

Chapter 2--Financial Reporting: Its Conceptual Framework

Student: _____

1. Which of the following statements is *not* true with regard to the benefits derived from the FASB's conceptual framework of accounting?

- A. It serves as a guide in establishing standards for the FASB.
- B. The *Statements of Financial Accounting Concepts* is the primary source of GAAP for accountants.
- C. It establishes the objectives of financial reporting.
- D. It enhances comparability between different companies' financial statements.

2. How many Statements of Financial Accounting Concepts have been issued?

- A. 6
- B. 7
- C. 31
- D. over 100

3. The first part of the conceptual framework project had to do with

- A. elements
- B. objectives
- C. qualitative characteristics
- D. recognition and measurement

4. The accounting projects portion of the FASB's conceptual framework project deals with

- A. which accounting elements should be reported and how they should be measured
- B. which accounting elements should be reported and where the information should be reported
- C. how the accounting elements should be measured and how information should be displayed in financial reports
- D. when accounting elements should be recognized and how information should be displayed in financial reports

5. The FASB divided its conceptual framework activities into several projects. Which of the following was *not* one of those projects?

- A. objectives project
- B. qualitative characteristics project
- C. financial reporting project
- D. accounting project

6. The accounting projects portion of the FASB's conceptual framework project deals with all of the following *except*

- A. how elements should be measured
- B. when various elements should be reported
- C. which accounting elements should be reported
- D. how financial reports should be displayed

7. The FASB has determined that the primary focus of financial reporting about an entity's performance is information on

- A. resources and obligations
- B. management's stewardship of resources
- C. comprehensive income and its components
- D. cash flows and financial flexibility

8. The FASB concluded that the most general objective of financial reporting is to

- A. provide information useful in the decisions made by external users
- B. meet the needs of internal users
- C. provide information about an entity's earnings
- D. provide information about an entity's cash flows

9. According to GAAP, which is *not* a specific objective?

- A. to provide information about an enterprise's cash flows
- B. to provide information that is useful to present to potential investors, creditors, and other users in making rational investment, credit, and similar decisions
- C. to provide information about an enterprise's comprehensive income and its components
- D. to provide information about an enterprise's economic resources, obligations, and owners' equity

10. Information about comprehensive income is useful to external users for all of the following purposes *except*

- A. evaluating management's performance
- B. examining cash flows for the current period
- C. predicting future income
- D. assessing the risk of lending to the company

11. In its "Objectives of Financial Reporting by Business Enterprises" the FASB identified a variety of primary users including all of the following *except*

- A. internal management
- B. investors
- C. creditors
- D. security analysts

12. GAAP emphasizes the importance of full disclosure by management including all of the following enhancements *except*

- A. explanations to enhance understanding of major transactions
- B. interpretations of the effects of dividing continuous operations into accounting periods
- C. outlines of internal control procedures in use
- D. explanations of underlying assumptions and methods used

13. Which of the following is a specific objective of financial reporting?

- A. provide information that is useful to investors in making investment decisions
- B. provide information useful in assessing the amounts, timing, and uncertainty of prospective cash receipts
- C. provide information useful in assessing the amounts, timing, and uncertainty of prospective cash inflows
- D. provide information about a company's economic resources, obligations, and owners' equity

14. A primary focus of financial reporting about a company's performance during an accounting period is information related to the company's

- A. balance sheet
- B. income statement
- C. comprehensive income
- D. cash flows

15. Accrual accounting relates the financial effects of a company's transactions

- A. so that the costs of nonoperating events are matched to the balance sheet in the period impacted
- B. to the period in which they occur rather than to when the cash receipts or payment occurs
- C. so that the revenue impact of every transaction in a period is properly reflected in the income statement
- D. so that the impact of every transaction is reflected in the statement of cash flows

16. Which of the following statements regarding financial flexibility is true?

- A. It is the ability of a company to provide a return on investment.
- B. It is the ability of a company to take effective actions to insure the return of capital to the company.
- C. It is the ability of a company to take effective actions to change the amounts and timing of cash flows.
- D. It is the ability of a company to maintain a given level of operations.

17. Which of the following types of information was specifically identified by the FASB as being useful in assessing the amounts, timing, and uncertainty of a company's future cash flows?

- A. liquidity
- B. return of investment
- C. financial capability
- D. credit standing

18. When investors and creditors make investment and credit decisions, they need information to assist them in assessing future cash receipts. Their focus is on assessing the potential of generating
- A. a return *of* investment of capital
 - B. a return *on* investment of capital
 - C. both a return *of* and a return *on* investment of capital
 - D. neither a return *of* nor a return *on* investment of capital
19. Which qualitative characteristic is an ingredient of relevance?
- A. verifiability
 - B. timeliness
 - C. neutrality
 - D. representational faithfulness
20. According to the FASB hierarchy of qualitative characteristics, the two primary qualities making accounting information useful are
- A. understandability and decision usefulness
 - B. relevance and reliability
 - C. verifiability and neutrality
 - D. predictive value and feedback value
21. Which qualitative characteristic is an ingredient of reliability?
- A. predictive value
 - B. feedback value
 - C. timeliness
 - D. neutrality
22. According to GAAP, verifiability is an ingredient of
- A. comparability
 - B. reliability
 - C. representational faithfulness
 - D. relevance
23. In order to be relevant, accounting information should have
- A. timeliness
 - B. verifiability
 - C. neutrality
 - D. representational faithfulness

24. Which of the following qualitative characteristics may have to be sacrificed in order to achieve timeliness?

- A. relevance
- B. reliability
- C. comparability
- D. predictive value

25. Representational faithfulness is a relationship between the reported accounting measurements or descriptions and the economic resources, obligations, and the transactions and events causing changes in these items. This is important because the

- A. bias associated with financial measurements can be reduced
- B. validity of accounting data is an important economic resource
- C. accounting information is relevant for all decisions
- D. financial information is faithfully reported in the accounting records

26. Which of the following are considered secondary characteristics of accounting information?

- A. verifiability and feedback value
- B. predictive value and timeliness
- C. comparability and consistency
- D. representational faithfulness and neutrality

27. Two constraints mentioned by GAAP on qualitative characteristics are

- A. understandability and decision usefulness
- B. comparability and consistency
- C. relevance and reliability
- D. benefits greater than costs and materiality

28. Which of the following items would most likely be a violation of the materiality constraint?

- A. A company did not separately report an unusual gain of \$50,000. Its income from operations was \$5,000,000.
- B. A company having reported total assets of \$20,000,000 immediately expensed the purchase of 20 pencil sharpeners that have an estimated useful life of three years.
- C. A \$25,000 illegal bribe by an executive of the company to a foreign official was not separately disclosed in the annual report.
- D. A \$5,000 expenditure to improve a building that originally cost \$5,000,000 was immediately expensed.

