**ENVIRONMENT AND THEORETICAL STRUCTURE OF FINANCIAL ACCOUNTING**

**Overview**

The primary function of financial accounting is to provide useful financial information to users external to the business enterprise. The focus of financial accounting is on the information needs of investors and creditors. These users make critical resource allocation decisions that affect the nation’s economy. The primary means of conveying financial information to investors, creditors, and other external users is through financial statements and related notes.

In this chapter you explore important topics such as the FASB’s conceptual framework that serve as a foundation for a more detailed study of financial statements, the way the elements of these statements are measured, and the concepts underlying these measurements and related disclosures.

**Learning Objectives**

LO1–1 Describe the function and primary focus of financial accounting.

LO1–2 Explain the difference between cash and accrual accounting.

LO1–3 Define generally accepted accounting principles (GAAP) and discuss the historical development of accounting standards, including convergence between U.S. and international standards.

LO1–4 Explain why the establishment of accounting standards is characterized as a political process.

LO1–5 Explain factors that encourage high-quality financial reporting.

LO1–6 Explain the purpose of the conceptual framework.

LO1–7 Identify the objective and qualitative characteristics of financial reporting information, and the elements of financial statements.

LO1–8 Describe the four basic assumptions underlying GAAP.

LO1–9 Describe the recognition, measurement and disclosure concepts that guide accounting practice.

LO1–10 Contrast a revenue/expense approach and an asset/liability approach to accounting standard setting.

LO1–11 Discuss the primary differences between U.S. GAAP and IFRS with respect to the development of accounting standards and the conceptual framework underlying accounting standards.

**Lecture Outline**

**Part A: Financial Accounting Environment**

**I. The Function and Primary Purpose of Financial Accounting**

A. There are a number of financial information supplier groups as well as several external user groups. (T1-1)

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

C. Financial statements convey financial information to external users. (T1-2)

1. Balance sheet or statement of financial position

2. Income statement or statement of operations

3. Statement of cash flows

4. Statement of shareholders' equity

5. Starting in 2012, either

a) a statement of other comprehensive income immediately following the income statement, or

b) a statement of comprehensive income (including information on the income statement as well as on the statement of other comprehensive income).

**II. The Economic Environment and Financial Reporting**

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

B. Corporations, the dominant form of business organization in the United States in terms of the ownership of productive resources, acquire capital from investors in exchange for ownership interest and by borrowing from creditors.

C. The investment-credit decision—A cash flow perspective

1. A company will be able to provide a return to investors and creditors only if it can generate cash receipts from selling a product or service that exceed the cash disbursements necessary to provide that product or service.

2. The objective of financial accounting is to provide information to investors and creditors to help them predict future cash flows.

D. Cash versus accrual accounting

1. Over short periods of time, operating cash flow may not be an accurate predictor of future operating cash flows.

2. The accrual accounting model provides a measure of periodic performance called net income.

3. Net income is considered a better indicator of future operating cash flows than is current net operating cash flows. (T1-3)

**III. The Development of Financial Accounting and Reporting Standards**

A. Historical perspective and U.S. standards (T1-4)

1. Generally accepted accounting principles (GAAP) are a set of guidelines companies follow in measuring and reporting financial information.

2. The Securities and Exchange Commission (SEC) has the authority to set accounting standards for companies, but always has delegated the task to the accounting profession.

3. The Financial Accounting Standards Board (FASB) currently sets accounting standards.

4. The FASB Accounting Standards Codification became effective on July 1, 2009, and now represents the single source of authoritative nongovernmental U.S. GAAP, except for rules and interpretive release of the SEC, which remain also as sources of authoritative GAAP.

5. The Codification is organized into nine main topics and approximately 90 subtopics. (T1-5)

B. International standard setting

1. The International Accounting Standards Committee (IASC) was formed in 1973 to develop global accounting standards. The IASC reorganized itself and created a new standard-setting body called the International Accounting Standards Board (IASB).

2. The IASC acts as an umbrella organization similar to the Financial Accounting Foundation in the United States. The International Accounting Standards Board (IASB) has responsibility for developing international financial reporting standards (IFRSs).

