This book offers adaptable prompts that can be customized to fit the latest AI capabilities, ensuring a cutting-edge learning experience. For those new to AI, step-by-step guides and support are available to help effectively implement these activities in your classroom. Whether or not you are familiar with AI, these prompts and exercises are designed to be engaging and educational, providing flexibility and enhancing your teaching strategies. By experimenting with these tools, you can discover new ways to enrich your student's learning experience and stay aligned with the latest developments in the field.

Activity 1: Understanding the Financial Reporting Environment

Learning Objective: Students will describe the financial reporting environment, major standard-setting bodies, and the meaning of generally accepted accounting principles (GAAP), aligning with LO 1.1 (Describe the financial reporting environment, major standard-setting bodies, and the meaning of GAAP).

Instructions for Instructors:

1. **Scenario Context:**
    - Imagine your students are financial analysts tasked with explaining the financial reporting environment to new interns at a financial firm. This exercise will help them understand the major standard-setting bodies and the significance of GAAP.
    - **Data Provided:**
        - Major standard-setting bodies: Financial Accounting Standards Board (FASB), Securities and Exchange Commission (SEC), International Accounting Standards Board (IASB).
        - Key concepts: GAAP, due process in standard setting, and the role of the SEC in overseeing the FASB.
    - **Steps to Follow:**

1. Explain the roles of the FASB, SEC, and IASB in setting accounting standards.
2. Describe the process through which the FASB sets standards.
3. Discuss the importance of GAAP in ensuring comparability and transparency in financial reporting.

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2. **What Students Should Work Out Themselves:**
    - Summarize the roles of each standard-setting body.
    - Explain the due process in setting standards.
3. **What Students Should Use AI For:**
    - Generate explanations and descriptions of the roles of the FASB, SEC, and IASB.
    - Provide examples of how GAAP ensures comparability and transparency in financial reporting.
4. **Sample Prompt for AI Model:**

Explain the roles of the Financial Accounting Standards Board (FASB), Securities and Exchange Commission (SEC), and International Accounting Standards Board (IASB) in setting accounting standards. Describe the process the FASB follows to set standards and discuss the importance of GAAP in financial reporting.

Answer Key:

Roles of Standard-Setting Bodies:

- **FASB:** Develops GAAP for the private sector in the U.S.
- **SEC:** Oversees the FASB and enforces compliance with GAAP among public companies.
- **IASB:** Develops International Financial Reporting Standards (IFRS) used by many countries outside the U.S.

Due Process in Setting Standards:

- Identification of issues.
- Research and analysis.
- Public hearings and exposure drafts.
- Finalizing and issuing standards after considering feedback.

Importance of GAAP:

- Ensures financial statements are comparable, reliable, and transparent.
- Helps investors make informed decisions.
- Supports efficient capital markets.

Activity 2: Components and Usefulness of the Conceptual Framework

Learning Objective: Students will describe the components and usefulness of the conceptual framework, aligning with LO 1.2 (Describe the components and usefulness of the conceptual framework).

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Instructions for Instructors:

1. **Scenario Context:**
    - Students act as members of an accounting standards advisory committee tasked with explaining the conceptual framework to stakeholders. This will help them understand the framework's role in guiding standard setting and financial reporting.
    - **Data Provided:**
        - Components of the conceptual framework: Objective of financial reporting, qualitative characteristics of useful financial information, elements of financial statements, and assumptions and principles.
    - **Steps to Follow:**

1. Describe the objective of financial reporting.
2. Explain the qualitative characteristics of useful financial information.
3. List and describe the elements of financial statements.
4. Discuss the basic assumptions and principles underlying financial reporting.

2. **What Students Should Work Out Themselves:**
    - Summarize each component of the conceptual framework.
    - Explain how these components contribute to the usefulness of financial information.
3. **What Students Should Use AI For:**
    - Generate descriptions and explanations of the components of the conceptual framework.
    - Provide examples of how these components enhance the usefulness of financial information.
4. **Sample Prompt for AI Model:**

Describe the components of the conceptual framework of financial reporting, including the objective of financial reporting, qualitative characteristics of useful financial information, elements of financial statements, and the basic assumptions and principles. Explain how these components contribute to the usefulness of financial information.

Answer Key:

Objective of Financial Reporting:

- Provide financial information useful for making decisions about providing resources to the entity.

Qualitative Characteristics of Useful Financial Information:

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- **Fundamental Qualities:** Relevance (predictive value, confirmatory value, materiality) and Faithful Representation (completeness, neutrality, free from error).
- **Enhancing Qualities:** Comparability, verifiability, timeliness, understandability.

Elements of Financial Statements:
- Assets, liabilities, equity, investments by owners, distributions to owners, comprehensive income, revenues, expenses, gains, losses.

Basic Assumptions and Principles:
- **Assumptions:** Economic entity, going concern, monetary unit, periodicity.
- **Principles:** Measurement, revenue recognition, expense recognition, full disclosure.

Usefulness of Financial Information:
- Ensures information is relevant and faithfully represented.
- Enhances comparability, verifiability, timeliness, and understandability.
- Supports informed decision-making by investors and creditors.

