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Accounting Principles: A Business Perspective 10e

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Highlights of 10e:

- **Former Irwin/McGraw Hill title recently revised (2018 copyright)**
- **New lead author and extensive author involvement in the revision of the text and all supplements to ensure relevance of chapter content and seamless integration with all supplementary materials.**
- **A current, fully up-to-date text (all accounting standards through 2017 are incorporated). Extensive revisions from prior edition with new content, new examples, and updated assignments.**
- **A great way to give your students a high-quality product at a low cost. A great value decision!**

Background: This book went through many editions with Business Publications, Inc. an imprint of Richard D. Irwin Publishers, and was among the company's best sellers. After Irwin's titles were sold to McGraw, the new owner dropped the project to avoid cannibalizing their native product. The authors brought the book to Textbook Media and we published 9e back in 2006.

Brief Description: Thoroughly updated in 2017, 10e builds on the strengths of previous editions and continues to provide a thorough understanding of how to use accounting information to analyze business performance and make business decisions. Uses real companies to illustrate many of the accounting concepts, and covers a variety of issues associated with these actual businesses to provide a real-world perspective. Combines solid coverage of financial accounting for business students, regardless of the selected major, and provides non-accounting majors a solid foundation for making effective use of accounting information.

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More on 10e:

One of the … most important things accomplished in this revision was to bring Dr. Susan Hermanson in as lead author of the text. She was a coauthor on previous editions of the Managerial Accounting text.

With Susan directing the development of 10e, know that there was a high level of personal involvement in updating this textbook by the author team, including bringing it up to date with all FASB pronouncements through early 2018. Susan oversaw the revising and working the solutions to all questions, exercises, and problems in each chapter of the book. All supplements including the Solutions Manual, Instructor's Resource Guide, Test Bank, Power Point Slides®, and Study Guide were personally revised by the authors.

The focus of 10e remains on giving your students an understanding of how to use accounting information to analyze business performance and make business decisions. Like previous editions, 10e takes a business perspective, seeking to involve the business student more in real-world business applications as we introduce and explain the subject matter. The authors use the annual reports of real companies to illustrate many of the accounting concepts. Your students are familiar with many of the companies used in 11e, including Apple, The Home Depot, and Coca-Cola Company.

TENTH EDITION

ACCOUNTING PRINCIPLES

A Business Perspective

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Preface

The Latest Revision

One of the most important things accomplished in this revision was to bring Dr. Susan Hermanson in as lead author of the text. She is a coauthor on previous editions of our Managerial Accounting text and has decided to become involved in this text also.

The most important content and revision changes were the following:

(1) Chapter 5, Accounting Theory, was thoroughly revised to bring it completely up to date with the latest Financial Accounting Standards Board (FASB) pronouncements (up through early 2018).

(2) The new FASB rules on accounting for leases are included in a new Appendix to Chapter 11.

(3) The old rules regarding trading equity securities and available-for-sale equity securities in Chapter 14 were deleted and the new coverage using one Marketable Equity Securities account to include all marketable equity securities and adjusting them to fair market values at the end of each accounting period was substituted.

(4) Also, there was heavy author personal involvement in revising and working the solutions to all questions, exercises, and problems in each chapter of the book. All supplements including the Instructor's Resource Guide, Test Bank, PowerPoint Slides, and Study Guide were personally revised by the authors.

One goal in publishing this book is to give the students a break in lowering the cost of attending college. Students are graduating with enormous student debts to try to pay off over their lifetimes. With no sacrifice in quality, this completely up-to-date text sells for only a fraction of the cost of other competing texts.

Philosophy and Purpose

Imagine that you have graduated from college without taking an accounting course. You are employed by a company as a sales person, and you eventually become the sales manager of a territory. While attending a sales managers' meeting, financial results are reviewed by the Vice President of Sales and terms such as gross margin percentage, cash flows from operating activities, and LIFO inventory methods are being discussed. The Vice President eventually asks you to discuss these topics as they relate to your territory. You try to do so, but it is obvious to everyone in the meeting that you do not know what you are talking about.

Financial accounting principles courses teach you the "language of business" so you understand terms and concepts used in business decisions. If you understand how accounting information is prepared, you will be in an even stronger position when faced with a management decision based on accounting information.

We wrote this text to give you an understanding of how to use accounting information to analyze business performance and make business decisions. The text takes a business perspective. We use the annual reports of real companies to illustrate many of the accounting concepts. You are familiar with many of the companies we use, such as Apple, The Home Depot, and Coca-Cola Company.

Gaining an understanding of accounting terminology and concepts, however, is not enough to ensure your success. You also need to be able to find financial information on the Internet, analyze various business situations, work effectively as a member of a team, and communicate your ideas clearly. This text was created to help you develop these skills.

Curriculum Concerns

Significant changes have been recommended for accounting education. Some parties have expressed concern that recent accounting graduates do not possess the necessary set of skills to succeed in an accounting career. The typical accounting graduate seems unable to successfully deal with complex and unstructured "**real world**" accounting problems and generally lacks communication and interpersonal skills. One recommendation is the greater use of active learning techniques in a reenergized classroom environment. The traditional lecture and structured problem solving method approach is being supplemented or replaced with a more informal classroom setting dealing with cases, simulations, and group projects. Both inside and outside the classroom, there is more two-way communication between (1) professor and student and (2) student and student. Study groups are formed so that students can tutor other students. The purposes of these recommendations include enhancing

students' critical thinking skills, written and oral communication skills, and interpersonal skills.

One of the most important benefits you can obtain from a college education is that you "learn how to learn." The concept that you gain all of your learning in school and then spend the rest of your life applying that knowledge is not valid. Change is occurring at an increasingly rapid pace. You will probably hold many different jobs during your career, and you will probably work for many different companies. Much of the information you learn in college will be obsolete in just a few years. Therefore, you will be expected to engage in life-long learning. Memorizing and application are much less important than the higher order learning skills of critical analysis and evaluation.

With this changing environment in mind, we have developed a text that will lend itself to developing the skills that will lead to success in your future career in business. The section at the end of each chapter titled, "Beyond the Numbers—Critical Thinking," provides the opportunity for you to address unstructured case situations, the analysis of real companies' financial situations, ethics cases, and team projects. For many of these items, you will use written and oral communication skills in presenting your results.

Objectives and Overall Approach of the Eleventh Edition The Accounting Education Change Commission (AECC) made the following statement regarding the role of the first-year accounting course in preparing students for success in their future careers:

> The first course in accounting can significantly benefit those who enter business, government, and other organizations, where decision-makers use accounting information. These individuals will be better prepared for their responsibilities if they understand the role of accounting information in decision-making by managers, investors, government regulators, and others. All organizations have accountability responsibilities to their constituents, and accounting, properly used, is a powerful tool in creating information to improve the decisions that affect those constituents.[1]

A working knowledge of accounting has become even more important in the decades since the AECC made its statement. Indeed, modern business professionals are expected to have such knowledge at the outset of their careers.

One of the purposes of the first course should be to recruit accounting majors. To help accomplish this, the text has a section preceding each chapter entitled, "Careers in Accounting."

We retained a solid coverage of accounting that serves business students well regardless of the majors they select. Those who choose not to major in accounting, which is a majority of those taking this course, will become better users of accounting information because they will know something about the preparation of that information.

1 Accounting Education Change Commission, *Position Statement No. Two,* "The First Course in Accounting" (Torrance, CA, June 1992), pp. 1–2.

Approach and Organization

Business Emphasis

Without actual business experience, business students sometimes lack a frame of reference in attempting to apply accounting concepts to business transactions. We seek to involve the business student more in real world business applications as we introduce and explain the subject matter.

- "An Accounting Perspective: Business Insight" boxes throughout the text provide examples of how companies featured in text examples use accounting information every day, or they provide other useful information.
- "Accounting Perspective: Uses of Technology" boxes throughout the text demonstrate how technology has affected the way accounting information is prepared, manipulated, and accessed.
- "Think About It" boxes throughout the text call upon the student to synthesize key concepts as they are introduced in the text.
- Some chapters contain "A Broader Perspective." These situations, taken from annual reports of real companies and from articles in current business periodicals relate to subject matter discussed in that chapter or present other useful information. These real world examples demonstrate the business relevance of accounting.
- Real world questions and real world business decision cases are included in almost every chapter.
- The Annual Report Appendix included with this text contains significant portions of the annual report of Apple Inc. Many of the real world questions and business decision cases are based on this annual report.
- Throughout the text we have included numerous references to the annual reports of many companies.
- Most of the chapters contain a section entitled, "Analyzing and Using the Financial Results." This section discusses and illustrates a ratio or other analysis technique that pertains to the content of the chapter. For instance, this section in Chapter 4 discusses the current ratio as it relates to a classified balance sheet.
- Many of the chapters contain end-of-chapter questions, exercises, or business decision cases that require the student to refer to the Annual Report Appendix and answer certain questions. As stated earlier, this appendix is included with the text and contains significant portions of the annual report of Apple Inc.
- Each chapter contains a section entitled, "Beyond the Numbers—Critical Thinking." This section contains business decision cases, annual report analysis

problems, writing assignments based on the Ethical Perspective and Broader Perspective boxes, group projects, and Internet projects.

Pedagogy

Students often come into accounting principles courses feeling anxious about learning the subject matter. Recognizing this apprehension, we studied ways to make learning easier and came up with some helpful ideas on how to make this edition work even better for students.

- Improvements in the text's content reflect feedback from adopters, suggestions by reviewers, and a serious study of the learning process itself by the authors and editors. New subject matter is introduced only after the stage has been set by transitional paragraphs between topic headings. These paragraphs provide students with the reasons for proceeding to the new material and explain the progression of topics within the chapter.
- The Introduction contains a section entitled "How to Study the Chapters in This Text," which should be very helpful to students.
- Each chapter has an "Understanding the Learning Objectives" section. These "summaries" enable the student to determine how well the Learning Objectives were accomplished. We were the first authors (1974) to ever include Learning Objectives in an accounting text. These objectives have been included at the beginning of the chapter, as marginal notes within the chapter, at the end of the chapter, and in supplements such as the Test Bank, Instructors' Resource Guide, Computerized Test Bank, and Study Guide. The objectives are also indicated for each exercise and problem.
- Demonstration problems and solutions are included for each chapter, and a different one appears for each chapter in the Study Guide. These demonstration problems help students to assess their own progress by showing them how problems that focus on the topic(s) covered in the chapter are worked before students do assigned homework problems.
- Key terms are printed in another color for emphasis. End-of-chapter glossaries contain the definition and the page number where the new term was first introduced and defined. Students can easily turn back to the original discussion and study the term's significance in context with the chapter material.
- Each chapter includes a "Self-Test" consisting of true/false and multiple-choice questions. The answers and explanations appear at the end of the chapter. These self-tests are designed to determine whether the student has learned the essential information in each chapter.
- In the margin beside each exercise and problem, we have included a description of the requirements and the related Learning Objective(s). These descriptions let students know what they are expected to do in the problem.
- Throughout the text we use examples taken from everyday life to relate an accounting concept being introduced or discussed to students' experiences.

Ethics

There is no better time to emphasize high ethical standards to students. This text includes many items throughout the text entitled, "An Ethical Perspective." These items present situations in which students are likely to find themselves throughout their careers. They range from resisting pressure by a superior or a client to do the wrong thing to deciding between alternative corporate behaviors that have environmental and profit consequences.

End-of-Chapter Materials

At the end of each chapter is a section entitled **"Beyond the Numbers—Critical Thinking."** The problems and cases in this section are designed to help students develop their skills in analysis, evaluation, and writing. **Business Decision Cases** require critical thinking in complex situations often based on real companies. The **Annual Report Analysis** section requires analyzing annual reports and interpreting the results in writing. The **Ethics Cases** require students to respond in writing to situations they are likely to encounter in their careers. These cases do not necessarily have one right answer. The **Group Projects** for each chapter teach students how to work effectively in teams, a skill that was stressed by the AECC and is becoming increasingly necessary for success in business. The **Internet Projects** teach students how to retrieve useful financial information from the Internet.

A team approach can also be introduced in the classroom using the regular exercises and problems in the text. Teams can be assigned the task of presenting their solutions to exercises or problems to the rest of the class. Using this team approach in class can help reenergize the classroom by creating an active, informal environment in which students learn from each other. (Two additional group projects are described in the Instructor's Resource Guide. These projects are designed to be used throughout the semester or quarter.)

We have included a vast amount of other resource materials for each chapter *within* the text from which the instructor may draw: (1) one of the largest selections of end-of-chapter questions, exercises, and problems available; (2) several comprehensive review problems that allow students to review all major concepts covered to that point; and (3) from one to three business decision cases per chapter. Other key features regarding end-of-chapter material follow.

- A uniform chart of accounts appears at the end of this textbook, p. CA-1. This uniform chart of accounts is used consistently throughout the first 11 chapters. We believe students will benefit from using the same chart of accounts for all homework problems in those chapters.
- Many of the end-of-chapter problem materials (questions, exercises, problems, business decision cases, other "Beyond the Numbers" items, and comprehensive review problems) have been updated. Each exercise and problem is identified with the learning objective(s) to which it relates.
- All end-of-chapter Exercises and problems have been traced back to the chapters to ensure that nothing is asked of a student that does not appear in the book. This feature was a strength of previous editions, ensuring that instructors could confidently assign problems without having to check for applicability. Also, we took notes while teaching from the text and clarified problem and exercise instructions that seemed confusing to our students.

Supplements for the Instructor

A complete package of supplemental teaching aids contains all you need to efficiently and effectively teach the course.