29. Intracompany comparability would be violated if

- A. a company used LIFO as its inventory cost method while other companies in the same industry used FIFO
- B. a company changed its bad debts expense estimate from one percent to two percent
- C. a bank did not classify its assets as current assets and noncurrent assets
- D. a company expenses all expenditures of less than \$500 even if the expenditures result in probable future economic benefit

30. In the FASB hierarchy of qualitative characteristics, understandability is a characteristic that is

- A. a secondary and interactive quality
- B. a threshold for recognition
- C. an overall quality
- D. a user-specific quality

31. The materiality of an item of financial information refers to the likelihood that its omission or misstatement would affect the judgments of those relying on that information. This concept most closely relates to the

- A. financial magnitude of the item
- B. verifiability of the item
- C. neutrality of the item
- D. feedback value of the item

32. Which is *not* one of the four recognition criteria identified by the FASB?

- A. reliable
- B. understandable
- C. meets the definition of an element
- D. measurable

33. All of the following items are classified as accounting assumptions and conventions *except* for

- A. going concern
- B. timeliness
- C. monetary unit
- D. entity

34. The city of Fairbanks sold land for its appraised value to the Big Oil Company on June 1, 2010, that originally cost the city \$1,000,000. On June 1, 2010, the land was appraised at a value of \$1,250,000, and on December 31, 2010, the land's value was estimated to be \$1,400,000. On Big Oil Company's balance sheet at December 31, 2010, the land should be valued at

- A. \$1,400,000
- B. \$1,250,000
- C. \$1,000,000
- D. \$ 0

35. According to the recognition criteria established for revenue, revenue is normally recognized

- A. during production
- B. at the completion of production
- C. at the point of sale
- D. when the cash is received from the customer

36. For fixed-price construction contracts that require more than one accounting period to complete and for which the costs can be reasonably estimated, revenue should be recognized

- A. during production
- B. at the completion of production
- C. when title to the project is transferred to the buyer
- D. when the cash is received from the buyer

37. If collectibility of the revenue is highly uncertain, an appropriate method that should be used to recognize revenue would be

- A. the percentage-of-completion method
- B. at the point of sale
- C. the proportional performance method
- D. the installment method

38. Using the straight-line method to amortize patents is an application of expense recognition using

- A. association of cause and effect
- B. a systematic and rational allocation method
- C. immediate recognition
- D. the percentage-of-completion method

39. Using an allowance method of accounting to recognize uncollectible accounts receivable is an application of which accounting convention?
- A. revenue recognition
 - B. historical cost
 - C. matching principle
 - D. period of time
40. The state legislature is currently debating a bill that, if passed, would require the Sandiken Company to go out of business. Which of the following principles or assumptions related to the preparation of Sandiken's financial statements is most directly affected by this impending vote of the legislature?
- A. going concern
 - B. verifiability principle
 - C. entity concept
 - D. materiality concept
41. Under current GAAP, most resources of a business entity are to be valued in its financial statements at
- A. a value that is most relevant to the needs of users of the financial statements
 - B. historical cost
 - C. the current cost of replacing the resource
 - D. current appraisal values
42. Revenue may be recognized by an entity at the completion of production during an accounting period
- A. only if full payment was received from the buyer before production began
 - B. when no specific point of sale can be identified
 - C. when there is a fixed selling price, and there are no limitations on the amount that can be sold
 - D. when collectibility is highly uncertain
43. FASB suggests that revenues are considered to be earned
- A. at a date subsequent to the point of sale
 - B. throughout the earnings process
 - C. when the company is entitled to its benefits
 - D. when cash is received
44. The principle of revenue recognition results in
- A. recording revenue in the income statement
 - B. recording realized revenue when it is earned
 - C. measuring relevant and reliable information whenever a transaction has occurred
 - D. assuring the existence of all amounts recorded as net income

45. Solon Corporation has adopted the policy of charging to expense at the time of purchase all assets having a cost of less than \$100, regardless of the life expectancy of the asset. This policy is most closely related to the

- A. historical cost principle
- B. period-of-time assumption
- C. verifiability principle
- D. materiality principle

46. A company that uses accounting methods in preparing its tax returns that differ from the accounting methods used to prepare its financial statements is

- A. in violation of the consistency principle
- B. not necessarily violating either the income tax laws or generally accepted accounting principles
- C. probably guilty of tax evasion
- D. in violation of the relevance assumption

47. Of the following reporting assumptions or reporting principles, the one most widely criticized is the

- A. consistency principle
- B. full-disclosure principle
- C. entity assumption
- D. historical cost principle

48. Which one of the following assumptions or principles most logically supports the preparation of a single set of consolidated financial statements that combines the financial information of several wholly owned but separately identifiable businesses?

- A. historical cost
- B. industry practices
- C. entity
- D. materiality

49. Expenses are recognized and matched against revenues on the basis of three principles. Which of the following is *not* one of these principles?

- A. immediate recognition
- B. associating cash flows
- C. systematic and rational allocation
- D. associating cause and effect

50. Which of the following sets includes only accounting assumptions and conventions?

- A. timeliness, prudence, historical cost, and neutrality
- B. matching, comparability, period of time, and reliability
- C. monetary unit, going concern, relevance, and materiality
- D. monetary unit, entity, going concern, and realization-recognition

51. The use of the historical cost principle is justified because the resulting information has the primary quality ingredients of

- A. neutrality and predictive value
- B. representational faithfulness and neutrality
- C. timeliness and neutrality
- D. verifiability and feedback value

52. Which of the following transactions would be reported in the cash flows from investing activities section in the statement of cash flows for the Haleem Company?

- A. Haleem sold a piece of land for \$500,000.
- B. Haleem borrowed \$2,000,000.
- C. Haleem issued common stock for \$800,000 to investors.
- D. Haleem paid a cash dividend to its stockholders.

53. Distributions that are paid to owners would affect both the

- A. balance sheet and statement of cash flows
- B. balance sheet and income statement
- C. income statement and statement of changes in equity
- D. income statement and statement of cash flows

54. The financial statement that would be most useful in evaluating a company's financial flexibility is the

- A. balance sheet
- B. income statement
- C. statement of owners' equity
- D. statement of retained earnings

55. The framework for the model of business reporting includes all of the following *except*

- A. financial and nonfinancial data
- B. independent analysis of the financial data
- C. forward-looking information
- D. information about management and shareholders

56. The AICPA's Special Committee on Financial Reporting issued a report on a model for business reporting that addresses concerns about
- A. the reliability and flexibility of financial reports
 - B. the relevance and timeliness of financial reports
 - C. the verifiability and neutrality of financial reports
 - D. the relevance and usefulness of financial reports
57. The model for business reporting is designed to fit the decision processes of users to
- A. make projections
 - B. value companies
 - C. assess the likelihood of loan repayments
 - D. do all of these
58. The AICPA's Special Committee on Financial Reporting issued a report on a model for business reporting. The "Financial Reporting" sources of information used in external decision making outlined in the model included all of the following *except*
- A. parenthetical and footnote disclosures
 - B. financial statements
 - C. macroeconomic statistics
 - D. management discussion and analysis
59. The CFA's *Comprehensive Business Reporting Model* argues that certain key weaknesses in the current financial reporting model exist. The weaknesses include all of the following *except*
- A. current financial statements are not presented in a structure that is useful to investors
 - B. current financial statements do not present sufficient information to enable investors to make effective decisions.
 - C. current financial statements contain inaccurate measurements
 - D. investors must resort to estimates and best guesses to generate the information they need
60. The goal of the boards of the IASB and FASB is to develop a joint conceptual framework project that is both complete and internally consistent. However, as a limitation the boards concluded that
- A. a comprehensive reconsideration of all concepts underlying financial reporting would slow the progress but would be a necessary use of their time
 - B. the project would have to be split into four phases and worked on one at a time
 - C. the project would have to be split into eight phases, and all phases would be worked on simultaneously
 - D. a comprehensive reconsideration of all concepts underlying financial reporting would not be an efficient use of their time

61. The IASB and FASB boards have agreed that the objective of general purpose financial reporting is to provide

- A. financial information about a company that is useful to external users in making decisions in their capacity as capital providers
- B. mainly cash flow information about a company that is useful to external users in making decisions in their capacity as capital providers
- C. financial information about a company that is useful to internal users in making decisions in their capacity as capital custodians
- D. financial information about a company that is useful to government regulators in making decisions in their capacity as capital markets monitors

