

2

OBJECTIVES

After reading this chapter, you will be able to:

- 1 Explain the FASB conceptual framework.
- 2 Understand the relationship among the objectives of financial reporting.
- 3 Identify the general objective of financial reporting.
- 4 Describe the three specific objectives of financial reporting.
- 5 Discuss the types of useful information for investment and credit decision making.
- 6 Explain the qualities of useful accounting information.
- 7 Understand the accounting assumptions and principles that influence GAAP.
- 8 Define the elements of financial statements.

Financial Reporting: Its Conceptual Framework

If It's Broken ... Fix It!

U.S. GAAP is widely considered the most complete and well-developed set of accounting standards in the world. However, because of the recent accounting scandals, U.S. accounting standards have come under increasing criticism as being too rules-based. Some have also questioned the role of accounting standards in facilitating these financial reporting failures. The criticisms of U.S. accounting standards are that they had become too long and complex, contained too many percentage tests (bright lines), and allowed numerous exceptions to the principles underlying the standards. Together, the rules-based nature of the standard is seen to have fostered a “check-the-box mentality” that allowed financial “engineers” to comply with the letter of the standard while not always showing the underlying reality of the transaction. In its review of U.S. accounting standards, the **Securities and Exchange Commission (SEC)** noted that the lease accounting rules are made up of approximately 16 FASB Statements and Interpretations, 9 Technical Bulletins, and more than 30 EITF Abstracts. Also, there are more than 800 pages of accounting guidance relating to derivatives. One prominent controller described recently issued accounting guidance as a mistake that was so complicated that organizations are uncertain if they can even follow the rules. What is the solution?

The SEC has recommended that future accounting standards should not follow a rules-based, nor principles-only approach, but



Credit: Image Source

should be “objectives-oriented.” This principles-based standard setting approach should be built on an improved and consistently applied conceptual framework. This framework should clearly state the accounting objective of the standard, provide sufficient detail and structure so that the standard can be applied consistently, minimize exceptions to the standard, and avoid the use of bright-line tests. The development of objectives-oriented standards should improve the relevance, reliability, and comparability of financial information resulting in more meaningful and informative financial statements.

FOR FURTHER INVESTIGATION

For a discussion of principles-based accounting standards and the implications for accounting standard setting, consult the Business & Company Resource Center (BCRC) and the Internet:

- Defining Principles-Based Accounting Standards. Rebecca Toppe Shortridge, Mark Myring, *The CPA Journal*, 0732-8435, August 2004, v74 i8 p34(4).
- Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System, Securities and Exchange Commission, <http://www.sec.gov/news/studies/principlesbasedstand.htm>.

As we saw in Chapter 1, accounting standards were developed in the United States by the Committee on Accounting Procedure (CAP) and the Accounting Principles Board (APB) before the inception of the Financial Accounting Standards Board (FASB). The CAP and the APB were not able to develop a broad, normative conceptual framework of accounting theory. The APB did issue **APB Statement No. 4**, “Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises.” However, this document described current practice instead of what *should* be appropriate accounting. Although the CAP and APB considered some accounting concepts in setting of accounting standards, generally this was limited to the concepts related to the particular accounting issue at hand. This led, at times, to accounting principles that were inconsistently applied from one issue to another. These inconsistencies led to political pressure on the FASB to develop a general set of concepts and principles to guide its standard setting. In this chapter we discuss the FASB’s conceptual framework of accounting theory. This framework includes:

- the objectives of financial reporting
- the types of useful accounting information
- the qualitative characteristics of accounting information
- accounting assumptions and principles

We also include a brief review of generally accepted accounting principles and financial statements.

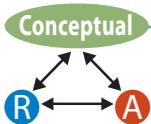
FASB CONCEPTUAL FRAMEWORK

The FASB has been given two charges. First, it is to develop a conceptual framework of accounting theory. Second, it is to establish standards (generally accepted accounting principles) for financial accounting practice. The intent is to develop a **theoretical foundation of interrelated objectives and concepts that leads to the establishment of consistent financial accounting standards**. In other words, the conceptual framework should provide a logical structure and direction to financial accounting and reporting. This conceptual framework is expected to:

1. guide the FASB in establishing accounting standards
2. provide a frame of reference for resolving accounting questions in situations where a standard does not exist
3. determine the bounds for judgment in the preparation of financial statements
4. increase users’ understanding of and confidence in financial reporting
5. enhance comparability

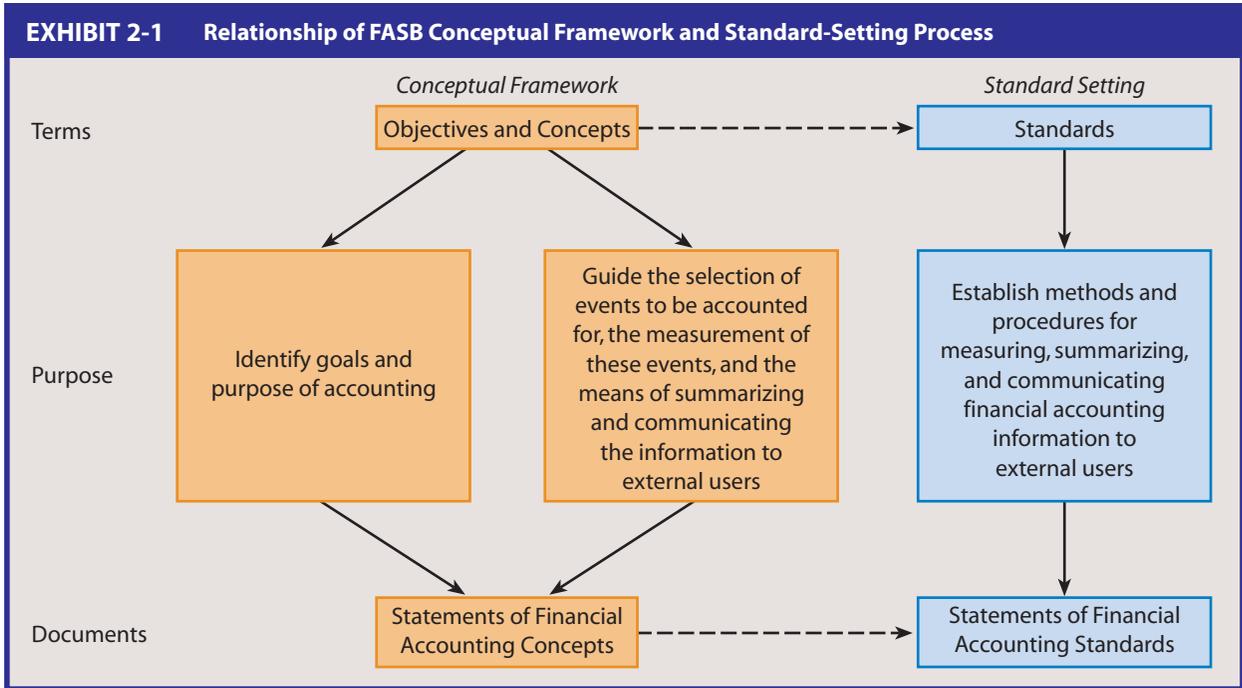
The FASB expects that the conceptual framework will encourage companies to provide financial (and related) information that is useful in efficiently allocating scarce economic resources in capital and other markets.¹

Exhibit 2-1 shows the relationship among the objectives, concepts, and standards, their purposes, and the documents issued by the FASB. The outputs of the conceptual framework are *Statements of Financial Accounting Concepts*; to date, seven have been issued. The outputs of the standard-setting process are *Statements of Financial Accounting Standards*; to date 154 have been issued. The many “statements of standards” are required to identify the preferable accounting practice from the various alternatives that arise in response to the changing, dynamic business environment. As much as possible, the FASB considers its conceptual framework in establishing these standards.



1 Explain the FASB conceptual framework.

1. This discussion is based on a background paper, “The Conceptual Framework Project,” Financial Accounting Standards Board (Stamford, Conn., 1980).

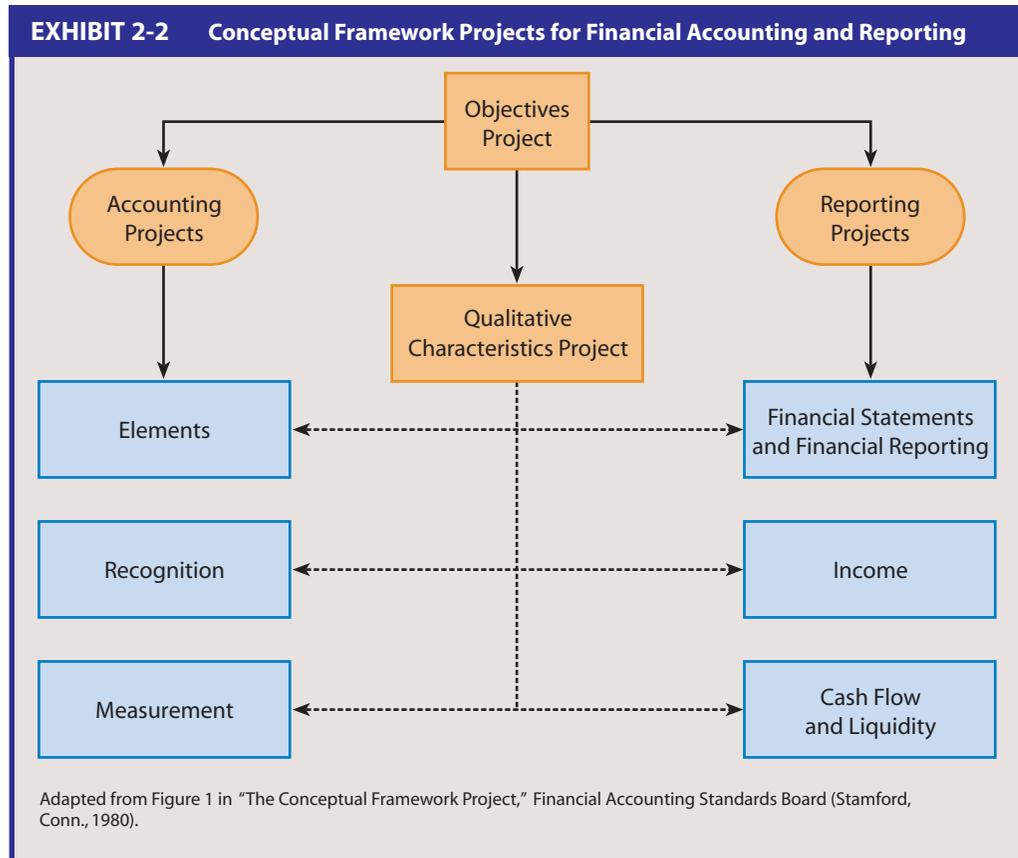


Because of the large task, the FASB divided its conceptual framework activities into several projects. Exhibit 2-2 shows these projects. The first project dealt with identifying the objectives of financial reporting. This project resulted in **FASB Statement of Financial Accounting Concepts No. 1**, “Objectives of Financial Reporting by Business Enterprises.” This document established the focus of the remaining projects, which are divided into two groups (accounting and reporting). The Qualitative Characteristics Project linked together the accounting and reporting projects, as illustrated by the dashed lines in Exhibit 2-2. It also resulted in **FASB Statement of Financial Accounting Concepts No. 2**, “Qualitative Characteristics of Accounting Information.”

The accounting projects define the accounting elements (e.g., assets, liabilities, revenues, expenses) and identify which elements should be reported, when they should be reported (recognized), and how they should be measured.² The reporting projects deal with how the elements of financial reports are “displayed.” Important issues include general questions such as what information should be provided, who should be required to provide the information, and where the information should be presented. Also included are more specific questions about income and its components, as well as cash flow and its components.

The FASB has issued several Statements of Concepts that deal with one or more of these accounting and reporting projects. **FASB Statement of Financial Accounting Concepts No. 3** was issued in 1980. However, this Statement of Concepts was replaced in 1986 by **FASB Statement of Financial Accounting Concepts No. 6**, “Elements of Financial Statements.” **FASB Statement of Financial Accounting Concepts No. 5**, “Recognition and Measurement in Financial Statements of Business Enterprises,” was issued in 1984.³ **FASB Statement of Financial Accounting Concepts No. 7**, “Using Cash Flow Information and Present Value in Accounting Measurements,” was issued in 2000. An Exposure Draft, *FASB Proposed Statement*

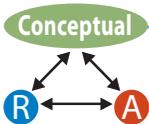
2. For a discussion of these and other issues, see L. T. Johnson and R. K. Storey, “Recognition in Financial Statements: Underlying Concepts and Practical Conventions,” *Research Report* (Stamford, Conn.: FASB, 1982).
 3. **FASB Statement of Financial Accounting Concepts No. 4**, titled “Objectives of Financial Reporting by Nonbusiness Organizations,” has also been issued but is not discussed in this book.



of *Financial Accounting Concepts*, "Reporting Income, Cash Flows, and Financial Position of Business Enterprises," was issued regarding the reporting projects. In addition, several working documents dealing with both accounting and reporting issues were published that may eventually lead to the issuance of other statements of financial accounting concepts. We discuss the Statements of Concepts dealing with the elements, recognition and measurement, and reporting of income and cash flows in Chapters 4 and 5.

