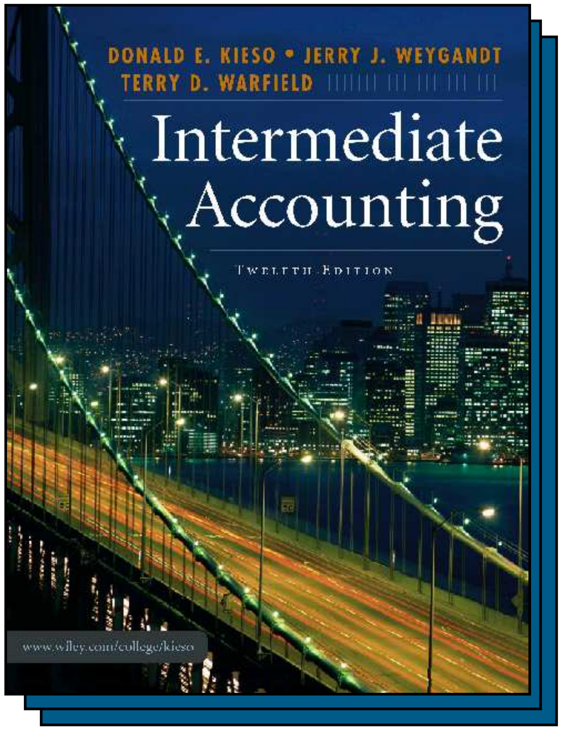
Concepts Underlying Financial Accounting

Chapter 2

Intermediate Accounting
12th Edition
Kieso, Weygandt, and Warfield



Prepared by Coby Harmon, University of California, Santa Barbara

Chapter 2 Learning Objectives

1. Describe the usefulness of a conceptual framework.
2. Describe the FASB's efforts to construct a conceptual framework.
3. Understand the objectives of financial reporting.
4. Identify the qualitative characteristics of accounting information.
5. Define the basic elements of financial statements.
6. Describe the basic assumptions of accounting.
7. Explain the application of the basic principles of accounting.
8. Describe the impact that constraints have on reporting accounting information.

Conceptual Framework

Conceptual Framework

- Need
- Development

First Level: Basic Objectives

Second Level: Fundamental Concepts

- Qualitative characteristics
- Basic elements

Third Level: Recognition and Measurement

- Basic assumptions
- Basic principles
- Constraints

Conceptual Framework

The Need for a Conceptual Framework

- To develop a coherent set of standards and rules
- To solve new and emerging practical problems

Conceptual Framework

Review:

A conceptual framework underlying financial accounting is important because it can lead to consistent standards and it prescribes the nature, function, and limits of financial accounting and financial statements.

True

LO 1 Describe the usefulness of a conceptual framework.

Conceptual Framework

Review:

A conceptual framework underlying financial accounting is necessary because future accounting practice problems can be solved by reference to the conceptual framework and a formal standard-setting body will not be necessary.

False

LO 1 Describe the usefulness of a conceptual framework.

Development of Conceptual Framework

The FASB has issued six **Statements of Financial Accounting Concepts** (SFAC) for business enterprises.

SFAC No.1 - Objectives of Financial Reporting

SFAC No.2 - Qualitative Characteristics of Accounting Information

SFAC No.3 - Elements of Financial Statements (superceded by SFAC No. 6)

SFAC No.4 - Nonbusiness Organizations

SFAC No.5 - Recognition and Measurement in Financial Statements

SFAC No.6 - Elements of Financial Statements (replaces SFAC No. 3)

SFAC No.7 - Using Cash Flow Information and Present Value in Accounting Measurements

LO 2 Describe the FASB's efforts to construct a conceptual framework.

Conceptual Framework

The Framework is comprised of three levels:

- **First Level** = Basic Objectives
- **Second Level** = Qualitative Characteristics and Basic Elements
- **Third Level** = Recognition and Measurement Concepts.

ASSUMPTIONS

1. Economic entity
2. Going concern
3. Monetary unit
4. Periodicity

PRINCIPLES

1. Historical cost
2. Revenue recognition
3. Matching
4. Full disclosure

CONSTRAINTS

1. Cost-benefit
2. Materiality
3. Industry practice
4. Conservatism

Third level

QUALITATIVE CHARACTERISTICS

Relevance

Reliability

Comparability

Consistency

ELEMENTS

Assets, Liabilities, and Equity
Investments by owners
Distribution to owners
Comprehensive income
Revenues and Expenses
Gains and Losses

Second level

OBJECTIVES

1. Useful in investment and credit decisions
2. Useful in assessing future cash flows
3. About enterprise resources, claims to resources, and changes in them

First level

Illustration 2-6

Conceptual Framework for Financial Reporting

LO 2 Describe the FASB's efforts to construct a conceptual framework.