Instructor's Resource Guide This guide contains sample syllabi for both semester-and quarter-based courses. Each chapter contains: (1) a summary of major concepts; (2) learning objectives from the text; (3) space for the instructor's own notes; (4) an outline of the chapter with an indication of when each exercise can be worked; and (5) detailed lecture notes that also refer to specific end-of-chapter exercise and problem materials illustrating these concepts. Also included are (6) a summary of the estimated time, learning objective(s), level of difficulty, and content of each exercise and problem that is useful in deciding which items to cover in class or to assign as homework. The Instructor's Resource Guide for Chapter 17 contains a case study based on Hasbro, Inc. This company is one of the world's leading manufacturer and marketer of toys, games, puzzles, and infant care products. You may want to assign this case as a special project to individuals or to teams. The results of the analysis, with recommendations, could then be presented to the class. The Instructor's Resource Guide is provided to adopters in both Word and PDF formats.

Solutions Manual The solutions manual contains suggested discussion points for each ethics case as well as detailed answers to questions, exercises, two series of problems, business decision cases, most "Beyond the Numbers" items, comprehensive review problems, and some group projects. The Solutions Manual is provided to adopters in both Word and PDF files.

Test Bank The test bank contains approximately 3,000 questions and problems from which to choose in preparing examinations. This test bank contains true/false questions, multiple-choice questions, and short problems for each chapter. Questions and problems are *classified by the learning objective* to which they relate. The Test Bank is provided to adopters in both Word and PDF files. A computer test bank version is also available for selecting questions and printing exams.

PowerPoint Slides An average of 26 PowerPoint slides exist for each chapter. These slides illustrate the most important points in the chapter. They can be used as a basis for classroom lectures and/or discussions.

Supplements for the Student

In addition to the text, the package of support items for the student includes the following:

Study Guide Included for each chapter are learning objectives, a reference outline, a chapter review, and an additional demonstration problem and solution. If students use the study guide throughout the course, their knowledge of accounting will be enhanced significantly. The study guide is a valuable learning tool in that it includes matching, true/false, and multiple-choice questions, completion questions, and exercises. Solutions to all exercises and questions are also included. The Study Guide is available to students in online or PDF format. It can be purchased at the publisher's website (*www.textbookmedia.com*).

Online Lecture Guide Chapter highlights in downloadable pdf chapter files to accompany the textbook.

Check Figures Check figures are available at the end of this textbook, p. CF-1. They show key amounts that students can check to see if they are on the right track when working the exercises and problems.

We are indebted to all our previous coauthors who have contributed to the project in the past, especially R. F. "Sully" Salmonson who worked on many of the early editions.

Susan D. Hermanson
James Don Edwards
Roger H. Hermanson

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Susan D Hermanson

Susan D. Hermanson is the Cameron Distinguished Professor of Accountancy and has published over 55 refereed articles in leading accounting journals. She has co-authored articles with some of the top researchers in the country. Her research investigating audit market mergers was referenced by the United States General Accounting Office (GAO) in its 2003 Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services. In addition, Susan was sought out by the GAO to participate in a research survey conducted by the GAO in conjunction with its report. Her works have been cited in top accounting journals throughout the United States, Europe, Asia, Africa, and Australia. Dr. Hermanson was solicited by the College Board to contribute the content regarding majoring in accounting for its *Book of Majors*, a resource utilized nationally by high school and college students to assist them in selecting a major. Susan is an author of several accounting textbooks published by Textbook Media.

Dr. Hermanson is a highly regarded teacher at both the graduate and undergraduate levels. She has received eight teaching awards, most notably the UNCW Chancellor's Teaching Excellence Award. She has served as a faculty advisor to the Beta Alpha Psi Accounting Honorary Society as well as the Beta Gamma Sigma Honorary Society. In addition, she is a frequent Chair of Honor's Theses in support of the Honor's College at UNCW.

Dr. Hermanson served as Dixon Hughes Goodman Faculty Fellow from 2008–2016, until being named as Cameron Distinguished Professor of Accounting. Before joining UNCW in 2000, Dr. Hermanson was on the faculty at the University of Tampa and the University of Nevada Las Vegas. She earned her Ph.D. in accounting from Texas A&M University. She worked in public accounting through the rank of senior auditor with Arthur Andersen & Co. She passed all four parts of the CPA Exam in November 1988 and became a licensed CPA in June 1992 in Texas, where she continues to hold her license.

James Don Edwards

James Don Edwards is the J. M. Tull Professor Emeritus of Accounting in the Terry College of Business at the University of Georgia. He is a graduate of Louisiana State University and has been inducted into the Louisiana State University Alumni Federation's Hall of Distinction. He received his M.B.A. from the University of Denver and his Ph.D. from the University of Texas and is a CPA in Texas and Georgia. He has served as a professor and chairman of the Department of Accounting and Financial Administration at Michigan State University, a professor and dean of the Graduate School of Business Administration at the University of Minnesota, and a Visiting Scholar at Oxford University in Oxford, England.

Professor Edwards is a past President of the American Accounting Association and a past national Vice President and executive committee member of the Institute of Management Accountants. He has served on the board of directors of the American Institute of Certified Public Accountants and as chairman of the Georgia State Board of Accountancy. He was an original trustee of the Financial Accounting Foundation, the parent organization of the FASB, and a member of the Public Review Board of Arthur Andersen & Co.

He has published in *The Accounting Review, The Journal of Accountancy, The Journal of Accounting Research, Management Accounting,* and *The Harvard Business History Review.* He is also the author of *History of Public Accounting in the United States.* He has served on various American Institute of Certified Public Accountants committees and boards, including the Objectives of Financial Statements Committee, Standards of Professional Conduct Committee, and the CPA Board of Examiners. He was the managing editor of the centennial issue of *The Journal of Accountancy.*

In 1974, Beta Alpha Psi, the National Accounting Fraternity, selected Professor Edwards for its first annual Outstanding Accountant of the Year award. This selection is made from industry, government, and educational leaders. In 1975, he was selected by the American Accounting Association as its Outstanding Educator.

He has served the AICPA as president of the Benevolent Fund, chairman of the Awards Committee, member of the Professional Ethics Committee and Program for World Congress of Accountants. He was on the Education Standards Committee of the International Federation of Accountants and the Committee on Planning for the Institute of Management Accountants. He was the director of the Seminar

for Management Accountants–Financial Reporting for the American Accounting Association. He is also a member of the Financial Executives Institute.

He received the 1993 AICPA Gold Medal Award, the highest award given by the Institute. A Doctor Honoris Causa (Honorary Doctorate) from the University of Paris was awarded to him in 1994. He is the first accountant to receive this distinction in France. The Academy of Accounting Historians awarded him the 1994 Hourglass Award which is the highest international honor in the field of Accounting History. He was inducted into the Ohio State University Accounting Hall of Fame in 2001.

Roger H. Hermanson

Regents Professor Emeritus of Accounting and Ernst & Young–J. W. Holloway Memorial Professor Emeritus at Georgia State University. He received his doctorate at Michigan State University in 1963 and held the CPA in Georgia. Professor Hermanson taught and later served as chairperson of the Division of Accounting at the University of Maryland. He has authored or coauthored approximately one-hundred articles for professional and scholarly journals and has coauthored numerous editions of several textbooks, including *Accounting Principles, Financial Accounting, Managerial Accounting, Survey of Financial and Managerial Accounting, Auditing Theory and Practice, How Accounting Works, Principles of Financial and Managerial Accounting,* and *Computerized Accounting with Peachtree Complete III.* He served as the editor of the Plaid Series of 85 programmed learning books on accounting, business, and economics. He also has served on the editorial boards of the *Journal of Accounting Education, New Accountant, Accounting Horizons,* and *Management Accounting.* Professor Hermanson has served as coeditor of the Trends in Accounting Education column for *Management Accounting.* He has held the office of Vice President of the American Accounting Association and served on its executive committee. He was also a member of the Institute of Management Accountants, the American Institute of Certified Public Accountants, and the Financial Executives Institute.

Professor Hermanson has been awarded two excellence in teaching awards, a doctoral fellow's award, and a Distinguished Alumni Professor award; and he was selected as the Outstanding Faculty Member for 1985 by the Federation of Schools of Accountancy. He has served as a consultant to many companies and organizations. In 1990, Professor Hermanson was named Accounting Educator of the Year by the Georgia Society of CPAs.

CAREERS in Accounting

Accounting Professor

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A Career as an Accounting Professor

Do you enjoy college life? Do you enjoy teaching others? If so, you might want to consider a career as a college professor. Although a position as a college professor may pay less than some other career alternatives, the intangible benefits are beyond measure. A college professor can make a real difference in the lives of hundreds, even thousands, of students over a career. Students come to college with great potential, but they are in need of some additional training and guidance. The work of a college professor is an investment in our nation's most valuable resource: people.

College faculty generally teach fewer hours each week than elementary and secondary school teachers. This is because most college faculty members have at least two additional important responsibilities: research and service. The research component represents far more than just summarizing what others have already learned. It represents arriving at new knowledge by discovering things that previously were unknown. For instance, accounting research has demonstrated the ways in which accounting numbers such as earnings and stockholders' equity are related to stock prices. This illustrates the importance of accounting numbers and has resulted in a large stream of discoveries in the area called capital markets research. Besides teaching and research, most faculty members have significant service responsibilities as well. Accounting faculty are involved

in service to the university, the accounting profession, and the general public. Many college faculty members dedicate 10 to 20 hours or more each week to the service component of their jobs.

The demand for college professors varies greatly by discipline. In fields such as psychology, history, and sociology, there is a large supply of candidates with advanced degrees; thus, the competition for positions as college professors in these areas is intense. However, in applied fields such as accounting, information systems, data analytics, and engineering, there is a shortage of candidates with advanced degrees. The opportunities for professors in these applied fields are excellent, and the chance to make a real difference in the lives of others is exciting.

Accounting Theory

CHAPTER 5

This chapter describes the Financial Accounting Standards Board's (FASB) conceptual framework for accounting, a framework that has been built over time taking into consideration previous theories, concepts, and assumptions as well as more current informational needs. To some people, the word *theory* implies something abstract and out of reach. Understanding the theory behind the accounting process, however, helps one to make decisions in diverse accounting situations. **Accounting theory** provides a logical framework for accounting practice. The conceptual framework serves as the theoretical foundation for the development of financial accounting standards. The FASB designed the conceptual framework project to resolve some disagreements about the proper theoretical foundation for accounting. We present only the portions of the project relevant to this text. The final part of the chapter discusses significant accounting policies contained in annual reports issued by companies and illustrates them with an actual example from an annual report of the Walt Disney Company.

Learning Objectives

After studying this chapter, you should be able to:

1. Describe the role of the Financial Accounting Standards Board (FASB).
2. Identify the components of the FASB's Conceptual Framework
3. Identify the objective of financial reporting
4. Identify and discuss the underlying assumptions of accounting.
5. Identify and discuss the major principles of accounting.
6. Identify and discuss the fundamental and enhancing qualitative characteristics of accounting.
7. Identify and discuss the pervasive constraint on accounting information
8. Identify the elements of accounting information.
9. Discuss the nature and content of a company's summary of significant accounting policies in its annual report.

Accounting Standards—Generally Accepted Accounting Principles

Generally accepted accounting principles (GAAP) set forth standards or methods for measuring and presenting financial accounting information. A standardized presentation format enables users to compare the financial information of different companies more easily. Generally accepted accounting principles have been either developed through accounting practice or established by authoritative organizations. Organizations that have contributed to the development of the principles in the United States are the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Standards Board (FASB), the Securities and Exchange Commission (SEC), the American Accounting Association (AAA), the Financial Executives Institute (FEI), and the Institute of Management Accounting (IMA). U.S. GAAP is also influenced by the development of the International Financial Reporting Standards (IFRS) promulgated by the International Accounting Standards Board (IASB).

The Role of the Financial Accounting Standards Board in Standard Setting

Objective 1
Describe the role of the Financial Accounting Standards Board (FASB).

Since the early 1970's, the FASB has been the most influential organization contributing to US GAAP. The **Financial Accounting Standards Board (FASB)** was established in 1973 as an independent, private, not-for-profit organization empowered with the responsibility of setting accounting standards in the United States. The Financial Accounting Foundation supports and oversees the FASB.[1]

1 Before the FASB was established and took over the role of standard setting, the Accounting Principles Board (APB), which was established in 1959, issued pronouncements on accounting principles, called APB Opinions. Prior to the APB, the Committee on Accounting Procedure (CAP), a committee of the AICPA, issued accounting standards in the form of Accounting Research Bulletins (ARBs).

The FASB issues Accounting Standards Updates (ASUs) and Statements of Financial Accounting Concepts. In addition, the FASB maintains the FASB **Accounting Standards Codification (ASC)**, which houses all current nongovernmental US GAAP in one location. Since 2009, all current authoritative generally accepted accounting principles have been included in the ASC. The ASC is organized and searchable by topic area or reference number. For instance, to research how goodwill is accounted for, you could type goodwill into the search area of the ASC, could scroll to goodwill using the ASC menu topics or could type in ASC Section 350-20 to see current GAAP for goodwill. When the FASB issues an ASU, each of which has an effective date of implementation, the changes enacted in the new ASU are updated within the ASC so that the ASC remains an up-to-date resource containing all current US GAAP.

The Financial Accounting Standards Board's Conceptual Framework Project

In addition to issuing Accounting Standards Updates, the FASB also issues Concepts Statements, which identify the objectives and fundamental concepts that should be used in developing accounting and reporting guidance. The Statements of Financial Accounting Concepts are not considered authoritative. In other words, the Concepts Statements provide guidance in developing future Accounting Standards Updates but do not represent new authoritative GAAP. However, the FASB indicated that they can provide guidance in how to apply GAAP in a given circumstance.