In this chapter we discuss the first two Statements of Concepts dealing with the objectives of financial reporting and the qualitative characteristics of accounting information. We also discuss parts of the Exposure Draft dealing with types of useful information.

OBJECTIVES OF FINANCIAL REPORTING



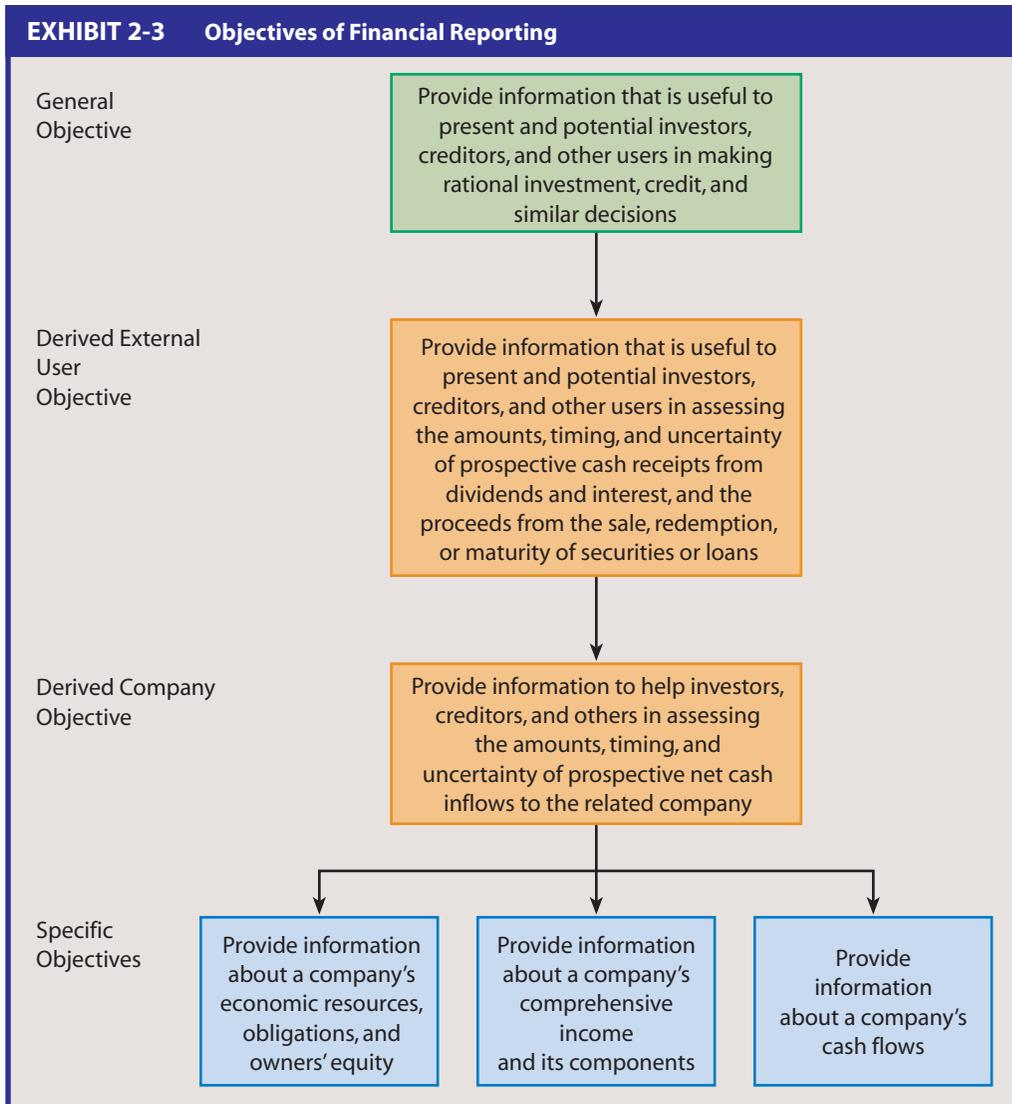
2 Understand the relationship among the objectives of financial reporting.

In its first concepts statement, the FASB stated that the objectives of financial reporting are those of *general-purpose* external reporting by companies. That is, the objectives relate to a *variety* of *external* users as opposed to specific internal users, such as management. These external users do not have the authority to prescribe the financial information they desire from a particular company. Therefore, they must use the information that the management of the company communicates to them.⁴

The FASB identified several objectives of financial reporting. These objectives proceed from the more general to the more specific. We show these objectives in Exhibit 2-3 and discuss them in the following sections.⁵

4. "Objectives of Financial Reporting by Business Enterprises," *FASB Statement of Financial Accounting Concepts No. 1* (Stamford, Conn.: FASB, 1978), par. 28.

5. The discussion in this section primarily is a summary of that presented by the FASB in its "Objectives of Financial Reporting by Business Enterprises."



Information Useful in Decision Making

The top of Exhibit 2-3 shows the most general objective. This objective states that **financial reporting should provide useful information for present and potential investors, creditors, and other external users in making their investment, credit, and similar decisions**. Investors include both equity security holders (stockholders) and debt security holders (bondholders). Creditors include suppliers, customers and employees with claims, individual lenders, and lending institutions. Other external users include brokers, lawyers, security analysts, and regulatory agencies. These external users are expected to have a reasonable understanding of business and economic activities. They are also expected to be willing to study carefully the information to comprehend it.

3 Identify the general objective of financial reporting.

Information Useful to External Users in Assessing Future Cash Receipts

The second objective shown in Exhibit 2-3 relates to external users' needs. It states that **financial reporting should provide information that is useful to external users in assessing the amounts, timing, and uncertainty of prospective cash receipts**. This objective is important because individuals and institutions make cash outflows for investing and lending activities primarily to increase their cash inflows. Whether or not

they are successful depends on the extent to which they receive a return of cash, goods, or services greater than their investment or loan. That is, they must receive not only a return *of* investment, but also a return *on* investment relative to the risk involved. Investment and credit decisions involve choices between present and prospective future cash flows. External users need financial information to help set expectations about the timing and amount of prospective cash receipts (e.g., dividends, interest, proceeds from resale, or repayment) and assess the risk involved.

Information Useful in Assessing Company Cash Flows

Since investors invest in and creditors lend to a particular company, their current and prospective cash receipts are affected by the cash flows of the company. Thus, a third objective shown in Exhibit 2-3 is that **financial reporting should provide information to help external users in assessing the amounts, timing, and uncertainty of the prospective net cash inflows to the related company.** This objective logically flows from the second objective, because a company also invests cash in noncash resources to earn more cash and receive a return *on* its investment in addition to a return *of* its investment.

A company's investment activities are more complex, however, than those of external users. The company completes an "operating cycle" or cycles during which it acquires goods or services, increases their value, sells the goods or services, and collects the selling price. Within this operating cycle numerous cash receipts and payments are collected and paid, in no precise order. The company's ability to generate net cash inflows (i.e., cash inflows greater than cash outflows) affects both its ability to pay dividends and interest and the market prices of its securities. These, in turn, affect investors' and creditors' cash flows.

Information About Economic Resources and Claims to These Resources

The most specific objectives in Exhibit 2-3 are those in the bottom tier, which indicate the types of information that a company should provide in its financial reports. A **specific objective of financial reporting is to provide information about a company's economic resources, obligations, and owners' equity.** This information is useful to external users for four reasons:

- to identify the company's financial strengths and weaknesses and to assess its liquidity
- to provide a basis for evaluating information about the company's performance during a given period
- to provide direct indications of the cash flow potentials of some resources and the cash needed to satisfy obligations
- to indicate the potential cash flows that are the joint result of combining various resources in the company's operations

Information About Comprehensive Income and Its Components

Another specific objective of financial reporting is to provide information about a company's financial performance during a specified period to help external users form expectations about its future performance. The *primary* focus of financial reporting about a company's performance is information concerning the company's *comprehensive income and its components.* Information about comprehensive income is useful to external users in:

- evaluating management's performance
- estimating the company's "earning power," or other amounts that are representative of long-term income-producing ability
- predicting future income
- assessing the risk of investing in or lending to the company

4 Describe the three specific objectives of financial reporting.

We discuss comprehensive income in Chapter 5.

The measurement of comprehensive income should relate (i.e., match) the costs (sacrifices) of a company's operations to the benefits from its operations. The measurement should also include the benefits and costs of other nonoperating transactions, events, and circumstances. This is accomplished by using accrual accounting. Under **accrual accounting** the financial effects of a company's transactions, events, and circumstances having cash consequences are related to the period in which they occur instead of to when the cash receipt or cash payment takes place.⁶

Information About Cash Flows

Although information about comprehensive income is important to external users, **another specific objective of financial reporting is to provide information about a company's cash flows.** Cash flow information shows how a company obtains and spends cash for its operations, investments, borrowings, and capital transactions, including cash dividends and other distributions of company resources to owners. External users use cash (or cash and cash equivalents) flow information about a company to:

- help understand its operations
- evaluate its financing and investing activities
- assess its liquidity
- interpret the comprehensive income information provided

Other Issues

The FASB raised two other important issues in *FASB Statement of Concepts No. 1*. First, **financial reporting should provide information about how the management of a company has discharged its stewardship responsibility** to owners (stockholders) for using the company resources. The management is responsible to the owners for the custody and safekeeping of the resources, their efficient and profitable use, and their protection against unfavorable economic impacts, technological developments, and social changes.

Second, **a company's financial statements and other means of financial reporting should include explanations and interpretations by its management to help external users understand the financial information provided.** This is known as **full disclosure**. Since a company's management knows more about the company's activities than "outsiders," the usefulness of financial information can be enhanced by, for instance:

- explanations of certain transactions, events, and circumstances
- interpretations of the effects on the financial results of dividing continuous operations into accounting periods
- explanations of underlying assumptions or methods used and any related significant uncertainties

The FASB established the qualitative characteristics (e.g., relevance, reliability) that accounting information should possess to be included in financial reports in *FASB Statement of Concepts No. 2*. We include them in the next section of this chapter. The FASB includes definitions of the elements (e.g., assets, liabilities, revenues, and expenses) of financial statements in *FASB Statement of Concepts No. 6*. We include them later in this chapter. We discuss financial statement elements in Chapters 4 and 5.

The FASB's first step in developing its conceptual framework was to establish the objectives of financial reporting. The FASB intends that these objectives will be guidelines



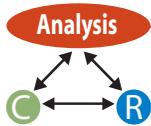
6. *FASB Statement of Concepts No. 1* originally used the term "earnings" instead of "comprehensive income." This latter term was substituted in *FASB Statement of Concepts No. 5* because comprehensive income includes more components. We discuss this issue more fully in Chapter 4.

for providing financial information for investment and credit decisions. Thus, these guidelines will help in the efficient operation of the capital markets and in promoting the efficient allocation of scarce resources.

5 Discuss the types of useful information for investment and credit decision making.

TYPES OF USEFUL INFORMATION

The general objective of financial reporting is to provide information that is useful in investment and credit decision making. On a more specific level, a company's financial reports should provide information to help external users assess the amounts, timing, and uncertainty about its future net cash inflows. The FASB has identified five types of information as being useful in meeting this specific objective. Exhibit 2-4 shows the interrelationship of this useful information with financial reports and external decision making.