Conceptual Framework

Review:

What are the Statements of Financial Accounting Concepts intended to establish?

a. Generally accepted accounting principles in financial reporting by business enterprises.

b. The meaning of "Present fairly in accordance with generally accepted accounting principles."

c. The objectives and concepts for use in developing standards of financial accounting and reporting.

d. The hierarchy of sources of generally accepted accounting principles.

(CPA adapted)

First Level: Basic Objectives

Financial reporting should provide information that:

(a) is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions.

(b) helps present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts.

(c) portrays the economic resources of an enterprise, the claims to those resources, and the effects of transactions, events, and circumstances that change its resources and claims to those resources.

Conceptual Framework

Review:

According to the FASB conceptual framework, the objectives of financial reporting for business enterprises are based on?

a. Generally accepted accounting principles

b. Reporting on management's stewardship.

c. The need for conservatism.

d. The needs of the users of the information.

(CPA adapted)

LO 3 Understand the objectives of financial reporting.

Second Level: Fundamental Concepts

Question:

How does a company choose an acceptable accounting method, the amount and types of information to disclose, and the format in which to present it?

Answer:

By determining which alternative provides the most useful information for decision-making purposes (**decision usefulness**).

Second Level: Fundamental Concepts

Qualitative Characteristics

"The FASB identified the **Qualitative Characteristics** of accounting information that distinguish better (more useful) information from inferior (less useful) information for decision-making purposes."

LO 4 Identify the qualitative characteristics of accounting information.