The FASB Concepts Statements are the foundation for our discussion of the FASB conceptual framework for standard setting. A summary of FASB Accounting Concepts Statements is listed in Exhibit 5.1 (source *www.fasb.org*). As shown in Exhibit 5.1, later Concepts Statements sometimes replace earlier ones. For instance, the most recent

Concepts Statement No. 8

Conceptual Framework for Financial Reporting—Chapter 1, The Objective of General Purpose Financial Reporting, and Chapter 3, Qualitative Characteristics of Useful Financial Information (a replacement of FASB Concepts Statements No. 1 and No. 2)—Issued 9/2010

Concepts Statement No. 7

Using Cash Flow Information and Present Value in Accounting Measurements—Issued 2/2000

Concepts Statement No. 6

Elements of Financial Statements—a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)—issued 12/1985

Concepts Statement No. 5

Recognition and Measurement in Financial Statements of Business Enterprises—Issued 12/1984

Concepts Statement No. 4

Objectives of Financial Reporting by Nonbusiness Organizations—Issue Date 12/1980

Concepts Statement No. 3 (Superseded)

Elements of Financial Statements of Business Enterprises—Issue Date 12/1980

Concepts Statement No. 2 (Superseded)

Qualitative Characteristics of Accounting Information—Issue Date 5/1980

Concepts Statement No. 1 (Superseded)

Objectives of Financial Reporting by Business Enterprises—Issue Date 11/1978

Exhibit 5.1 Summary of Financial Accounting Concepts Statements (source www.fasb.org)

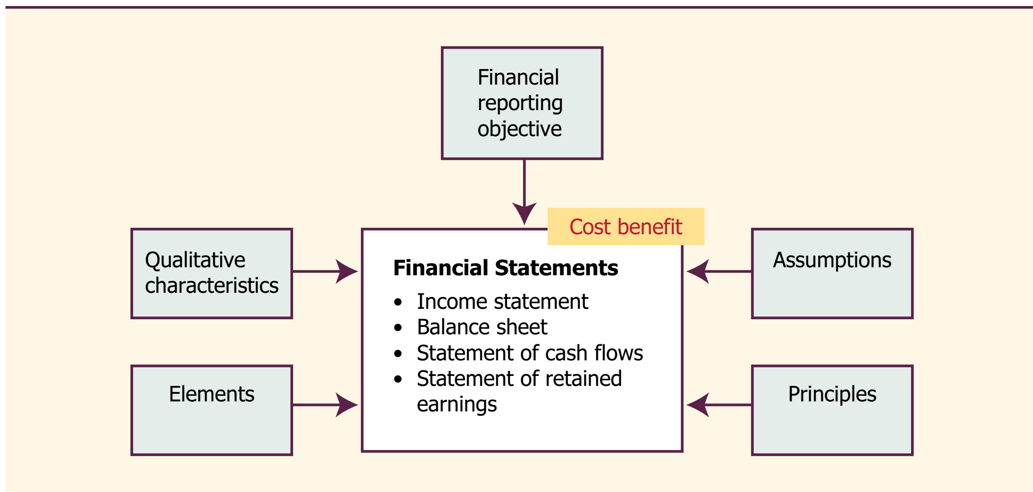

Exhibit 5.2 Major Components of the FASB Conceptual Framework

Statement of Accounting Concepts No. 8 (September 2010) superseded Concepts Statements No. 1 (1978) and No. 2 (1980). Concepts Statement No. 3 was superseded by Concepts Statement No. 6, and Concepts Statement No. 4 pertains to nonbusiness organizations. Therefore, only Concepts Statements No. 5–8 are still relevant for discussing the current format of the conceptual framework for accounting standard setting. Future Concepts Statements are expected and may supersede earlier ones.

Components of the FASB Conceptual Framework

In its present form, the FASB conceptual framework includes an objective of financial reporting, assumptions, principles, qualitative characteristics (both fundamental and enhancing), elements and an overall pervasive constraint (cost-benefit). Exhibit 5.2 graphically exhibits the major components of the FASB Conceptual Framework. As shown in the Exhibit, each of these components play a role in the development of accounting standards governing the preparation of the financial statements and related notes. Each component is discussed in more detail in this chapter.

Objective 2
Identify the components of the FASB's Conceptual Framewor

Objective of Financial Reporting

The FASB defines the **Objective of Financial Reporting** as follows:

> … to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit.[2]

Objective 3
Identify the objective of financial reporting

Underlying Assumptions

The current FASB conceptual framework includes four major assumptions, specifically: (1) business entity, (2) going concern (continuity), (3) money measurement, and (4) periodicity.[3] This section discusses the effects of these assumptions on the accounting process.

Objective 4
Identify and discuss the underlying assumptions of accounting.

2 FASB, *Statement of Financial Accounting Concepts No. 8*, "Conceptual Framework for Financial Reporting—Chapter 1, The Objective of General Purpose Financial Reporting, and Chapter 3, Qualitative Characteristics of Useful Financial Information" (Stamford, Conn., 2010). Copyright © by the Financial Accounting Standards Board, High Ridge Park, Stamford, Connecticut 06905, U.S.A. Copies of the complete document are available from the FASB.

3 FASB, *Statement of Financial Accounting Concepts No. 8,* "Conceptual Framework for Financial Reporting—Chapter 1, The Objective of General Purpose Financial Reporting, and Chapter 3, Qualitative Characteristics of Useful Financial Information" (Stamford, Conn., 2010). Copyright © by the Financial Accounting Standards Board, High Ridge Park, Stamford, Connecticut 06905, U.S.A. Copies of the complete document are available from the FASB.

Business Entity

Data gathered in an accounting system must relate to a specific business unit or entity. The **business entity concept** assumes that each business has an existence separate from its owners, creditors, employees, customers, interested parties, and other businesses. For each business (such as a horse stable or a fitness center), the business—not the business owner—is the accounting entity. Therefore, financial statements are identified as belonging to a particular business entity. The content of these financial statements reports only on the activities, resources, and obligations of that entity.

A business entity may be made up of several different legal entities. For instance, a large business (such as General Electric Corporation) may consist of several separate corporations, each of which is a separate legal entity. For reporting purposes, however, the corporations may be considered as one business entity because they have a common ownership. Chapter 14 illustrates this concept.

Going Concern (continuity)

When accountants record business transactions for an entity, they assume it is a going concern. The **going-concern (continuity) assumption** states that an entity will continue to operate indefinitely unless strong evidence exists that the entity will terminate. The termination of an entity occurs when a company ceases business operations and sells its assets. The process of termination is called liquidation. If liquidation appears likely, the going-concern assumption is no longer valid.

NOTE TO THE STUDENT

The going-concern concept is important because it serves as the basis for allowing accountants to classify certain assets and liabilities as long-term or short-term. Without this assumption, balance sheet accounts would have to be reported at liquidation values and reported as short-term.

Accountants often cite the going-concern assumption to justify using historical costs rather than market values in measuring certain assets. Market values are of less significance to an entity that is using its assets for operations rather than selling them. Conversely, if an entity is liquidating, it should use **liquidation** values to report assets. In August 2014, the FASB issued new disclosure guidance regarding an entity's ability to continue as a going concern.[4] The guidance requires management to evaluate at each annual and interim reporting period whether substantial doubt exists about an entity's ability to meet its obligations as they become due within one year after the date that the financial statements are issued. The new guidance became effective for annual reporting periods ending after December 15, 2016.

Money Measurement

The economic activity of a business is normally recorded and reported in monetary terms. **Money measurement** is the use of a monetary unit such as the dollar instead of physical or other units of measurement. Using a particular monetary unit provides accountants with a common unit of measurement to report economic activity. Without a monetary unit, it would be impossible to add such items as buildings, equipment, and inventory on a balance sheet.

Financial statements identify their unit of measure (such as the dollar in the United States) so that the statement user can make valid comparisons of amounts. For example, it would be difficult to compare the relative asset amounts or profitability of a company reporting in U.S. dollars with those of a company reporting in Japanese yen.

4 FASB, *Accounting Standards Update ("ASU") 2014-15*, Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern. (Stamford, Conn., 2014). Copyright © by the Financial Accounting Standards Board, High Ridge Park, Stamford, Connecticut 06905, U.S.A. Copies of the complete document are available from the FASB.

An Accounting Perspective

Business Insight The following excerpt from the 2017 annual report of Peregrine Pharmaceuticals, Inc., is an example of the disclosure required when there is substantial doubt as to an entity's ability to continue as a going concern.

> Going Concern–For the year ended April 30, 2017, we adopted Financial Accounting Standards Board ("FASB") Accounting Standards Update ("ASU") 2014-15, Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern, which requires us to evaluate whether there are conditions or events that, in the aggregate, raise substantial doubt about our ability to continue as a going concern and to meet our obligations as they become due within one year after the date that the financial statements are issued.
>
> Our consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. The financial statements do not include any adjustments relating to the recoverability of the recorded assets or the classification of liabilities that may be necessary should it be determined that we are unable to continue as a going concern.
>
> At April 30, 2017, we had $46,799,000 in cash and cash equivalents. We have expended substantial funds on the research and development of our product candidates, and funding the operations of Avid. As a result, we have historically experienced losses and negative cash flows from operations since our inception and we expect negative cash flows from operations to continue for the foreseeable future until we can generate sufficient revenue from Avid's contract manufacturing services to achieve profitability. Therefore, unless and until we are able to generate sufficient revenue from Avid's contract manufacturing services or from the sale or licensing of our product candidate under development, we expect such losses to continue through at least the fiscal year ending April 30, 2018, and as a result, we will require additional capital to fund our operations and to execute our business plans.
>
> Our ability to continue to fund our operations is highly dependent on the amount of cash and cash equivalents on hand combined with our ability to raise additional capital to support our future operations through one or more methods, including but not limited to, (i) raising additional capital in the equity markets, (ii) generating additional revenue from Avid, or (iii) licensing or partnering our product candidate in development.
>
> Historically, we have funded a significant portion of our operations through the issuance of equity. During fiscal year 2017, we raised $31,277,000 in aggregate gross proceeds from the sale of shares of our common stock and raised an additional $1,634,000 in aggregate gross proceeds from the sale of shares of our Series E Preferred Stock (Note 5). Subsequent to April 30, 2017 and through June 30, 2017, we raised an additional $4,304,000 in aggregate gross proceeds from the sale of shares of our common stock (Note 12). As of July 14, 2017, $67,674,000 remained available to us under our effective shelf registration statement, which allows us from time to time to offer and sell shares of our common stock, in one or more offerings, either individually or in combination.
>
> Our ability to raise additional capital in the equity markets to fund our obligations in future periods is dependent on a number of factors, including, but not limited to, the market demand for our common stock. The market demand or liquidity of our common stock is subject to a number of risks and uncertainties, including but not limited to, negative economic conditions, adverse market conditions, adverse financial results, and negative research and development results. If we are unable to either (i) raise sufficient capital in the equity markets, (ii) generate additional revenue from Avid, or (iii) license or partner our product candidate in development, or any combination thereof, we may need to delay, scale back, or eliminate all our research and development efforts, or restructure our operations. In addition, even if we are able to raise additional capital, it may not be at a price or on terms that are favorable to us.
>
> As a result, we have concluded that there is substantial doubt about our ability to continue as a going concern within one year after the date that our financial statements are issued.

An Accounting Perspective

Business Insight What happens when a company not only ceases to be a going concern but is, in fact, in the process of being liquidated? What financial statements should it provide while in liquidation?

There had been diversity in practice for such situations until the FASB provided additional guidance in 2013. On April 22, 2013, the FASB issued ASU 2013–07, *Presentation of Financial Statement: Liquidation Basis of Accounting* (Topic 205). The ASU prescribes that an organization in liquidation must prepare statements that enable users to develop expectations as to what assets will be available for distribution to investors. The provisions of the ASU apply when liquidation is considered "imminent"—that is, when a voluntary plan for liquidation has been approved or when a plan for liquidation has been imposed by other forces such as involuntary bankruptcy. In such cases, an entity must present a statement of net assets in liquidation and a statement of changes in net assets in liquidation. The entity must also include various disclosures, including its plan for liquidation and the significant assumptions being used in preparing the statements.

The amendments under the ASU became effective in 2014.

Implicit in the money measurement assumption in the US is the idea that the dollar is accepted as a reasonably stable unit of measurement. Thus, accountants make no adjustments for the changing value of the dollar in the primary financial statements. However, this assumption creates some difficulty in depreciation accounting. Assume, for example, that a company acquired a building in 1989 and computed the 30-year straight-line depreciation on the building without adjusting for any changes in the value of the dollar. The depreciation deducted in 2019 is the same as the depreciation deducted in 1989. The company makes no adjustments for the difference between the values of the 1989 dollar and the 2019 dollar. Both dollars are treated as equal monetary units of measurement despite substantial price inflation over the 30-year period. Some accountants and business executives have expressed concern over this inflation problem, especially during periods of high inflation.

Periodicity (Time Periods)

According to the **periodicity (time periods) assumption**, accountants divide an entity's life into months or years to report its economic activities. Then, accountants attempt to prepare accurate reports on the entity's activities for these periods. Although these time-period reports provide useful and timely financial information for investors and creditors, they may be inaccurate for some of these time periods because accountants must estimate depreciation expense and certain other adjusting entries.

Accounting reports cover relatively short periods. These time periods are usually of equal length so that statement users can make valid comparisons of a company's performance from period to period. The length of the accounting period must be stated in the financial statements. For instance, so far, the income statements in this text were for either one month or one year. Companies that must publish their financial statements, such as public business entities, generally prepare monthly statements for internal management and publish financial statements quarterly and annually for external statement users.