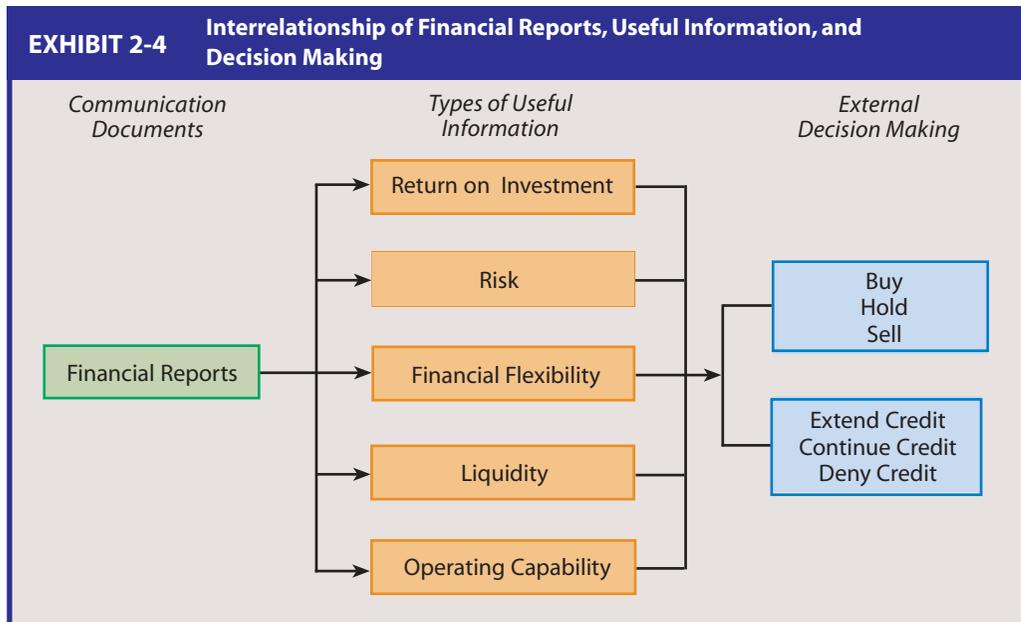


Return on Investment

Return on investment provides a measure of overall company performance. Shareholders (stockholders) invest capital for a share of the equity (stockholders' equity) of a company. These investors are concerned with a return *on* capital. Before a company can provide a return on capital, its capital must be maintained or recovered (i.e., first there must be a return *of* capital to the company). Once a company's capital is maintained, the return *on* capital (i.e., comprehensive income) may be distributed to investors or may be retained by the company for reinvestment.

Risk

Risk is the uncertainty or unpredictability of the future results of a company. The greater the range within which a company's future results are likely to fall, the greater the risk of an investment in or extension of credit to the company. Risk is caused by numerous factors including, for example, high rates of technological change, uncertainty about demand, exposure to the effects of price changes, and political changes in the United States and other countries. In general, the greater the risk of an investment in a particular company, the higher the rate of return expected by investors (or the higher the rate of interest charged by creditors).



Financial Flexibility

Financial flexibility is the ability of a company to use its financial resources to adapt to change. Financial flexibility is important because it enables a company to respond to unexpected needs and opportunities. Financial flexibility comes from a company's ability to:

- adapt operations to increase net operating cash inflows
- raise new capital through, for instance, the sale of debt or stock securities at short notice
- obtain cash by selling assets without disrupting ongoing operations

Financial flexibility affects risk as well as cash flows. It reduces the risk of failure in the event of a shortage in net cash flows from operations.

Liquidity

Liquidity refers to how quickly a company can convert its assets into cash to pay its bills. Liquidity reflects an asset's "nearness to cash." For operating assets, liquidity relates to the timing of cash flows in the normal course of business. For nonoperating assets, liquidity refers to marketability. The liquidity of a company is an indication of its ability to meet its obligations when they come due. Liquidity is positively related to financial flexibility but negatively related to both risk and return on investment. A more liquid company is likely to have a superior ability to adapt to unexpected needs and opportunities, as well as a lower risk of failure. On the other hand, liquid assets often offer lower rates of return than nonliquid assets.

Operating Capability

Operating capability refers to the ability of a company to maintain a given physical level of operations. This level of operations may be indicated by (1) the quantity of goods or services (e.g., inventory) of a specified quality produced in a given period or (2) the physical capacity of the fixed assets (e.g., property, plant, and equipment). Information about operating capability is helpful in understanding a company's past performance and in predicting future changes in its volume of activities. Operating capability may be affected by changes in methods of operations, changes in product lines, and the timing of the replacement of the service potential used up in operations.⁷



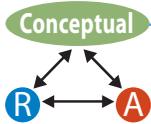
SECURE YOUR KNOWLEDGE 2-1

- The conceptual framework consists of a coherent system of interrelated objectives and concepts that prescribes the nature, function, and limitations of financial reporting.
- The conceptual framework serves as a conceptual underpinning that provides a unified and consistent structure and direction to financial accounting and reporting that allows the FASB to effectively fulfill its mission.
- The objective of financial reporting is to provide information that is useful for external users in making investment, credit, and similar decisions. More specifically, financial reporting should provide information about a company's:
 - economic resources, obligations, and owners' equity;
 - financial performance during a specified period of time; and
 - cash flows.

(continued)

7. "Reporting Income, Cash Flows, and Financial Position of Business Enterprises," *FASB Proposed Statement of Financial Accounting Concepts* (Stamford, Conn.: FASB, 1981), par. 7–33.

- Financial reporting should provide information about how the management of a company has discharged its stewardship responsibility and include explanations and interpretations that help external users understand the financial information provided (full disclosure).
- Information relating to return on investment, risk, financial flexibility, liquidity and operating capability is considered to be useful in assessing the amounts, timing, and uncertainty of a company's future net cash flows.



QUALITATIVE CHARACTERISTICS OF USEFUL ACCOUNTING INFORMATION

In the previous sections we discussed the types of information that are helpful in investment and credit decision making. But what are the characteristics of useful information? The purpose of *FASB Statement of Financial Accounting Concepts No. 2* is to specify the qualitative characteristics or “ingredients” that accounting information should have to be most useful.⁸ These characteristics should be considered when choosing among accounting alternatives, because these qualities distinguish more useful from less useful information.

Each accounting alternative, however, may possess more of one quality and less of another. Although there is much agreement about the qualitative characteristics that “good” accounting information should possess, no “equation” can determine which information has the “best” combination of qualitative characteristics for decision-making purposes. Furthermore, the FASB strives to meet the needs of all users through *general-purpose* financial statements. However, the qualitative characteristics are still important for establishing common accounting standards. The qualitative criteria are helpful to the FASB in setting “minimum” and “maximum” limits of useful accounting information so that it can develop logical accounting standards consistent with these “limits.”

Hierarchy of Qualitative Characteristics

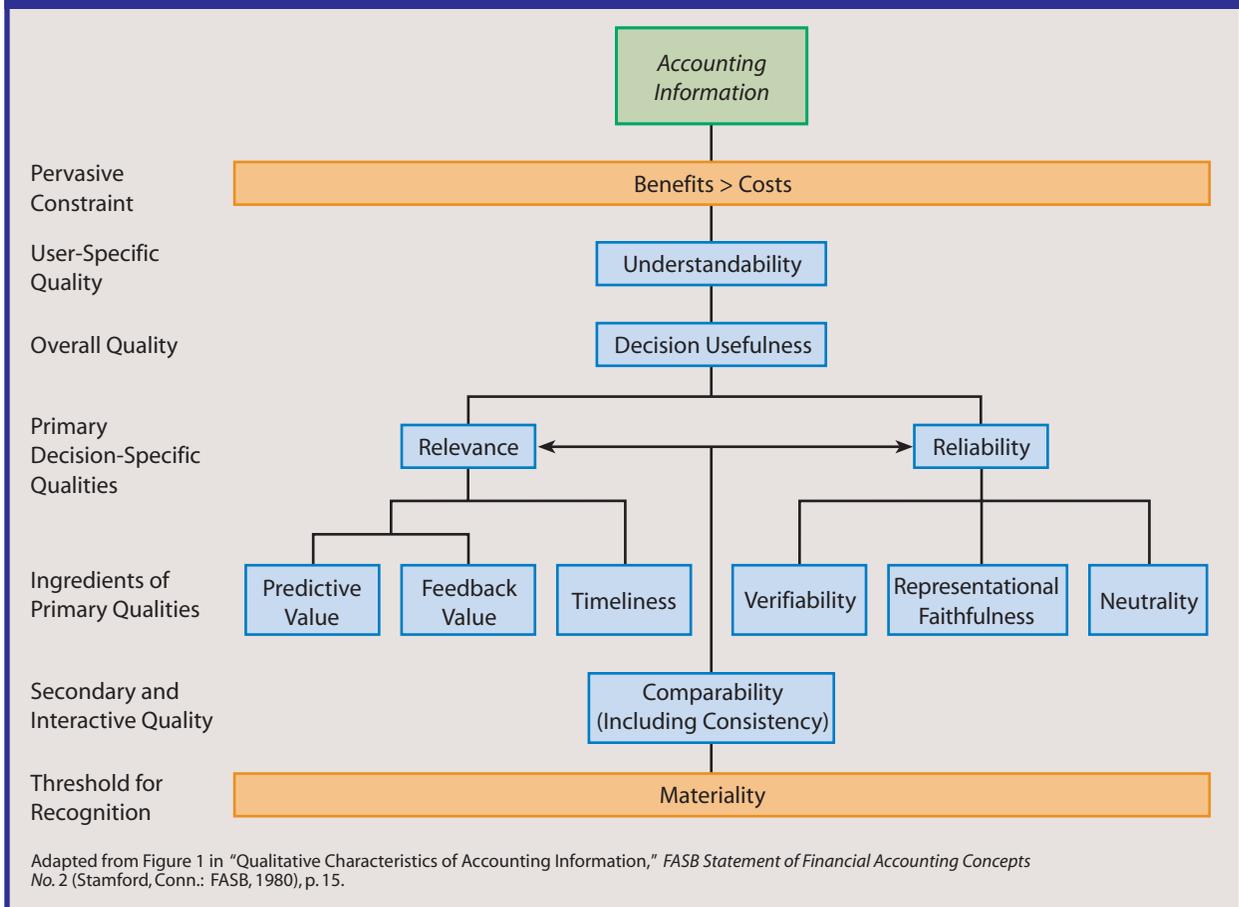
Exhibit 2-5 shows a hierarchy of the qualitative characteristics of accounting information. This section presents an overview of the hierarchy, after which we define and discuss the components in detail. The hierarchy is bounded by *two constraints*: (1) **the benefits must be greater than the costs** (to justify providing the accounting information); and (2) **the dollar amount of the information must be material** (i.e., large enough to make a difference in decision making). The hierarchy is not designed to assign priorities among the qualitative characteristics in all situations. To be useful, **accounting information must have each of the qualitative characteristics to a minimum degree**. However, different situations may require tradeoffs, where the level of one quality is sacrificed for an increase in that of another quality.

Understandability

Accounting information should be **understandable to users who have a reasonable knowledge of business and economic activities and who are willing to study the information carefully**. *Understandability* serves as a “link” between the decision makers and the accounting information. Since the FASB establishes standards for general-purpose financial statements, it is concerned that *broad classes* of decision makers are able to understand the accounting information.

6 Explain the qualities of useful accounting information.

8. The discussion in this section primarily is a summary of that presented in “Qualitative Characteristics of Accounting Information,” *FASB Statement of Financial Accounting Concepts No. 2* (Stamford, Conn.: FASB, 1980).

EXHIBIT 2-5 Hierarchy of Qualitative Characteristics of Accounting Information

Decision Usefulness

Decision usefulness is the overall qualitative characteristic to be used in judging the quality of accounting information. Whether or not information is useful depends on the decision to be made, the way in which it is made, the information already available, and the decision maker's ability to process the information. Since the FASB establishes standards for broad classes of users, however, it must consider the quality of decision usefulness in a broad context. This overall quality can be separated into the primary qualities of relevance and reliability.

Relevance

Accounting information is relevant if it can make a difference in a decision by helping users predict the outcomes of past, present, and future events or confirm or correct prior expectations. In this context, an "event" is a happening that is significant to a company (e.g., the purchase of a building). An "outcome" is the effect or result of an event or series of events (e.g., cash flows generated by use of the building). To be relevant, accounting information does not have to be expressed as a prediction. Information about a company's current resources or obligations or about its past performance commonly is used as a basis for expectations. To be relevant, accounting information should have either predictive or feedback value, or both. In addition, it should be timely.

Predictive Value and Feedback Value

Accounting information has **predictive value** when it helps decision makers forecast more accurately the outcome of past or present events. Accounting information has **feedback value** when it enables decision makers to confirm or correct prior expectations. Often, information has both predictive value and feedback value. This is because knowledge about a company's previous actions (i.e., feedback) generally will improve a decision maker's ability to predict the results of similar future actions. An example is an interim income statement, which provides feedback about a company's income to date and can be used to forecast its annual income.

Timeliness

Accounting information is **timely** when it is available to decision makers before it loses its ability to influence decisions. Timeliness is an ingredient of relevance. If information is not available when it is needed, it lacks relevance and is not useful. Timeliness alone cannot make information relevant, but a lack of timeliness reduces its potential relevance. However, a gain in relevance resulting from increased timeliness may involve a sacrifice of other desirable qualitative characteristics (e.g., reliability). The SEC has defined timeliness, requiring that each company under its jurisdiction file a Form 10-K annual report within 60 days of its fiscal year-end and a Form 10-Q quarterly report within 35 days of the end of each quarter.

Reliability

Accounting information is most useful when it is reliable as well as relevant. **Reliable information is reasonably free from error and bias, and faithfully represents what it is intended to represent.** That is, to be reliable, information must be verifiable, neutral, and possess representational faithfulness. Reliability does not necessarily imply certainty or precision. For instance, estimates may be reliable. Reliability has different degrees, and what is an acceptable degree of reliability will depend on the circumstances.