3. The organizations involved in setting IFRSs parallel those involved in setting U.S. GAAP. (T1-6)

2. IASB standards are used in some form in over 115 jurisdictions, including the companies in the European Union.

C. Convergence between FASB and IASB standards

1. In 2002 the FASB and IASB signed the Norwalk Agreement, pledging to remove existing differences between standards. Since then, both boards have been working towards convergence.

2. In November 2008, the SEC proposed a Roadmap for the potential use of financial statements prepared in accordance with IFRS. The Roadmap sets forth several milestones that, if achieved, could lead to the required use of IFRS by publicly-traded U.S. companies.

3. Progress has been slow achieving milestones, and the SEC has postponed making a decision on whether the U.S. will incorporate IFRS into U.S. GAAP, and if so, when that event will occur. The SEC has guaranteed that it will not occur before 2015.

4. One possible process by which incorporation could occur was described by the SEC as “condorsement”, which involves continuing the convergence process coupled with endorsement of additional International Financial Reporting Standards by the FASB for inclusion in U.S. GAAP if those standards are of sufficiently high quality. Under this approach, the SEC and FASB still have sovereignty over U.S. accounting standards, but those standards should largely converge to IFRS over time.

D. The establishment of accounting standards—A political process

1. A standard setter must consider potential economic consequences of accounting standards.

2. The FASB undertakes a series of information gathering steps before issuing a substantive accounting standard. (T1-7)

3. In the past, various interest groups have successfully lobbied standard setters for changes in standards involving such topics as accounting for stock-based compensation, business combinations, and other-than-temporary impairments of investments.

4. Political pressures on IASB standard setting are severe, with funding dependent on voluntary contributions and important groups like the EU threatening to “carve out” aspects of standards that they view as undesirable.

**IV. Encouraging high-quality financial reporting**

A. Auditors offer credibility to financial statements by verifying that they are presented fairly in conformity with GAAP.

B. The *Public Company Accounting Reform and Investor Protection Act of 2002*, commonly referred to as the *Sarbanes-Oxley Act*, provides for the regulation of auditors and the types of services they furnish to clients, increases accountability if corporate executives, addresses conflicts of interest for securities analysts, and provides for stiff criminal penalties for violators. (T1-8)

C. Recent accounting scandals have rekindled the debate over *principles-based*, or more recently termed, *objectives-oriented*, versus *rules-based* accounting standards. A principles-based approach to standard setting stresses professional judgment, as opposed to following a list of rules.

**IV. Ethics in Accounting**

A. Recent accounting scandals have rekindled the debate over *principles-based*, or more recently termed, *objectives-oriented*, versus *rules-based* accounting standards. A principles-based approach to standard setting stresses professional judgment, as opposed to following a list of rules.

B. Ethical judgment is critical in accounting, particularly if decisions are not specified by rules.

1. Ethics deal with the ability to distinguish right from wrong.

2. Many professions have articulated ethical standards in a code of ethics.

3. There are a number of steps that provide a framework for analyzing ethical issues. (T1-9)

**Part B: The Conceptual Framework**

**I. Purpose of the Conceptual Framework**

A. The conceptual framework does not prescribe GAAP.

B. It provides an underlying foundation for accounting standards.

C. The FASB and IASB are working together to develop a common and improved conceptual framework. The project consists of eight phases and only Phase A has been completed.

D. The framework consists of a financial reporting objective, qualitative characteristics of information, financial statement elements, recognition and measurement concepts, and constraints. (T1-10)