Second Level: Qualitative Characteristics

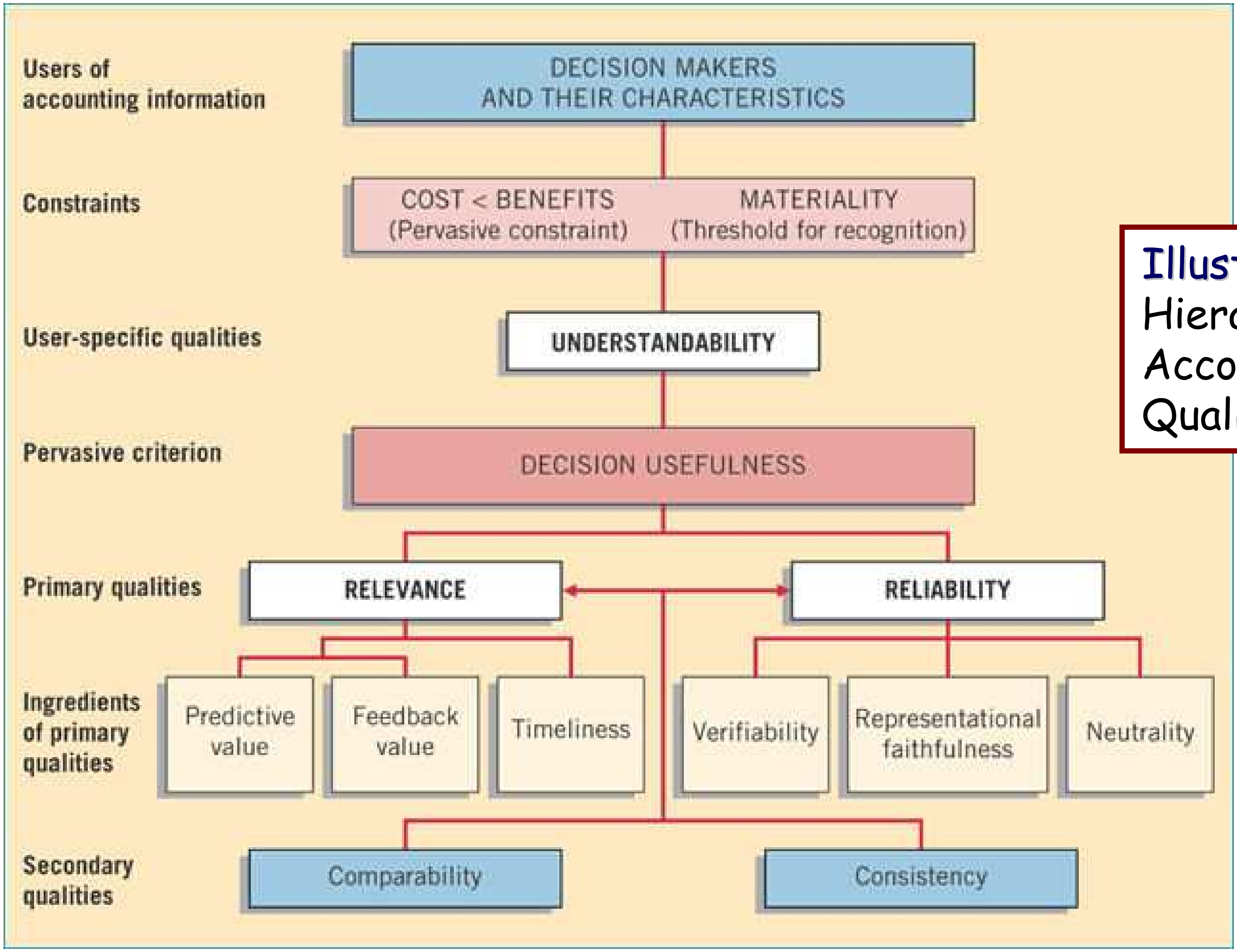


Illustration 2-2
Hierarchy of Accounting Qualities