62. The IASB and FASB joint boards feel that financial reporting should

- A. be general purpose
- B. be useful in assessing a company's future cash flows
- C. provide information on an accrual basis
- D. all of these are true

63. The IASB and FASB joint boards have identified the primary user groups of financial information as all of the following *except*

- A. equity investors
- B. labor groups
- C. lenders
- D. other creditors (capital providers)

64. One of the differences between the IASB/FASB joint conceptual framework and the FASB conceptual framework is that while the FASB identifies relevance and reliability as the primary decision-specific qualities, the tentative joint framework identifies the fundamental qualitative characteristics to be

- A. relevance and completeness
- B. reliability and completeness
- C. relevance and faithful representation
- D. reliability and faithful representation

65. The joint IASB and FASB boards identified several "enhancing" characteristic of financial information including

- A. comparability, verifiability, timeliness, and understandability
- B. materiality, verifiability, timeliness, and understandability
- C. comparability, verifiability, timeliness, and materiality
- D. comparability, relevance, timeliness, and understandability

66. Similar to the constraints in the FASB's qualitative characteristics, the joint IASB/FASB boards have identified two constraints including

- A. benefits that justify the costs and consistency
- B. benefits that justify the costs and materiality
- C. consistency and materiality
- D. objectivity and materiality

67. The joint IASB/FASB qualitative characteristics *Exposure Draft* identifies a logical order in which to evaluate the qualities. That order (first, second, third) is

- A. faithful representation, relevance, enhancing characteristics
- B. relevance, enhancing characteristics, faithful representation
- C. relevance, faithful representation, enhancing characteristics
- D. enhancing characteristics, relevance, faithful representation

68. The FASB identified several objectives of financial reporting, which are listed below. Following the list is a series of descriptive statements.

- a. general objective
- b. derived external user objective
- c. derived company objective
- d. specific objectives

- ___ 1. Provide information about a company's economic resources, obligations, and owners' equity.
- ___ 2. Provide useful information for present and potential investors, creditors, and other external users in making their investment, credit, and similar decisions.
- ___ 3. Provide information about a company's financial performance during a period.
- ___ 4. Provide information about a company's cash flows.
- ___ 5. Provide information that is useful to external users in assessing the amounts, timing, and uncertainty of prospective cash receipts.
- ___ 6. Provide information to help external users in assessing the amounts, timing, and uncertainty of a company's prospective net cash flows.

Required:

Match each objective with the appropriate statement by placing the appropriate letter in the space provided.

69. A list of statements follows:

- a. GAAP identifies the _____ of financial reporting.
- b. Financial reporting should, above all, provide information that is _____ to external decision makers.
- c. 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 represents management's _____ to outsiders.

Required:

Fill in the words necessary to complete the statements.

70. A list of statements follows:

- a. _____ on _____ provides a measure of overall company performance.
- b. _____ is the uncertainty or unpredictability of the future results of a company.
- c. _____ is the ability of a company to take effective actions to change the amounts and timing of cash flows.
- d. _____ is the term used to describe how quickly a company can convert its assets into cash to pay a liability.
- e. _____ refers to the ability of a company to maintain a given physical level of operations.

Required:

Fill in the words necessary to complete the statements.

71. A list of statements follows:

- a. GAAP states that the two primary qualitative characteristics that make accounting information useful for decision-making purposes are _____ and _____.
- b. Corporations prepare quarterly financial statements in order to help achieve _____, an ingredient of the primary quality of relevance.
- c. Expensing the purchase of waste paper baskets that have a three-year estimated useful life at the date of acquisition is a permissible procedure according to the _____ constraint.
- d. The three components of reliability are _____, _____, and _____.
- e. _____ is the overall qualitative characteristic to be used in judging the quality of accounting information.

Required:

Fill in the words necessary to complete the statements.

72. Below is a list of the qualitative characteristics identified by GAAP. Following the list is a series of descriptive phrases.

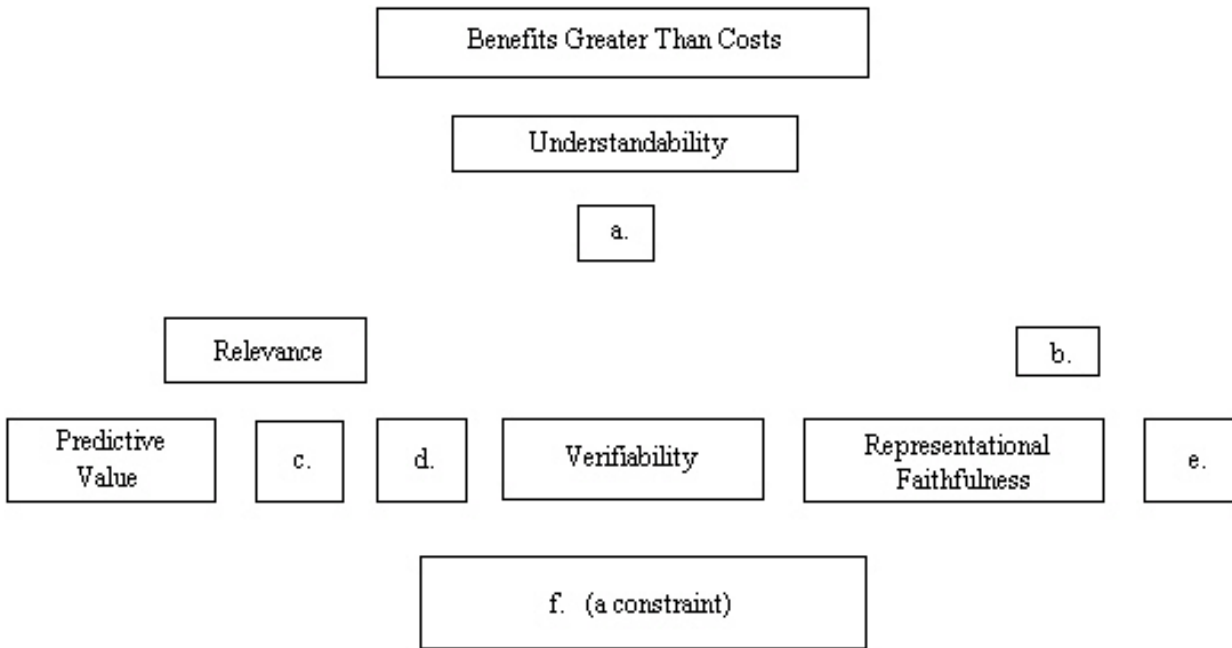
- | | | | |
|----|---------------------|----|-------------------------------|
| a. | feedback value | g. | verifiability |
| b. | relevance | h. | consistency |
| c. | decision usefulness | i. | representational faithfulness |
| d. | reliability | j. | timeliness |
| e. | comparability | k. | neutrality |
| f. | predictive value | | |

- ___ 1. When information can make a difference in a decision.
- ___ 2. Making information available when it is needed.
- ___ 3. When accounting policies and procedures are unchanged from period to period.
- ___ 4. When information is verifiable and neutral.
- ___ 5. Occurs when the measurement results can be duplicated.
- ___ 6. The overall qualitative characteristic accounting information should possess.
- ___ 7. When information enables decision makers to confirm prior expectations.
- ___ 8. When accounting information is reported the same way by different companies.

Required:

Match each characteristic with the appropriate phrase.

73. Part of the hierarchy of qualitative characteristics is presented below.



Required:

Provide the qualitative characteristic for each lettered box.