Verifiability

Accounting information is **verifiable** (sometimes called **objective**) when measurers (i.e., accountants) can agree that the selected method has been used without error or bias. That is, the measurement results can be duplicated. Verification is useful in reducing *measurer bias*, because by using the same method to repeat measurements, both unintentional and intentional errors are reduced.

Verification is a primary concern of auditing. The **Certified Public Accountant (CPA)** is an independent professional who reviews (audits) the published financial statements of a company. The performance of this duty is termed the **attest function**. It involves a review of a sample of a company's transactions during a reporting period to provide assurance that the recording and reporting of its financial information can be duplicated substantially by an independent measurer. As a result of the review, the CPA issues an auditor's report. (We discuss audit reports in Chapters 4 and 6.) Verification does not, however, ensure the appropriateness of the accounting methods used. That quality of accounting information is representational faithfulness.

Representational Faithfulness

Accounting information has **representational faithfulness** when there is a relationship between the reported accounting measurements or descriptions and the economic resources, obligations, and transactions and events causing changes in these items. Social scientists define this concept as "validity." For instance, a company may record an item leased on a long-term basis from another entity as an economic resource even though it does not own the item. This recording increases the representational faithfulness of the reported economic resources available to the company. Having a high degree of representational faithfulness is useful in reducing *measurement bias*. Having representational

faithfulness in one decision-making context, however, does not mean that accounting information will be relevant for other decisions. For instance, the current value of an economic resource that a company expects to replace in the near future would be useful information, but it might not be useful if the company has no intention of replacing it.

Neutrality

Accounting information is **neutral** when it is not biased to attain a predetermined result or to influence behavior in a *particular* direction. Neutrality does not mean that accounting information has no purpose or does not influence human behavior. The purpose of providing accounting information is to serve different users with many interests. Furthermore, accounting information is intended to be useful in decision making, thereby influencing the decision makers' behavior, but not in a predetermined direction. Neutrality also implies *completeness* of information. An omission of information can lead to bias if it is intended to induce or inhibit a particular behavior. Sometimes, in conjunction with neutrality, you will hear that accounting information needs to be *transparent*. Transparent accounting information is clear and not distorted, which allows external users to clearly see the information they need to make decisions.

Comparability and Consistency

A secondary qualitative characteristic of accounting information is comparability (including consistency). Information about a company is more useful if it can be compared with similar information from other companies (this is referred to as *intercompany* comparison) or with similar information from past periods within the company (*intracompany* comparison). Comparability is not a primary quality of useful information, like relevance and reliability, because it must involve more than one item of information. It is an *interactive quality* of the relationship between two or more items of information. **Comparability of accounting information enables users to identify and explain similarities and differences between two or more sets of economic facts.**

Closely linked to comparability is consistency. **Consistency means conformity from period to period, with accounting policies and procedures remaining unchanged.** Consistency, like comparability, is a quality of the relationship between numbers rather than a quality of the numbers themselves. Consistency helps enhance comparability across periods. Without consistency, it would be difficult for a user to determine whether differences in results were caused by economic differences or simply by differences in accounting methods. On the other hand, a change in accounting method is sometimes desirable. Economic situations may change, or more preferable new accounting methods may evolve. A company must make some sacrifice in consistency at certain times to improve the usefulness of its accounting information.

Constraints to the Hierarchy

Two constraints to the hierarchy of qualitative characteristics help to identify further what accounting information should be disclosed in financial reports. The first is a benefit/cost constraint; the second is a threshold-for-recognition, or materiality, constraint.

Benefits Greater Than Costs

Accounting information is a commodity. Unless the benefits expected to be received from a commodity exceed its costs, the commodity will not be sought after. The preparer (the company) initially incurs the costs of providing financial information and then passes the costs on to consumers (external users). These costs include the cost of collecting, processing, auditing, and communicating the information. The costs also include those associated with losing a competitive advantage by disclosing the information. The benefits are enjoyed by a diverse group of investors and creditors, by customers (because they are assured a steady supply of goods and services), and by the preparer itself (for use in internal decision

making). To be reported, accounting information not only must be relevant and reliable but it also must satisfy the benefit/cost constraint. That is, the FASB must have reasonable assurance that the costs of implementing a standard will not exceed the benefits.

Materiality

The second constraint, that of materiality, is really a *quantitative* “threshold” constraint linked very closely to the qualitative characteristic of relevance. **Materiality refers to the magnitude of an omission or misstatement of accounting information that makes it likely the judgment of a reasonable person relying on the information would have been influenced by the omission or misstatement.** Materiality and relevance are both defined in terms of the influences that affect a decision maker, but there is a difference between the two terms. A company may make a decision to disclose certain information because users have a need for that information (it is relevant) *and* because the amount is large enough to make a difference (it is material). Alternatively, a decision not to disclose certain information may be made because the user has no need for the information (it is not relevant) *or* because the amount is too small to make a difference (it is not material).

The FASB did not set overall quantitative guidelines for materiality in the *Statements of Concepts*. It felt that materiality involves judgment, and that no general standards could be set that took into account all the elements of sound human judgment. Materiality judgments should be concerned with thresholds of recognition. Is an item large enough to pass over the threshold that separates material from immaterial items? To answer that question, the FASB suggested that a company give consideration to:

- the *nature* of the item (i.e., items considered too small to be significant when they result from routine transactions might be material if they arose from abnormal circumstances)
- the *relative size* rather than absolute size of an item (i.e., a \$10,000 error in inventory of a large company may be insignificant while a similar \$10,000 error by a small company may be material)

The FASB observed that quantitative guidelines have been and will continue to be set for specific accounting issues where appropriate.

In regard to the relative size of a misstatement, some companies establish an initial percentage threshold; for instance, 5% of net income for the income statement and 5% of total assets for the balance sheet. Thus, if the misstatement of an amount is less than 5% of net income it is not considered material for the income statement. External users feel that some companies are using a percentage threshold as an “absolute” cutoff without considering the qualitative factors of the information, such as the surrounding circumstances or the “total mix” of information. In response, several groups (the SEC, the AICPA, and the Big Five Audit Materiality Task Force) have provided guidance in assessing the materiality of a misstated item for a company. These include, for instance, whether the misstatement:

- has an effect on trends (particularly trends in profitability)
- masks a change in earnings (and earnings per share)
- is currently immaterial but may have a material impact in future periods because of a cumulative effect
- changes a loss into net income (or vice versa)
- misrepresents the company’s compliance with loan agreements
- relates to a segment of the company that is of particular importance to the company’s long-run profitability
- has the effect of increasing management’s compensation.⁹

9. For a more extensive discussion, see “Materiality,” *SEC Staff Accounting Bulletin No. 99* (Washington, D.C.: Securities and Exchange Commission, August 12, 1999) and “Audit Risk and Materiality in Conducting an Audit,” *AICPA Professional Standards*, Volume 1 (New York: AICPA, 2004), sec. 312.

Thus, companies may use a quantitative threshold as an initial step in assessing materiality, but need to consider qualitative factors in making the final judgment on the materiality of an item.

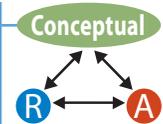


SECURE YOUR KNOWLEDGE 2-2

- For accounting information to be useful for decision making, it must be understandable to users who possess a reasonable knowledge of business and economic activities and who are willing to study the information with reasonable diligence.
- The primary qualities that make accounting information useful for decision making are relevance and reliability.
 - Relevant information is available in a timely manner and assists users in predicting the outcome of past, present, or future events or confirming prior expectations.
 - Reliable information is reasonably free from error and bias, and faithfully represents what it is intended to represent.
- External decision makers need accounting information that is comparable across different companies and consistent within a company over time.
- Two constraints on the qualitative characteristics of accounting information are:
 - The costs of providing the information should not exceed the benefits received from the using the information; and
 - The information should be material (capable of influencing a decision).

ACCOUNTING ASSUMPTIONS AND PRINCIPLES

Certain accounting assumptions and principles have had an important impact on the development of GAAP. Exhibit 2-6 is useful in understanding the relationship among the objectives, types of useful information, qualitative characteristics, accounting assumptions and principles, generally accepted accounting principles, financial reports, and elements of financial statements. We discuss the accounting assumptions and principles listed in Exhibit 2-6 in this section. We will discuss others later in the book as they apply to specific accounting standards.



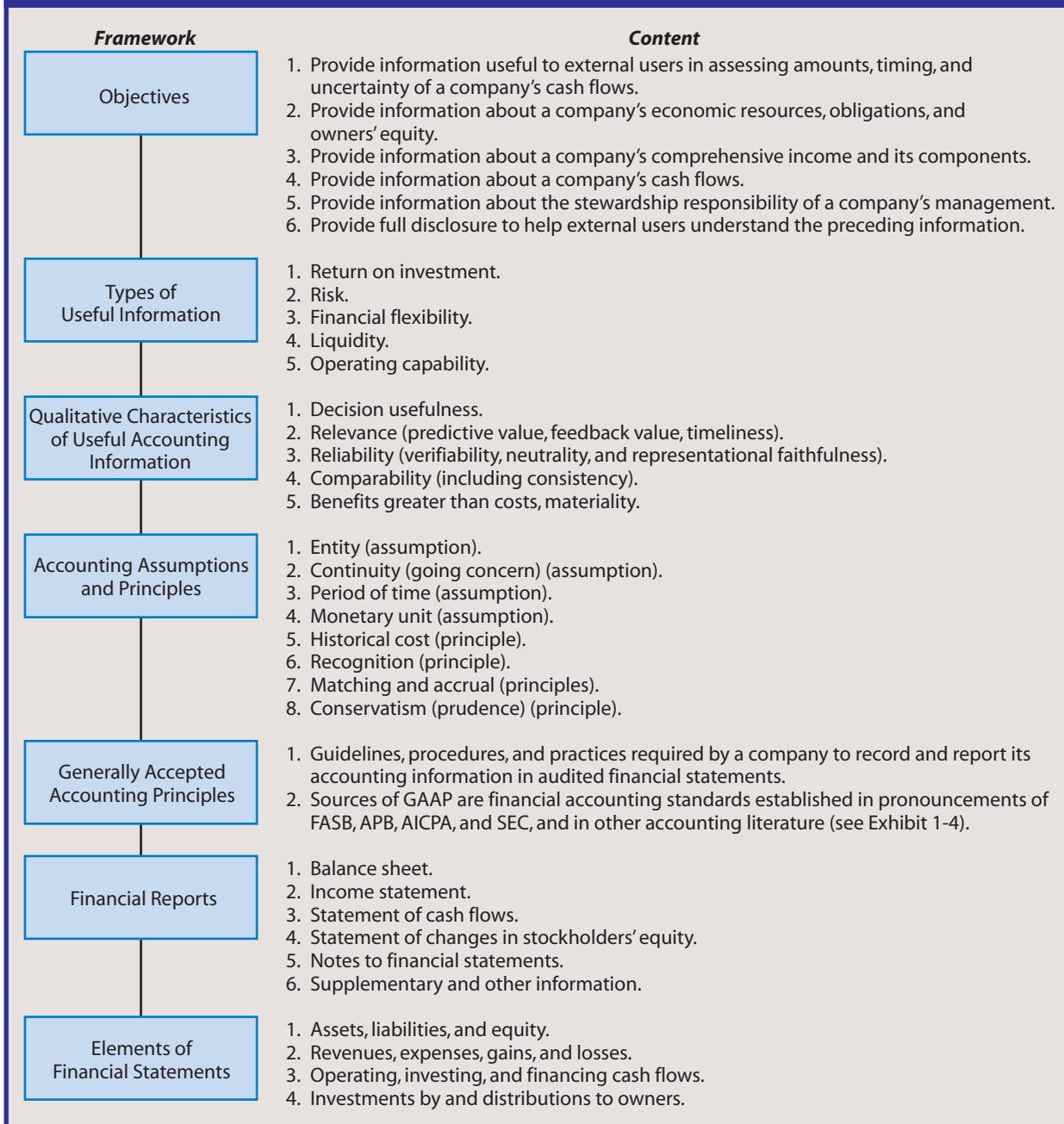
7 Understand the accounting assumptions and principles that influence GAAP.

Entity (Assumption)

Most of the economic activity in the United States can be directly or indirectly attributed to business enterprises, termed **economic entities**. These entities vary in size from small, one-owner companies such as hair salons or restaurants, to partnerships such as law or accounting firms, and to large multinational corporations such as **Wal-Mart**. Financial accounting is concerned with the economic activity of each of these entities, regardless of its size, and involves recording and reporting its transactions and events. A transaction involves the transfer of something of value between the entity and another party. In certain instances the financial records of related but separate legal entities may be *consolidated* (combined) to report more realistically the resources, obligations, and operating results of the overall economic entity.