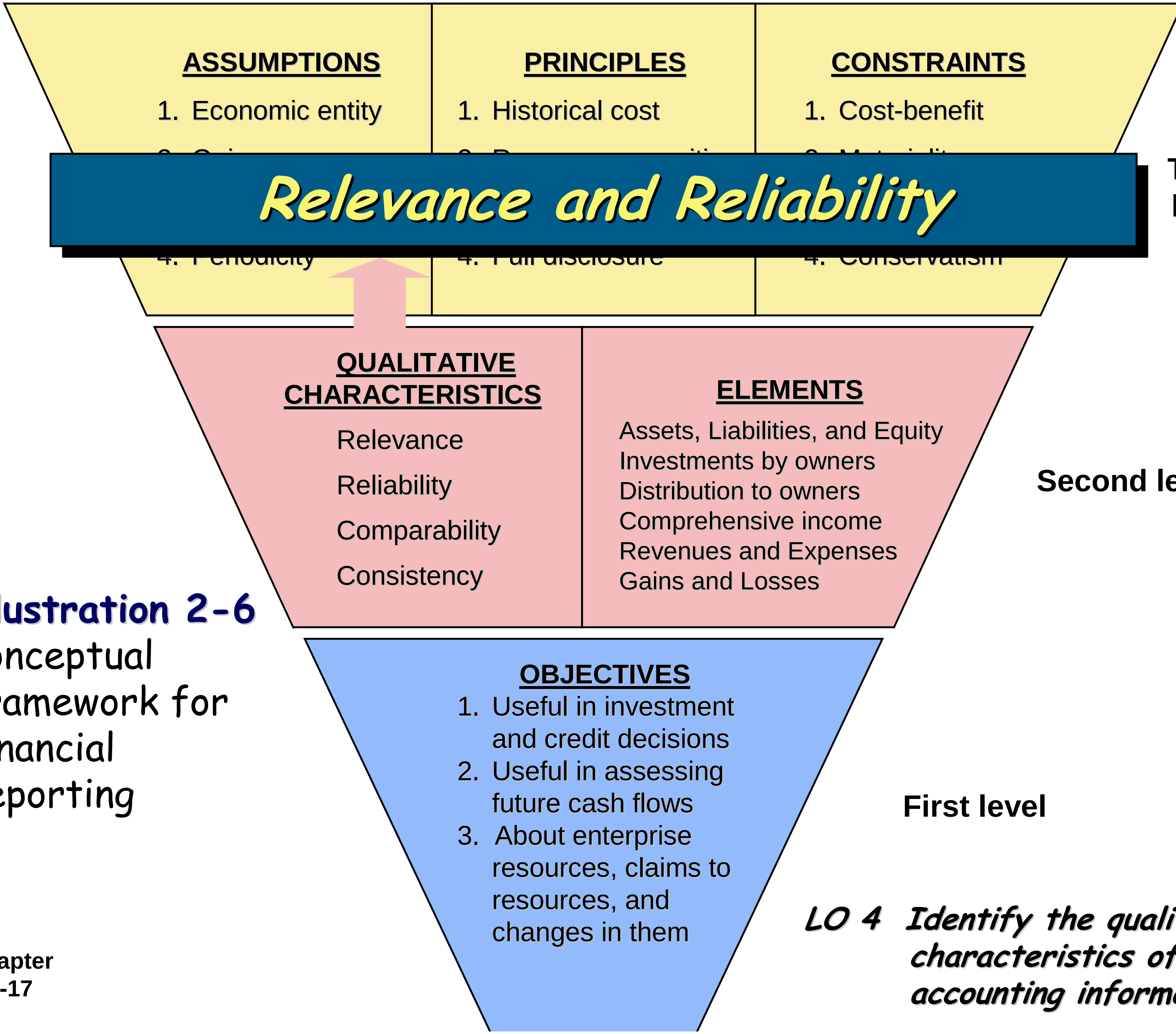
LO 4 Identify the qualitative characteristics of accounting information.