- a. _____
- b. _____
- c. _____
- d. _____
- e. _____
- f. _____

74. Following the list below is a series of descriptions of inappropriate accounting procedures.

- a. full disclosure
- b. historical cost
- c. revenue recognition
- d. conservatism
- e. monetary-unit assumption
- f. matching principle
- g. period of time

- _____ 1. The company signs a contract to produce four machines according to the customer's specifications. On the date of the contract, the customer pays one half of the total contract price, and the company records the cash receipt as a sale. The machines will be manufactured and delivered during the next year.
- _____ 2. The company delayed issuing its annual financial statements in order to include a large sale expected early in the next year.
- _____ 3. The market value of the company's inventory declined sharply. The president, optimistically predicting a rise in value, insisted that the inventory be reported at its historical cost.
- _____ 4. The market value of the company's large inventory rose sharply. The inventory was reported on the balance sheet at current market value.
- _____ 5. Although the company can estimate its uncollectible accounts receivable, it does not recognize the bad debts expense until it determines that an account receivable is uncollectible.

Required:

Indicate which item (or items) on the list was (were) violated in each description by placing the appropriate letter(s) in the space provided.

75. Below is a list of accounting assumptions, conventions, and principles. Following the list is a series of descriptive statements.

- a. entity assumption
- b. historical cost principle
- c. going-concern assumption
- d. conservatism convention
- e. monetary-unit assumption
- f. matching principle
- g. period of time
- h. realization
- i. recognition

- ___ 1. A company records sales on account when providing a service.
- ___ 2. A company recognizes as expense the portion of its prepaid rent that has expired.
- ___ 3. A company reports the land that it purchased in 1990 for \$500,000, at the same amount on its 2010 balance sheet.
- ___ 4. A company reports its inventories on the balance sheet at the lower of cost or market.
- ___ 5. An entity is preparing its five-year strategic plan.
- ___ 6. A company amortizes its patent, an intangible asset, over its useful life.

Required:

Match each item in the list with its descriptive statement by placing the appropriate letter in the space provided.

76. Presented below are five inappropriate accounting procedures that are being used by the Devin Corporation.

- a. On the year-end balance sheet, Devin Corporation reported its inventory at market value, which was greater than cost. As a result of this procedure, a gain was recognized on the company's income statement.
- b. Mrs. Devin, the president of the company, purchased an automobile for her son using the company's money. The company's accountant recorded the expenditure as salaries expense.
- c. Devin Corporation reported income from operations of \$5,000,000 for the current year. During the year, Devin settled and paid a \$5,000,000 class action lawsuit against the company resulting from damages incurred from the sale of defective products. The settlement was reported as a miscellaneous expense with no footnotes provided.
- d. Devin Corporation is going to issue additional common stock next year. In order to improve its income, the company switched from the LIFO inventory cost flow method to FIFO. The company did not disclose the accounting change. Comparative financial statements were prepared.
- e. The company made \$3,000,000 of expenditures to expand a building that originally cost \$5,000,000. The expenditures are expected to benefit operations over the building's remaining useful life of ten years. The expenditures were expensed as maintenance.

Required:

For each of the above items, list the accounting assumption(s), convention(s), or principle(s) that is (are) being violated.

77. Certain elements of the financial statements are listed below, followed by a series of descriptive statements.

- | | | | |
|----|-------------|----|----------------------|
| a. | assets | f. | gains |
| b. | liabilities | g. | losses |
| c. | equity | h. | operating cash flows |
| d. | revenues | i. | investing cash flows |
| e. | expenses | j. | financing cash flows |

- ___ 1. Decrease in equity from peripheral or incidental transactions.
- ___ 2. The owners' residual interest in a company's assets.
- ___ 3. Inflows of assets or settlement of liabilities, or a combination of both, from the sale of goods or services.
- ___ 4. Acquiring and selling investments; property, plant & equipment; and intangibles, as well as lending money and collecting on loans.
- ___ 5. Probable future sacrifices of economic benefits arising from present obligations.
- ___ 6. Outflows or other using up of assets or incurrence of liabilities, or a combination of both, in the sale of goods and services.
- ___ 7. Cash flows from acquiring, selling, and delivering goods or from providing services.
- ___ 8. Probable future economic benefits obtained as a result of past transactions or events.
- ___ 9. Increases in equity from peripheral or incidental transactions.
- ___ 10. Obtaining resources from owners and providing them with a return on, and of, their investment, as well as obtaining and repaying resources from long-term creditors.

Required:

Match each element with the appropriate statement by placing the appropriate letter in the space provided.

78. The AICPA Special Committee on Financial Reporting developed a comprehensive model of business reporting in an attempt to provide a foundation for future improvement in business reporting. The five statements below relate to the five categories of information outlined in the committee's work.

- a. _____ and _____, including (1) financial statements and related disclosures and (2) high-level operating data and performance measurements.
- b. _____ of the financial and nonfinancial data, including (1) reasons for changes in the data and (2) the identity and past effect of key trends.
- c. _____, including (1) assessment of opportunities and risks, (2) management's plans, and (3) comparison of actual performance to previously disclosed opportunities, risks, and plans.
- d. _____ about _____ and _____, including (1) directors, management, compensation, and major shareholders and (2) transactions and relationships among related parties.
- e. _____ about the _____, including (1) broad objectives and strategies, (2) scope and description of the company's business and properties, and (3) the impact of industry structure.

Required:

Fill in the blanks in each statement above with the appropriate information category.

79. At lunch recently, two accountants were discussing the merits of the FASB's conceptual framework project, which resulted in the publication of seven *Statements of Financial Accounting Concepts* and required more than ten years of effort. One accountant thought the effort was a waste of resources, since accounting was unlike physics, chemistry, and biology, where natural laws apply. The other accountant thought the effort was very valuable. He stated that "accounting, like any other discipline, benefits from having a coherent theory."

Required:

Write a brief essay that discusses the advantages that are derived from the existence of a conceptual framework for financial accounting and reporting.

80. The task of developing the conceptual framework was so enormous that the FASB had to divide it into several projects.

Required:

Identify each of the projects by name and provide a brief description of their results.

81. GAAP lists and describes the qualitative characteristics that make accounting information useful for decision-making purposes. The FASB viewed the characteristics as a hierarchy of qualities that make accounting information useful. The FASB stated that accounting information must possess both relevance and reliability qualities to be useful, but it was noted that relevance and reliability may conflict with each other in some instances. For example, to increase relevance, reliability may have to be sacrificed, or vice versa.

Required:

- a. Define "relevance" and "reliability" and list the components or "ingredients" of each quality.
- b. Give an example in financial accounting that illustrates the following tradeoffs:
 - (1) Relevance is sacrificed in order to make accounting information more reliable.
 - (2) Reliability is sacrificed in order to make accounting information more relevant.

82. The CFA's Comprehensive Business Reporting Model Subcommittee reported that current financial statements do not provide the information necessary to analyze and value securities or make optimal financial decisions.

Required:

Discuss the objectives of changes identified by the Subcommittee that need to be made to the current system of reporting.

83. The IASB/FASB tentative joint conceptual framework includes two "fundamental qualitative characteristics" that must be present for financial reporting information to be useful.

Required:

Name and describe the two joint conceptual framework fundamental characteristics.

Chapter 2--Financial Reporting: Its Conceptual Framework **Key**

1. Which of the following statements is *not* true with regard to the benefits derived from the FASB's conceptual framework of accounting?