Because the entity assumption distinguishes each organization from its owners, each separate entity prepares its own financial records and reports. The personal transactions of the owners are kept separate from those of the business enterprise. Throughout this book we refer to a business enterprise as a *company* (and when the discussion applies to a type of company, we use the specific type of entity, e.g., *corporation*).

EXHIBIT 2-6 Framework of Financial Accounting Theory and Practice



Continuity (Assumption)

The **continuity assumption** is also known as the **going-concern assumption**. This assumption is that the company will continue to operate in the near future, unless substantial evidence to the contrary exists. Obviously, not all companies are successful, and failures do occur. However, the continuity assumption is valid in most cases and is necessary for many of the accounting procedures used. For example, if a company is not regarded as a going concern, the company should not depreciate its fixed assets over their expected useful lives, nor should the company record its inventory at its cost, because the receipt of future economic benefits from these items is uncertain.

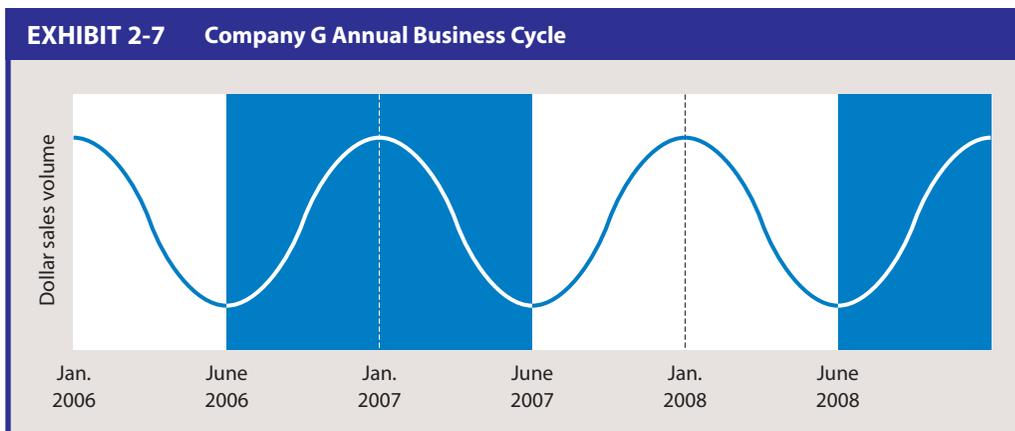
The continuity assumption does not imply permanence. It simply indicates that the company will operate long enough to carry out its existing commitments. If a company

appears to be going bankrupt, it must discard the continuity assumption. The company then reports its financial statements on a liquidation basis, with all assets and liabilities valued at the amounts estimated to be collected or paid when they are sold or liquidated.

Period of Time (Assumption)

The profit or loss earned by a company cannot be determined *accurately* until it stops operating. At that time the total lifetime profit or loss may be determined by comparing the cash on hand after liquidating the business (plus any cash payments to the owners during the period of operations) with the amount invested by the owners during the company's lifetime. Obviously, financial statement users need more current information to evaluate a company's profitability. Companies primarily use a year as the reporting period. In accordance with the **period-of-time assumption**, a company prepares financial statements at the end of each year and includes them in its annual report. Furthermore, the annual reporting period (called the **accounting period** or **fiscal year**) is used for reports issued to government regulators such as the Internal Revenue Service (IRS) and the Securities and Exchange Commission (SEC).

The period-of-time assumption is the basis for the adjusting entry process in accounting. If companies did not prepare financial statements on a yearly (or shorter time) basis, there would be no reason to determine the time frame affected by particular transactions. Historically, most companies adopted the calendar year as the accounting period. However, many companies now choose a fiscal year that more closely approximates their annual *business cycle*. (The yearly period from lowest sales through highest sales and back to lowest sales is known as a business cycle.) For example, consider Exhibit 2-7, which shows the annual sales pattern for Company G. Notice that peak sales occur each year in January, while the lowest sales volume occurs in June. A company that sells ski equipment might have such a sales pattern. If Company G were to report on a calendar-year basis, its financial reports would be prepared at about the time of peak yearly sales (i.e., the midpoint of the business cycle). Alternatively, a fiscal year that ended on June 30 would include a single complete annual business cycle. Many large retail chains have a fiscal year-end that follows the peak Christmas selling season. For example, Wal-Mart's year-end is January 31, which is after most of the returns and allowances related to those sales have occurred. Fiscal-year reports that include an annual business cycle contain information that is more easily comparable to past and future periods because annual sales patterns are not broken by the reporting period.



In addition to annual reports, publicly traded companies issue financial statements for interim (quarterly) periods. These interim periods are integral parts of the annual period, and interim reports disclose summary information to provide investors with more timely information.

Monetary Unit (Assumption)

Since the time when gold and other precious metals were accepted in exchange for goods and services, there has been a unit of exchange. This unit of exchange is different for almost every nation. Accountants generally have adopted the national currency of the reporting company as the unit of measure in preparing financial statements.

In using the dollar or any other currency as the unit of measure, accountants traditionally have assumed that it is a stable measuring unit. Prior to the FASB, accounting policy-making bodies had felt that fluctuations in the value of the dollar were not a serious enough problem to affect the comparability of accounting information. Therefore, any adjustment in the monetary unit assumption was not needed.

In today's world the assumption that the dollar or any other national currency is a stable measure over time is not necessarily valid. Consider the building you are now in. If you were to measure its width in feet and inches today, next year, and five years from now, an accurate physical measurement would yield the same results each time. In contrast, consider the monetary value of the same building. Real estate prices have changed (increased or decreased) during the past several years and undoubtedly will continue to vary, resulting in changing monetary measures of value even though the physical capacity remains the same.

There are two primary reasons for changes in reported values over time:

1. The real value of the item in question may change in relation to the real value of all other goods and services in the economy.
2. The purchasing power of the measuring unit (in this case the dollar) may change.

Currently the dollar is considered to be a stable monetary unit for preparing a company's financial statements. As we mentioned earlier, however, to enhance comparability the FASB encourages companies to make supplemental disclosures relating to the impacts of changing prices.

Historical Cost (Principle)

The economic activities and resources of a company initially are measured using the exchange price at the time each transaction occurs. For many economic resources, usually the company retains the exchange price (the **historical cost**) in its accounting records as the value of the resource until the company consumes or sells it and removes it from the records. That is, a company usually delays recording gains and losses resulting from value changes of assets (or liabilities) until another exchange occurs. The reason for using historical cost (as opposed to other valuation methods such as current market value or appraisal value) is that it is reliable, and that source documents usually are available to confirm the recorded amount. Also, historical cost provides evidence that an independent buyer and seller were in agreement on the value of an exchanged good or service at the time of the transaction and thus has the qualities of representational faithfulness, neutrality, and verifiability.

One of the most frequently heard criticisms of accounting comes from those who prefer alternative valuation methods that they believe would report information more relevant for user decisions. Accountants understand that historical cost information may not always be completely *relevant* for all decisions, but it does have a significant degree of *reliability*. In certain cases accounting standards require the use of valuation methods other than historical cost to report the *fair value* of selected items in the financial statements. These methods are required when they provide more relevant information and possess an acceptable degree of reliability.¹⁰ However, it is often felt that the measurement problems

10. See, for instance, "Fair Value Measurements," *FASB Proposed Statement of Financial Accounting Standards* (Norwalk, Conn.: FASB, 2004).

inherent in alternative valuation methods are greater than those of historical cost. That is, reliability often takes precedence over relevance. The FASB, however, understands the significance of this relevance/reliability tradeoff and encourages companies to disclose *supplemental* current value information in their annual reports. Also, you should understand that when a company changes the values of its assets and liabilities the company must include these value changes in its comprehensive income for the period. We discuss valuation methods in Chapter 4.



LINK TO ETHICAL DILEMMA

You have been hired as an accounting consultant to review the financial reporting policies of Parker Company as it enters merger negotiations with an interested buyer. Of particular interest is the way in which Parker Company accounts for its property, plant, and equipment. As rumors of possible mergers began several years ago, the company's management periodically began using independent valuation experts to determine fair market values for the company's net assets. As a result of these analyses, management was able to determine that its long-term productive assets had book values that were significantly less than their market values. Citing the increased reliability provided by the valuation experts, management decided to write the company's assets up to market value to provide investors and creditors with the most relevant information possible and to be consistent with the FASB's increasing use of fair value measurements. Do you agree with this decision?

Recognition (Principle)

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

- meet the definition of an element
- be measurable
- be relevant
- be reliable

In regard to revenues, two other factors provide guidance for revenue recognition. Revenues should be recognized when (1) realization has taken place, and (2) they have been earned. These factors provide acceptable assurance of the existence and amounts of revenues.

A company usually recognizes revenue at the time of sale because this is when realization occurs and its earning process is substantially complete. **Realization** means the process of converting noncash resources and rights into cash or rights to cash; that is, when the company receives cash or obtains a receivable. Actually, revenue is earned by a company throughout the earning process as it adds economic utility to goods. This **earning process** includes acquisition, production and/or distribution, sales, and the collection and payment of cash. A company could recognize revenue at one or more points in this process. In this regard, the FASB suggests that revenues are considered to be earned when a company has

substantially completed what it must do to be entitled to the benefits (i.e., assets) generated by the revenues. Usually, this is the point of sale.¹¹

Occasionally a company may advance (accrue) or delay (defer) the recognition of revenue in the earning process to increase the relevance of its income statement. Thus, a company may not recognize (record) revenue at the same time as realization. A company might recognize revenue (1) during production, (2) at the end of production, or (3) after the sale. In the case of certain long-term construction contracts extending over more than one accounting period, a company usually recognizes revenue during production to better depict economic reality by the use of the **percentage-of-completion** method. Similarly, revenue usually is recognized for certain long-term service contracts by use of the **proportional performance** method. These methods allocate the revenues of each contract to each period, based on an estimate of the percentage completed during the period. We discuss these revenue recognition methods in Chapters 5 and 8.

A company might recognize revenue at the completion of production if there is a fixed selling price and there is no limit on the amount that it can sell. This situation might be the case for certain valuable minerals or for farm products sold on the futures market. Finally, revenue may be recognized after the sale if the ultimate collectibility of the revenue is highly uncertain. This situation might arise, for instance, in the case of real estate land sales where a very small down payment is required and the payment terms extend over many years. In situations of high uncertainty about collections, a company uses either the installment or the cost-recovery method to recognize revenue. Under the **installment** method, a portion of each receipt is recognized as revenue. Under the **cost-recovery** method, no revenue is recognized until the cost of the product has been recovered.

Matching and Accrual Accounting (Principles)

Earlier, **accrual accounting** was defined as the process of relating the financial effects of transactions, events, and circumstances having cash consequences to the period in which they occur instead of to when the cash receipt or payment occurs. The **matching** principle is linked closely to accrual accounting and to revenue recognition. The matching principle states that to determine the income of a company for an accounting period, the company computes the total expenses involved in obtaining the revenues of the period and relates these total expenses to (matches them against) the total revenues recorded in the period. Thus, some expenses are advanced (accrued) or delayed (deferred) in a manner similar to revenues. The intent is to match the sacrifices against the benefits (i.e., the efforts against the accomplishments) in the appropriate accounting period.

A company recognizes and matches expenses against revenues on the basis of three principles:

- association of cause and effect
- systematic and rational allocation
- immediate recognition

Expenses recorded as a result of associating cause and effect include sales commissions and the **product costs** included in cost of goods sold. Expenses recorded on the basis of systematic and rational allocation include depreciation of property and equipment and amortization of intangibles. Immediate recognition is appropriate for **period costs**—those expenses related to a period of time, such as administrative salaries.¹²

Some smaller companies do not use accrual accounting and matching. Instead they use **cash basis** accounting for simplicity. In cash basis accounting, a company computes

11. "Recognition and Measurement in Financial Statements of Business Enterprises," *FASB Statement of Financial Accounting Concepts No. 5* (Stamford, Conn.: FASB, 1984), par. 63 and 83.

12. "Elements of Financial Statements," *FASB Statement of Financial Accounting Concepts No. 6* (Stamford, Conn.: FASB, 1985), par. 146–149.

its income for an accounting period by subtracting the cash payments from the cash receipts from operations. While this method may be convenient to use, it can lead to incorrect evaluations of a company's operating results. This may happen because the receipt and payment of cash may occur much earlier or later than the sale of goods or the providing of services to customers (benefits) and the related costs (sacrifices). Because cash basis accounting does not attempt to match expenses against revenues, it is not a generally accepted accounting principle.