**II. Objective of Financial Reporting** (T1-10)

A. To provide financial information that is useful to capital providers.

**III. Fundamental Qualitative Characteristics of Accounting Information**  (T1-11)

A. Overriding objective is decision usefulness.

B. Primary qualities of useful information are relevance and faithful representation.

C. Components of relevance are:

1. Predictive value

2. Confirmatory value

3. Materiality is an aspect of information that enhances relevance

D. Components of faithful representation are:

1. Completeness

2. Neutrality

3. Free from error

E. Enhancing qualities are comparability (including consistency), verifiability, timeliness and understandability.

F. A key constraints is cost effectiveness.

**IV. Elements of Financial Statements** (T1-12)

A. Balance sheet elements:

1. Assets

2. Liabilities

3. Equity

4. Investments by owners

1. Distributions to owners

B. Income statement elements:

1. Revenues

2. Gains

3. Expenses

4. Losses

5. Comprehensive income

**V. Underlying Assumptions** (T1-13)

A. Economic entity assumption

B. Going concern assumption

C. Periodicity assumption

D. Monetary unit assumption

**VI. Recognition, Measurement and Disclosure Concepts**

1. Recognition

1. An item should be recognized in the basic financial statements when it meets certain criteria. (T1-14)

2. Revenue recognition typically depends on realization, which requires that the earnings process be virtually complete and there is reasonable certainty as to the collectivility of assets to be received.

3. Expense recognition typically matches expenses to the periods in which they are incurred to produce revenue.

B. Measurement (T1-15)

1. GAAP uses a “mixed attribute” model, in which different attributes are used to measure different financial statement elements.

2. The five measurement attributes commonly employed in GAAP are:

a. Historical cost

b. Net realizable value

c. Current cost

d. Present value

e. Fair value

1) The FASB has provideda framework for measuring fair value whenever fair value is called for in applying GAAP. (T1-16)

2) GAAPgives a company the option to report some or all of its *financial* assets and liabilities at fair value.

C. Disclosure (T1-17)

1. Financial reports should include any information that could affect users’ decisions.

2. Techniques for providing full disclosure include parenthetical comments, disclosure notes and supplemental schedules and tables.

**VII. Evolution of Accounting Principles**

1. Two competing approaches for the recognition of revenues and expense are (1) the revenue/expense approach and (2) the asset/liability approach.
2. Under the revenue/expense approach, principles for recognizing revenues and expenses are emphasized, with assets and liabilities recognized as necessary to make the balance sheet reconcile with the income.
3. Under the asset/liability approach, principles for asset and liability measurement are emphasized, and revenues, expenses, gains and losses are recognized as necessary to make the balance sheet reconcile with the income statement.

**PowerPoint Slides**

A PowerPoint presentation of the chapter is available at the textbook website.

**Teaching Transparency Masters**

The following can be reproduced on transparency film as they appear here, or you can use the disk version of this manual and first modify them to suit your particular needs or preferences.

## financial information supplier groups and external user groups

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **Providers of** |  |  |  |
|  | **financial** |  | **External user** |  |
|  | **information** |  | **groups** |  |
|  |  |  |  |  |
|  | Profit-oriented |  | Investors |  |
|  | companies |  |  |  |
|  |  |  | Creditors  (banks, bondholders, other lenders) |  |
|  |  |  |  |  |
|  |  |  | Employees |  |
|  |  |  |  |  |
|  |  |  | Labor unions |  |
|  |  |  |  |  |
|  |  |  | Customers |  |
|  | Not-for-profit entities  (e.g., government entities, charitable  organizations, schools) | ⭢ | Suppliers |  |
|  |  |  | Government regulatory |  |
|  |  |  | agencies (e.g., Internal |  |
|  |  |  | Revenue Service, |  |
|  |  |  | Securities and Exchange |  |
|  |  |  | Commission) |  |
|  |  |  |  |  |
|  |  |  | Financial intermediaries |  |
|  |  |  | (e.g., financial analysts, stockbrokers, |  |
|  | Households |  | mutual fund managers, |  |
|  |  |  | credit rating organizations) |  |
|  |  |  |  |  |

Illustration 1-1

T1-1

## financial statements

⮚ The primary means of conveying financial information to investors, creditors, and other external users is through financial statements and related notes.

⮚ The financial statements most frequently provided are:

1. The balance sheet or statement of financial position

2. The income statement or statement of operations

3. The statement of cash flows

4. The statement of shareholders' equity

5. Starting in 2012, either

a) a statement of other comprehensive income immediately following the income statement, or

b) a statement of comprehensive income (including information on the income statement as well as on the statement of other comprehensive income).