Activity 3: Operational Concepts

Learning Objective: Students will discuss the basic assumptions and principles of accounting, aligning with LO 1.3 (Discuss the basic operational concepts of GAAP).

Instructions for Instructors:

1. **Scenario Context:**
    - Students are accountants at a mid-sized firm tasked with training new hires on the basic assumptions and principles of accounting. This will help them understand the foundation of financial reporting practices.
    - **Data Provided:**
        - Basic assumptions: Economic entity, going concern, monetary unit, periodicity.
        - Basic principles: Measurement (historical cost and fair value), revenue recognition, expense recognition, full disclosure.
    - **Steps to Follow:**

1. Explain each of the basic assumptions in accounting.
2. Describe the basic principles of accounting.
3. Provide examples of how these assumptions and principles are applied in practice.

2. **What Students Should Work Out Themselves:**
    - Summarize each assumption and principle.

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- Provide examples demonstrating the application of these assumptions and principles.

3. **What Students Should Use AI For:**
   - Generate explanations and examples of the basic assumptions and principles of accounting.
   - Verify their summaries and examples.
4. **Sample Prompt for AI Model:**

Explain the basic assumptions and principles of accounting, including the economic entity, going concern, monetary unit, and periodicity assumptions, as well as the measurement, revenue recognition, expense recognition, and full disclosure principles. Provide examples of how these assumptions and principles are applied in practice.

Answer Key:

Basic Assumptions:

- **Economic Entity:** Separates personal and business transactions.
- **Going Concern:** Assumes the business will continue to operate indefinitely.
- **Monetary Unit:** Financial reporting is done in a stable currency.
- **Periodicity:** Financial information is reported for specific time periods.

Basic Principles:

- **Measurement:** Use of historical cost and fair value for asset valuation.
- **Revenue Recognition:** Revenue is recognized when earned and realizable.
- **Expense Recognition:** Expenses are recognized when incurred to generate revenue.
- **Full Disclosure:** All relevant financial information is disclosed in the financial statements.

Examples:

- **Economic Entity:** A business owner's personal expenses are not included in the company's financial statements.
- **Going Concern:** Assets are not valued at liquidation prices, assuming the business will continue operating.
- **Monetary Unit:** Financial statements are presented in U.S. dollars.
- **Periodicity:** Companies issue quarterly and annual financial statements.
- **Measurement:** A building is recorded at its purchase price (historical cost) or market value (fair value).
- **Revenue Recognition:** A software company recognizes revenue when the software is delivered to the customer.

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- **Expense Recognition:** A retailer records the cost of goods sold when the related sales revenue is recognized.
- **Full Disclosure:** A company includes notes in its financial statements detailing pending litigation.

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CHAPTER 1

The Environment and Conceptual Framework of Financial Reporting

ASSIGNMENT CLASSIFICATION TABLE (By Topic)

Topics		Questions	Brief Exercises	Exercises
1.	Financial reporting environment.	1, 2		1,2
2.	Standards and standard setting bodies.	3, 4, 5, 6	1, 2	2
3.	Conceptual framework.	7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17, 18, 19	3, 4, 5, 6, 7, 8	3,4,5,6,7
4.	Assumptions and principles.	20, 21, 22, 23, 24, 25, 26, 27, 28, 29, 30, 31, 32, 33	9, 10, 11, 12, 13	8,9,10,11,12
5.	Challenges in financial reporting.	34, 35, 36, 37, 38		2
6.	Ethical issues.	39		

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ASSIGNMENT CLASSIFICATION TABLE (BY LEARNING OBJECTIVE)

Learning Objectives	Brief Exercises	Exercises	Critical Thinking Cases
1. Describe the financial reporting environment, major standard-setting bodies, and the meaning of general accepted accounting principles (GAAP).	1, 2	1,2	1
2. Describe the components and usefulness of the conceptual framework.	3,4,5,6,7, 8	3,4,5,6,7	2, 3, 4, 5, 10
3. Discuss the basic operational concepts of GAAP.	9,10,11, 12,13	8,9,10, 11,12	6, 7, 8, 9, 11, 12
4. Identify the major challenges in the financial reporting environment.		2	3, 11, 13, 14, 15, 16

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ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
E1-1	Need for GAAP.	Simple	15–20
E1-2	Financial reporting and accounting standards.	Simple	15–20
E1-3	Usefulness, objectives of financial reporting.	Simple	15–20
E1-4	Usefulness, objectives of financial reporting, qualitative characteristics.	Simple	15–20
E1-5	Qualitative characteristics.	Moderate	20–25
E1-6	Qualitative characteristics.	Simple	15-20
E1-7	Elements of financial statements.	Simple	15–20
E1-8	Assumptions, principles, and constraint.	Simple	15-20
E1-9	Assumptions, principles, and constraint.	Simple	20–25
E1-10	Full disclosure principle.	Complex	30–40
E1-11	Accounting principles and assumptions - comprehensive.	Moderate	20-25
E1-12	Accounting principles - comprehensive.	Moderate	30–40

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LEARNING OBJECTIVES

1. Describe the financial reporting environment, major standard-setting bodies, and the meaning of general accepted accounting principles (GAAP).
2. Describe the components and usefulness of the conceptual framework.
3. Discuss the basic operational concepts of GAAP.
4. Identify the major challenges in the financial reporting environment.