Conservatism (Principle)

The principle of **conservatism** states that when alternative accounting valuations are equally possible, the accountant should select the one that is least likely to overstate the company's assets and income in the current period. Over the years conservatism gained prominence because of the optimism of management and the tendency, during the first three decades of the twentieth century, to overstate assets and net income on financial statements. Recently, conservatism has been criticized for being "anticonservative" in the years following the conservative act. That is, a deliberate understatement of an asset with a corresponding loss and understatement of income in one year will result in an overstatement of income in a later year when the asset is sold because of the greater difference between the selling price and lower recorded value of the asset. Furthermore, conservatism can conflict with qualitative characteristics such as neutrality. For instance, conservative financial statements may be unfair to present stockholders and biased in favor of future stockholders because the net valuation of the company does not include some future expectations. This factor may result in a relatively lower current market price of the company's common stock. These criticisms notwithstanding, conservatism has played an important role in the establishment of certain generally accepted accounting principles.

The FASB has attempted to modify the principle of conservatism so that it is more synonymous with **prudence**. That is, conservatism should be a prudent reaction to uncertainty so as to ensure, to the extent possible, that the uncertainties and risks inherent in business situations are adequately considered. These uncertainties and risks should be reflected in accounting information to improve its predictive value and neutrality. Prudent reporting based on a healthy skepticism promotes integrity and best serves the various users of financial reports.¹³

GAAP AND FINANCIAL STATEMENTS

As we noted in Chapter 1, generally accepted accounting principles (GAAP) are the guidelines, procedures, and practices that a company is required to use in recording and reporting its accounting information in its audited financial statements. In its *Conceptual Framework*, the FASB has identified various sources from which investors, creditors, and other users might obtain information useful in decision making. Exhibit 2-8 shows this model of financial reporting. We discuss components of this model in Chapters 4, 5, and 23.

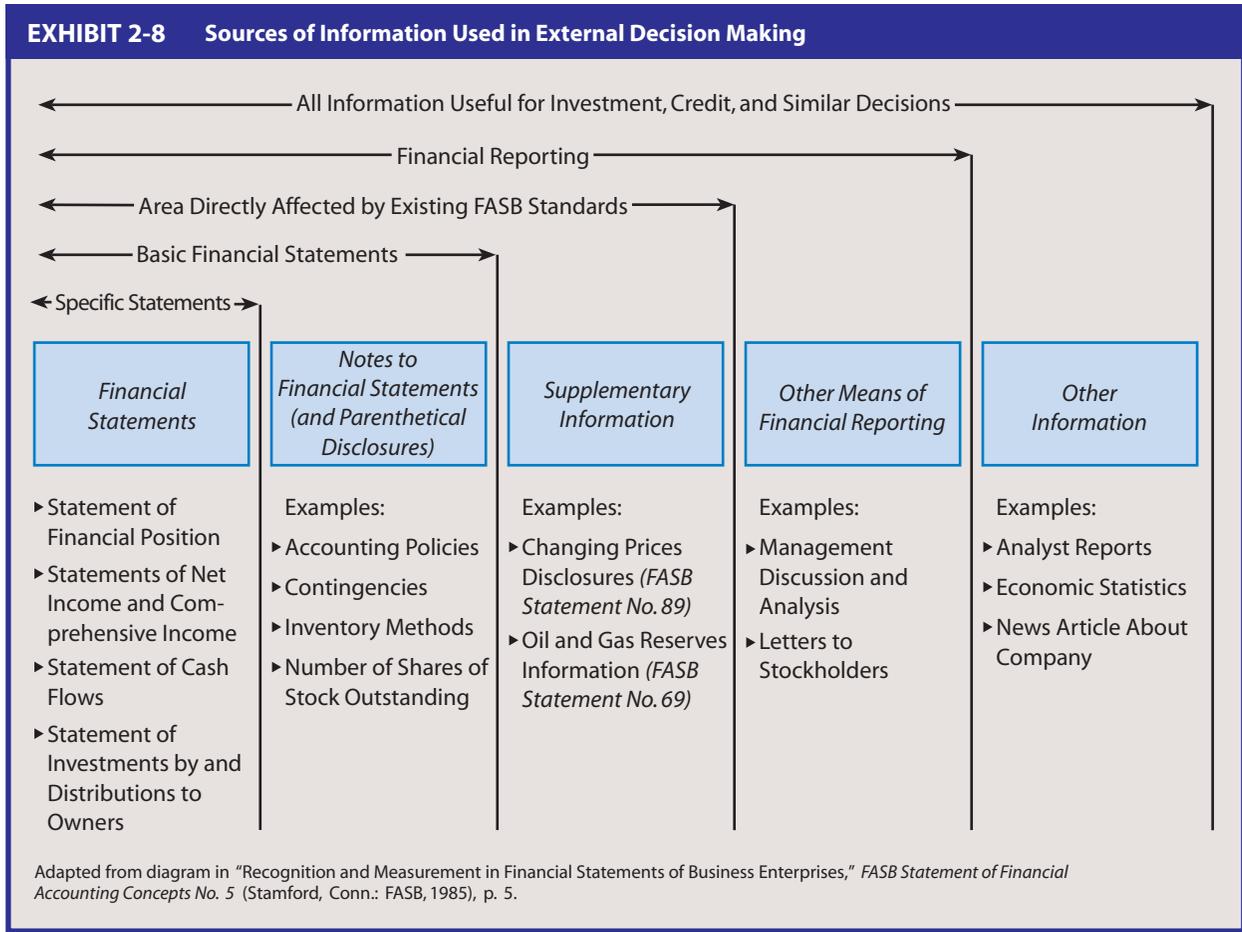
Conceptually, the FASB identified the four specific financial statements listed in Exhibit 2-8. In practice, companies prepare at least three major financial statements: (1) the balance sheet (statement of financial position), (2) the income statement, and (3) the statement of cash flows. Many companies also prepare a statement of changes in equity as a major financial statement (or in a note to the financial statements).¹⁴ In this section we discuss briefly these financial statements and the elements of the financial

8 Define the elements of financial statements.



13. FASB *Statement of Financial Accounting Concepts No. 2, op. cit.*, par. 95–97.

14. Each company also must report its comprehensive income and may choose to do so on its income statement, a statement of comprehensive income, or on its statement of changes in stockholders' equity. We will discuss these alternatives in Chapter 5.



statements. The elements of each financial statement are the broad classes of items comprising it. In other words, they are the "building blocks" with which each financial statement is prepared.¹⁵ We discuss the financial statements and their elements in more depth in later chapters.

Balance Sheet

A **balance sheet** (or statement of financial position) is a financial statement that summarizes the financial position of a company on a particular date (usually the end of the accounting period). The financial position of a company includes its economic resources, economic obligations, and equity, and their relationships to each other. There are three elements of a balance sheet:

1. **Assets:** Assets are the probable future economic benefits obtained and controlled by a company as a result of past transactions or events.
2. **Liabilities:** Liabilities are the probable future sacrifices of economic benefits arising from present obligations of a company to transfer assets or provide services in the future as a result of past transactions or events.
3. **Equity:** Equity is the owners' residual interest in the assets of a company that remains after deducting its liabilities.

15. The discussion in this section primarily is a summary of that presented in "Elements of Financial Statements of Business Enterprises," *FASB Statement of Financial Accounting Concept No. 6* (Stamford, Conn.: FASB, 1985) and "Statement of Cash Flows," *FASB Statement of Financial Accounting Standards No. 95* (Stamford, Conn.: FASB, 1987).

In other words, the assets of a company are its economic resources, and the liabilities are its economic obligations. The equity of a corporation is referred to as stockholders' equity because the owners are the stockholders.

Income Statement

An **income statement** is a financial statement that summarizes the results of a company's operations (i.e., net income) for a period of time (generally a one-year or one-quarter accounting period). A company's operations (sometimes called the earning process) include its purchasing, producing, selling, delivering, servicing, and administrating activities. There are four elements of an income statement:

1. **Revenues:** Revenues are inflows of assets of a company or settlement of its liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or other activities that are the company's ongoing major or central operations. Revenues increase the equity of a company.
2. **Expenses:** Expenses are outflows of assets of a company or incurrences of liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that are the company's ongoing major or central operations. Expenses decrease the equity of a company.
3. **Gains:** Gains are increases in the equity of a company from peripheral or incidental transactions, and from all other events and circumstances during a period, except those that result from revenues or investments by owners.
4. **Losses:** Losses are decreases in the equity of a company from peripheral or incidental transactions, and from all other events and circumstances during a period, except those that result from expenses or distributions to owners.

Revenues may be thought of as measures of the accomplishments of a company during its accounting period, while expenses are measures of the efforts to achieve the revenues. Gains are similar to revenues and losses are similar to expenses, except that revenues and expenses relate to a company's primary operations, while gains and losses relate to its secondary activities.

Statement of Cash Flows

A **statement of cash flows** is a financial statement that summarizes the cash inflows and outflows of a company for a period of time (generally one year or one quarter). There are three elements of a statement of cash flows:

1. **Operating Cash Flows:** Operating cash flows are the inflows and outflows of cash from acquiring, selling, and delivering goods for sale, as well as providing services.
2. **Investing Cash Flows:** Investing cash flows are the inflows and outflows of cash from acquiring and selling investments, property, plant, and equipment, and intangibles, as well as from lending money and collecting on loans.
3. **Financing Cash Flows:** Financing cash flows are the inflows and outflows of cash from obtaining resources from owners and paying them dividends, as well as obtaining and repaying resources from creditors on long-term credit.

In addition to these three elements, the statement of cash flows reconciles the amount of cash a company reports on its balance sheets at the beginning and end of the accounting period.

Statement of Changes in Equity

A **statement of changes in equity** summarizes the changes in a company's equity for a period of time (generally one year or one quarter). For a corporation, the statement is called the statement of changes in stockholders' equity. There are two elements in a statement of changes in equity:

1. **Investments by Owners:** Investments by owners are increases in the equity of a company resulting from transfers of something valuable (usually cash) to the company in order to obtain or increase ownership interests.
2. **Distributions to Owners:** Distributions to owners are decreases in the equity of a company caused by transferring assets, rendering services, or incurring liabilities.

In addition to these elements, the statement of changes in equity also reconciles the amounts of the equity items a company reports on its beginning and ending balance sheets for such items as net income and other comprehensive income.



Model of Business Reporting

The AICPA Special Committee on Financial Reporting issued a report that addressed concerns about the relevance and usefulness of reporting by companies. In this report the committee developed a comprehensive model of *business reporting*—the information that a company provides to help users with capital allocation decisions about the company. The model was designed to help focus attention on a broader, integrated range of information than that addressed in the FASB's conceptual framework. The goal was to provide the foundation for future improvement in business reporting. The model includes 10 items within five categories of information. These categories are designed to fit the decision processes of users to make projections, value companies, or assess the likelihood of loan repayments. The framework of the model is as follows:

1. *Financial and nonfinancial data* including (a) financial statements and related disclosures and (b) high-level operating data and performance measurements that a company's management uses to manage the business.
2. *Management's analysis of the financial and nonfinancial data*, including (a) reasons for changes in the financial, operating, and performance-related data and (b) the identity and past effect of key trends.
3. *Forward-looking information*, including (a) the assessment of opportunities and risks, including those resulting from key trends, (b) management's plans, including critical success factors, and (c) a comparison of actual business performance to previously disclosed opportunities, risk, and management's plans.
4. *Information about management and shareholders*, including (a) directors, management, compensation, and major shareholders and (b) transactions and relationships among related parties.
5. *Background about the company*, including (a) broad objectives and strategies, (b) scope and description of the company's business and properties, and (c) the impact of industry structure on the company.

The model is responsive to users' needs, but includes practical constraints to balance the costs and benefits of reporting. Since the AICPA committee is not a standard-setting body, the model is a recommendation to standard setters who have an interest in improving the cost-effective quality of business reporting.¹⁶ We discuss components of this model in Chapters 4, 5, and 6.

16. "Improving Business Reporting—A Customer Focus," *AICPA Special Committee on Financial Reporting* (New York: AICPA, 1994), pp. 2–9.



SECURE YOUR KNOWLEDGE 2-3

- Four basic assumptions underlie GAAP. These are:
 - The entity assumption, which relates economic activities to a particular economic entity;
 - The continuity (going concern) assumption, which states that with no evidence to the contrary, a company will continue to operate in the near future;
 - The period of time assumption which allows the life of a company to be divided into artificial time periods and serves as the basis for the adjusting entry process; and
 - The monetary unit assumption, which requires financial statement elements to be expressed in terms of the dollar.
- Four broad principles have greatly influenced the development of GAAP. These are:
 - The historical cost principle, which provides highly reliable, although not always the most relevant, information by measuring economic activities at their historical exchange price;
 - The recognition principle, which determines when an item is to be reported in the financial statements (revenue recognition usually occurs when revenue is realized and the earnings process is complete);
 - The matching principle, which applies accrual accounting by stating that expenses should be recognized in the same period as the related revenues; and
 - The conservatism principle, which states that when given alternative accounting valuations, the accountant should select the one that is least likely to overstate current period assets and income.
- The FASB identified four basic financial statements (the balance sheet, the income statement, the statement of cash flows, and the statement of changes in stockholders' equity) as sources of useful information.