T1-2

**CASH VERSUS ACCRUAL ACCOUNTING**

Carter Company — 3 Years of Operating Transactions

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

Illustration 1-2

T1-3

⮚ Measuring the same activities by the accrual accounting model provides a more accurate prediction of future operating cash flows.

Carter Company — Income Statements

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

Illustration 1-3

T1-3 (Continued)

#### accounting standard setting

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **hierarchy of standard-setting authority** | | | | | | |  |  |
|  | | | Congress |  | | | | | |
|  | | | 🡻 |  | | | | | |
|  | | | SEC |  | | | | | |
|  | | | 🡻 |  | | | | | |
|  | | | Private Sector |  | | | | | |
|  | | | 🡻 |  | | | | | |
|  |  | | | | |  | | |
|  | **|** | | | | |  | | |
| CAP | | APB | | | FASB | | | |

Illustration 1-4

T1-4

**FASB Accounting Standards Codification Topics**

|  |  |
| --- | --- |
| **Topic** | **Numbered** |
| General Principles | 100-199 |
| Presentation | 200-299 |
| Assets | 300-399 |
| Liabilities | 400-499 |
| Equity | 500-599 |
| Revenues | 600-699 |
| Expenses | 700-799 |
| Broad Transactions | 800-899 |
| Industry | 900-999 |

Illustration 1-5

T1-5

**THE FASB's STANDARD-SETTING PROCESS**

|  |  |  |
| --- | --- | --- |
|  | U.S. GAAP | IFRS |
| Regulatory oversight provided by: | Securities Exchange Commission (SEC) | International Organization of Securities Commissions (IOSCO)\* |
| Foundation providing oversight, appointing members, raising funds: | Financial Accounting Foundation (FAF): 20 trustees | International Accounting Standards Committee Foundation (IASCF): 22 trustees |
| Standard-setting board: | Financial Accounting Standards Board (FASB): 7 full-time members | International Accounting Standards Board (IASB): 14 members (12 full-time; 2 part-time) |
| Advisory council providing input on agenda and projects: | Financial Accounting Standards Advisory Council (FASAC): 30-40 members | Standards Advisory Council (SAC): 30-40 members |
| Group to deal with emerging issues: | Emerging Issues Task Force (EITF): 15 members | International Financial Reporting Interpretations Committee (IFRIC): 14 members |

\*Each country’s security regulator has authority. IOSCO includes representatives from numerous regulators, including the SEC, to facilitate coordination among those regulators and other organizations and encourage effective capital markets.

Illustration 1-6

T1-6

**THE FASB's STANDARD-SETTING PROCESS**

|  |  |
| --- | --- |
| **STEP** | **EXPLANATION** |
| 1. | The Board receives requests/recommendations for possible projects and reconsideration of existing standards from various sources. |
| 2. | The FASB Chairman decides whether to add a project to the technical agenda, subject to oversight by the Foundation's Board of Trustees and after appropriate consultation with FASB Members and others. |
| 3. | The Board deliberates at one or more public meetings the various issues identified and analyzed by the staff. |
| 4. | The Board issues an Exposure Draft. (In some projects, a Discussion Paper may be issued to obtain input at an early stage that is used to develop an Exposure Draft.) |
| 5. | The Board holds a public roundtable meeting on the Exposure Draft, if necessary. |
| 6. | The staff analyzes comment letters, public roundtable discussion, and any other information. The Board redeliberates the proposed provisions at public meetings. |
| 7. | The Board issues an Accounting Standards Update describing amendments to the Accounting Standards Codification. |

Illustration 1-7

T1-7

THE SARBANES-OXLEY ACT

**Key Provisions of the Act:**

• **Oversight board.** The five-member (two accountants) Public Company Accounting Oversight Board has the authority to establish standards dealing with auditing, quality control, ethics, independence and other activities relating to the preparation of audit reports, or can choose to delegate these responsibilities to the AICPA. Prior to the act, the AICPA set auditing standards. The SEC has oversight and enforcement authority.

• **Corporate executive accountability.** Corporate executives must personally certify the financial statements and company disclosures with severe financial penalties and the possibility of imprisonment for fraudulent misstatement.