A. It serves as a guide in establishing standards for the FASB.

B. The *Statements of Financial Accounting Concepts* is the primary source of GAAP for accountants.

C. It establishes the objectives of financial reporting.

D. It enhances comparability between different companies' financial statements.

2. How many Statements of Financial Accounting Concepts have been issued?

A. 6

B. 7

C. 31

D. over 100

3. The first part of the conceptual framework project had to do with

A. elements

B. objectives

C. qualitative characteristics

D. recognition and measurement

4. The accounting projects portion of the FASB's conceptual framework project deals with

A. which accounting elements should be reported and how they should be measured

B. which accounting elements should be reported and where the information should be reported

C. how the accounting elements should be measured and how information should be displayed in financial reports

D. when accounting elements should be recognized and how information should be displayed in financial reports

5. The FASB divided its conceptual framework activities into several projects. Which of the following was *not* one of those projects?

A. objectives project

B. qualitative characteristics project

C. financial reporting project

D. accounting project

6. The accounting projects portion of the FASB's conceptual framework project deals with all of the following *except*

- A. how elements should be measured
- B. when various elements should be reported
- C. which accounting elements should be reported
- D.** how financial reports should be displayed

7. The FASB has determined that the primary focus of financial reporting about an entity's performance is information on

- A. resources and obligations
- B. management's stewardship of resources
- C.** comprehensive income and its components
- D. cash flows and financial flexibility

8. The FASB concluded that the most general objective of financial reporting is to

- A.** provide information useful in the decisions made by external users
- B. meet the needs of internal users
- C. provide information about an entity's earnings
- D. provide information about an entity's cash flows

9. According to GAAP, which is *not* a specific objective?

- A. to provide information about an enterprise's cash flows
- B.** to provide information that is useful to present to potential investors, creditors, and other users in making rational investment, credit, and similar decisions
- C. to provide information about an enterprise's comprehensive income and its components
- D. to provide information about an enterprise's economic resources, obligations, and owners' equity

10. Information about comprehensive income is useful to external users for all of the following purposes *except*

- A. evaluating management's performance
- B.** examining cash flows for the current period
- C. predicting future income
- D. assessing the risk of lending to the company

11. In its "Objectives of Financial Reporting by Business Enterprises" the FASB identified a variety of primary users including all of the following *except*

- A.** internal management
- B. investors
- C. creditors
- D. security analysts

12. GAAP emphasizes the importance of full disclosure by management including all of the following enhancements *except*

- A. explanations to enhance understanding of major transactions
- B. interpretations of the effects of dividing continuous operations into accounting periods
- C.** outlines of internal control procedures in use
- D. explanations of underlying assumptions and methods used

13. Which of the following is a specific objective of financial reporting?

- A. provide information that is useful to investors in making investment decisions
- B. provide information useful in assessing the amounts, timing, and uncertainty of prospective cash receipts
- C. provide information useful in assessing the amounts, timing, and uncertainty of prospective cash inflows
- D.** provide information about a company's economic resources, obligations, and owners' equity

14. A primary focus of financial reporting about a company's performance during an accounting period is information related to the company's

- A. balance sheet
- B. income statement
- C.** comprehensive income
- D. cash flows

15. Accrual accounting relates the financial effects of a company's transactions

- A. so that the costs of nonoperating events are matched to the balance sheet in the period impacted
- B.** to the period in which they occur rather than to when the cash receipts or payment occurs
- C. so that the revenue impact of every transaction in a period is properly reflected in the income statement
- D. so that the impact of every transaction is reflected in the statement of cash flows

16. Which of the following statements regarding financial flexibility is true?

- A. It is the ability of a company to provide a return on investment.
- B. It is the ability of a company to take effective actions to insure the return of capital to the company.
- C.** It is the ability of a company to take effective actions to change the amounts and timing of cash flows.
- D. It is the ability of a company to maintain a given level of operations.

17. Which of the following types of information was specifically identified by the FASB as being useful in assessing the amounts, timing, and uncertainty of a company's future cash flows?

- A.** liquidity
- B. return of investment
- C. financial capability
- D. credit standing

18. When investors and creditors make investment and credit decisions, they need information to assist them in assessing future cash receipts. Their focus is on assessing the potential of generating
- A. a return *of* investment of capital
 - B. a return *on* investment of capital
 - C.** both a return *of* and a return *on* investment of capital
 - D. neither a return *of* nor a return *on* investment of capital
19. Which qualitative characteristic is an ingredient of relevance?
- A. verifiability
 - B.** timeliness
 - C. neutrality
 - D. representational faithfulness
20. According to the FASB hierarchy of qualitative characteristics, the two primary qualities making accounting information useful are
- A. understandability and decision usefulness
 - B.** relevance and reliability
 - C. verifiability and neutrality
 - D. predictive value and feedback value
21. Which qualitative characteristic is an ingredient of reliability?
- A. predictive value
 - B. feedback value
 - C. timeliness
 - D.** neutrality
22. According to GAAP, verifiability is an ingredient of
- A. comparability
 - B.** reliability
 - C. representational faithfulness
 - D. relevance
23. In order to be relevant, accounting information should have
- A.** timeliness
 - B. verifiability
 - C. neutrality
 - D. representational faithfulness

24. Which of the following qualitative characteristics may have to be sacrificed in order to achieve timeliness?

- A. relevance
- B. reliability**
- C. comparability
- D. predictive value

25. Representational faithfulness is a relationship between the reported accounting measurements or descriptions and the economic resources, obligations, and the transactions and events causing changes in these items. This is important because the

- A. bias associated with financial measurements can be reduced**
- B. validity of accounting data is an important economic resource
- C. accounting information is relevant for all decisions
- D. financial information is faithfully reported in the accounting records

26. Which of the following are considered secondary characteristics of accounting information?

- A. verifiability and feedback value
- B. predictive value and timeliness
- C. comparability and consistency**
- D. representational faithfulness and neutrality

27. Two constraints mentioned by GAAP on qualitative characteristics are

- A. understandability and decision usefulness
- B. comparability and consistency
- C. relevance and reliability
- D. benefits greater than costs and materiality**

28. Which of the following items would most likely be a violation of the materiality constraint?

- A. A company did not separately report an unusual gain of \$50,000. Its income from operations was \$5,000,000.
- B. A company having reported total assets of \$20,000,000 immediately expensed the purchase of 20 pencil sharpeners that have an estimated useful life of three years.
- C. A \$25,000 illegal bribe by an executive of the company to a foreign official was not separately disclosed in the annual report.**
- D. A \$5,000 expenditure to improve a building that originally cost \$5,000,000 was immediately expensed.