Accrual Basis and Periodicity Chapter 3 demonstrated that financial statements more accurately reflect the financial status and operations of a company when prepared under the accrual basis rather than the cash basis of accounting. Under the cash basis, we record revenues when cash is received and expenses when cash is paid. Under the accrual basis, however, we record revenues when services are rendered or products are sold and expenses when incurred.

The periodicity assumption requires preparing adjusting entries under the accrual basis. Without the periodicity assumption, a business would have only one time period running from its inception to its termination. As a result, the concepts of cash basis and accrual basis accounting would be irrelevant because all revenues and all expenses would be recorded in that one time period and would not have to be assigned to artificially short periods of one year or less.

Approximation and Judgment because of Periodicity To provide periodic financial information, accountants must often estimate expected uncollectible accounts (see Chapter 9) and the useful lives of depreciable assets. Uncertainty about future events prevents precise measurement and makes estimates necessary in accounting. Fortunately, these estimates are often reasonably accurate.

The Major Principles

The conceptual framework identifies four major principles that have evolved over time within the accounting profession and standard setting community. These four principles include the following:

> **Objective 5**
> Identify and discuss the major principles of accounting.

1. Measurement principle.
2. Revenue recognition principle. } Matching Concept
3. Expense recognition principle. }
4. Full disclosure principle.

Measurement Principle

Whenever resources are transferred between two parties, such as buying merchandise on account, the accountant must follow the *measurement principle* in determining what amount should be used in measuring and presenting that information. The **measurement principle** generally requires an accountant to record transfers of resources at prices agreed on by the parties to the exchange at the time of the exchange. This principle sets forth (1) what goes into the accounting system—transaction data; (2) when it

Reinforcing Problem
E5-1 Match theory terms with definitions.

Assumption or Concept	Description	Importance
Business entity	Each business has an existence separate from its owners, creditors, employees, customers, other interested parties, and other businesses.	Defines the scope of the business, such as a horse stable or physical fitness center. Identifies which transactions should be recorded on the company's books.
Going concern (continuity)	An entity will continue to operate indefinitely unless strong evidence exists that the entity will terminate.	Allows a company to continue carrying plant assets at their historical costs in spite of a change in their market values.
Money measurement	Each business uses a monetary unit of measurement, such as the dollar, instead of physical or other units of measurement.	Provides accountants with a common unit of measure to report economic activity. This concept permits accountants to add and subtract items on the financial statements.
Periodicity (time periods)	An entity's life can be subdivided into months or years to report its economic activities.	Permits accountants to prepare financial statements that cover periods shorter than the entire life of a business. Thus, we know how well a business is performing before it terminates its operations. The need for adjusting entries arises because of this concept and the use of accrual accounting.

Exhibit 5.3 The Underlying Assumptions

is recorded—at the time of exchange; and (3) the amounts—exchange prices—at which assets, liabilities, stockholders' equity, revenues, and expenses are recorded.

With many assets, this principle is referred to as the cost concept, since applicable purchased or self-constructed assets are initially recorded at historical cost. **Historical cost** is the amount paid, or the fair market value of the liability incurred or other resources surrendered, to acquire an asset and place it in a condition and position for its intended use. For instance, when the cost of a plant asset (such as a machine) is recorded, its cost includes the net purchase price plus any costs of reconditioning, testing, transporting, and placing the asset in the location for its intended use.

Some assets such as inventory and accounts receivable are subsequently valued and reported at net realizable value (NRV). In the case of inventory, companies report their inventory at lower-of-cost-or-market values, where market is measured as the net realizable value for most inventory costing methods or as market value (or current cost) for a few types. This topic is discussed in more detail in Chapter 7. **Net realizable value** is defined as the value a company expects to receive after subtracting costs to sell (e.g., as applied to inventory) or costs to collect (e.g., as applied to accounts receivable). The Statement on Accounting Concepts No. 7[5] also discusses how certain assets are valued using a present value of cash flows computation. Present values are discussed in the Appendix to Chapter 15.

Increasingly, many financial statement elements are reported at their **fair values**, meaning what they would be valued at in a fair market if they were sold today. Valuing assets at fair value can be simple as is the case when there is a ready market (e.g., stocks and bonds) for the item, but can also be very complex (e.g., a unique investment with no identifiable market). Both the FASB and the IASB have agreed to use the same framework in determining fair value measurements. Fair values are also used in testing certain plant assets and intangible assets for impairment (a way of determining if an asset should be reduced in value on the financials because of a deterioration of value below book value).

Revenue Recognition Principle

In December 1984, the FASB issued Statement of Financial Accounting Concepts No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises," describing recognition criteria and providing guidance for the timing and nature of information included in financial statements.[6] In theory, revenue should not be difficult to define or measure; it is the inflow of assets from the sale of goods and services to customers, measured by the cash expected to be received from customers. However, the crucial question for the accountant is when to record an item of revenue. The complexity of business transactions and special characteristics of various industries have led to the issuance of nearly 200 pieces of guidance from standards setters regarding revenue recognition. Much of this guidance has to do with how to apply the revenue recognition principle in a given setting. Under the **revenue recognition principle**, revenues should generally be earned and realized before they are recognized (recorded).

Earning of Revenue All economic activities undertaken by a company to create revenues are part of the earning process. Many activities may have preceded the actual receipt of cash from a customer, including (1) placing advertisements, (2) calling on the customer several times, (3) submitting samples, (4) acquiring or manufacturing goods, and (5) selling and delivering goods. For these activities, the company incurs costs. Although revenue was actually being earned by these activities, accountants do not recognize revenue until the time of sale because of the requirement that revenue be *substantially* earned before it is recognized (recorded). This requirement is the earning concept.

5 FASB, *Statement of Financial Accounting Concepts No. 7,* "Using Cash Flow Information and Present Value in Accounting Measurements (Stamford, Conn., 2000). Copyright © by the Financial Accounting Standards Board, High Ridge Park, Stamford, Connecticut 06905, U.S.A. Copies of the complete document are available from the FASB.

6 FASB, *Statement of Financial Accounting Concepts No. 5,* "Recognition and Measurement in Financial Statements of Business Enterprises" (Stamford, Conn., 1984). Copyright © by the Financial Accounting Standards Board, High Ridge Park, Stamford, Connecticut 06905, U.S.A. Copies of the complete document are available from the FASB.

Realization of Revenue Under the **realization concept**, the accountant does not recognize (record) revenue until the seller acquires the right to receive payment from the buyer. The seller acquires this right from the buyer at the time of sale for merchandise transactions or when services have been performed in service transactions. Legally, a sale of merchandise occurs when title to the goods passes to the buyer. The time at which title passes normally depends on the shipping terms—free on board (FOB) shipping point or FOB destination (as we discuss in Chapter 6). As a practical matter, accountants generally record revenue when goods are delivered.

The advantages of recognizing revenue at the time of sale are (1) the actual transaction—delivery of goods—is an observable event; (2) revenue is easily measured; (3) risk of loss due to price decline or destruction of the goods has passed to the buyer; (4) revenue has been earned, or substantially so; and (5) because the revenue has been earned, expenses and net income can be determined. A disadvantage of recognizing revenue at the time of sale is that the revenue might not be recorded in the period during which most of the activity creating it occurred.

Additional Guidance The FASB recently determined that new guidance regarding revenue recognition was needed. A motivating factor was the diversity of recognition practices across industries. Also, the complexity of certain sales and service contracts called for closer scrutiny. For instance, consider a scenario where a computer manufacturer sells a computer bundled with various software programs, a one-year limited warranty on the machine, a commitment for free customer support for one year, and a commitment for one year of software updates for a single price. When should the sales revenue be recognized? At the point of sale? Or one year hence? Or ratably throughout the year after the point of sale? Should the sales price be allocated among the various elements of the agreement, and if so, how?

The FASB issued ASU 2014-09, *Revenue from Contracts with Customers*, on May 28, 2014, to provide new guidance that affects almost all for-profit entities.[7] The new guidance seeks to provide consistent principles for recognizing revenue, regardless of industry or geography. This would replace more than 200 pieces of industry-related guidance that previously existed. The new guidance provides much more disclosure than had previously been included in financial statements.

The ASU requires an organization to identify each of the goods or services promised to customers, then determine whether those goods or services represent a "performance obligation." Under these new rules, revenue will be recognized as each performance obligation is satisfied. Also, the company must allocate the total transaction price of an agreement to each of the various performance obligations contained therein.

Although the ASU itself is quite long (it was issued in three different files), it basically requires a business entity to go through a five-step process to determine the appropriate time to recognize revenue. The steps are as follows:

1. Identify the contract with the customer.
2. Identify the performance obligations or promises in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the various performance obligations in the contract.
5. Recognize revenue as the entity satisfies a performance obligation.

The provisions of the ASU were first scheduled to take effect in 2017 for public business entities and in 2018 for nonbusiness entities. However, feedback from its various stakeholders was such that the FASB issued ASU 2015-04 in May 2014, which deferred

7 FASB, *Statement of Financial Accounting Concepts No. 5,* "Recognition and Measurement in Financial Statements of Business Enterprises" (Stamford, Conn., 1984). Copyright © by the Financial Accounting Standards Board, High Ridge Park, Stamford, Connecticut 06905, U.S.A. Copies of the complete document are available from the FASB. (In case you are wondering why we do not mention *Statement of Financial Accounting Concepts No. 4,* it pertains to accounting for not-for-profit organizations and is, therefore, not relevant to this text.)

An Accounting Perspective

Business Insight Alphabet Inc., the parent holding company of Google, included the following disclosures in its 2015 annual report regarding the application of the new guidance on revenue recognition:

> In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2014-09 (ASU 2014-09) "Revenue from Contracts with Customers." ASU 2014-09 supersedes the revenue recognition requirements in "Revenue Recognition (Topic 605)" and requires entities to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. As currently issued and amended, ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period, though early adoption is permitted for annual reporting periods beginning after December 15, 2016. We are currently in the process of evaluating the impact of the adoption of ASU 2014-09 on our consolidated financial statements, implementing accounting system changes related to the adoption, and considering additional disclosure requirements.

Reinforcing Problem
Annual Report Analysis 5-3 Review the revenue recognition policies in the annual report of Apple Inc.

the effective date of ASU 2014-09 by one year, until 2018 and 2019 for public and non-public entities, respectively. In your intermediate financial accounting courses, you will study the revenue recognition steps in much more detail.

NOTE TO THE STUDENT
In many ways, the new revenue recognition guidance from the FASB mirrors the provisions of IFRS 15, *Revenue from Contracts with Customers*.

NOTE TO THE STUDENT
The FASB and the IASB have been engaged in a long-range project with a view toward *convergence* of U.S. GAAP and IFRS to enhance the consistency and comparability of financial reporting in global capital markets. However, at the present time, full convergence does not appear probable. It is likely that the two bodies will converge where possible but will continue to disagree on the treatment of certain items such as how to account for financial instruments.

Expense Recognition Principle

Expense recognition is closely related to, and sometimes discussed as part of, the revenue recognition principle. The **expense recognition principle** (historically referred to as the **matching concept**) states that expenses should be recognized (recorded) as they are incurred to produce revenues. An expense is the outflow or using up of assets in the generation of revenue. Firms voluntarily incur expense to produce revenue. For instance, a television set delivered by a dealer to a customer in exchange for cash is an asset consumed to produce revenue; its cost becomes an expense. Similarly, the cost of services such as labor is incurred to produce revenue.

Reinforcing Problem
E5-4 Compute the effect on financial statements of incorrectly expensing an asset.

The Timing of Expense Recognition The matching concept implies that a relationship exists between expenses and revenues. For certain expenses, such as costs of acquiring or producing the products sold, you can easily see this relationship. However, when a direct relationship cannot be seen, we charge the costs of assets with limited lives to expense in the periods benefited on a systematic and rational allocation basis. Depreciation of plant assets is an example.

Product costs are costs incurred in the acquisition or manufacture of goods. As you will see in the next chapter, included as product costs for purchased goods are invoice, freight,

and insurance-in-transit costs. For manufacturing companies, product costs include all costs of materials, labor, and factory operations necessary to produce the goods. Product costs attach to the goods purchased or produced and remain in inventory accounts as long as the goods are on hand. We charge product costs to expense when the goods are sold. The result is a precise matching of cost of goods sold expense to its related revenue.

Period costs are costs not traceable to specific products and are expensed in the period incurred. Selling and administrative costs are period costs.

Full Disclosure Principle

The **full disclosure principle** states that information important enough to influence the decisions of an informed user of the financial statements should be disclosed. Depending on its nature, companies should disclose this information either in the financial statements, in notes to the financial statements, or in supplemental statements. In judging whether or not to disclose information, it is better to err on the side of too much disclosure rather than too little. Many lawsuits against Certified Public Accountant (CPAs) and their clients have resulted from inadequate or misleading disclosure of the underlying facts.

We summarize the major principles and describe the importance of each in Exhibit 5.4.

Qualitative Characteristics

Objective 6
Identify and discuss the fundamental and enhancing qualitative characteristics of accounting.

Accounting information should possess qualitative characteristics to be useful in decision making. This criterion is difficult to apply. The usefulness of accounting information in a given instance depends not only on information characteristics but also on the capabilities of the decision makers and their professional advisers. Accountants cannot specify who the decision makers are, their characteristics, the decisions to be made, or the methods

Principle	Description	Importance	
Measurement	Generally requires transfers of resources to be recorded at prices agreed on by the parties to the exchange at the time of the exchange (cost). Certain items are recorded at other amounts, such as current cost, net realizable value, present value, and fair value.	Tells the accountant to record a transfer of resources at an objectively determinable amount at the time of the exchange. Other items are recorded at an amount deemed more meaningful to users.	
Revenue recognition	Revenues should be earned and realized before they are recognized (recorded).	Informs accountant that revenues generally should be recognized when services are performed or goods are sold. Exceptions are made for items such as installment sales and long-term construction projects.	Matching Concept
Expense recognition	Expenses should be recognized (recorded) as they are incurred to produce revenues.	Indicates that expenses are to be recorded as soon as they are incurred rather than waiting until some future time.	Matching Concept
Full disclosure	Information important enough to influence the decisions of an informed user of the financial statements should be disclosed.	Requires the accountant to disclose everything that is important. A good rule to follow is this: if in doubt, disclose. Another good rule is this: if you are not consistent, disclose all the facts and the effect on income.	