• N**on-audit services**. The law makes it unlawful for the auditors of public companies to perform a variety of non-audit services for audit clients. Prohibited services include bookkeeping, internal audit outsourcing, appraisal or valuation services, and various other consulting services. Other non-audit services, including tax services, require pre-approval by the audit committee of the company being audited.

• **Retention of workpapers.** Auditors of public companies must retain all audit or review work papers for seven years or face the threat of a prison term for willful violations.

• **Auditor rotation.** Lead audit partners are required to rotate every five years. Mandatory rotation of audit firms came under consideration.

• **Conflicts of interest.** Audit firms are not allowed to audit public companies whose chief executives worked for the audit firm and participated in that company’s audit during the preceding year.

• **Hiring of auditor.** Audit firms are hired by the audit committee of the board of directors of the company, not by company management.

• **Internal Control.** Section 404 of the Act requires that company management document and assess the effectiveness of all internal control processes that could affect financial reporting. The PCAOB’s *Auditing Standard No. 2* (since replaced by *Auditing Standard No. 5*) requires that the company auditors express an opinion on whether the company has maintained effective internal control over financial reporting.

Illustration 1-5

T1-8

### ANALYTICAL MODEL FOR ETHICAL DECISIONS

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

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

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

**Step 4.** Specify the alternative courses of action.

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

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

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

T1-9

### THE CONCEPTUAL FRAMEWORK

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  | | | | | | | | | |  |  | |
|  |  |  | **Objective**  To provide financial information that is useful to capital  providers.  **Phase A** | | | | | | | | | |  |  | |
|  |  | | | | | |  |  |  |  | | | | | |
|  | **Qualitative Characteristics** | | | | | |  | ↓ |  | **Recognition and Measurement Concepts** | | | | |
|  | **Primary**  **Relevance**  Predictive value  Confirmatory value  Materiality  **Faithful Representation**  Completeness  Neutrality  Free from error  **Enhancing**  **Comparability**  (including consistency)  **Verifiability**  **Timeliness**  **Understandability** | | | | | | → | **Elements**  Assets  Liabilities  Equity  Investments by owners  Distributions to owners  Revenues  Expenses  Gains  Losses  Comprehensive income  **SFAC 6** | **←** | **Assumptions**  Economic entity  Going concern  Periodicity  Monetary unit  **Principles**  Revenue recognition  Expense recognition  Mixed attribute measurement  Full disclosure | | | | |
|  | **Phase A** | | | | | |  | ↓ |  | **SFAC 5**  **SFAC 7** | | | | |
|  |  | | | **🡶** | |  | | | | | **🡷** |  | | | |
|  | ↓ | | |  | | **Financial Statements** | | | | |  |  | | | |
|  | **Constraint**  Cost effectiveness  **Phase A** | | | | → | • Balance sheet  • Income statement  • Statement of cash flows  • Statement of shareholders' equity  • Statement of Comprehensive Income  • Related disclosures | | | | |  |  | | | |

Illustration 1-9

T1-10

**QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION**

### Primary Qualitative Characteristics

### ⮚ Relevance

♦ **Predictive value**

♦ **Confirmatory value**

♦ **Enhancing aspect: materiality**

### ⮚ Faithful representation

♦ **Completeness** — All information that is necessary for faithful representation.

♦ **Neutrality** — Accounting standards should be set with overall societal goals and specific objectives in mind, and should try not to favor particular groups or companies.

♦ **Free from error**

### Enhancing Qualitative Characteristics

### ⮚ Comparability

♦ Ability to help users see similarities and differences among events and conditions (also includes *consistency*).

### ⮚ Verifiability

♦ Consensus among different measurers.

### ⮚ Timeliness

♦ Available to users before a decision is made.

### ⮚ Understandability

♦ Users must understand the information.