Second Level: Fundamental Concepts

Understandability

A company may present highly relevant and reliable information, however it was useless to those who do not understand it.

LO 4 Identify the qualitative characteristics of accounting information.



Third level

Second level

First level

Illustration 2-6
Conceptual Framework for Financial Reporting

LO 4 Identify the qualitative characteristics of accounting information.

Second Level: Qualitative Characteristics

Primary Qualities:

Relevance – making a difference in a decision.

- Predictive value
- Feedback value
- Timeliness

Reliability

- Verifiable
- Representational faithfulness
- Neutral - free of error and bias

LO 4 Identify the qualitative characteristics of accounting information.

Second Level: Qualitative Characteristics

Review:

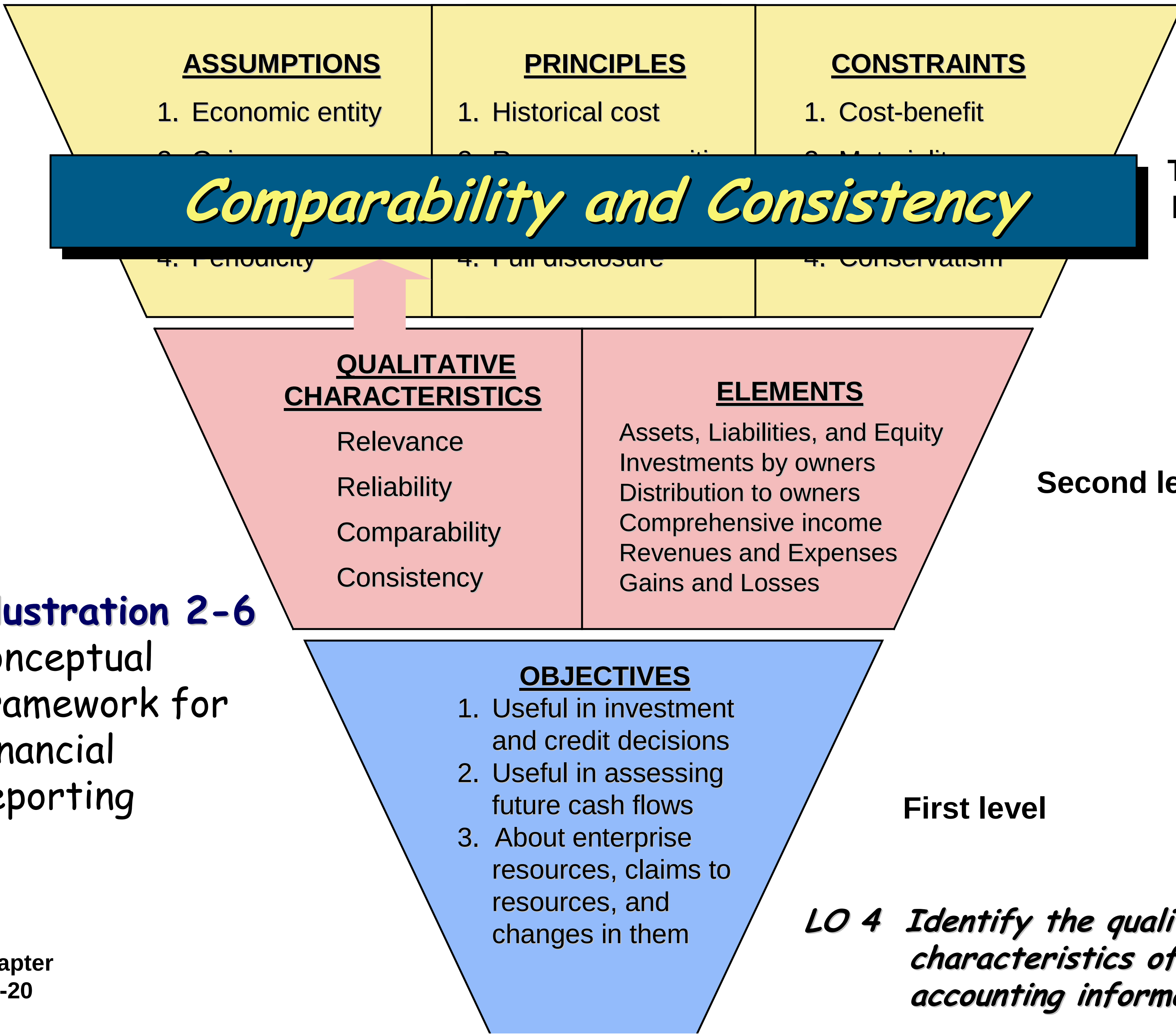
Relevance and reliability are the two primary qualities that make accounting information useful for decision making.