Exhibit 5.4 The Major Principles

An Accounting Perspective

Business Insight The accounting model involves reporting revenues earned and expenses incurred by the company. Some have argued that the social benefits and social costs created by the company should also be reported. Suppose, for instance, that a company is dumping waste into a river, and it is believed that this action could cause cancer years later among the citizens downstream. Should this potential future cost be reported when preparing financial statements showing the performance of the company in the current year? What do you think?

chosen to make the decisions. Therefore, they direct their attention to the characteristics of accounting information. The **fundamental qualitative characteristics** of accounting are relevance and faithful representation. These fundamental characteristics are considered critical to accounting information. As discussed below, each of these has sub characteristics. Exhibit 5.5 illustrates the relationship between the fundamental and enhancing qualitative characteristics and the financial reporting objective of decision usefulness to users, with the pervasive constraint cost-benefit serving as a moderator.

Relevance

To have **relevance**, information must be pertinent to or affect a decision. The information must make a difference to someone who does not already have it. Relevant information makes a difference in a decision by first being material and then by affecting users' predictions of outcomes of past, present, or future events and/or also being useful in confirming or correcting expectations. Note that information need not be a prediction to be useful in developing, confirming, or altering expectations. Expectations are commonly based on the present or past. For example, any attempt to predict future earnings of a company would quite likely start with a review of present and past earnings. Although information that merely confirms prior expectations may be less useful, it is still relevant because it reduces uncertainty.

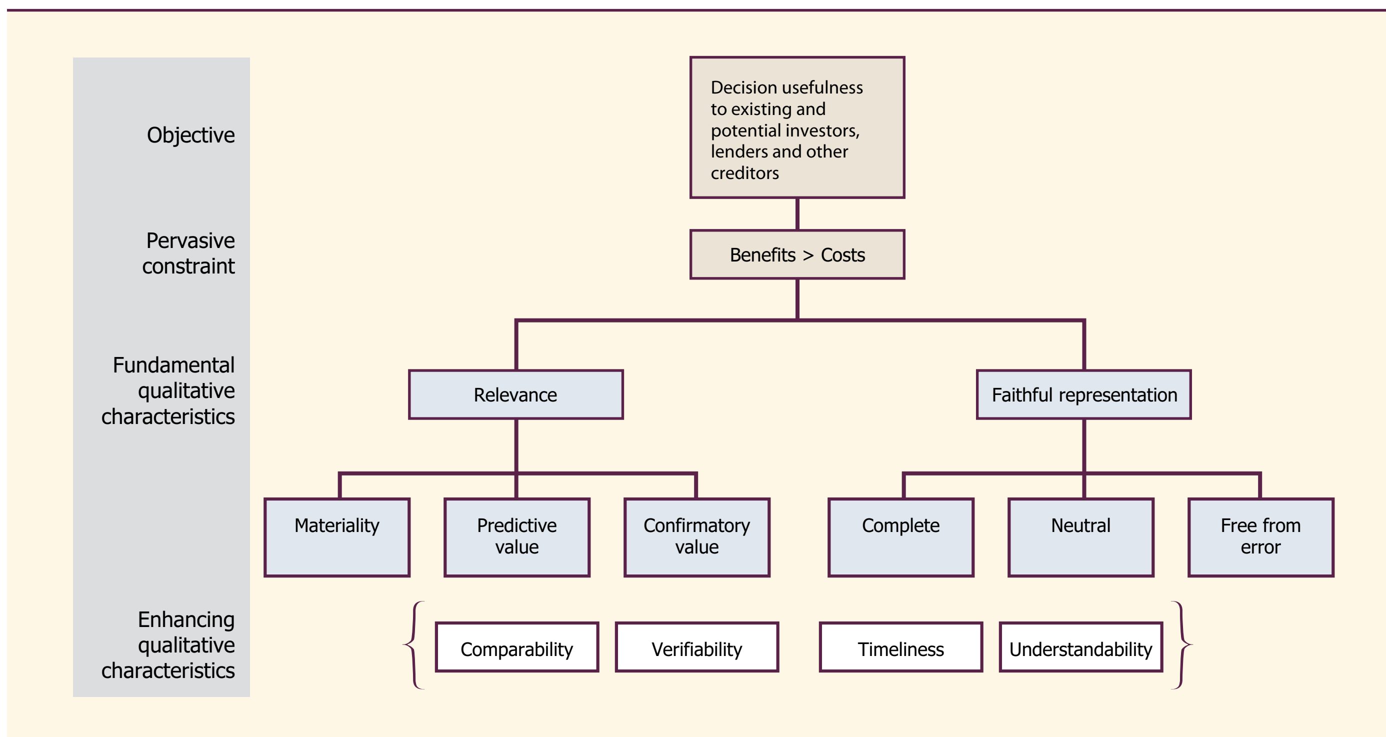

Exhibit 5.5 A Hierarchy of Accounting Qualities

Critics have alleged that certain types of accounting information lack relevance. For example, some argue that a cost of $1 million paid for a tract of land 40 years ago and reported in the current balance sheet at that amount is irrelevant (except for possible tax implications) to users for decision making today. Such criticism has encouraged research into the types of information that are relevant to users. Some suggest using a different valuation basis, such as current cost, in reporting such assets.

Materiality, Predictive Value and Confirmatory (Feedback) Value The three ingredients of relevance are materiality, predictive value and confirmatory value.

Materiality Accounting information must be material to a user to be relevant. The fundamental question accountants must ask in judging the materiality of an item is whether or not the item is significant enough to change a knowledgeable user's decision. If not, the item is immaterial and not relevant and therefore may be recorded in a manner that may not be theoretically correct. For instance, because inexpensive items such as calculators often do not make a difference in a statement user's decision to invest in the company, they are immaterial (unimportant) and may be expensed when purchased. However, because expensive items such as mainframe computers usually do make a difference in such a decision, they are material (important) and should be recorded as assets and depreciated. Accountants should record all material items in a theoretically correct manner because they are relevant for users. They may record immaterial items in a theoretically incorrect manner simply because it is more convenient and less expensive to do so. For example, they may debit the cost of a wastebasket to an expense account rather than an asset account even though the wastebasket has an expected useful life of 30 years. It simply is not worth the cost of recording depreciation expense on such a small item over its life.

The FASB defines **materiality** as "Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report."[8]

The term magnitude in this definition suggests that the materiality of an item may be assessed by looking at its relative size. Materiality is entity specific. Therefore, a $10,000 error in an expense in a company with earnings of $30,000 is material, while the same error in a company earning $30,000,000 may not be material.

Materiality involves more than the relative dollar amounts. Often, the nature of the item makes it material. For example, it may be quite significant to know that a company is paying bribes or making illegal political contributions, even if the dollar amounts of such items are relatively small.

Predictive Value Because actions taken now can affect only future events, information is obviously relevant when it possesses **predictive value**, that is, when it improves users' abilities to predict outcomes of events. Remember that although accounting information may possess predictive value, it does not consist of predictions. Making predictions is a function performed by the decision maker, meaning the decision maker utilizes the accounting information in making predictions. For instance, a decision maker may predict future sales based on past sales trends, or predict future earnings growth based on past earnings and other factors.

Confirmatory Value Many times, information initially has predictive value and then later it has **feedback** or confirmatory value. Information that reveals the relative success of users in predicting outcomes possesses **confirmatory value** (i.e., the ability to provide feedback). Confirmatory value reports on past activities and can make a difference in decision making by (1) reducing uncertainty in a situation, (2) refuting or confirming prior expectations,

8 FASB, *Statement of Financial Accounting Concepts No. 8*, "Conceptual Framework for Financial Reporting—Chapter 1, The Objective of General Purpose Financial Reporting, and Chapter 3, Qualitative Characteristics of Useful Financial Information" (Stamford, Conn., 2010). Copyright © by the Financial Accounting Standards Board, High Ridge Park, Stamford, Connecticut 06905, U.S.A. Copies of the complete document are available from the FASB.

and (3) providing a basis for further predictions. For example, a report on the first-quarter earnings of a company reduces the uncertainty surrounding the amount of such earnings, confirms or refutes the predicted amount of such earnings, and provides a possible basis on which to predict earnings for the full year.

Faithful Representation

To gain insight into this quality, consider a map. When it shows roads and bridges where roads and bridges actually exist, a map possesses faithful representation. A correspondence exists between what is on the map and what is present physically. Similarly, faithful representation exists when accounting statements on economic activity correspond to the actual underlying activity. For accounting information to exhibit **faithful representation**, it should be complete, neutral, and free from error.

Completeness Information must be sufficiently complete to ensure that it validly represents underlying events and conditions. **Completeness** means disclosing all significant information in a way that aids understanding and does not mislead. Firms can reduce the faithful representation of information by omitting information that would make a difference to users. Currently, full disclosure requires presentation of a balance sheet, an income statement, and a statement of cash flows. Companies must also provide necessary notes to the financial statements and supporting schedules. Public business entities have additional reporting requirements. The annual reports of corporations also include a calculation of comprehensive income and statements of changes in stockholders' equity, which contain information included in a statement of retained earnings. Such statements must be complete, with items properly classified and segregated (such as reporting sales revenue separately from other revenues). Required disclosures may be made in (1) the body of the financial statements, (2) the notes to such statements, (3) special communications, and/or (4) the president's letter or other management reports in the annual report.

Another aspect of completeness is fully disclosing all changes in accounting principles and their effects.[9] Disclosure should include unusual activities (loans to officers), changes in expectations (losses on inventory), depreciation expense for the period, details of long-term obligations, new arrangements with certain groups (pension and profit-sharing plans for employees), and significant events that occur after the date of the statements (loss of a major customer). Firms must also disclose accounting policies (major principles and their manner of application) followed in preparing the financial statements.[10] Because of its emphasis on disclosure, we often call this aspect of reliability the *full disclosure principle.*

Neutral **Neutral** means that the accounting information should be free of measurement method bias. The primary concern should be relevance and reliability of the information that results from application of the principle, not the effect that the principle may have on a particular interest. Non-neutral accounting information favors one set of interested parties over others. For example, a particular form of measurement might favor stockholders over creditors, or vice versa. Accounting measurements are not neutral if they are consistently too high or too low. Accountants create bias in accounting measurements by choosing the wrong measurement method or introducing bias either deliberately or through lack of skill. Neutrality seeks to eliminate measurement method **bias**. Accounting information should report economic activity without trying to influence users in a particular direction. Accounting standards are not like tax regulations that deliberately foster or restrain certain types of activity.

9 APB, *APB Opinion No. 20,* "Accounting Changes" (New York, July 1971).

10 APB, *APB Opinion No. 22,* "Disclosure of Accounting Policies" (New York, April 1972).

Free From Error The final attribute of faithful representation is that the information should be **free from error**. Free from error does not mean that it is completely accurate. What it does mean is that information is complete, fully disclosed, described correctly, and comes from an error free process. For instance, an estimate regarding the allowance for uncollectible accounts may not reflect the true exact dollars of receivables that will become uncollectible, but the estimate should have been disclosed as an estimate, described correctly, be complete, and be prepared from an error free process.

Enhancing Qualitative Characteristics

Enhancing qualitative characteristics are less critical than the fundamental characteristics but are still highly desirable. There are four enhancing qualitative characteristics: (1) Comparability, (2) Verifiability, (3) Timeliness, and (4) Understandability.

Reinforcing Problems
E5-5 Match accounting qualities with proper descriptions.
P5-5 Answer questions regarding the conceptual framework project.

Comparability

When c**omparability** exists, reported differences and similarities in financial information are real and not the result of differing accounting treatments. Comparable information reveals relative strengths and weaknesses in a single company through time and between two or more companies at the same time.

Consistency is a component of comparability that requires that a company use the same accounting principles and reporting practices throughout time. Consistency leads to comparability of financial information for a single company over time. Comparability between companies is more difficult because they may account for the same activities in different ways. For example, Company B may use one method of depreciation, whereas Company C accounts for an identical asset in similar circumstances using another method. A high degree of intercompany comparability in accounting information does not exist unless accountants are required to account for the same activities in the same manner across companies and throughout time.

Consistency prohibits indiscriminate switching of accounting principles or methods, such as changing inventory methods every year. However, consistency does not prohibit a change in accounting principles if the information needs of financial statement users are better served by the change. When a company makes a change in accounting principles, it must make the following disclosures in the financial statements: (1) nature of the change; (2) reasons for the change; (3) effect of the change on current net income, if significant; and (4) cumulative effect of the change on past income.

Verifiability

Financial information has **verifiability** when independent measurers can substantially duplicate it by using the same measurement methods. Verifiability eliminates measurer bias. The requirement that financial information must be based on objective evidence arises from the demonstrated needs of users for reliable, unbiased financial information. Unbiased information is especially necessary when parties with opposing interests (credit seekers and credit grantors) rely on the same information. If the information is verifiable, this enhances the reliability of information.