### Constraint: Cost effectiveness

T1-11

### ELEMENTS OF FINANCIAL STATEMENTS

|  |  |
| --- | --- |
|  |  |
| **Assets** | Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. |
| **Liabilities** | Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. |
| **Equity (or net**  **assets)** | Called shareholders’ equity or stockholders’ equity for a corporation is the residual interest in the assets of an entity that remains after deducting its liabilities. |
| **Investments  by owners** | Increases in equity of a particular business enterprise resulting from transfers to it from other entities of something of value to obtain or increase ownership interests in it. |
| **Distributions  to owners** | Decreases in equity of a particular enterprise resulting from transfers to owners. |
|  |  |
| **Comprehensive income** | The change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. |
| **Revenues** | Inflows or other enhancements of assets of an entity or settlements of its liabilities during a period from delivering or producing goods, rendering services, or other activities that constitute the entity’s ongoing major or central operations. |
| **Expenses** | Outflows or other using up of assets or incurrences of liabilities during a period from delivering or producing goods, rendering services, or other activities that constitute the entity’s ongoing major, or central, operations. |
| **Gains** | Increases in equity from peripheralor incidentaltransactions of an entity. |
| **Losses** | Represent decreases in equity arising from peripheral or incidental transactions of an entity. |

Illustration 1-11

T1-12

### UNDERLYING ASSUMPTIONS

► **Economic Entity Assumption**

♦ All economic events can be identified with a particular economic entity.

► **Going Concern Assumption**

♦ In the absence of information to the contrary, it is anticipated that a business entity will continue to operate indefinitely.

► **Periodicity Assumption**

♦ The life of a company can be divided into artificial time periods to provide timely information to external users.

► M**onetary Unit Assumption**

♦ Financial statement elements should be measured in terms of the United States dollar.

T1-13

### RECOGNITION

Recognition — An item should be recognized in the basic financial statements when it meets the following criteria:

⮚ Definition — the item meets the definition of an element of financial statements.

⮚ Measurability — the item has a relevant attribute measurable with sufficient reliability.

⮚ Relevance — the information about it is capable of making a difference in user decisions.

⮚ Reliability — the information is representationally faithful, verifiable, and neutral (Phase A of the joint FASB/IASB conceptual framework project has replaced reliability with faithful representation as the second primary qualitative characteristic of financial information).

### ⮚ Realization Principle

♦ Revenue should be recognized only after the earnings process is virtually complete and there is reasonable certainty of collecting the asset.

♦ Revenue should be recognized in the period it is earned, *not necessarily in the period in which cash is received*.

### ⮚ Matching Principle

♦ Expenses are recognized in the same period as the related revenues. T1-14

MEASUREMENT

Measurement — Associating numerical amounts to the elements.

⮚ GAAP uses a “mixed attribute” model

⮚ Measurement attributes presently used to measure different financial statement elements include:

♦ historical cost

♦ net realizable value

♦ current cost

♦ present value of future cash flows

♦ fair value

T1-15

### FAIR VALUE HIERARCHY

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

Illustration 1-13

T1-16

### FULL-DISCLOSURE PRINCIPLE

► The **full-disclosure principle** means that the financial reports should include any information that could affect the decisions made by external users, subject to the cost effectiveness constraint.

⮚ Supplemental information is disclosed in a variety of ways, including **parenthetical** or **modifying comments** placed on the face of the financial statements.

⮚ **Disclosure notes** conveying additional insights about company operations, accounting principles, contractual agreements, and pending litigation.

⮚ **Supplemental financial statements** that report more detailed information than is shown in the primary financial statements.

T1-17

**Suggestions for Class Activities**

**1. Real World Scenario**

America Online (AOL) is a leader in the Internet access provider industry. In 1996, the company changed a controversial accounting method involving the treatment of the cost of advertising and free trials. The following is an excerpt from a May 15, 2000, *CNET News.com* article:

America Online will pay a civil penalty of $3.5 million as part of a settlement with the Securities and Exchange Commission over the accounting of advertising costs. According to the SEC, the Internet and media giant improperly reported most of the costs of acquiring new subscribers – such as the expense of sending computer disks to potential customers – as an asset. As a result, the SEC said AOL posted a profit for six of eight quarters in 1995 and 1996 but would have recorded a loss if the company followed recommended accounting practices.

AOL, backed by its auditor, defended the accounting method of capitalizing these costs arguing that spreading the costs over two years was a justifiable way to match expenses against revenue flows that would emerge later. In 1996, AOL switched to expensing these costs in the period incurred.