True

To be reliable, accounting information must be capable of making a difference in a decision.

False

LO 4 Identify the qualitative characteristics of accounting information.



Third level

Second level

First level

Illustration 2-6
Conceptual Framework for Financial Reporting

LO 4 Identify the qualitative characteristics of accounting information.

Second Level: Qualitative Characteristics

Secondary Qualities:

Comparability – Information that is measured and reported in a similar manner for different companies is considered comparable.

Consistency - When a company applies the same accounting treatment to similar events from period to period.

Second Level: Qualitative Characteristics

Review:

Adherence to the concept of consistency requires that the same accounting principles be applied to similar transactions for a minimum of five years before any change in principle is adopted.

False

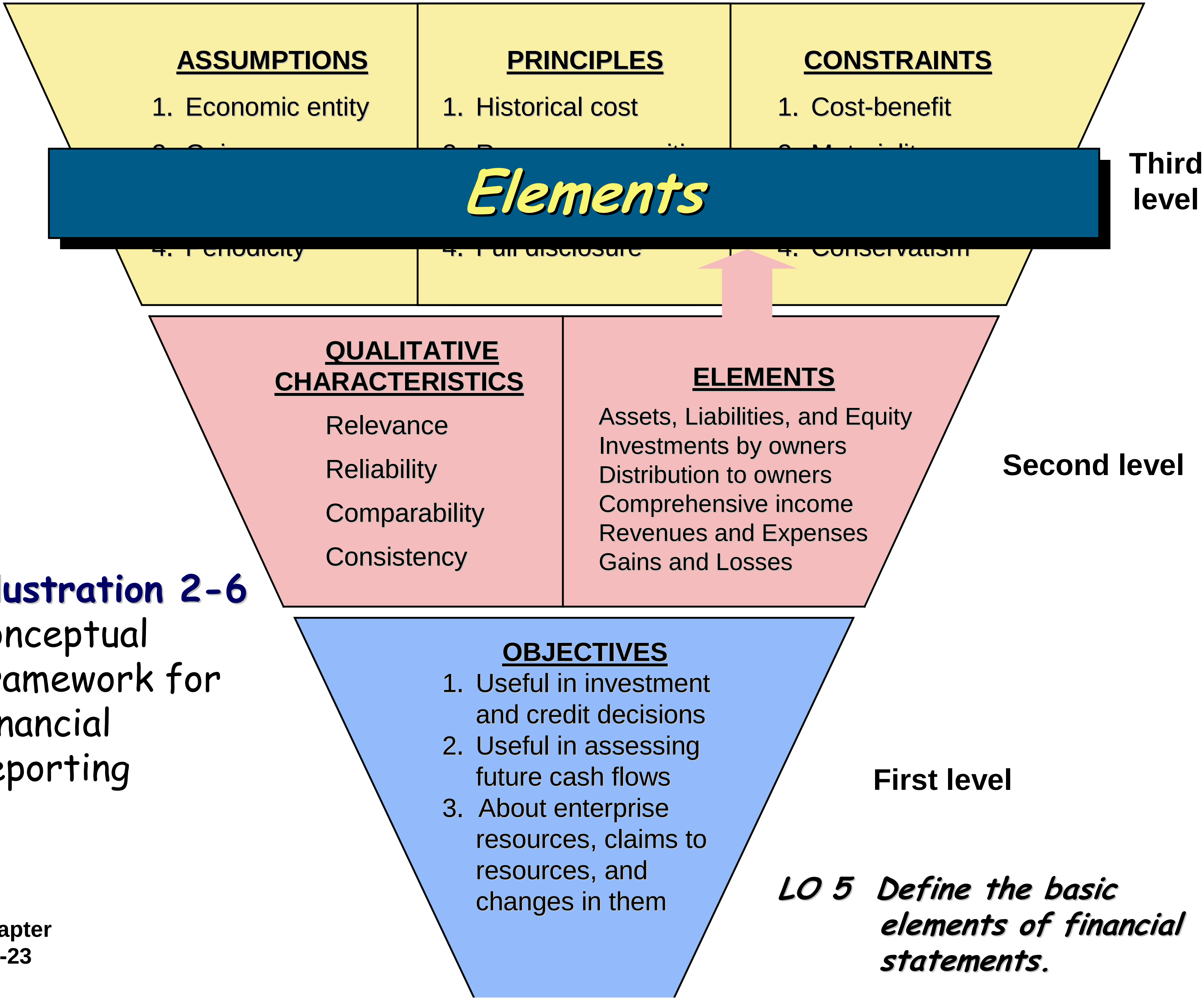


Illustration 2-6
Conceptual Framework for Financial Reporting

LO 5 Define the basic elements of financial statements.

Second Level: Elements

Concepts Statement No. 6 defines ten interrelated elements that relate to measuring the performance and financial status of a business enterprise.

"Moment in Time"

- Assets
- Liabilities
- Equity

"Period of Time"

- Investment by owners
- Distribution to owners
- Comprehensive income
- Revenue
- Expenses
- Gains
- Losses

LO 5 Define the basic elements of financial statements.

Second Level: Elements

Exercise 2-3 Identify the element or elements associated with items below.

(a) Arises from peripheral or incidental transactions.

(b) Obligation to transfer resources arising from a past transaction.

(c) Increases ownership interest.

(d) Declares and pays cash dividends to owners.

(e) Increases in net assets in a period from nonowner sources.

		Elements
		Assets
	(b)	Liabilities
		Equity
	(c)	Investment by owners
	(d)	Distribution to owners
(e)	(c)	Comprehensive income
		Revenue
		Expenses
	(a)	Gains
	(a)	Losses

LO 5 Define the basic elements of financial statements.

Second Level: Elements

Exercise 2-3 Identify the element or elements associated with items below.

(f) Items characterized by future economic benefit.

(g) Equals increase in net assets during the year, after adding distributions to owners and subtracting investments by owners.

(h) Arises from income statement activities that constitute the entity's ongoing major or central operations.

			Elements
		(f)	Assets
		(b)	Liabilities
			Equity
		(c)	Investment by owners
		(d)	Distribution to owners
(g)	(e)	(c)	Comprehensive income
		(h)	Revenue
		(h)	Expenses
		(a)	Gains
		(a)	Losses

LO 5 Define the basic elements of financial statements.

Second Level: Elements

Exercise 2-3 Identify the element or elements associated with items below.

(i) Residual interest in the net assets of the enterprise.

(j) Increases assets through sale of product.

(k) Decreases assets by purchasing the company's own stock.

(l) Changes in equity during the period, except those from investments by owners and distributions to owners.

	Elements
(f)	Assets
(b)	Liabilities
(i)	Equity
(c)	Investment by owners
(k) (d)	Distribution to owners
(l) (g) (e) (c)	Comprehensive income
(j) (h)	Revenue
(h)	Expenses
(a)	Gains
(a)	Losses

LO 5 Define the basic elements of financial statements.

Second Level: Elements

Review:

According to the FASB conceptual framework, an entity's revenue may result from

a. A decrease in an asset from primary operations.

b. An increase in an asset from incidental transactions.

c. An increase in a liability from incidental transactions.

d. A decrease in a liability from primary operations.

(CPA adapted)

Third Level: Recognition and Measurement

The FASB sets forth most of these concepts in its **Statement of Financial Accounting Concepts No. 5**, "Recognition and Measurement in Financial Statements of Business Enterprises."