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CHAPTER REVIEW

1. Chapter 1 describes the environment that has influenced both the development and use of the financial accounting process. The chapter traces the development of financial accounting standards, focusing on the groups that have had or currently have the responsibility for developing such standards. Certain groups other than those with direct responsibility for developing financial accounting standards have significantly influenced the standard-setting process. These various pressure groups are also discussed.

Financial Reporting Environment

2. (L.O. 1) The essential characteristics of accounting are (1) the identification, measurement, and communication of financial information about (2) economic entities to (3) interested parties. **Financial accounting** is the process that culminates in the preparation of financial reports on the enterprise for use by both internal and external parties.

3. **Financial statements** are the principal means through which a company communicates its financial information to those outside it. The financial statements most frequently provided are (1) the balance sheet, (2) the income statement, (3) the statement of cash flows, and (4) the statement of owners' or stockholders' equity. Other means of financial reporting include the president's letter or supplementary schedules in the corporate annual report, prospectuses, reports filed with government agencies, news releases, management forecasts, and social or environmental impact statements.

4. **Financial reporting** helps investors to assess the amounts, timing and uncertainty of future cash flows from dividends, interest and the proceeds from the sale or maturity of investments. It also helps to compare income and assets of different companies.

Accounting, Decision-Usefulness, and Capital Allocation

5. Accounting is important for markets, free enterprise, and competition because it assists in providing information that leads to capital allocation. The better the information, the more effective the process of capital allocation and then the healthier the economy.

Need to Develop Standards

6. To enhance the decision-usefulness of accounting information, the accounting profession has developed a set of standards that are generally accepted and universally practiced.

7. This common set of standards and procedures are known as **generally accepted accounting principles (GAAP).** These principles serve as a general guide to the accounting practitioner in accumulating and reporting the financial information of a business enterprise.

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Securities and Exchange Commission (SEC)

8. After the stock market crash in 1929 and the Great Depression, there were calls for increased government regulation and supervision—especially of financial institutions and the stock market. As a result, the federal government established the Securities and Exchange Commission (**SEC**) to help develop and standardize financial information presented to stockholders. The SEC is a federal agency and administers the Securities Exchange Act of 1934 and several other acts. Most companies that issue securities to the public or are listed on a stock exchange are required to file audited financial statements with the SEC. In addition, the SEC has broad powers to prescribe the accounting practices and standards to be employed by companies that fall within its jurisdiction.

9. At the time the SEC was created, it encouraged the creation of a private standards-setting body. As a result, accounting standards have generally been developed in the private sector either through the American Institute of Certified Public Accountants (**AICPA**) or the Financial Accounting Standards Board (**FASB**). The SEC has affirmed its support for the FASB by indicating that financial statements conforming to standards set by the FASB will be presumed to have substantial authoritative support.

10. Over its history, the SEC's involvement in the development of accounting standards has varied. In some cases, the private sector has attempted to establish a standard, but the SEC has refused to accept it. In other cases, the SEC has prodded the private sector into taking quicker action on setting standards.

11. If the SEC believes that an accounting or disclosure irregularity exists regarding a company's financial statements, the SEC sends a deficiency letter to the company. If the company's response to the deficiency letter proves unsatisfactory, the SEC has the power to issue a "stop order," which prevents the registrant from issuing securities or trading securities on the exchanges. Criminal charges may also be brought by the Department of Justice.

Financial Accounting Standards Board (FASB)

12. The FASB represents the current rule-making body within the accounting profession. The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, which includes issuers, auditors, and users of financial information.

    Two basic premises of the FASB are that in establishing financial accounting standards: (a) it should be responsive to the needs and viewpoints of the entire economic community, not just the public accounting profession, and (b) it should operate in full view of the public through a "due process" system that gives interested persons ample opportunity to make their views known.

Due Process

13. The FASB issues two major types of pronouncements:

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a. **Accounting Standards Updates.** The Updates amend the Accounting Standards Codification, which represents the source of authoritative accounting standards, other than standards issued by the SEC. Each Update explains how the Codification has been amended and also includes information to help the reader understand the changes and when those changes will be effective. They are considered GAAP and must be followed in practice.

b. **Financial Accounting Concepts**. The Statements of Financial Accounting Concepts (SFAC) represent an attempt to move away from the problem-by-problem approach to standard setting that has been characteristic of the accounting profession. The Concept Statements are intended to form a cohesive set of interrelated concepts, a conceptual framework that will serve as tools for solving existing and emerging problems in a consistent manner. Unlike FASB statements, the Concept Statements do not establish GAAP.

FASB Codification

14. Generally accepted accounting principles (GAAP) are those principles that have **substantial authoritative support.** Accounting principles that have substantial authoritative support are those found in FASB Statements, Interpretations, and Staff Positions; APB Opinions; and Accounting Research Bulletins (ARBs). If an accounting transaction is not covered in any of these documents, the accountant may look to other authoritative accounting literature for guidance.