**Suggestions:**

Have the class consider the general treatment of advertising and promotion costs. Why are these costs normally expensed in the period incurred even though they are incurred with the intention of generating future revenues? Why did they expense these costs over a two-year period? Then discuss the possible reasons why AOL chose a different approach followed by a discussion of the possible reasons why the company decided to change its method. Another interesting discussion is the civil penalty of $3.5 million leveled by the SEC four years after AOL changed its method. This could lead to a general discussion of the SEC’s role in the financial reporting process.

**Points to note:**

Perhaps an important factor prompting the switch was the increased competition in the industry and the loss of customers that prompted AOL to implement a new pricing scheme. The loss of customers creates significant uncertainty with respect to the realization of deferred advertising and promotion costs. Another reason is pressure exerted by the SEC to make the switch and another is that AOL’s competitors all expensed these costs.

**2. Dell Analysis**

Have students, individually or in groups, go to the most recent Dell Inc. annual report using EDGAR which can be located at: **ww.sec.gov**. Ask them to:

1. Compare revenues, total costs and expenses, net income, total assets and total shareholders' equity with those in the 2011 report in Appendix B of the text. Are there any discernible trends? How might they be interpreted?

1. Use EDGAR to locate the most recent annual report information for Apple, Dell’s competitor. Using the most recent annual report information for both companies, compare:
2. growth rates in revenues and net income, and
3. the relationship between revenues and net income (profit margin).

**3. Group/Research Activity**

The debate over principles-based versus rules-based accounting standards provides an excellent opportunity for class discussion, in-class debate, or for a writing assignment. One suggestion is to form groups of 4 or 5 students to research the issue. Assign half of the groups to defend a principles-based approach and the other half to defend the rules-based approach. There are numerous articles written on the subject. A google search will find many hits. For example a link to a *CPA Journal* article entitled “Defining Principles-Based Accounting Standards” appears below.

<http://www.nysscpa.org/cpajournal/2004/804/essentials/p34.htm>

Also, the March 2005 issue of *Accounting Horizons* contains a commentary entitled “Rules-Based Standards and the Lack of Principles in Accounting.”

**4. International Accounting Activity**

What are the advantages and disadvantages to accounting convergence? Two recent articles in Accounting Horizons provide an excellent overview of the research evidence:

* Luzi Hail, Christian Leuz, and Peter Wysocki (2010) Global Accounting Convergence and the Potential Adoption of IFRS by the U.S. (Part I): Conceptual Underpinnings and Economic Analysis. *Accounting Horizons*: September 2010, Vol. 24, No. 3, pp. 355-394.
* Luzi Hail, Christian Leuz, and Peter Wysocki (2010) Global Accounting Convergence and the Potential Adoption of IFRS by the U.S. (Part II): Political Factors and Futre Scenarios for U.S. Accounting Standards. *Accounting Horizons*: Decmber 2010, Vol. 24, No. 4, pp. 567-588.

**Suggestions:**

Have your students write a paper summarizing the issue and the papers’ results. Alternatively, have a debate in which different groups of students take pro- vs. con-convergence positions.

**5. Professional Skills Development Activities**

The following are suggested assignments from the end-of-chapter material that will help your students develop their communication, research, analysis and judgment skills.

**Communication Skills.** In addition to Communication Case 1-7, Judgment Case 1-12 can be adapted to ask students to write a letter to the client. Communication Case 1-6 and Judgment Case 1-1 do well as group assignments. Ethics Case 1-8 and Judgment Cases 1-9 and 1-10 create good class discussions. Judgment Cases 1-11, 1-13 and 1-16 are suitable for student presentation(s).

**Research Skills.** In their careers, our graduates will be required to locate and extract relevant information from available resource material to determine the correct accounting practice, perhaps identifying the appropriate authoritative literature to support a decision. Research Cases 1-2, 1-3, and 1-4 and Exercises 1-3 and 1-4 provide excellent opportunities to help students develop this skill by introducing them to some important resources available on the Internet.