29. Intracompany comparability would be violated if

- A. a company used LIFO as its inventory cost method while other companies in the same industry used FIFO
- B.** a company changed its bad debts expense estimate from one percent to two percent
- C. a bank did not classify its assets as current assets and noncurrent assets
- D. a company expenses all expenditures of less than \$500 even if the expenditures result in probable future economic benefit

30. In the FASB hierarchy of qualitative characteristics, understandability is a characteristic that is

- A. a secondary and interactive quality
- B. a threshold for recognition
- C. an overall quality
- D.** a user-specific quality

31. The materiality of an item of financial information refers to the likelihood that its omission or misstatement would affect the judgments of those relying on that information. This concept most closely relates to the

- A.** financial magnitude of the item
- B. verifiability of the item
- C. neutrality of the item
- D. feedback value of the item

32. Which is *not* one of the four recognition criteria identified by the FASB?

- A. reliable
- B.** understandable
- C. meets the definition of an element
- D. measurable

33. All of the following items are classified as accounting assumptions and conventions *except* for

- A. going concern
- B.** timeliness
- C. monetary unit
- D. entity

34. The city of Fairbanks sold land for its appraised value to the Big Oil Company on June 1, 2010, that originally cost the city \$1,000,000. On June 1, 2010, the land was appraised at a value of \$1,250,000, and on December 31, 2010, the land's value was estimated to be \$1,400,000. On Big Oil Company's balance sheet at December 31, 2010, the land should be valued at

- A. \$1,400,000
- B. \$1,250,000**
- C. \$1,000,000
- D. \$ 0

35. According to the recognition criteria established for revenue, revenue is normally recognized

- A. during production
- B. at the completion of production
- C. at the point of sale**
- D. when the cash is received from the customer

36. For fixed-price construction contracts that require more than one accounting period to complete and for which the costs can be reasonably estimated, revenue should be recognized

- A. during production**
- B. at the completion of production
- C. when title to the project is transferred to the buyer
- D. when the cash is received from the buyer

37. If collectibility of the revenue is highly uncertain, an appropriate method that should be used to recognize revenue would be

- A. the percentage-of-completion method
- B. at the point of sale
- C. the proportional performance method
- D. the installment method**

38. Using the straight-line method to amortize patents is an application of expense recognition using

- A. association of cause and effect
- B. a systematic and rational allocation method**
- C. immediate recognition
- D. the percentage-of-completion method

39. Using an allowance method of accounting to recognize uncollectible accounts receivable is an application of which accounting convention?
- A. revenue recognition
 - B. historical cost
 - C. matching principle**
 - D. period of time
40. The state legislature is currently debating a bill that, if passed, would require the Sandiken Company to go out of business. Which of the following principles or assumptions related to the preparation of Sandiken's financial statements is most directly affected by this impending vote of the legislature?
- A. going concern**
 - B. verifiability principle
 - C. entity concept
 - D. materiality concept
41. Under current GAAP, most resources of a business entity are to be valued in its financial statements at
- A. a value that is most relevant to the needs of users of the financial statements
 - B. historical cost**
 - C. the current cost of replacing the resource
 - D. current appraisal values
42. Revenue may be recognized by an entity at the completion of production during an accounting period
- A. only if full payment was received from the buyer before production began
 - B. when no specific point of sale can be identified
 - C. when there is a fixed selling price, and there are no limitations on the amount that can be sold**
 - D. when collectibility is highly uncertain
43. FASB suggests that revenues are considered to be earned
- A. at a date subsequent to the point of sale
 - B. throughout the earnings process
 - C. when the company is entitled to its benefits**
 - D. when cash is received
44. The principle of revenue recognition results in
- A. recording revenue in the income statement
 - B. recording realized revenue when it is earned**
 - C. measuring relevant and reliable information whenever a transaction has occurred
 - D. assuring the existence of all amounts recorded as net income

45. Solon Corporation has adopted the policy of charging to expense at the time of purchase all assets having a cost of less than \$100, regardless of the life expectancy of the asset. This policy is most closely related to the

- A. historical cost principle
- B. period-of-time assumption
- C. verifiability principle
- D. materiality principle**

46. A company that uses accounting methods in preparing its tax returns that differ from the accounting methods used to prepare its financial statements is

- A. in violation of the consistency principle
- B. not necessarily violating either the income tax laws or generally accepted accounting principles**
- C. probably guilty of tax evasion
- D. in violation of the relevance assumption

47. Of the following reporting assumptions or reporting principles, the one most widely criticized is the

- A. consistency principle
- B. full-disclosure principle
- C. entity assumption
- D. historical cost principle**

48. Which one of the following assumptions or principles most logically supports the preparation of a single set of consolidated financial statements that combines the financial information of several wholly owned but separately identifiable businesses?

- A. historical cost
- B. industry practices
- C. entity**
- D. materiality

49. Expenses are recognized and matched against revenues on the basis of three principles. Which of the following is *not* one of these principles?

- A. immediate recognition
- B. associating cash flows**
- C. systematic and rational allocation
- D. associating cause and effect

50. Which of the following sets includes only accounting assumptions and conventions?

- A. timeliness, prudence, historical cost, and neutrality
- B. matching, comparability, period of time, and reliability
- C. monetary unit, going concern, relevance, and materiality
- D.** monetary unit, entity, going concern, and realization-recognition

51. The use of the historical cost principle is justified because the resulting information has the primary quality ingredients of

- A. neutrality and predictive value
- B.** representational faithfulness and neutrality
- C. timeliness and neutrality
- D. verifiability and feedback value

52. Which of the following transactions would be reported in the cash flows from investing activities section in the statement of cash flows for the Haleem Company?

- A.** Haleem sold a piece of land for \$500,000.
- B. Haleem borrowed \$2,000,000.
- C. Haleem issued common stock for \$800,000 to investors.
- D. Haleem paid a cash dividend to its stockholders.

53. Distributions that are paid to owners would affect both the

- A.** balance sheet and statement of cash flows
- B. balance sheet and income statement
- C. income statement and statement of changes in equity
- D. income statement and statement of cash flows

54. The financial statement that would be most useful in evaluating a company's financial flexibility is the

- A.** balance sheet
- B. income statement
- C. statement of owners' equity
- D. statement of retained earnings

55. The framework for the model of business reporting includes all of the following *except*

- A. financial and nonfinancial data
- B.** independent analysis of the financial data
- C. forward-looking information
- D. information about management and shareholders

56. The AICPA's Special Committee on Financial Reporting issued a report on a model for business reporting that addresses concerns about
- A. the reliability and flexibility of financial reports
 - B. the relevance and timeliness of financial reports
 - C. the verifiability and neutrality of financial reports
 - D.** the relevance and usefulness of financial reports
57. The model for business reporting is designed to fit the decision processes of users to
- A. make projections
 - B. value companies
 - C. assess the likelihood of loan repayments
 - D.** do all of these
58. The AICPA's Special Committee on Financial Reporting issued a report on a model for business reporting. The "Financial Reporting" sources of information used in external decision making outlined in the model included all of the following *except*
- A. parenthetical and footnote disclosures
 - B. financial statements
 - C.** macroeconomic statistics
 - D. management discussion and analysis
59. The CFA's *Comprehensive Business Reporting Model* argues that certain key weaknesses in the current financial reporting model exist. The weaknesses include all of the following *except*
- A. current financial statements are not presented in a structure that is useful to investors
 - B. current financial statements do not present sufficient information to enable investors to make effective decisions.
 - C.** current financial statements contain inaccurate measurements
 - D. investors must resort to estimates and best guesses to generate the information they need
60. The goal of the boards of the IASB and FASB is to develop a joint conceptual framework project that is both complete and internally consistent. However, as a limitation the boards concluded that
- A. a comprehensive reconsideration of all concepts underlying financial reporting would slow the progress but would be a necessary use of their time
 - B. the project would have to be split into four phases and worked on one at a time
 - C. the project would have to be split into eight phases, and all phases would be worked on simultaneously
 - D.** a comprehensive reconsideration of all concepts underlying financial reporting would not be an efficient use of their time

61. The IASB and FASB boards have agreed that the objective of general purpose financial reporting is to provide

- A.** financial information about a company that is useful to external users in making decisions in their capacity as capital providers
- B. mainly cash flow information about a company that is useful to external users in making decisions in their capacity as capital providers
- C. financial information about a company that is useful to internal users in making decisions in their capacity as capital custodians
- D. financial information about a company that is useful to government regulators in making decisions in their capacity as capital markets monitors