15. The FASB developed the Financial Accounting Standards Board Accounting Standards Codification ("**the Codification**") to provide in one place all the authoritative literature related to a particular topic. The Codification changes the way GAAP is documented, presented, and updated.

Conceptual Framework

16. (L.O. 2) **The conceptual framework** in accounting is important because rule-making should be built on and relate to an established body of concepts. The benefits of a soundly developed conceptual framework are as follows: (a) it should be easier to issue a coherent set of standards and rules; and (b) practical problems should be more quickly solved. There are eight chapters in the conceptual framework.

Chapter 1 - The Objective

17. The basic objective of financial reporting is the foundation of the conceptual framework and requires that general-purpose financial reporting provide information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions about providing resources to the entity. To understand general-purpose financial reporting, users need reasonable knowledge of business and financial matters.

Chapter 2 - The Reporting Entity

18. The reporting entity concept refers to companies that prepare general purpose financial reports.

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Chapter 3 - Qualitative Characteristics

19. The fundamental qualities of accounting information are:

    a. **Relevance** – information that is capable of making a difference in a decision. Comprised of

        1. **Predictive value** means that the information can help users form expectations about the future.
        2. **Confirmatory value** means that the information validates or refutes expectations based on previous evaluations.
        3. **Materiality** means that information is material if omitting it or misstating it could influence decisions that users make on the basis of the reported financial information.

    b. **Faithful representation** – numbers and descriptions match what really happened or existed. Comprised of

        1. **Completeness** means that all necessary information is provided.
        2. **Neutrality** means that the information is unbiased.
        3. **Free from error** means that the information is accurate.

Enhancing Qualities

20. Enhancing qualities complement the fundamental qualities and include:

    a. **Comparability** means that companies record and report information in a similar manner. **Consistency** is another type of comparability and means the company uses the same accounting methods from period to period.

    b. **Verifiability** means that independent people using the same methods arrive at similar conclusions.

    c. **Timeliness** means that information is available before it loses its relevance.

    d. **Understandability** means that reasonably informed users should be able to comprehend the information that is clearly classified and presented.

Chapter 4 - Elements

21. An important aspect of developing an accounting theoretical structure is the body of basic elements or definitions. Ten basic elements that are most directly related to measuring the performance and financial status of a business enterprise are formally defined in *SFAC No. 8, Chapter 4*. These elements, as defined below, are further discussed and interpreted throughout the text. Divided into two distinct groups: assets, liabilities and equity (net assets) are described at a point in time while the remaining seven elements describe transactions during a period of time.

    Assets. Present rights of an entity to economic benefits.

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Liabilities. Present obligations of an entity to transfer economic benefits.

Equity or Net Assets. Residual interest in the assets of an entity that remains after deducting its liabilities.

Investments by Owners. Increases in equity of an entity resulting from transfers to the entity from other entities of something of valuable to obtain or increase ownership interests (or equity) in the entity. Assets are most commonly received as investments by owners, but that which is received may include services or satisfaction or conversion of liabilities of the entity.

Distributions to Owners. Decreases in equity of an entity resulting from transferring assets, rendering services, or incurring liabilities by the entity to owners. Distributions to owners decrease ownership interests (or equity) in an entity.

Comprehensive Income. Change in equity (net assets) of an entity 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.

Revenues. 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 carrying out other activities.

Expenses. Outflows or other using up of assets of an entity or incurrences of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities.

Gains. Increases in equity (net assets) from transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners.

Losses. Decreases in equity (net assets) from transactions and other events and circumstances affecting the entity except those that result from expenses or distributions to owners.

Chapter 5 – Recognition and Derecognition

22. This chapter sets forth criteria to guide when an item should be incorporated into, recognition, or removed from, derecognition, the financial statements. For an item to be recognized, it must (1) meet the definition of an element, (2) have a relevant measurement, and (3) meet the requirements of faithful representation.

Chapter 6 – Measurement

23. Measurement is the process of determining the relevant numerical depictions of items recognized in the financial statements.

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Chapter 7 – Presentation

24. Presentation relates to the display of line items, totals, and subtotals on the financial statements.

Chapter 8 – Notes

25. Notes to financial statements generally amplify or explain the items presented in the main body of the financial statements.

Operational Concepts

26. (L.O. 3) In the practice of financial accounting, certain basic assumptions are important to an understanding of the manner in which data are presented. The following four basic assumptions underlie the financial accounting structure:

    Economic Entity Assumption. Economic activity can be identified with a particular unit of accountability in a manner that assumes the company is separate and distinct from its owners or other business units. This assumption and the reporting entity concept identified in the conceptual framework are very similar. The main difference is that the reporting entity concept is limited to general purpose financial reporting whereas the economic entity assumption is broader in scope.

    Going Concern Assumption. In the absence of contrary information, a company is assumed to have a long life. The current relevance of the historical cost principle is dependent on the going-concern assumption.