Credit: Michael Reynolds/EPX/Landov



IASB FRAMEWORK

The International Accounting Standards Board (IASB) has issued a **Framework for the Preparation and Presentation of Financial Statements** that is similar, in many respects, to the FASB Conceptual Framework.

The IASB Framework states that the objective of financial statements is to provide information about the financial position, performance, and changes in financial position of a company that is useful to a wide range of users in making economic decisions. The Framework has two underlying assumptions; that a company is a going concern and uses accrual accounting. It identifies four qualitative characteristics of financial statements—understandability, relevance (including materiality), reliability (including faithful presentation, substance over form, neutrality, prudence, and completeness), and comparability. Three constraints on relevant and reliable information are identified; they include timeliness, balance between benefit and cost, and balance between the qualitative characteristics. The Framework calls for financial statements that present a true and fair view of the company and a fair presentation of the company's activities.

The IASB Framework identifies and defines the elements of a statement of financial position (i.e., assets, liabilities, and equity) and a statement of performance (i.e., income and expenses). It also discusses conceptual issues dealing with the recognition of the elements of financial statements, measurement of the elements, and concepts of capital and capital maintenance.

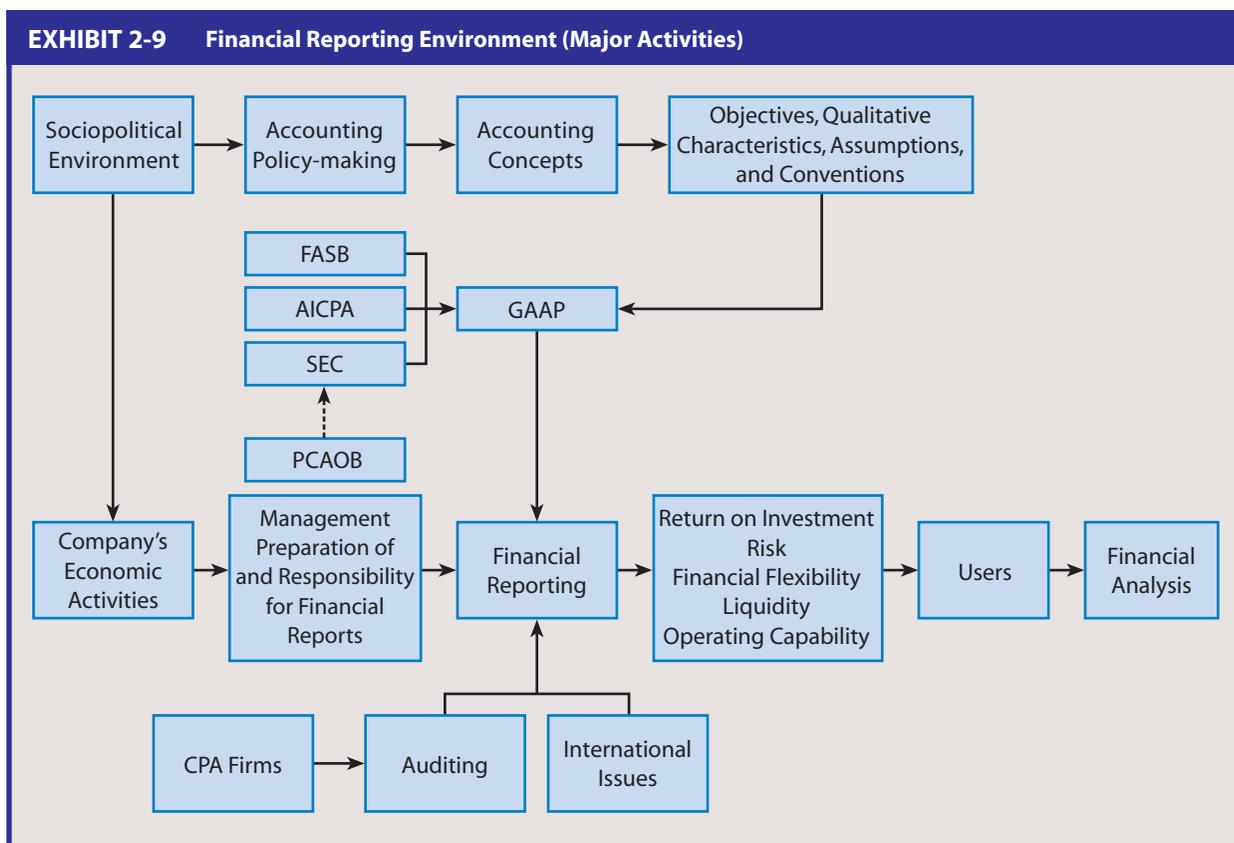
The IASB Framework is designed (1) to help the Board in developing future International Accounting Standards and reviewing existing Standards and (2) to promote the harmonization of regulations, accounting standards, and accounting procedures regarding the preparation of financial statements.¹⁷

In 2004, the FASB and the IASB added to their respective agendas a project to develop a common conceptual framework that is based on, and builds on, their existing frameworks. The Boards will focus on issues that are more likely to yield near term standard-setting benefits and cut across several current standard-setting projects. Issues relating to the definitions of assets and liabilities, historical cost versus fair value measurements, and relevance versus reliability will all be key concerns as the conceptual framework project progresses. In addition to promoting international harmonization of future accounting standards, the end result of this project should provide a more consistent and unified set of concepts that will result in accounting standards that are principles-based.

OVERVIEW

We discuss the financial statements and their elements, as they fit into the FASB's model of financial reporting and the AICPA's model of business reporting in depth in the later chapters of this book. In addition, we discuss supplementary schedules and notes to the financial statements, along with various recognition and measurement issues. As you read the discussions, it may be helpful for you to place them in the context of the *FASB Conceptual Framework* as we summarized in Exhibit 2-6, as well as the financial reporting environment as we summarize in Exhibit 2-9.

17. For further discussion, go to *International Accounting Reporting Standards* (London: IASCF, 2004).



SUMMARY

At the beginning of the chapter, we identified several objectives you would accomplish after reading the chapter. The objectives are listed below, each followed by a brief summary of the key points in the chapter discussion.

1. **Explain the FASB conceptual framework.** The FASB conceptual framework is a theoretical foundation of interrelated objectives and concepts that leads to the establishment of consistent financial accounting standards. It provides a logical structure and direction to financial accounting and reporting.
2. **Understand the relationship among the objectives of financial reporting.** The FASB conceptual framework consists of four levels of objectives that proceed from the more general to the more specific. The top level is the general objective of financial reporting, the next level is the derived external user objective, the third level is the derived company objective, and the final level includes the specific objectives.
3. **Identify the general objective of financial reporting.** The general objective states that financial reporting should provide useful information for present and potential investors, creditors, and other external users in making their investment, credit, and similar decisions.
4. **Describe the three specific objectives of financial reporting.** The three specific objectives are to provide information about a company's: (1) economic resources, obligations, and owners' equity; (2) comprehensive income and its components; and (3) cash flows.

5. **Discuss the types of useful information for investment and credit decision making.** For investment and credit decision making, a company's financial reports should provide useful information about its return on investment, risk, financial flexibility, liquidity, and operating capability.
6. **Explain the qualities of useful accounting information.** Accounting information should be understandable and have decision usefulness. The two primary decision-specific qualities are relevance and reliability. To be relevant, accounting information must have predictive value, feedback value, and timeliness. To be reliable, it must have verifiability, representational faithfulness, and neutrality. In addition, accounting information should be comparable and consistent. Two constraints in preparing and reporting accounting information are that the benefits must be greater than the costs of preparing the information and that the information must be material.
7. **Understand the accounting assumptions and principles that influence GAAP.** Certain assumptions and principles play an important role in the development of GAAP. These include the entity, continuity (going-concern), accounting period, historical cost, monetary unit, recognition and realization, accrual accounting and matching, and conservatism (prudence) assumptions and principles.
8. **Define the elements of financial statements.** The elements of each financial statement are the broad classes of items comprising it. For a balance sheet, the elements are assets, liabilities, and equity. For an income statement, they are revenues, expenses, gains, and losses. For a statement of cash flows, they are operating, investing, and financing cash flows. For a statement of changes in equity, they are investments by and distributions to owners.

QUESTIONS

- Q2-1** What is the "conceptual framework" of the FASB? What are the titles of the *Statements of Concepts* issued by the FASB?
- Q2-2** What is the most general objective of financial reporting? Who are investors and creditors?
- Q2-3** What is the "derived external user objective" and why is it important?
- Q2-4** What is the "derived company objective" and what types of information about a company should be reported to satisfy this objective?
- Q2-5** List the reasons why external users use information about a company's (a) economic resources and claims to these resources, (b) comprehensive income and its components, and (c) cash flows.
- Q2-6** Define (a) return on investment, (b) risk, (c) financial flexibility, (d) liquidity, and (e) operating capability.
- Q2-7** What is the overall qualitative characteristic of useful accounting information and what are its two primary qualities?
- Q2-8** What is relevant accounting information? Identify and define the ingredients of relevant accounting information.
- Q2-9** What is reliable accounting information? Identify and define the ingredients of reliable accounting information.
- Q2-10** Identify the secondary quality of useful accounting information. Why is this important and how does it relate to consistency?
- Q2-11** What is materiality and how does it relate to relevance?
- Q2-12** What is the continuity assumption and why is it important in financial accounting?
- Q2-13** What is the period-of-time assumption and why is it important in financial accounting?
- Q2-14** Discuss the relationship between historical cost and reliability.
- Q2-15** What is recognition? What is realization? What two factors provide guidance for revenue recognition? Why is revenue usually recognized at the time of sale?
- Q2-16** What is accrual accounting and how does it relate to the matching principle?
- Q2-17** List the three principles for matching expenses against revenues.
- Q2-18** What is conservatism and how might it conflict with neutrality?
- Q2-19** Define a balance sheet and list its three elements.
- Q2-20** Define an income statement and list its four elements.
- Q2-21** Define a statement of cash flows and list its three elements.
- Q2-22** Define a statement of changes in equity and list its two elements.
- Q2-23** For the IASB Framework, list the objective of financial statements and identify the underlying assumptions, qualitative characteristics, and constraints.

MULTIPLE CHOICE (AICPA Adapted)

Select the best answer for each of the following.

M2-1 Accruing net losses on non-cancelable purchase commitments for inventory is an example of the accounting concept of

- a. Conservatism
- b. Realization
- c. Consistency
- d. Materiality

M2-2 The information provided by financial reporting pertains to

- a. Individual companies, rather than to industries or the economy as a whole or to members of society as consumers.
- b. Individual companies and industries, rather than to the economy as a whole or to members of society as consumers.
- c. Individual companies and the economy as a whole, rather than to industries or to members of society as consumers.
- d. Individual companies, industries, and the economy as a whole, rather than to members of society as consumers.

M2-3 According to **Statement of Financial Accounting Concepts No. 2**, an interim earnings report is expected to have which of the following?

	Predictive value	Feedback value
a.	No	No
b.	Yes	Yes
c.	Yes	No
d.	No	Yes

M2-4 A patent, purchased in 2004 and being amortized over a 10-year life, was determined to be worthless in 2007. The write-off of the asset in 2007 is an example of which of the following principles?

- a. Associating cause and effect
- b. Immediate recognition
- c. Systematic and rational allocation
- d. Objectivity

M2-5 An accrued expense is an expense

- a. Incurred but not paid
- b. Incurred and paid
- c. Paid but not incurred
- d. Not reasonably estimable

M2-6 Which of the following accounting concepts states that an accounting transaction should be supported by sufficient evidence to allow two or more qualified individuals to arrive at essentially similar measures and conclusions?

- a. Matching
- b. Verifiability
- c. Periodicity
- d. Stable monetary unit

M2-7 Which of the following is considered a pervasive constraint by **Statement of Financial Accounting Concepts No. 2**?

- a. Benefits/costs
- b. Conservatism
- c. Timeliness
- d. Verifiability

M2-8 The valuation of a promise to receive cash in the future at present value on the financial statements of a company is valid because of the accounting concept of

- a. Entity
- b. Materiality
- c. Going concern
- d. Neutrality

M2-9 Under **Statements of Financial Accounting Concepts No. 2**, which of the following relates to both relevance and reliability?

- a. Timeliness
- b. Neutrality
- c. Feedback value
- d. Consistency

M2-10 Under **Statement of Financial Accounting Concepts No. 6**, which of the following, in the most precise sense, means the process of converting noncash resources and rights into cash or claims to cash?

- a. Allocation
- b. Recordation
- c. Recognition
- d. Realization

CASES

COMMUNICATION

C2-1 Qualitative Characteristics

In *FASB Statement of Concepts No. 2*, several qualitative characteristics of useful accounting information were identified. The following is a list of these qualities as well as a list of statements describing the qualities.