62. The IASB and FASB joint boards feel that financial reporting should

- A. be general purpose
- B. be useful in assessing a company's future cash flows
- C. provide information on an accrual basis
- D.** all of these are true

63. The IASB and FASB joint boards have identified the primary user groups of financial information as all of the following *except*

- A. equity investors
- B.** labor groups
- C. lenders
- D. other creditors (capital providers)

64. One of the differences between the IASB/FASB joint conceptual framework and the FASB conceptual framework is that while the FASB identifies relevance and reliability as the primary decision-specific qualities, the tentative joint framework identifies the fundamental qualitative characteristics to be

- A. relevance and completeness
- B. reliability and completeness
- C.** relevance and faithful representation
- D. reliability and faithful representation

65. The joint IASB and FASB boards identified several "enhancing" characteristic of financial information including

- A.** comparability, verifiability, timeliness, and understandability
- B. materiality, verifiability, timeliness, and understandability
- C. comparability, verifiability, timeliness, and materiality
- D. comparability, relevance, timeliness, and understandability

66. Similar to the constraints in the FASB's qualitative characteristics, the joint IASB/FASB boards have identified two constraints including

- A. benefits that justify the costs and consistency
- B. benefits that justify the costs and materiality**
- C. consistency and materiality
- D. objectivity and materiality

67. The joint IASB/FASB qualitative characteristics *Exposure Draft* identifies a logical order in which to evaluate the qualities. That order (first, second, third) is

- A. faithful representation, relevance, enhancing characteristics
- B. relevance, enhancing characteristics, faithful representation
- C. relevance, faithful representation, enhancing characteristics**
- D. enhancing characteristics, relevance, faithful representation

68. The FASB identified several objectives of financial reporting, which are listed below. Following the list is a series of descriptive statements.

- a. general objective
- b. derived external user objective
- c. derived company objective
- d. specific objectives

- ___ 1. Provide information about a company's economic resources, obligations, and owners' equity.
- ___ 2. Provide useful information for present and potential investors, creditors, and other external users in making their investment, credit, and similar decisions.
- ___ 3. Provide information about a company's financial performance during a period.
- ___ 4. Provide information about a company's cash flows.
- ___ 5. Provide information that is useful to external users in assessing the amounts, timing, and uncertainty of prospective cash receipts.
- ___ 6. Provide information to help external users in assessing the amounts, timing, and uncertainty of a company's prospective net cash flows.

Required:

Match each objective with the appropriate statement by placing the appropriate letter in the space provided.

- | | | | |
|----|---|----|---|
| 1. | d | 4. | d |
| 2. | a | 5. | b |
| 3. | d | 6. | c |

69. A list of statements follows:

- a. GAAP identifies the _____ of financial reporting.
- b. Financial reporting should, above all, provide information that is _____ to external decision makers.
- c. 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 represents management's _____ to outsiders.

Required:

Fill in the words necessary to complete the statements.

- a. objectives
- b. useful
- c. full disclosure

70. A list of statements follows:

- a. _____ on _____ provides a measure of overall company performance.
- b. _____ is the uncertainty or unpredictability of the future results of a company.
- c. _____ is the ability of a company to take effective actions to change the amounts and timing of cash flows.
- d. _____ is the term used to describe how quickly a company can convert its assets into cash to pay a liability.
- e. _____ refers to the ability of a company to maintain a given physical level of operations.

Required:

Fill in the words necessary to complete the statements.

- a. Return, investment
- b. Risk
- c. Financial flexibility
- d. Liquidity
- e. Operating capability

71. A list of statements follows:

- a. GAAP states that the two primary qualitative characteristics that make accounting information useful for decision-making purposes are _____ and _____.
- b. Corporations prepare quarterly financial statements in order to help achieve _____, an ingredient of the primary quality of relevance.
- c. Expensing the purchase of waste paper baskets that have a three-year estimated useful life at the date of acquisition is a permissible procedure according to the _____ constraint.
- d. The three components of reliability are _____, _____, and _____.
- e. _____ is the overall qualitative characteristic to be used in judging the quality of accounting information.

Required:

Fill in the words necessary to complete the statements.

- a. relevance, reliability
- b. timeliness
- c. materiality
- d. verifiability, neutrality, representational faithfulness
- e. Decision usefulness

72. Below is a list of the qualitative characteristics identified by GAAP. Following the list is a series of descriptive phrases.

- | | | | |
|----|---------------------|----|-------------------------------|
| a. | feedback value | g. | verifiability |
| b. | relevance | h. | consistency |
| c. | decision usefulness | i. | representational faithfulness |
| d. | reliability | j. | timeliness |
| e. | comparability | k. | neutrality |
| f. | predictive value | | |

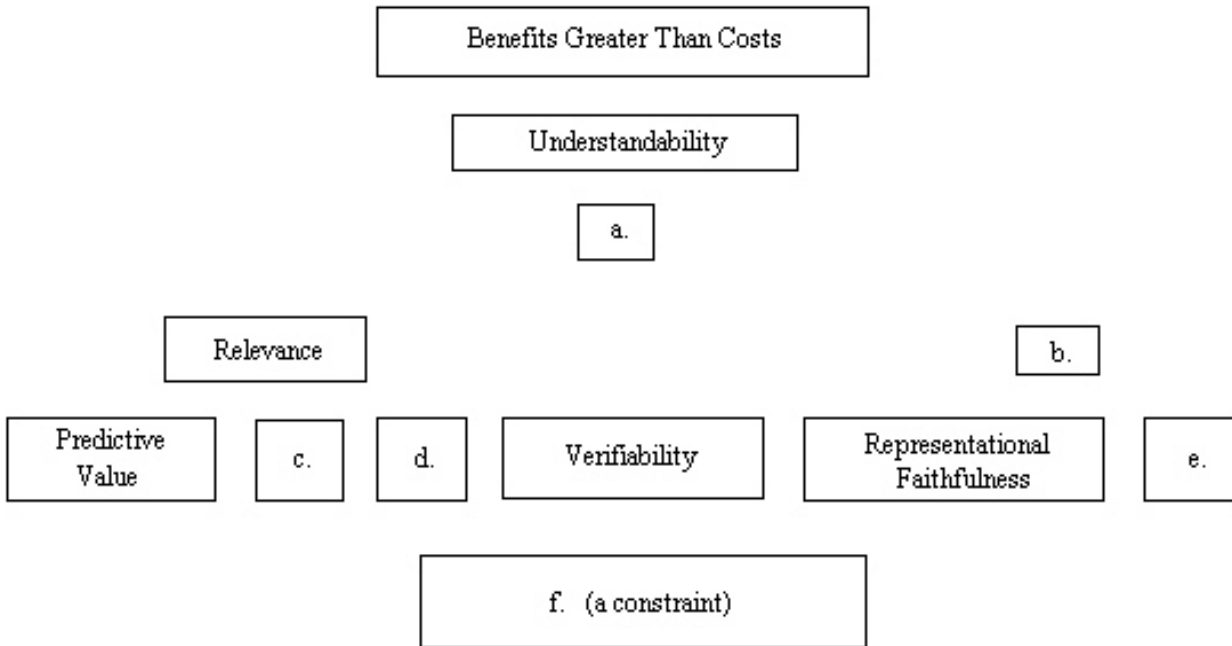
- ___ 1. When information can make a difference in a decision.
- ___ 2. Making information available when it is needed.
- ___ 3. When accounting policies and procedures are unchanged from period to period.
- ___ 4. When information is verifiable and neutral.
- ___ 5. Occurs when the measurement results can be duplicated.
- ___ 6. The overall qualitative characteristic accounting information should possess.
- ___ 7. When information enables decision makers to confirm prior expectations.
- ___ 8. When accounting information is reported the same way by different companies.