    Monetary Unit Assumption. Money is the common denominator of economic activity and provides an appropriate basis for accounting measurement and analysis. The monetary unit is assumed to remain relatively stable over the years in terms of purchasing power. In essence, this assumption disregards any inflation or deflation in the economy in which the company operates.

    Periodicity Assumption. The economic activities of a company can be divided into artificial time periods for the purpose of providing the company's periodic reports.

Basic Principles

27. Certain **basic principles** are followed by accountants in recording and reporting the transactions of a business entity. These principles relate to how assets, liabilities, revenues, and expenses are to be **identified, measured,** and **reported.**

    Measurement Principle. A 'mixed-attribute' system permits the use of various measurement bases.

    Historical Cost Principle. Acquisition cost is considered a reliable basis upon which to account for assets and liabilities of a company. Historical cost has an advantage over other valuations, as it is thought to be verifiable.

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Fair Value Principle. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. GAAP has increasingly called for the use of fair value measurements in the financial statements that is divided into three levels: 1) based on independent third party quoted prices: least subjective, 2) evaluate similar assets or liabilities: more subjective, and 3) observable inputs based on company's data or assumptions: most subjective.

Revenue Recognition Principle. Revenue is recognized at the time in which the performance obligation is satisfied.

Expense Recognition Principle (matching principle). Recognition of expenses is related to net changes in assets and earning revenues. The expense recognition principle is implemented in accordance with the definition of expense by matching efforts (expenses) with accomplishment (revenues).

Product costs, such as material, labor, and overhead, attach to the product, and are recognized in the same period the products are sold.

Period costs, such as officers' salaries and other administrative expenses, attach to the period, and are recognized in the period incurred.

Full Disclosure Principle. In the preparation of financial statements, the accountant should include sufficient information to influence the judgment and decision of an informed user. A series of judgmental tradeoffs must occur.

Financial Statements. To be recognized in the main body of the financial statements, an item should meet the definition of a basic element, be measurable with sufficient certainty, and be faithfully represented.

Notes to the Financial Statements. The purpose of the notes is to amplify or explain items presented in the main body of the statements.

Supplementary Information. May include details or amounts that represent a different perspective than those adopted in the financial statements.

Cost Constraint

28. Although accounting theory is based upon certain assumptions and the application of basic principles, there are some exceptions to these assumptions. One exception is often called a constraint, and sometimes justifies departures from basic accounting theory.

    Cost Constraint. The cost constraint (or cost-benefit relationship) relates to the notion that the benefits to be derived from providing certain accounting information should exceed the costs of providing that information. The difficulty in cost-benefit analysis is that the costs and especially the benefits are not always evident or measurable.

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Major Challenges in Financial Reporting

29. User groups (CPA's AICPA, Financial Community, Preparers, etc.) play a significant role in influencing GAAP.

Expectations Gap

30. The expectations gap is the difference between what the public thinks accountants should do versus what accountants think they can do. This issue was formalized due to the Sarbanes-Oxley Act (SOX) that arose due to numerous accounting scandals. Key legislation resulting from SOX are:

    a. Creation of an external oversight board, the (Public Company Accounting Oversight Board (PCAOB).

    b. CEOs and CFOs have to certify the financial statements and will forfeit bonuses and profits when there is an accounting restatement.

    c. Audit committee members must have financial expertise and be independent members of the board of directors.

    d. Large public companies must document and evaluate the effectiveness of their internal controls over financial reporting.

Financial Reporting

31. Some of the challenges facing financial reporting in the future include:

    a. **Nonfinancial measurements,** which include customer satisfaction indexes, backlog information, and reject rates on goods purchased.

    b. **Forward-looking information.**

    c. **Soft assets** include such intangibles as market dominance, expertise in supply chain management, and brand image.

    d. **Timeliness,** including real-time financial statement information.

    e. **Understandability,** including concerns about the complexity and lack of understandability of financial reports raised by investors and market regulators.

32. In accounting, ethical dilemmas are encountered frequently. The whole process of ethical sensitivity and selection among alternatives can be complicated by pressures that may take the form of time pressures, job pressures, client pressures, personal pressures, and peer pressures. Throughout the text, ethical considerations are presented to sensitize you to the type of situations you may encounter in your profession.

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LECTURE OUTLINE

The material in this chapter usually can be covered in one class session. The issues in this chapter can be addressed by organizing a lecture around the following.

A. (L.O. 1) Financial Reporting Environment.

1. **Identification, measurement,** and **communication** of financial information.

    a. Financial statements:

        (1) Income statement.

        (2) Balance sheet.

        (3) Statement of cash flows.

        (4) Statement of owners' or stockholders' equity.

2. About **economic entities.**

3. To **interested parties** (including owner/managers, creditors, stockholders, government agencies, management, employees, consumers, labor unions, etc.).

B. Need for accounting standards.

1. To meet the various needs of users, companies prepare a single set of general-purpose financial reports.

2. Users expect financial statements to present fairly, clearly, and completely the company's financial operations.

3. The accounting profession has developed a set of standards and procedures called **generally accepted accounting principles (GAAP)**.