ASSUMPTIONS	PRINCIPLES	CONSTRAINTS
1. Economic entity	1. Historical cost	1. Cost-benefit
2. Going concern	2. Revenue recognition	2. Materiality
3. Monetary unit	3. Matching	3. Industry practice
4. Periodicity	4. Full disclosure	4. Conservatism

LO 6 Describe the basic assumptions of accounting.

Third Level: Assumptions

Economic Entity – company keeps its activity separate from its owners and other businesses.

Going Concern - company to last long enough to fulfill objectives and commitments.

Monetary Unit - money is the common denominator.

Periodicity - company can divide its economic activities into time periods.

LO 6 Describe the basic assumptions of accounting.

Third Level: Assumptions

Brief Exercise 2-4 Identify which basic assumption of accounting is best described in each item below.

(a) The economic activities of FedEx Corporation are divided into 12-month periods for the purpose of issuing annual reports.

Periodicity

(b) Solectron Corporation, Inc. does not adjust amounts in its financial statements for the effects of inflation.

Monetary Unit

(c) Walgreen Co. reports current and noncurrent classifications in its balance sheet.

Going Concern

(d) The economic activities of General Electric and its subsidiaries are merged for accounting and reporting purposes.

Economic Entity

LO 6 Describe the basic assumptions of accounting.

Third Level: Principles

Historical Cost – the price, established by the exchange transaction, is the "cost".

Issues:

- Historical cost provides a reliable benchmark for measuring historical trends.
- Fair value information may be more useful.
- FASB issued SFAS 15X, "Fair Value Measurements (2005)."
- Reporting of fair value information is increasing.

Third Level: Principles

Revenue Recognition - generally occurs (1) when realized or realizable and (2) when earned.

Exceptions:

- During Production.
- At End of Production
- Upon Receipt of Cash

LO 7 Explain the application of the basic principles of accounting.

Third Level: Principles

Matching - efforts (expenses) should be matched with accomplishment (revenues) whenever it is reasonable and practicable to do so. "Let the expense follow the revenues."

Type of Cost	Relationship	Recognition
Product costs: • Material • Labor • Overhead	Direct relationship between cost and revenue.	Recognize in period of revenue (matching).
Period costs: • Salaries • Administrative costs	No direct relationship between cost and revenue.	Expense as incurred.

Illustration 2-4
Expense Recognition

LO 7 Explain the application of the basic principles of accounting.

Third Level: Principles

Full Disclosure – providing information that is of sufficient importance to influence the judgment and decisions of an informed user.

Provided through:

- Financial Statements
- Notes to the Financial Statements
- Supplementary information

LO 7 Explain the application of the basic principles of accounting.

Third Level: Principles

Brief Exercise 2-5 Identify which basic principle of accounting is best described in each item below.

(a) Norfolk Southern Corporation reports revenue in its income statement when it is earned instead of when the cash is collected.

Revenue Recognition

(b) Yahoo, Inc. recognizes depreciation expense for a machine over the 2-year period during which that machine helps the company earn revenue.

Matching

(c) Oracle Corporation reports information about pending lawsuits in the notes to its financial statements.

Full Disclosure

(d) Eastman Kodak Company reports land on its balance sheet at the amount paid to acquire it, even though the estimated fair market value is greater.

Historical Cost

LO 7 Explain the application of the basic principles of accounting.

Third Level: Constraints

Cost Benefit – the cost of providing the information must be weighed against the benefits that can be derived from using it.

Materiality - an item is material if its inclusion or omission would influence or change the judgment of a reasonable person.

Industry Practice - the peculiar nature of some industries and business concerns sometimes requires departure from basic accounting theory.

Conservatism – when in doubt, choose the solution that will be least likely to overstate assets and income.

LO 8 Describe the impact that constraints have on reporting accounting information.

Third Level: Constraints

Brief Exercise 2-6 What accounting constraints are illustrated by the items below?

(a) Zip's Farms, Inc. reports agricultural crops on its balance sheet at market value.

Industry Practice

(b) Crimson Tide Corporation does not accrue a contingent lawsuit gain of $650,000.

Conservatism

(c) Wildcat Company does not disclose any information in the notes to the financial statements unless the value of the information to users exceeds the expense of gathering it.

Cost-Benefit

(d) Sun Devil Corporation expenses the cost of wastebaskets in the year they are acquired.

Materiality

LO 8 Describe the impact that constraints have on reporting accounting information.

Copyright