Financial information is never completely free of subjective opinion and judgment; it always possesses varying degrees of verifiability. Canceled checks and invoices support some measurements. Accountants can never verify certain measurements, such as periodic depreciation charges, because of their very nature. Thus, financial information in many instances is verifiable only in that it represents a consensus of what other accountants would report if they followed the same procedures.

Timeliness

Timeliness requires accountants to provide accounting information at a time when it may be considered in reaching a decision. The utility of information decreases with age—to know what the net income for 2018 was in early 2019 is much more useful than receiving this information a year later. If information is to be of any value in decision making, it

must be available before the decision is made. If not, the information is of little value. In determining what constitutes timely information, accountants consider the other qualitative characteristics and the cost of gathering information. For example, a timely estimate for uncollectible accounts may be more valuable than a later, verified actual amount. Timeliness alone cannot make information relevant, but potentially relevant information can be rendered irrelevant by a lack of timeliness.

Understandability

To be **understandable**, information should be presented, classified and reported in a clear and concise manner (to the extent possible) with the knowledge that the users of accounting information are assumed to have a reasonable understanding of business and economics. It is also understood that in some cases, users may need to use an advisor for particularly complex information because some information is so complex in nature that it cannot be made easy to understand.

Pervasive Constraint

Ojective 7
Identify and discuss the pervasive constraint on accounting information.

In certain instances, companies do not strictly apply accounting principles because of constraints. **The overriding constraint that modifies all accounting information is the cost-benefit consideration.**

Cost-Benefit The **cost-benefit consideration** involves deciding whether the benefits of including optional information in financial statements exceed the costs of providing the information. Users tend to think information is cost free because they incur none of the costs of providing the information. Preparers realize that providing information is costly. The benefits of using information should exceed the costs of providing it. The measurement of benefits is inexact, which makes application of this modifying convention difficult in practice.

See Exhibit 5.6 for a summary of the pervasive constraint, cost-benefit, and its importance.

As we show in Exhibit 5.6, accountants must consider one pervasive constraint in providing useful information. The benefits secured from the information must be greater than the costs of providing that information. Otherwise, the information should not be provided.

The Basic Elements of Financial Statements

Objective 8
Identify the elements of accounting information.

Thus far we have discussed objectives of financial reporting and qualitative characteristics of accounting information. A third important task in developing a conceptual framework for any discipline is identifying and defining its basic elements. The FASB identified and defined the basic elements of financial statements in *Concepts Statement No. 3*. Later, *Concepts Statement No. 6* revised some of the definitions. We defined most of the terms earlier in this text in a less technical way; the more technical definitions follow. (These items are not repeated in this chapter's New Terms.)

Constraint	Description	Importance
Cost-benefit	Optional information should be included in financial statements only if the benefits of providing it exceed its costs.	Lets the accountant know that information that is not required should be made available only if its benefits exceed its costs. An example may be companies incurring the expense of providing information on the effects of inflation when the inflation rate is low and/or users do not seem to benefit significantly from the information.

Exhibit 5.6 Pervasive Constraint

An Accounting Perspective

Uses of Technology You may want to visit the home page of the Financial Accounting Standards Board at:

http://www.fasb.org

You can check out the latest developments at the FASB to see how the rules of accounting might be changing. You can investigate facts about the FASB, press releases, exposure drafts, publications, emerging issues, FASB actions, forthcoming meetings, and many other topics.

NOTE TO THE STUDENT
Review the definitions of all the terms listed.

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

Equity or net assets is the residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest.

Comprehensive income is 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 are inflows or other enhancements of assets of any entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

Expenses are outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.

Gains are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners.

Losses are decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from expenses or distributions to owners.

Investments by owners are increases in equity of a particular business enterprise resulting from transfers to it from other entities of something valuable to obtain or increase ownership interests (or equity) in it. Assets are most commonly received as investments by owners, but that which is received may also include services or satisfaction or conversion of liabilities of the enterprise.

Distributions to owners are decreases in equity of a particular business enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interest (or equity) in an enterprise.[11]

11 FASB, *Statement of Financial Accounting Concepts No. 6.* "Elements of Financial Statements" (Stamford, Conn., 2010). Copyright © by the Financial Accounting Standards Board, High Ridge Park, Stamford, Connecticut 06905, U.S.A. Copies of the complete document are available from the FASB.

An Accounting Perspective

Business Insight Accountants record expenditures on physical resources such as land, buildings, and equipment that benefit future periods as assets. However, they expense expenditures on human resources for hiring and training that benefit future periods. Also, when a computer is dropped and destroyed, accountants record a loss. However, when the president of the company dies, they record no loss. Should the accounting model be changed regarding the accounting for human resources?

Summary of Significant Accounting Policies

Objective 9
Discuss the nature and content of a company's summary of significant accounting policies in its annual report.

As part of their annual reports, companies include summaries of significant accounting policies. These policies assist users in interpreting the financial statements. To a large extent, accounting theory determines the nature of these policies. Companies must follow GAAP in preparing their financial statements.

Excerpts of the accounting policies of the Walt Disney Company as contained in a recent annual report follow. After each policy, the chapter of this text where we discuss that particular policy is in parentheses. Although a few of the items have already been covered, the others offer a preview of the concepts explained in later chapters.

Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements of the Company include the accounts of The Walt Disney Company and its majority-owned and controlled subsidiaries. Intercompany accounts and transactions have been eliminated in consolidation. (Chapter 14)

Revenue Recognition

Television advertising revenues are recognized when commercials are aired. Revenues from advance theme park ticket sales are recognized when the tickets are used. Revenues from the theatrical distribution of motion pictures are recognized when motion pictures are exhibited. Revenues from home entertainment and video game sales, net of anticipated returns and customer incentives, are recognized on the later of the delivery date or the date that the product can be sold by retailers. Revenues from the licensing of feature films and television programming are recorded when the content is available for telecast by the licensee and when certain other conditions are met. (Chapter 5)

Allowance for Doubtful Accounts

The Company maintains an allowance for doubtful accounts to reserve for potentially uncollectible receivables. The allowance for doubtful accounts is estimated based on our analysis of trends in overall receivables aging, specific identification of certain receivables that are at risk of not being paid, past collection experience and current economic trends. (Chapter 9)

Cash and Cash Equivalents

Cash and cash equivalents consist of cash on hand and marketable securities with original maturities of three months or less. (Chapter 8)

Investments

Debt securities that the Company has the positive intent and ability to hold to maturity are classified as "held-to-maturity" and reported at amortized cost. Debt securities not classified as held-to-maturity and marketable equity securities are considered "available-for-sale" and recorded at fair value with unrealized gains and losses included in accumulated other comprehensive income/(loss) (AOCI). All other equity securities are accounted for using either the cost method or the equity method. (Chapter 14)

An Ethical Perspective

Maplehurst Company

Maplehurst Company manufactures large spinning machines for the textile industry. The company had purchased $100,000 of small hand tools to use in its business. The company's accountant recorded the tools in an asset account and was going to write them off over 20 years. Management wanted to write these tools off as an expense of the current year because revenues this year had been abnormally high and were expected to be lower in the future. Management's goal was to smooth out income rather than showing sharp increases and decreases. When told by the accountant that $100,000 was a material item that must be accounted for in a theoretically correct manner, management decided to consider the tools as consisting of 10 groups, each having a cost of $10,000. Because amounts under $20,000 are considered immaterial for this company, all of the tools could then be charged to expense in the current year.

The accountant is concerned about this treatment. She doubts that she could successfully defend management's position if the auditors or others challenge the expensing of these items.

Inventories

Carrying amounts of merchandise, materials, and supplies inventories are generally determined on a moving average cost basis and are recorded at the lower of cost or market. (Chapter 7)

Film and Television Costs

Film and television costs include capitalizable production costs, production overhead, interest, development costs, and acquired production costs are stated at the lower of cost, less accumulated amortization, or fair value.

The costs of television broadcast rights for acquired movies, series and other programs are expensed based on the number of times the program is expected to be aired or on a straight-line basis over the useful life, as appropriate. (Chapter 11)

Parks, Resorts and Other Property

Parks, resorts, and other property are carried at historical cost. Depreciation is computed on the straight-line method over estimated useful lives. (Chapter 10)

Goodwill, Other Intangible Assets and Long-Lived Assets

The Company is required to test goodwill and other indefinite-lived intangible assets for impairment on an annual basis and if current events or circumstances require, on an interim basis. The Company is required to compare the fair values of other indefinite-lived intangible assets to their carrying amounts. If the carrying amount of an indefinite-lived intangible asset exceeds its fair value, an impairment loss is recognized. Amortizable intangible assets are generally amortized on a straight-line basis over periods up to 40 years. (Chapter 11)

Risk Management Contracts

In the normal course of business, the Company employs a variety of financial instruments (derivatives) including interest rate and cross-currency swap agreements and forward and option contracts to manage its exposure to fluctuations in interest rates, foreign currency exchange rates, and commodity prices. The Company designates and assigns the derivatives as hedges of forecasted transactions, specific assets or specific liabilities. When hedged assets or liabilities are sold or extinguished or the forecasted transactions being hedged are no longer expected to occur, the Company recognizes the gain or loss on the designated hedging instruments. Realized gains and losses from hedges are classified in the income statement consistent with the accounting treatment of the items being hedged. Gains and losses on the termination of effective swap agreements, prior to the original maturity, are deferred and amortized to interest expense over the remaining term of the underlying hedged transactions. (Chapter 14)

Cash flows from hedging activities are classified in the Consolidated Statements of Cash Flows under the same category as the cash flows from the related assets, liabilities or forecasted transactions. (Chapter 16)

Earnings per Share
The Company presents both basic and diluted earnings per share (EPS) amounts. Basic EPS is calculated by dividing net income attributed to Disney by the weighted average number of common and common equivalent shares outstanding during the year. Diluted EPS is based upon the weighted average number of common and common equivalent shares outstanding during the year, which is calculated using the treasury-stock method for equity-based awards (Awards). Common equivalent shares are excluded from the computation in periods for which they have an anti-dilutive effect. Stock options for which the exercise price exceeds the average market price over the period are anti-dilutive and, accordingly, are excluded from the calculation. (Chapter 13)

As you proceed through the remaining chapters, you can see the accounting theories introduced in this chapter being applied. In Chapter 6, for instance, we discuss why sales revenue is recognized and recorded only after goods have been delivered to the customer. So far, we have used service companies to illustrate accounting techniques. Chapter 6 introduces merchandising operations. Merchandising companies, such as clothing stores, buy goods in their finished form and sell them to customers.

Understanding the Learning Objectives

Objective 1
Describe the role of the Financial Accounting Standards Board (FASB)

- The FASB is the current accounting standard setting body in the US and is also responsible for maintaining the Accounting Standards Codification (ASC) and created the conceptual framework for standard setting through the issuance of Concepts Statements.

Objective 2
Identify the components of the FASB's Conceptual Framework

- The FASB's conceptual framework includes an objective of financial reporting, assumptions, principles, qualitative characteristics (both fundamental and enhancing), elements and an overall pervasive constraint (cost-benefit).

Objective 3
Identify the objective of financial reporting

- The objective of financial reporting is to provide accounting information that has decision usefulness to existing and potential investors, lenders, and other creditors.

- Describe the conceptual framework project of the Financial Accounting Standards Board.

Objective 4
Identify and discuss the underlying assumptions of accounting.

- The major underlying assumptions or concepts of accounting are (1) business entity, (2) going concern (continuity), (3) money measurement, and(4) periodicity.

Objective 5
Identify and discuss the major principles of accounting

- The major principles include measurement, revenue recognition, expense recognition, and full disclosure

- The fundamental qualitative characteristics are critical to accounting information and include relevance and faithful representation. Relevance includes materiality, predictive value and confirmatory value. Faithful representation requires that information be complete, neutral, and free from error. The enhancing qualitative characteristics are less critical but still highly desirable and include comparability, verifiability, timeliness, and understandability.

Objective 6
Identify and discuss the fundamental and enhancing qualitative characteristics of accounting.

- Cost-benefit is the pervasive constraint affecting all accounting information. Accounting information should only be reported when the benefits exceed the costs.

Objective 7
Identify and discuss the pervasive constraint on accounting information

- The elements of the financial statements include assets, liabilities, equity, comprehensive income, revenues, expenses, gains, losses, investments by owners and distributions to owners.

Objective 8
Identify the elements of accounting information.

- The summary of significant accounting policies aids users in interpreting the financial statements.

Objective 9
Discuss the nature and content of a company's summary of significant accounting policies in its annual report.

Demonstration Problem

For each of the following transactions or circumstances, state which, if any, of the assumptions, principles, qualitative characteristics, or constraint of accounting have been violated. For each violation, discuss the correction needed, assuming the books have not been closed.

During the year, Dorsey Company did the following:

1. Changed its inventory method from FIFO to weighted average but did not disclose this change in the notes to the financial statements. This change made accounting net income higher for the year.
2. Purchased new electric pencil sharpeners for its offices at a total cost of $60. These pencil sharpeners were recorded as assets and are being depreciated over five years.
3. Recorded the new Mercedes driven by the CEO's spouse as an asset of the company and recorded the first year of depreciation on the vehicle.

Solution to Demonstration Problem

1. The comparability (consistency) principle has been violated. Companies can change their inventory methods but must disclose the change in the notes to the financial statements. In addition, the effects of the change must be shown in the financials by recasting comparative numbers and reflecting any cumulative effect of the change.
2. Theoretically, no violations occurred, but the cost of compiling insignificant information could be considered a violation of acceptable accounting practice. As a practical matter, the $60 could have been expensed on materiality grounds.
3. This violates the business entity assumption that calls for personal economic events to be separately recorded from business economic events. The financial statements of the business should only reflect business related activity. As such, the vehicle should be removed from assets and the means of payment (e.g., loan) should also be removed. The depreciation expense and related accumulated depreciation should also be removed.