C. Parties involved in standard-setting.

1. Securities and Exchange Commission (SEC). The role of the SEC, reasons for its establishment, SEC jurisdiction.

2. Delegation of SEC's authority to the FASB.

3. Financial Accounting Standards Board (FASB).

    a. Description of the FASB's "due process" system in setting standards.

    b. Two major types of pronouncements issued by FASB:

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(1) **Accounting Standards Updates** amend the Accounting Standards Codification, which represents the source of authoritative accounting standards, other than standards issued by the SEC.

(2) **Financial Accounting Concepts** represent an attempt to move away from the problem-by-problem approach to standard setting that has been characteristic of the accounting profession. The Concept Statements are intended to form a cohesive set of interrelated concepts, a conceptual framework.

c. The FASB developed the Financial Accounting Standards Board Accounting Standards Codification ("the Codification").

a. The Codification changes the way GAAP is documented, presented and updated.

b. Explains what GAAP is and eliminates nonessential information.

D. (L.O. 2) Need for a Conceptual Framework.

1. Build on and relate to an established body of concepts.
2. Issue more useful and consistent pronouncements over time.
3. Increase financial statement users' understanding of and confidence in financial reporting.
4. Enhance comparability among companies' financial statements.
5. Provide a framework for solving new and emerging practical problems.

E. Chapter 1 - Objective

1. Information that is **useful** to present and potential equity **investors, lenders** and other **creditors** in making decisions in their capacity as capital providers.
2. Information helpful to capital providers may also be helpful to other users who are not capital providers.

F. Chapter 2 – The Reporting Entity – refers to companies that prepare general purpose financial reports.

G. Chapter 3 – Qualitative Characteristics The overriding criterion for evaluating accounting information is that it must be **useful for decision making.**

a. Fundamental qualities of useful accounting information.

(1) **Relevance.** Accounting information is relevant if it is capable of making a difference in a decision. Relevant information has

(a) Predictive value.

(b) Confirmatory value.

(c) Materiality.

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(2) **Faithful Representation.** For accounting information to be useful, the numbers and descriptions contained in the financial statements must faithfully represent what really existed or happened. To be a faithful representation, information must be

(a) Complete.

(b) Neutral.

(c) Free of error.

H. Enhancing qualities of useful accounting information.

(1) **Comparability.** Information that is measured and reported in a similar manner for different companies is considered comparable. **Consistency** exists when a company applies the same accounting treatment to similar events, period to period.

(2) **Verifiability.** When independent measurers, using the same methods, obtain similar results.

(3) **Timeliness.** Having information available to decision-makers before it loses its capacity to influence decisions.

(4) **Understandability.** When information lets reasonably informed users see the connection between their decisions and the information contained in the financial statements.

I. Chapter 4 - Elements. (See text page 1-18 for definitions.) Items a-c are elements at a moment in time. Items d-j are elements during a period of time.

a. Assets.

b. Liabilities.

c. Equity or net assets.

d. Investments by owners.

e. Distributions to owners.

f. Comprehensive income.

g. Revenues.

h. Expenses.

i. Gains.

j. Losses.

J. Chapter 5 – Recognition and Derecognition

(1) To be recognized in the financial statements, an item must

a. meet the definition of an element.

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b. have a relevant measurement.

c. meet the requirement of faithful representation.

(2) To be derecognized in the financial statements, an item ceases to meet the criteria for recognition.

K. Chapter 6 – Measurement – process of determining relevant numerical depictions of items recognized in the financial statements.

L. Chapter 7 – Presentation – relates to the display of line items, totals, and subtotals on the financial statements.

M. Chapter 8 – Notes – amplify or explain the items presented in the main body of the statements.

N. (L.O. 3) Operational Concepts

1. Assumptions.

a. **Economic entity assumption**. Economic activity can be identified with a particular unit of accountability.

b. **Going concern assumption**. Companies will have a long enough life to justify depreciation and amortization.

c. **Monetary unit assumption**. The monetary unit (i.e., the dollar) is the most effective means of expressing to interested parties changes in capital and exchanges of goods and services. A second assumption is that the monetary unit remains reasonably stable.

d. **Periodicity assumption.** Activities of an enterprise can be divided into artificial time periods.

2. Basic Principles.

a. **Measurement principle**. GAAP permits the use of historical cost and fair value bases.

(1) **Historical cost principle.** Generally thought to be verifiable.

(2) **Fair value principle.** Fair value information may be more useful for certain types of assets and liabilities. The three broad levels of the fair value hierarchy are:

a. **Level 1**. Observable inputs that reflect quoted prices for identical assets or liabilities in active markets.
b. **Level 2**. Inputs other than quoted prices included in Level 1 that are observable for the asset or liability either directly or through corroboration with observable data.

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c. **Level 3**. Unobservable inputs such as discounted expected future net cash flows.

b. **Revenue recognition principle.** Revenue is recognized at the time in which the performance obligation is satisfied.

c. **Expense recognition principle (matching principle).** Efforts (expenses) should be matched with accomplishments (revenues) if feasible.

(1) Practical rules for expense recognition: Analyze costs to determine whether a direct relationship exists with revenue.