**Analysis Skills.** The “Broaden Your Perspective” section includes Analysis Cases that direct students to gather, assemble, organize, process, or interpret data to provide options for making business and investment decisions. In addition to Analysis Case 1-13, Brief Exercise 1-1, Exercises 1-1 and 1-2, and Real World Case 1-15 also provide opportunities to develop and sharpen analytical skills.

**Judgment Skills.** The “Broaden Your Perspective” section includes Judgment Cases that require students to critically analyze issues to apply concepts learned to business situations in order to evaluate options for decision-making and provide an appropriate conclusion. This chapter includes Judgment Cases 1-1, 1-9, 1-10, 1-11, 1-12, and 1-14. The AirFrance-KLM case’s question 3 requires consideration of potential departures from IFRS.

**6. Ethical Dilemma**

The chapter contains the following ethical dilemma:

**Ethical Dilemma**

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

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

You may wish to discuss this in class. If so, discussion should include these elements.

**Step 1—The Facts:**

One of your tasks as an employee of a large sporting goods chain is to prepare financial statements for external use. You are currently preparing quarterly statements for the quarter ending June 30, 2013, that will be given to the chain's largest creditor, National Savings & Loan. The CFO has asked you to capitalize (charge to a prepaid asset) the $1,200,00 cost for an advertising campaign conducted in May and June of 2013. The capitalization of advertising will prevent an operating loss for the quarter and maintain the company's good standing with the creditor. The CFO believes that the commercials improved sales in May and June and expects the advertising effect to continue in July. The matching principle states that expenses are recognized in the same period as the related revenue. In some situations it is impossible to determine in which periods revenues will be earned from expenses such as advertising. Because of the difficulty in estimating the effect of advertising expenditures, accounting principles dictate that advertising should be recognized as an expense in the period incurred.

**Step 2—The Ethical Issue and the Stakeholders:**

The ethical issue or dilemma is whether your obligation to challenge the CFO's request for capitalization of the advertising expense is stronger than your obligation to your employer's financial interests.

Stakeholders include you, the accountant, the CFO, other corporate managers, company employees, the bank and other creditors, and current and future investors.

**Step 3—Values:**

Values include competence, honesty, integrity, objectivity, loyalty to your employer, and responsibility to users of financial statements.

**Step 4—Alternatives:**

1. Follow the suggestion of the CFO to record the advertising costs as a prepaid asset.

2. Record the advertising costs as an expense in the quarter ending June 30, 2013.

3. Report the CFO's request to a higher level of management, the audit committee, or the auditors.

4. Resign from the company and seek employment elsewhere.

**Step 5—Evaluation of Alternatives in Terms of Values:**

1. Alternative 1 illustrates loyalty to the employer.

2. Alternative 2 exhibits the values of competence, honesty, integrity, objectivity, and responsibility to users of the financial statements.

3. Alternative 3 illustrates loyalty to the employer at a level higher than that of the CFO, but also includes the values of honesty, integrity, and objectivity on the part of the accountant.

4. Alternative 4 supports the values of honesty and integrity, but does not reflect competence or responsibility to financial statement users.

**Step 6—Consequences:**

*Alternative 1*

Positive consequences: You would keep your job and please the CFO. The company would remain in good standing with the bank.

Negative consequences: Users of the financial statements would be misinformed. Users of financial statements may sue the company upon learning the truth if the amount of advertising is material and affects their financial decisions. You may lose your self-respect and the respect of co-workers.

*Alternative 2*

Positive consequences: Users of financial statements would receive more conservative information concerning advertising costs. You would maintain your integrity.

Negative consequences: You may incur disfavor with the CFO and other top management, resulting in a loss of future promotions or your job. You also may lose the trust of other employees.

*Alternative 3*

Positive consequences: You would maintain your integrity. Users may receive more conservative information concerning advertising costs if upper management levels or the audit committee compel fair presentation in the financial statements.

Negative consequences: You may incur disfavor with the CFO and other top management, resulting in a loss of future promotions or your job. You also may lose the trust of other employees. Whistle blowers often are not rewarded.

*Alternative 4*

Positive consequences: You maintain your integrity and avoid conflict with management and other employees.

Negative consequences: You have no job and you may have difficulty getting references for a new job. Users of financial statements still do not receive correct information regarding advertising costs.