New Terms

Accounting Standards Codefication (ASC) A resource maintained by the FASB that houses all current authoritative generally accepted accounting principles in one location. *192*

Accounting theory "A set of basic concepts and assumptions and related principles that explain and guide the accountant's actions in identifying, measuring, and communicating economic information." *191*

Bias Exists when accounting measurements are consistently too high or too low. *204*

Business entity concept The specific unit for which accounting information is gathered. Business entities have a separate existence from owners, creditors, employees, customers, other interested parties, and other businesses. *194*

Comparability An enhancing qualitative characteristic of accounting information; when information is comparable, it reveals differences and similarities that are real and are not the result of differing accounting treatments. *205*

Completeness A quality of accounting information that portrays faithful representation; requires disclosure of all significant information in a way that aids understanding and does not mislead; sometimes called the *full disclosure principle*. *204*

Confirmatory value The ability of information to provide feedback. *203*

Consistency Requires a company to use the same accounting principles and reporting practices through time, and a characteristic of comparability. *205*

Cost-benefit consideration The pervasive constrain on accounting information; determining whether benefits of including information in financial statements exceed costs. *206*

Expense recognition principle Expenses should be recognized as they are incurred to produce revenues, and are generally matched against those revenues in determining net income. *200*

Fair values The amount that an asset is currently worth in a fair market if sold today; also known as market value. *198*

Faithful representation The fundamental qualitative characteristic requiring that accounting statements on economic activity must correspond to the actual underlying activity. Qualities of faithful representation are that the accounting information is complete, neutral, and free from error. *204*

Feedback value A qualitative characteristic that information has when it reveals the relative success of users in predicting outcomes. *203*

Financial Accounting Standards Board (FASB) An independent, private, not-for-profit organization empowered with the responsibility of setting accounting standards in the United States. *191*

Free from error Information that is complete, fully disclosed, described correctly, and comes from an error free process. *205*

Full disclosure principle Information important enough to influence the decisions of an informed user of the financial statements should be disclosed. *201*

Fundamental qualitative characteristics Critical characteristics of accounting information; include relevance and faithful representation. *202*

Generally accepted accounting principles (GAAP) Accepted standards or methods for measuring and presenting financial accounting information. *191*

Going-concern (continuity) assumption The assumption that an entity will continue to operate indefinitely unless strong evidence exists that the entity will terminate. *194*

Historical cost The amount paid, or the fair market value of a liability incurred or other resources surrendered, to acquire an asset and place it in a condition and position for its intended use. *198*

Liquidation Terminating a business by ceasing business operations and selling off its assets. *194*

Matching concept The matching concept can be defined as recognizing expenses in the same period as the related revenues that the expenses were used to generate. *200*

Materiality A modifying convention that allows the accountant to deal with immaterial (unimportant) items in an expedient but theoretically incorrect manner; also, a qualitative characteristic specifying that financial accounting report only information significant enough to influence decisions or evaluations. *203*

Measurement principle Generally requires transfers of resources to be recorded at prices agreed on by the parties to the exchange at the time of the exchange (cost). Certain items are recorded at other amounts, such as current cost, net realizable value, present value, and fair value. *197*

Money measurement Use of a monetary unit of measurement, such as the dollar, instead of physical or other units of measurement—feet, inches, grams, and so on. *194*

Net realizable value (NRV) The value a company expects to receive after subtracting all costs to sell or collect. *198*

Neutral A quality of information that demonstrates faithful representation; requires accounting information to be free of measurement method bias. *204*

Objective of Financial Reporting The broad, overriding goal sought by accountants engaging in financial reporting; that accounting information be useful for decision making by users such as existing and potential investors, lenders and other creditors. *193*

Period costs Costs that cannot be traced to specific products and are expensed in the period incurred. *201*

Periodicity (time periods) assumption An assumption of the accountant that an entity's life can be divided into time periods for reporting its economic activities. *196*

Predictive value A qualitative characteristic that information has when it improves users' abilities to predict outcomes of events. *203*

Product costs Costs incurred in the acquisition or manufacture of goods. Product costs are accounted for as if they were attached to the goods, with the result that they are charged to expense when the goods are sold. *200*

Qualitative characteristics Characteristics that accounting information should possess to be useful in decision making. *202*

Realization concept States that you should not recognize (realize) revenues until the seller acquires the right to receive payment from the buyer. 199

Relevance A qualitative characteristic requiring that information be pertinent to or affect a decision; qualities of relevant information include materiality, predictive value and confirmatory value. *202*

Revenue recognition principle The principle that revenues should be earned and realized before they are recognized (recorded). *198*

Timeliness An enhancing qualitative characteristic requiring that accounting information must be provided at a time when it may be considered before making a decision. *205*

Understandability An enhancing characteristic of accounting information; when possible accounting information should be understandable by someone with a reasonable knowledge of accounting and economic principles. *206*

Verifiability An enhancing qualitative characteristic of accounting information; information is verifiable when it can be substantially duplicated by independent measurers using the same measurement methods. *205*

Self-Test

True/False

Indicate whether each of the following statements is true or false.

1. The business entity assumption assumes that each business has an existence separate from all parties except its owners.
2. When the cost of reporting accounting information exceeds its benefit, it should not be required to be reported.
3. The revenue recognition and expense recognition principles are fundamental to the accrual basis of accounting.
4. Immaterial items do not have to be recorded at all.
5. The conceptual framework project resulted in identifying two primary qualitative characteristics that accounting information should possess: relevance and faithful represenation.

Multiple Choice

Select the best answer for each of the following questions.

1. The underlying assumptions of accounting include all of the following *except*
   a. business entity.
   b. going concern.
   c. full disclosure
   d. money measurement and periodicity.
2. Which accounting concept requires companies to use the same accounting practices and reporting practices throughout time?
   a. Verifiability
   b. Comparability (or Consistency)
   c. Periodicity
   d. None of the above
3. Which of the following statements is *false* regarding the revenue recognition principle and expense recognition principle?
   a. Revenue must be generally be substantially earned before it is recognized.
   b. The accountant usually recognizes revenue before the seller acquires the right to receive payment from the buyer.
   c. Expenses are often matched with the revenues they were used to generate.
   d. Sometimes expenses are best matched with a period.
4. Which of the following is the pervasive constraint applicable to accounting information?
   a. periodicity.
   b. cost-benefit.
   c. materiality.
   d. conservatism.
5. Which of the following is *not* part of the conceptual framework project?
   a. Objectives of financial reporting
   b. Quantitative characteristics
   c. Qualitative characteristics.
   d. Basic elements of financial statements

Now turn to page 222 to check your answers.

Questions

1. Name the assumptions underlying generally accepted accounting principles. Comment on the validity of a stable unit of measurement during periods of high inflation.
2. Why does the accountant use the business entity concept?
3. When is the going-concern assumption not to be used?

4. What is meant by the term *accrual basis of accounting?* What is its alternative?
5. What kind of organization is the FASB and what is its purpose?
6. What other organizations have played a role in standard setting in the United States?
7. Identify the major parts of the conceptual framework project.
8. What are the four assumptions underlying accounting information?
9. What are the two fundamental qualitative characteristics of accounting information?
10. Does materiality relate only to the relative size of dollar amounts?
11. What two requirements generally must be met before recognizing revenue in a period?
12. Define *expense*. What principles guide the recognition of expense?
13. How does an expense differ from a loss?
14. What is full disclosure and what fundamental qualitative characteristic does it relate to?
15. What role does cost-benefit play in financial reporting?
16. If a company changes an accounting principle because the change better meets the information needs of users, what disclosures must be made?
17. What is the measurement principle? What options are there for valuing transations?
18. What is timeliness? Are there any tradeoffs associated with providing timely information?
19. **Real-World Question** A recent annual report of Chevron Corporation stated the following:

    Environmental expenditures that relate to ongoing operations or to conditions caused by past operations are expensed. Expenditures that create future benefits or contribute to future revenue generation are capitalized.

    Which principle of accounting is being followed by this policy?
20. What is the purpose of including a "Summary of Significant Accounting Policies" in the company's annual report?

Exercises

Exercise 5-1
Match theory terms with definitions (L.O. 1–6)

Match the items in Column A with the proper descriptions in Column B.

Column A

1. Going concern (continuity)
2. Comparability(Consistency)
3. Full disclosure
4. Periodicity
5. Money measurement
6. Expense recognition
7. Materiality
8. Historical cost
9. FASB
10. Business entity

Column B

a. Concerned with relative size of dollar amounts
b. Requires separation of personal from business activities in the recording and reporting processes
c. A common basis for the recording of assets
d. Required if the accounting treatment differs from that previously used for a particular item
e. An assumption that would be unreasonable to use in reporting on a firm that had become insolvent
f. None of these
g. Requires a company to use the same accounting procedures and practices through time
h. An assumption that the life of an entity can be subdivided into time periods for reporting purposes
i. The assumption that economic activity can be measured by a monetary unit such as the dollar.
j. The current body responsible for setting accounting standards in the United States.

Exercise 5-2
Answer questions on accounting theory (L.O. 6)

Respond to each of the following:

1. A company acquired some wastebaskets that would last for 20 years to use in its corporate offices. They cost $120 in total. The accountant did not want to set up a depreciation process for such a small asset. How can the accountant avoid doing so and not violate generally accepted accounting principles?

2. A company prepares general-purpose financial statements. One user, who does not have a basic understanding of accounting, complains that he does not understand the complex information contained in the financial statements. What obligation do you believe the company has to meet this user's lack of understanding?
3. Show the impact that revenues and expenses have on each of the financial statements as the financial statements articulate with each other. For example, they would first be recorded in the income statement. Where would their impact be felt in the other financial statements?

Exercise 5-3
Answer questions on accounting theory (L.O. 4, 8)

Respond to each of the following:

1. Describe the difference between the income statement and the comprehensive income statement.
2. Describe how gains and losses are different from revenues and expenses.
3. Describe in what general way the fundamental qualitative characteristics differ from the enhancing qualitative characteristics.
4. Discuss how each of the assumptions of business entity, going concern, periodicity, and money measurement are necessary in accounting theory.

Exercise 5-4
Compute the effect on financial statements of incorrectly expensing an asset (L.O. 5, 6, 8)

A company follows a practice of expensing the premium on its fire insurance policy when the policy is paid. In 2018, the company charged to expense the $9,000 premium paid on a three-year policy covering the period July 1, 2018, to June 30, 2021. In 2015, a premium of $5,400 was charged to expense on the same policy for the period July 1, 2015, to June 30, 2018.

a. State the principle of accounting that was violated by this practice.
b. Compute the effects of this violation on the financial statements for the calendar year 2018.
c. State the basis on which the company's practice might be justified.

Exercise 5-5
Match accounting qualities with proper descriptions (L.O. 2-7)

Match the descriptions in Column B with the accounting qualities in Column A. Use some descriptions more than once.

Column A: Accounting Qualities

1. Relevance
2. Confirmatory value
3. Decision makers
4. Faithful representation
5. Free from error
6. Comparability
7. Benefits exceed costs
8. Predictive value
9. Timeliness
10. Decision usefulness
11. Verifiability
12. Understandability
13. Neutrality
14. Materiality

Column B: Descriptions

a. Users of accounting information
b. Pervasive constraint
c. Objective of financial reporting
d. Fundamental qualitative characteristics
e. Qualities/ingredients of fundamental qualitative characteristics
f. Enhancing qualitative characteristics
g. Entity specific threshold for recognition

Problems

Problem 5-1
Answer multiple-choice questions regarding accounting theory (L.O. 2, 4, 5, 6)

Select the best answer to each of the following questions.

1. The assumption that each business has an existence separate from its owners, creditors, employees, customers, other interested parties, and other businesses is the
   - **a.** going-concern assumption.
   - **b.** business entity concept.
   - **c.** separate entity concept.
   - **d.** corporation concept.
2. Companies should use liquidation values to report assets if which of the following conditions exists?
   - **a.** There are changes in the value of the dollar.
   - **b.** The periodicity assumption is applied.
   - **c.** The company is not a going concern and will be dissolved.
   - **d.** The accrual basis of accounting is not used.
3. Assume that a company has paid for advertising and that the ad has already appeared. The company chose to report the item as prepaid advertising and includes it among the assets on the balance sheet. Previously, the company had always expensed expenditures such as this. This practice is a violation of which of the following?
   - **a.** Generally accepted accounting principles
   - **b.** The expense recognition concept
   - **c.** The consistency concept
   - **d.** All of the above
4. Recording revenue only after the seller has obtained the right to receive payment from the buyer for merchandise sold or services performed is called:
   - **a.** full disclosure.
   - **b.** expense recognition.
   - **c.** revenue recognition.
   - **d.** none of the above.

Problem 5-2
Answer questions on accounting theory (L.O. 2, 4–6,8)

Identify where each of the following terms fits into the Conceptual Framework and indicate how each of them affects one or more of the following financial statements—the income statement, the balance sheet, and the statement of retained earnings.

- **a.** Materiality
- **b.** Comparability
- **c.** Timeliness
- **d.** Going concern
- **e.** Business entity
- **f.** Gains

Problem 5-3
Answer questions on accounting theory (L.O. 2, 4–6, 8)

Identify where each of the following terms fits into the Conceptual Framework and indicate how each of them affects one or more of the following financial statements—the income statement, the balance sheet, and the statement of retained earnings.