- A. Comparability
- B. Decision usefulness
- C. Relevance
- D. Reliability

- E. Predictive value
- F. Feedback value
- G. Timeliness
- H. Verifiability

- I. Neutrality
- J. Representational faithfulness
- K. Consistency
- L. Materiality

- _____ 1. Ability of measurers to form a consensus that the selected accounting method has been used without error or bias.
- _____ 2. Making information available to decision makers before it loses its capacity to influence decisions.
- _____ 3. Capacity to make a difference in a decision.
- _____ 4. Overall qualitative characteristic.
- _____ 5. Absence of bias intended to influence behavior in a particular direction.
- _____ 6. Reasonably free from error and bias.
- _____ 7. Helps decision makers forecast correctly.
- _____ 8. Validity.
- _____ 9. Interactive quality; helps explain similarities and differences between two sets of facts.
- _____ 10. Quantitative “threshold” constraint.
- _____ 11. Conformity from period to period.
- _____ 12. Helps decision makers confirm or correct prior expectations.

Required

Place the appropriate letter identifying each quality on the line in front of the statement describing the quality.

C2-2 Accounting Assumptions and Principles

Certain accounting assumptions and principles have had an important impact on the development of generally accepted accounting principles. The following is a list of these assumptions and principles as well as a list of statements describing certain accounting practices.

- | | |
|--------------------|------------------|
| A. Entity | E. Monetary unit |
| B. Continuity | F. Realization |
| C. Period of time | G. Matching |
| D. Historical cost | H. Conservatism |
- _____ 1. The business, rather than its owners, is the reporting unit.
- _____ 2. Depreciation costs are expensed in the periods of use rather than at the time the asset is acquired.
- _____ 3. Accounting measurements are reported in dollars.
- _____ 4. The year is the normal reporting unit.
- _____ 5. In the absence of evidence to the contrary, the business will operate long enough to carry out its existing commitments.
- _____ 6. Revenue is usually recognized at the time of sale.
- _____ 7. Exchange price is retained in the accounting records.
- _____ 8. An accounting alternative is selected that is least likely to overstate assets and income.

Required

Select the accounting assumption or principle that justifies each accounting practice and place the appropriate letter on the line preceding the statement.

C2-3 Objectives of Financial Reporting

The FASB has identified several objectives of financial reporting. These objectives proceed from the more general to the more specific and are intended to act as guidelines for providing accounting information in financial reports.

Required

Starting with the most general objective, prepare a written report that identifies and briefly explains the objectives of financial reporting.

C2-4 Qualities of Useful Accounting Information

A friend of yours, who is not an accounting major, is concerned about the “usefulness” of accounting information. The friend states: “I have watched you prepare many financial statements in completing your homework assignments. But how do you determine whether the information in these financial statements is useful? What are the characteristics or qualities of useful accounting information?”

Required

Prepare a written response for your friend that identifies and explains the qualitative characteristics of useful accounting information.

C2-5 Cost and Expense Recognition

AICPA Adapted An accountant must be familiar with the concepts involved in determining earnings of a company. The amount of earnings reported for a company is dependent on the proper recognition, in general, of revenue and expense for a given time period. In some situations costs are recognized as expenses at the time of product sale; in other situations guidelines have been developed for recognizing costs as expenses or losses by other criteria.

Required

1. Explain the rationale for recognizing costs as expenses at the time of product sale.
2. What is the rationale underlying the appropriateness of treating costs as expenses of a period instead of assigning the costs to an asset? Explain.
3. Some expenses are assigned to specific accounting periods on the basis of systematic and rational allocation of asset cost. Explain the underlying rationale for recognizing expenses on this basis.

C2-6 Characteristics of Useful Information

CMA Adapted Financial accounting and reporting provide information that is used in decision making regarding the allocation of resources. In **Statement of Financial Accounting Concepts No. 1**, “Objectives of Financial Reporting by Business Enterprises,” the FASB defined the following basic objectives of financial reporting:

Financial reporting should provide understandable information to present and potential users:

- That is useful in making rational decisions.
- That facilitates assessing the amounts, timing, and uncertainty related to the company’s cash flows.
- About the company’s economic resources, its claims to those resources, and the changes in its resources and obligations occurring from earnings and other operating activities.

The qualitative characteristics of useful accounting information were identified in the FASB's **Statement of Financial Accounting Concepts No. 2**, "Qualitative Characteristics of Accounting Information." These characteristics distinguish better information (more useful) from inferior information (less useful).

Required

1. For the primary quality relevance,
 - a. define relevance
 - b. explain the meaning and importance of each of the three ingredients of relevance
2. For the primary quality reliability,
 - a. define reliability
 - b. explain the meaning and importance of each of the three ingredients of reliability
3. Explain the concepts of
 - a. comparability
 - b. consistency
 - c. materiality

C2-7 Objectives, Users, and Stewardship

CMA Adapted The owners of CSC Inc., a privately held company, are considering a public offering of the company's common stock as a means of acquiring additional funds. Prior to making a decision about a public offering, the

owners had a lengthy conversation with John Duncan, CSC's chief financial officer. Duncan informed the owners of the reporting requirements of the Securities and Exchange Commission, including the necessity for audited financial statements. At the request of the owners, Duncan also discussed the objectives of financial reporting, the sophistication of users of financial information, and the stewardship responsibilities of management, all of which are addressed in **Statement of Financial Accounting Concepts No. 1**, "Objectives of Financial Reporting by Business Enterprises."

Required

1. Discuss the primary objectives of financial reporting.
2. Describe the level of sophistication that can be expected of the users of financial information.
3. Explain the stewardship responsibilities of management.

C2-8 Segment Reporting

The FASB requires that a company organized in different "operating segments" disclose the revenues, profits, and assets of each of its major operating segments.

Required

Prepare a short memo that briefly explains what types of useful information for investment decision making is provided by requiring these disclosures.

CREATIVE AND CRITICAL THINKING

C2-9 Relevance versus Reliability

You are listening to two accounting majors, both of whom are seniors. They are debating the merits of having relevant versus reliable accounting information for external decision making. One student states: "In my decision making, if given a choice between relevant and reliable accounting information, I would prefer to have relevant information." The other student replies: "Nonsense! If you cannot rely on the information, then of what use is it?"

Required

Based on your knowledge of the FASB's conceptual framework, define the qualitative characteristics of relevance and reliability. Include definitions of the ingredients of each. Which do you think is more important?

C2-10 Inconsistent Statements on Accounting Principles

AICPA Adapted The following two statements have been taken directly or with some modification from the accounting literature. Each of them is either taken out of context, involves circular reasoning, and/or contains one or more fallacies, half-truths, erroneous comments, conclusions, or inconsistencies (internally or with generally accepted principles or practices).

Statement 1 Accounting is a service activity. Its function is to provide quantitative financial information that is intended

to be useful in making economic decisions about and for economic entities. Thus the accounting function might be viewed primarily as being a tool or device for providing quantitative financial information to management to facilitate decision making.

Statement 2 Financial statements that were developed in accordance with generally accepted accounting principles, which apply the conservatism convention, can be free from bias (or can give a presentation that is fair with respect to continuing and prospective stockholders as well as to retiring stockholders).

Required

Evaluate each of the preceding numbered statements as follows:

1. List the fallacies, half-truths, circular reasoning, erroneous comments or conclusions, and/or inconsistencies.
2. Explain by what authority and/or on what basis each item listed in (1) can be considered to be fallacious, circular, inconsistent, a half-truth, or an erroneous comment or conclusion. If the statement or a portion of it is merely out of context, indicate the context(s) in which the statement would be correct.

C2-11 Accounting Entity

AICPA Adapted The concept of the accounting entity often is considered to be the most fundamental of accounting concepts, one that pervades all of accounting.

Required

- What is an accounting entity? Explain.
 - Explain why the accounting entity concept is so fundamental that it pervades all of accounting.
- For each of the following indicate whether the accounting concept of entity is applicable; discuss and give illustrations.
 - A unit created by or under law
 - The product-line operating segment of an enterprise
 - A combination of legal units and/or product-line operating segments
 - All of the activities of an owner or a group of owners
 - An industry
 - The economy of the United States

C2-12 Timing of Revenue Recognition

AICPA Adapted Revenue usually is recognized at the point of sale. Under special circumstances, however, bases other than the point of sale are used for the timing of revenue recognition.

Required

- Why is the point of sale usually used as the basis for the timing of revenue recognition?
- Disregarding the special circumstances when bases other than the point of sale are used, discuss the merits of each of the following objections to the sales basis of revenue recognition:
 - It is too conservative because revenue is earned throughout the entire process of production.
 - It is not conservative enough because accounts receivable do not represent disposable funds; sales returns and allowances may be made; and collection and bad debt expenses may be incurred in a later period.
- Revenue may also be recognized (a) during production and (b) when cash is received. For each of these two bases of timing revenue recognition, give an example of the circumstances in which it is properly used and discuss the accounting merits of its use in lieu of the sales basis.

C2-13 Accruals and Deferrals

AICPA Adapted Generally accepted accounting principles require the use of accruals and deferrals in the determination of income.

Required

- How does accrual accounting affect the determination of income? Include in your discussion what constitutes an accrual and a deferral, and give appropriate examples of each.
- Contrast accrual accounting with cash accounting.

C2-14 Revenue Recognition

The following are brief descriptions of several companies in different lines of business.

- Company A is a construction company. It has recently signed a contract to build a highway over a three-year period. A down payment was collected; the remaining

collections will occur periodically over the construction period based upon the degree of completion.

- Company B is a retailer. It makes sales on a daily basis for cash and on credit cards.
- Company C is a health spa. It has recently signed contracts with numerous individuals to use its facilities over a two-year period. The contract price was collected in advance.
- Company D is a land development company. It has recently begun developing a “retirement community” and has sold lots to senior citizens. The sales contract requires a small down payment and periodic payments until completion of the roads and a clubhouse, after which the remainder of the purchase price is due. Prior to this point, a purchaser may cancel the contract and receive a refund of all payments.

Required

Describe when revenue should be recognized by each company. If revenue should not be recognized at the time of sale, indicate what method should be used to recognize the revenue. Justify your decision.

C2-15 Violations of Assumptions and Principles

The following are accounting procedures and practices used by several companies.

- As soon as it purchases inventory, Sokolich Company records the purchase price as cost of goods sold to simplify its accounting procedures.
- At the end of each year Sloan Company records and reports its economic resources based on appraisal values.
- Ebert Company prepares financial statements only every two years to reduce its costs of preparing the statements.
- Guthrie Company sells on credit and records revenue at that time, even though it knows that collection is highly uncertain and very significant efforts have to be made to collect the accounts.
- Because of inflation, Cross Company adjusts its financial statements each year to show the current purchasing power for all items.
- David Thomas combines his personal transactions and business transactions when he prepares his company’s financial statements so that he can tell how well he is doing on an “overall” basis.
- At the end of each year Vann Company reports its economic resources on a liquidation basis even though it is likely to operate in the future.

Required

Identify what accounting assumption or principle each procedure or practice violates, and indicate what should be done to rectify the violation.

C2-16 Conceptual Framework

CMA Adapted The Financial Accounting Standards Board has developed a conceptual framework for financial accounting and reporting. The FASB has issued **7 Statements of Financial Accounting Concepts**. These statements set

forth objectives and fundamentals that will be the basis for developing financial accounting and reporting standards. The objectives identify the goals and purposes of financial reporting. The fundamentals are the underlying concepts of financial accounting concepts that guide the selection of transactions, events, and circumstances to be accounted for; their recognition and measurement; and the means of summarizing and communicating them to interested parties.

The purpose of **Statement of Financial Accounting Concepts No. 2**, "Qualitative Characteristics of Accounting Information," is to examine the characteristics that make accounting information useful. The characteristics or qualities of information discussed in *Concepts No. 2* are the ingredients that make information useful and are the qualities to be sought when accounting choices are made.

Required

1. Identify and discuss the benefits which can be expected to be derived from the FASB's conceptual framework study.
2. What is the most important quality for accounting information as identified in **Statement of Financial Accounting Concepts No. 2**? Explain why it is the most important.
3. **Statement of Financial Accounting Concepts No. 2** describes a number of key characteristics or qualities for

accounting information. Briefly discuss the importance of understandability, relevance, and reliability for financial reporting purposes.



C2-17 Ethics and Income Reporting

You have been hired as an "accounting consultant" by Watson Company to evaluate its financial reporting policies. Watson is a small corporation with a few stockholders owning stock that is not publicly traded. In a discussion with you, Chris Watson, the company president, says "For the Watson Company's annual income statement, it is our policy to always record and report revenues when we collect the cash and to record and report expenses when we pay the cash. I like this approach and I think our stockholders and creditors do too. This policy results in income that is reliable and conservative, which is the way accounting should be. Besides, it is easy to keep track of our income. All I need are the receipts and payments recorded in the company's checkbook."

Required

From financial reporting and ethical perspectives, how would you reply to Chris?