(a) When a direct relationship exists, expense costs against revenues in the period when the revenue is recognized.

(b) When a direct relationship exists but is difficult to identify, allocate costs rationally and systematically to an expense in the periods benefited.

(c) When little, if any, direct relationship exists, expense as incurred.

d. **Full disclosure principle.** Reveals in financial statements any facts of sufficient importance to influence the judgment and decisions of an informed reader. (Develop concept of reasonably prudent investor.) Discuss use of notes and supplementary information in financial reporting.

3. **Cost constraint.** The benefit to be derived from having accounting information should exceed the cost of providing it. Frequently it is easier to assess the costs than it is to determine the benefits of providing a particular item of information.

O. (L.O. 4) Major challenges in the financial reporting environment.

1. **Politicization** and the impact of various user groups on the development of GAAP.

2. The **expectations gap.**

a. What people think accountants should do vs. what accountants think they can do.

b. Sarbanes-Oxley Act and the Public Company Accounting Oversight Board.

3. Financial reporting challenges:

a. Nonfinancial measurements. Financial reports failed to provide some key performance measures widely used by management.

b. Forward-looking information. Financial reports failed to provide forward-looking information needed by present and potential investors and creditors

c. Soft assets. Financial reports focused on hard assets (inventory, plant assets) but failed to provide much information about a company's soft assets (intangibles).

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d. Timeliness. Generally only historical information is provided with little to no real-time financial statement information available.

e. Understandability. Financial reports are often complex and hard to understand.

P. Ethics and financial accounting.

1. In accounting, companies frequently encounter ethical dilemmas. Some of these dilemmas are easy to resolve but many are not, requiring difficult choices among allowable alternatives.

2. Time, job, client, personal, and peer pressures can complicate the process of ethical sensitivity and selection among alternatives.

3. Decisions are sometimes difficult because a public consensus has not emerged to formulate a comprehensive ethical system that provides guidelines in making ethical judgments.

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Artificial Intelligence Activities

Prepared by Mfon Akpan, DBA, CGMA, Methodist University

Chapter 1: The Environment and Conceptual Framework of Financial Reporting

Disclaimer: Artificial intelligence platforms continuously change with frequent and often unexpected updates. The AI prompts and content in this book were designed and tested with the most current models available at the time of writing. However, as technology advances, instructors are encouraged to verify the accuracy and functionality of the sample prompts with the latest AI tools they are using.

This book offers adaptable prompts that can be customized to fit the latest AI capabilities, ensuring a cutting-edge learning experience. For those new to AI, step-by-step guides and support are available to help effectively implement these activities in your classroom. Whether or not you are familiar with AI, these prompts and exercises are designed to be engaging and educational, providing flexibility and enhancing your teaching strategies. By experimenting with these tools, you can discover new ways to enrich your student's learning experience and stay aligned with the latest developments in the field.

Activity 1: Understanding the Financial Reporting Environment

Learning Objective: Students will describe the financial reporting environment, major standard-setting bodies, and the meaning of generally accepted accounting principles (GAAP), aligning with LO 1.1 (Describe the financial reporting environment, major standard-setting bodies, and the meaning of GAAP).

Instructions for Instructors:

1. **Scenario Context:**
    - Imagine your students are financial analysts tasked with explaining the financial reporting environment to new interns at a financial firm. This exercise will help them understand the major standard-setting bodies and the significance of GAAP.
    - **Data Provided:**
        - Major standard-setting bodies: Financial Accounting Standards Board (FASB), Securities and Exchange Commission (SEC), International Accounting Standards Board (IASB).
        - Key concepts: GAAP, due process in standard setting, and the role of the SEC in overseeing the FASB.
    - **Steps to Follow:**

1. Explain the roles of the FASB, SEC, and IASB in setting accounting standards.
2. Describe the process through which the FASB sets standards.
3. Discuss the importance of GAAP in ensuring comparability and transparency in financial reporting.

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2. **What Students Should Work Out Themselves:**
    - Summarize the roles of each standard-setting body.
    - Explain the due process in setting standards.
3. **What Students Should Use AI For:**
    - Generate explanations and descriptions of the roles of the FASB, SEC, and IASB.
    - Provide examples of how GAAP ensures comparability and transparency in financial reporting.
4. **Sample Prompt for AI Model:**

Explain the roles of the Financial Accounting Standards Board (FASB), Securities and Exchange Commission (SEC), and International Accounting Standards Board (IASB) in setting accounting standards. Describe the process the FASB follows to set standards and discuss the importance of GAAP in financial reporting.

Answer Key:

Roles of Standard-Setting Bodies:

- **FASB:** Develops GAAP for the private sector in the U.S.
- **SEC:** Oversees the FASB and enforces compliance with GAAP among public companies.
- **IASB:** Develops International Financial Reporting Standards (IFRS) used by many countries outside the U.S.

Due Process in Setting Standards:

- Identification of issues.
- Research and analysis.
- Public hearings and exposure drafts.
- Finalizing and issuing standards after considering feedback.

Importance of GAAP:

- Ensures financial statements are comparable, reliable, and transparent.
- Helps investors make informed decisions.
- Supports efficient capital markets.