- **a.** Predictive value
- **b.** Completeness
- **c.** Verifiability
- **d.** Understandability
- **e.** Periodicity
- **f.** Losses

Problem 5-4
Match principles, assumptions, or concepts with certain accounting procedures followed (L.O. 4-5)

For each of the following numbered items, state the letter or letters of the principle(s), assumption(s), or concept(s) used to justify the accounting procedure followed. The accounting procedures are all correct.

a. Business entity
b. Money measurement assumption
c. Revenue recognition principle
d. Going concern (continuity) assumption
e. Expense recognition principle
f. Measurement principle

1. Inventory is recorded at the lower of cost or market value.
2. A truck purchased in January was reported at 80% of its cost even though its market value at year-end was only 70% of its cost.
3. The collection of $40,000 of cash for services to be performed next year was reported as a current liability.
4. The president's salary was treated as an expense of the year even though he spent most of his time planning the next two years' activities.
5. A supply of printed stationery, checks, and invoices with a cost of $8,500 was treated as a current asset at year-end even though it had no value to others.
6. A tract of land acquired for $180,000 was recorded at that price even though it was appraised at $230,000, and the company would have been willing to pay that amount.
7. The company paid and charged to expense the $4,200 paid to Craig Nelson for the rental of a truck owned by him. Craig Nelson is the sole stockholder of the company.

Problem 5-5
Answer matching question regarding the conceptual framework project (L.O. 2-7)

Match the descriptions in Column B with the proper terms in Column A.

Column A

1. Financial reporting objectives
2. Qualitative characteristics
3. Relevance
4. Predictive value
5. Confirmatory value
6. Timeliness
7. Reliability
8. Faithful representation
9. Verifiability.
10. Neutrality.
11. Comparability.
12. Consistency.
13. Cost-benefit.
14. Materiality.

Column B

a. Information is free of measurement method bias
b. The benefits exceed the costs
c. Relatively large items must be accounted for in a theoretically correct way
d. The information can be substantially duplicated by independent measurers using the same measurement methods
e. When information improves users' ability to predict outcomes of events
f. Broad overriding goals sought by accountants engaging in financial reporting
g. When information is pertinent or bears on a decision
h. The characteristics that accounting information should possess to be useful in decision making
i. Information that reveals the relative success of users in predicting outcomes
j. When accounting statements on economic activity correspond to the actual underlying activity
k. When information is provided soon enough that it may be considered in decision making
l. When information faithfully depicts for users what it purports to represent
m. Requires a company to use the same accounting principles and reporting practices throughout time
n. When reported differences and similarities in information are real and not the result of differing accounting treatments

Alternate Problems

Problem 5-1A
Answer multiple-choice questions regarding accounting theory (L.O. 2, 5-8)

Select the best answer to each of the following questions.

1. A set of basic concepts and assumptions and related principles that explain and guide the accountant's actions in identifying, measuring, and communicating economic information is called
   a. accounting theory.
   b. accounting rules.
   c. accrual basis.
   d. matching concept.
2. Which of the following statements is *false*?
   a. Several separate legal entities properly may be considered to be one accounting entity.
   b. The money measurement assumption is used only when the dollar is absolutely stable.
   c. Public business entities generally prepare monthly financial statements for internal management and publish quarterly and annual financial statements for users outside the company.
   d. Without the periodicity assumption, a business would have only one time period running from the inception of the business to its termination.
3. Which of the following statements is true?
   a. Assets are always recorded at fair value.
   b. The consistency concept prohibits a change in accounting principle even when such a change would better meet the information needs of financial statement users.
   c. Gains and losses primarily differ from revenues and expenses due to the nature of the economic event giving rise to the transaction.
   d. Accounting information must always be understandable by someone with little accounting or economic knowledge.
4. Which of the following statements is true?
   a. All assets are carried indefinitely at their original costs in the financial statements.
   b. Accounting information that is useful for decision making should be required regardless of its cost to report it.
   c. The expense recognition principle is closely related to the revenue recognition principle.
   d. Accountants can easily measure all changes in assets and liabilities because they never involve estimates or calculations.

Problem 5-2A
Determine the effects that each of the following has on one or more of the financial statements. (L.O. 2, 4-6, 8)

Identify where each of the following terms fits into the Conceptual Framework and indicate how each of them affects one or more of the following financial statements—the income statement, the balance sheet, and the statement of retained earnings. (L.O. 2, 4-6, 8)

a. Money measurement
b. Revenue recognition
c. Full disclosure
d. Free from error
e. Neutrality
f. Investments by owners

Problem 5-3A
Determine the effects that each of the following has on one or more of the financial statements. (L.O. 5-8)

Identify where each of the following terms fits into the Conceptual Framework and indicate how each of them affects one or more of the following financial statements—the income statement, the balance sheet, and the statement of retained earnings.

a. Expense recognition
b. Cost-benefit
c. Confirmatory value
d. Comprehensive income
e. Distributions to owners
f. Inflows of cash from performing services

Problem 5-4A
Indicate agreement or disagreement with accounting practices followed and comment (L.O. 4,5)

In each of these circumstances, the accounting practices may be questioned. Indicate whether you agree or disagree with the accounting practice employed, and state the assumptions, concepts, or principles that justify your position.

1. The salaries paid to the top officers of the company were charged to expense in the period in which they were incurred even though the officers spent over half of their time planning next year's activities.
2. No entry was made to record the belief that the market value of the land owned (carried in the accounts at $800,000) had increased.
3. The acquisition of a tract of land was recorded at the price of $400,000 paid for it, even though the company would have been willing to pay $600,000.
4. A truck acquired at the beginning of the year was reported at year-end at 80% of its acquisition price even though its market value then was only 65% of its original acquisition price.

Problem 5-5A
Answer multiple-choice questions regarding the conceptual framework project (L.O. 2-8)

Select the best answer to each of the following questions.

1. The two fundamental qualitative characteristics are
   a. predictive value and materiality.
   b. timeliness and verifiability.
   c. relevance and faithful representation.
   d. comparability and neutrality.
2. A pervasive constraint of accounting information is that
   a. benefits must exceed costs.
   b. the information must be timely.
   c. the information must be neutral.
   d. the information must be verifiable.
3. Enhancing qualitative characteristics include all of the following **except**:
   a. verifiability
   b. timeliness
   c. understandability
   d. neutrality
4. The *basic elements* of financial statements consist of all of the following **except**:
   a. investments by owners
   b. revenues
   c. gains
   d. objectives of financial reporting

Beyond the Numbers—Critical Thinking

Business Decision Case 5-1
Evaluate correctness of accounting practices and give reasons for conclusions (L.O. 2-8)

Jim Casey recently received his accounting degree from State University and went to work for a Big Four CPA firm. After he had been with the firm for about six months, he was sent to the Ling Clothing Company to work on the audit. He was not very confident of his knowledge at this early point in his career. He noticed, however, that some of the company's transactions and events were recorded in a way that might be in violation of accounting theory and generally accepted accounting principles.

Study each of the following facts to see if the auditors should challenge the financial accounting practices used or the intentions of management. Write your decisions and the reasoning behind your conclusions.

This problem can serve as an opportunity to apply accounting theory to situations with which you are not yet familiar and as a preview of future chapters. Some of the following situations relate to material you have already covered, and some situations relate to material to be covered in future chapters. After each item, we have given an indication of the chapter in which that item is discussed. You may research future chapters to find the correct answer. Alternatively, you could use your present knowledge of accounting theory to determine whether or not Casey should challenge each of the financial accounting practices used. Realize, however, that some generally accepted accounting practices were based on compromise and seem to differ with accounting theory as described in this chapter.

1. One of the senior members of management stated the company planned to replace all of the furniture next year. He said that the cash in the Accumulated Depreciation account would be used to pay for the furniture. (Ch. 3)
2. The company held the books open at the end of 2018 so that the company could record some early 2019 sales as 2018 revenue. The justification for this practice was that 2018 was not a good year for profits. (Ch. 3, 5, 6)
3. The company's buildings were appraised for insurance purposes. The appraised values were $10,000,000 higher than the book value. The accountant debited Buildings and credited Paid-in Capital from Appreciation for the difference. (Ch. 5)
4. The company recorded purchases of merchandise at the list price rather than the gross selling (invoice) price. (Ch. 6)
5. Goods shipped to the company from a supplier, FOB destination, were debited to Purchases. The goods were not included in ending inventory because the goods had not yet arrived. (Ch. 5, 6)
6. The company counted some items twice in taking the physical inventory at the end of the year. The person taking the inventory said he had forgotten to include some items in last year's physical inventory, and counting some items twice would make up for the items missed last year so that net income this year would be approximately correct. (Ch. 7)
7. The company switched from FIFO to LIFO in accounting for inventories. The preceding year it had switched from the weighted-average method to FIFO. The reason given for the most recent change was that federal income taxes would be lower. No indication of this switch was to appear in the financial statements. (Ch. 5, 7)
8. Because things were pretty hectic at year-end, the accountant made no effort to reconcile the bank account. His reason was that the bank probably had not made any errors. The bank balance was lower than the book balance, so the accountant debited Miscellaneous Expense and credited Cash for the difference. (Ch. 8)
9. When a customer failed to pay the amount due, the accountant debited Allowance for Uncollectible Accounts and credited Accounts Receivable. The amount of accounts written off in this manner was huge. (Ch. 9)

10. A completely depreciated machine was still being used. The accountant left the asset and its related accumulated depreciation on the books, stopped recording depreciation on the machine, and did not go back and correct earlier years' net income and reduce accumulated depreciation. (Ch. 10)
11. The accountant stated that even though research and development costs incurred to develop a new product would benefit future periods, these costs must be expensed as incurred. This year, $200,000 of these costs were charged to expense. (Ch. 11)
12. An old truck was traded for a new truck. Because the trade-in value of the old truck was higher than its book value, a gain was recorded on the transaction. (Ch. 11)
13. The company paid for a franchise that gave it the exclusive right to operate in a given geographical area for 60 years. The accountant is amortizing the asset over 60 years. (Ch. 11)
14. The company leases a building and has a nonrenewable lease that expires in 15 years. The company made some improvements to the building. Because the improvements will last 30 years, they are being written off over 30 years. (Ch. 11)

Annual Report Analysis 5-2
List "Summary of Significant Accounting Policies" for a real company (L.O. 9)

Refer to the "Summary of Significant Accounting Policies" of Apple Inc., included in the Annual Report Appendix. List the policies discussed. For each of the policies, explain in writing what the company is trying to communicate.

Annual Report Analysis 5-3
Review "Summary of Significant Accounting Policies—Revenue Recognition" for a real company (L.O. 5)

Refer to the section labeled "Revenue Recognition" in the "Summary of Significant Accounting Policies" of Apple Inc., included in the Annual Report Appendix, and answer the following:

a. What types of net sales are included in revenue?
b. When does Apple recognize revenue from the sale of third-party products?
c. How does Apple allocate revenue to the various deliverables included in "multi-element arrangements"?

Ethics—A Writing Experience 5-4
Answer questions regarding ethics case

Refer to the feature "An Ethical Perspective" on page 209. Write out the answers to the following questions:

Is management being ethical in this situation? Explain.

Is the accountant correct in believing that management's position could not be successfully defended? Explain.

What would you do if you were the accountant? Describe in detail.

Group Project 5-5
Undertake research project concerning annual reports (L.O. 9)

In teams of two or three students, go to the library to locate one company's annual report for the most recent year. (As an alternative, annual reports can be downloaded from the SEC's EDGAR site at www.sec.gov/edgar.shtml) Examine the "Summary of Accounting Policies," which is part of the "Notes to Financial Statements" section immediately following the financial statements. As a team, write a memorandum to the instructor detailing the significant accounting policies of the company. The heading of the memorandum should contain the date, to whom it is written, from whom, and the subject matter.

Group Project 5-6
Perform library research (L.O. 1)

With one or two other students and using library sources, write a paper on the history and achievements of the Financial Accounting Standards Board. This board is responsible for establishing the accounting standards and principles for financial accounting in the private sector. It was formed in 1973 and took over the rule-setting function from the Accounting Principles Board of the American Institute of Certified Public Accountants at that time. Be sure to cite sources used and to treat direct quotes properly.

Internet Project 5-7
Check out significant accounting policies (L.O. 9)

Visit the following Internet site for General Electric:

http://www.ge.com

Click on "Investors " and then "Financial Reporting." Find the most recent annual report listed under "Financial Reporting" and then "Notes to Consolidated Financial Statements." Print a copy of the "Summary of Significant Accounting Policies." Write a short report to your instructor summarizing your findings.

Internet Project 5-8
Check on company notes to financial statements

Visit the following Internet site for Tootsie Roll Industries, Inc.:

http://www.tootsie.com

Click on "Company" and then "Financials." Open the most current annual report listed, and locate the notes to the consolidated financial statements. Print a copy of the "Significant Accounting Policies." Write a short report to your instructor summarizing your findings.

Answers to Self-Test

True/False

1. **False.** The business entity assumption assumes that each business has an existence separate from its owners, creditors, employees, customers, other interested parties, and other businesses.
2. **True.** The pervasive constraint on accounting information is that its cost should not exceed its benefit.
3. **True.** Both revenue recognition and expense recognition require that economic events generally be recognized when earned or incurred and accounted for in the proper periods.
4. **False.** Immaterial items do have to be recorded, but they can be recorded in a theoretically incorrect way (e.g., expensing a wastebasket that will last many years).
5. **True.** Relevance and faithful representation are the two primary characteristics.

Multiple Choice

1. **c.** The full disclosure concept is one of the major principles of accounting, rather than an assumption.
2. **b.** The comparability (consistency) concept requires that a company must use the same accounting principles and reporting practices throughout time.
3. **b.** Usually, the accountant does not recognize revenue until the seller acquires the right to receive payment from the buyer.
4. **b.** The pervasive constraint on accounting information is that its benefit should exceed its cost.
5. **b.** The category "quantitative characteristics" is not part of the conceptual framework project.