Activity 2: Components and Usefulness of the Conceptual Framework

Learning Objective: Students will describe the components and usefulness of the conceptual framework, aligning with LO 1.2 (Describe the components and usefulness of the conceptual framework).

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Instructions for Instructors:

1. **Scenario Context:**
    - Students act as members of an accounting standards advisory committee tasked with explaining the conceptual framework to stakeholders. This will help them understand the framework's role in guiding standard setting and financial reporting.
    - **Data Provided:**
        - Components of the conceptual framework: Objective of financial reporting, qualitative characteristics of useful financial information, elements of financial statements, and assumptions and principles.
    - **Steps to Follow:**

1. Describe the objective of financial reporting.
2. Explain the qualitative characteristics of useful financial information.
3. List and describe the elements of financial statements.
4. Discuss the basic assumptions and principles underlying financial reporting.

2. **What Students Should Work Out Themselves:**
    - Summarize each component of the conceptual framework.
    - Explain how these components contribute to the usefulness of financial information.
3. **What Students Should Use AI For:**
    - Generate descriptions and explanations of the components of the conceptual framework.
    - Provide examples of how these components enhance the usefulness of financial information.
4. **Sample Prompt for AI Model:**

Describe the components of the conceptual framework of financial reporting, including the objective of financial reporting, qualitative characteristics of useful financial information, elements of financial statements, and the basic assumptions and principles. Explain how these components contribute to the usefulness of financial information.

Answer Key:

Objective of Financial Reporting:

- Provide financial information useful for making decisions about providing resources to the entity.

Qualitative Characteristics of Useful Financial Information:

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- **Fundamental Qualities:** Relevance (predictive value, confirmatory value, materiality) and Faithful Representation (completeness, neutrality, free from error).
- **Enhancing Qualities:** Comparability, verifiability, timeliness, understandability.

Elements of Financial Statements:
- Assets, liabilities, equity, investments by owners, distributions to owners, comprehensive income, revenues, expenses, gains, losses.

Basic Assumptions and Principles:
- **Assumptions:** Economic entity, going concern, monetary unit, periodicity.
- **Principles:** Measurement, revenue recognition, expense recognition, full disclosure.

Usefulness of Financial Information:
- Ensures information is relevant and faithfully represented.
- Enhances comparability, verifiability, timeliness, and understandability.
- Supports informed decision-making by investors and creditors.

Activity 3: Operational Concepts

Learning Objective: Students will discuss the basic assumptions and principles of accounting, aligning with LO 1.3 (Discuss the basic operational concepts of GAAP).

Instructions for Instructors:

1. **Scenario Context:**
    - Students are accountants at a mid-sized firm tasked with training new hires on the basic assumptions and principles of accounting. This will help them understand the foundation of financial reporting practices.
    - **Data Provided:**
        - Basic assumptions: Economic entity, going concern, monetary unit, periodicity.
        - Basic principles: Measurement (historical cost and fair value), revenue recognition, expense recognition, full disclosure.
    - **Steps to Follow:**

1. Explain each of the basic assumptions in accounting.
2. Describe the basic principles of accounting.
3. Provide examples of how these assumptions and principles are applied in practice.

2. **What Students Should Work Out Themselves:**
    - Summarize each assumption and principle.

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- Provide examples demonstrating the application of these assumptions and principles.

3. **What Students Should Use AI For:**
   - Generate explanations and examples of the basic assumptions and principles of accounting.
   - Verify their summaries and examples.
4. **Sample Prompt for AI Model:**

Explain the basic assumptions and principles of accounting, including the economic entity, going concern, monetary unit, and periodicity assumptions, as well as the measurement, revenue recognition, expense recognition, and full disclosure principles. Provide examples of how these assumptions and principles are applied in practice.

Answer Key:

Basic Assumptions:

- **Economic Entity:** Separates personal and business transactions.
- **Going Concern:** Assumes the business will continue to operate indefinitely.
- **Monetary Unit:** Financial reporting is done in a stable currency.
- **Periodicity:** Financial information is reported for specific time periods.

Basic Principles:

- **Measurement:** Use of historical cost and fair value for asset valuation.
- **Revenue Recognition:** Revenue is recognized when earned and realizable.
- **Expense Recognition:** Expenses are recognized when incurred to generate revenue.
- **Full Disclosure:** All relevant financial information is disclosed in the financial statements.

Examples:

- **Economic Entity:** A business owner's personal expenses are not included in the company's financial statements.
- **Going Concern:** Assets are not valued at liquidation prices, assuming the business will continue operating.
- **Monetary Unit:** Financial statements are presented in U.S. dollars.
- **Periodicity:** Companies issue quarterly and annual financial statements.
- **Measurement:** A building is recorded at its purchase price (historical cost) or market value (fair value).
- **Revenue Recognition:** A software company recognizes revenue when the software is delivered to the customer.

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- **Expense Recognition:** A retailer records the cost of goods sold when the related sales revenue is recognized.
- **Full Disclosure:** A company includes notes in its financial statements detailing pending litigation.

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