Required:

Match each characteristic with the appropriate phrase.

- | | | | |
|----|---|----|---|
| 1. | b | 5. | g |
| 2. | j | 6. | c |
| 3. | h | 7. | a |
| 4. | d | 8. | e |

73. Part of the hierarchy of qualitative characteristics is presented below.



Required:

Provide the qualitative characteristic for each lettered box.

- a. _____
- b. _____
- c. _____
- d. _____
- e. _____
- f. _____

- a. decision usefulness
- b. reliability
- c. feedback value or timeliness
- d. timeliness or feedback value
- e. neutrality
- f. materiality

74. Following the list below is a series of descriptions of inappropriate accounting procedures.

- a. full disclosure
- b. historical cost
- c. revenue recognition
- d. conservatism
- e. monetary-unit assumption
- f. matching principle
- g. period of time

- ___ 1. The company signs a contract to produce four machines according to the customer's specifications. On the date of the contract, the customer pays one half of the total contract price, and the company records the cash receipt as a sale. The machines will be manufactured and delivered during the next year.
- ___ 2. The company delayed issuing its annual financial statements in order to include a large sale expected early in the next year.
- ___ 3. The market value of the company's inventory declined sharply. The president, optimistically predicting a rise in value, insisted that the inventory be reported at its historical cost.
- ___ 4. The market value of the company's large inventory rose sharply. The inventory was reported on the balance sheet at current market value.
- ___ 5. Although the company can estimate its uncollectible accounts receivable, it does not recognize the bad debts expense until it determines that an account receivable is uncollectible.

Required:

Indicate which item (or items) on the list was (were) violated in each description by placing the appropriate letter(s) in the space provided.

- 1. c
- 2. f, c
- 3. d
- 4. b, c, d
- 5. g, d, f

75. Below is a list of accounting assumptions, conventions, and principles. Following the list is a series of descriptive statements.

- a. entity assumption
- b. historical cost principle
- c. going-concern assumption
- d. conservatism convention
- e. monetary-unit assumption
- f. matching principle
- g. period of time
- h. realization
- i. recognition

- ___ 1. A company records sales on account when providing a service.
- ___ 2. A company recognizes as expense the portion of its prepaid rent that has expired.
- ___ 3. A company reports the land that it purchased in 1990 for \$500,000, at the same amount on its 2010 balance sheet.
- ___ 4. A company reports its inventories on the balance sheet at the lower of cost or market.
- ___ 5. An entity is preparing its five-year strategic plan.
- ___ 6. A company amortizes its patent, an intangible asset, over its useful life.

Required:

Match each item in the list with its descriptive statement by placing the appropriate letter in the space provided.

- 1. i
- 2. g, f
- 3. b
- 4. d
- 5. c
- 6. f

76. Presented below are five inappropriate accounting procedures that are being used by the Devin Corporation.

- a. On the year-end balance sheet, Devin Corporation reported its inventory at market value, which was greater than cost. As a result of this procedure, a gain was recognized on the company's income statement.
- b. Mrs. Devin, the president of the company, purchased an automobile for her son using the company's money. The company's accountant recorded the expenditure as salaries expense.
- c. Devin Corporation reported income from operations of \$5,000,000 for the current year. During the year, Devin settled and paid a \$5,000,000 class action lawsuit against the company resulting from damages incurred from the sale of defective products. The settlement was reported as a miscellaneous expense with no footnotes provided.
- d. Devin Corporation is going to issue additional common stock next year. In order to improve its income, the company switched from the LIFO inventory cost flow method to FIFO. The company did not disclose the accounting change. Comparative financial statements were prepared.
- e. The company made \$3,000,000 of expenditures to expand a building that originally cost \$5,000,000. The expenditures are expected to benefit operations over the building's remaining useful life of ten years. The expenditures were expensed as maintenance.

Required:

For each of the above items, list the accounting assumption(s), convention(s), or principle(s) that is (are) being violated.

- a. conservatism, historical cost, revenue recognition
- b. entity
- c. materiality, disclosure
- d. consistency, disclosure
- e. matching

77. Certain elements of the financial statements are listed below, followed by a series of descriptive statements.

- | | | | |
|----|-------------|----|----------------------|
| a. | assets | f. | gains |
| b. | liabilities | g. | losses |
| c. | equity | h. | operating cash flows |
| d. | revenues | i. | investing cash flows |
| e. | expenses | j. | financing cash flows |

- ___ 1. Decrease in equity from peripheral or incidental transactions.
- ___ 2. The owners' residual interest in a company's assets.
- ___ 3. Inflows of assets or settlement of liabilities, or a combination of both, from the sale of goods or services.
- ___ 4. Acquiring and selling investments; property, plant & equipment; and intangibles, as well as lending money and collecting on loans.
- ___ 5. Probable future sacrifices of economic benefits arising from present obligations.
- ___ 6. Outflows or other using up of assets or incurrence of liabilities, or a combination of both, in the sale of goods and services.
- ___ 7. Cash flows from acquiring, selling, and delivering goods or from providing services.
- ___ 8. Probable future economic benefits obtained as a result of past transactions or events.
- ___ 9. Increases in equity from peripheral or incidental transactions.
- ___ 10. Obtaining resources from owners and providing them with a return on, and of, their investment, as well as obtaining and repaying resources from long-term creditors.

Required:

Match each element with the appropriate statement by placing the appropriate letter in the space provided.

- | | | | |
|----|---|-----|---|
| 1. | g | 6. | e |
| 2. | c | 7. | h |
| 3. | d | 8. | a |
| 4. | i | 9. | f |
| 5. | b | 10. | j |

78. The AICPA Special Committee on Financial Reporting developed a comprehensive model of business reporting in an attempt to provide a foundation for future improvement in business reporting. The five statements below relate to the five categories of information outlined in the committee's work.

- a. _____ and _____, including (1) financial statements and related disclosures and (2) high-level operating data and performance measurements.
- b. _____ of the financial and nonfinancial data, including (1) reasons for changes in the data and (2) the identity and past effect of key trends.
- c. _____, including (1) assessment of opportunities and risks, (2) management's plans, and (3) comparison of actual performance to previously disclosed opportunities, risks, and plans.
- d. _____ about _____ and _____, including (1) directors, management, compensation, and major shareholders and (2) transactions and relationships among related parties.
- e. _____ about the _____, including (1) broad objectives and strategies, (2) scope and description of the company's business and properties, and (3) the impact of industry structure.

Required:

Fill in the blanks in each statement above with the appropriate information category.

- a. Financial, nonfinancial data
- b. Management's analysis
- c. Forward-looking information
- d. Information, management, shareholders
- e. Background, company

79. At lunch recently, two accountants were discussing the merits of the FASB's conceptual framework project, which resulted in the publication of seven *Statements of Financial Accounting Concepts* and required more than ten years of effort. One accountant thought the effort was a waste of resources, since accounting was unlike physics, chemistry, and biology, where natural laws apply. The other accountant thought the effort was very valuable. He stated that "accounting, like any other discipline, benefits from having a coherent theory."

Required:

Write a brief essay that discusses the advantages that are derived from the existence of a conceptual framework for financial accounting and reporting.

The FASB's conceptual framework should result in the following advantages. It should "(1) guide the FASB in establishing accounting standards, (2) provide a framework for resolving accounting questions in situations where a standard doesn't currently exist, (3) determine the bounds for judgment in the preparation of financial statements, (4) increase users' understanding of and confidence in financial reporting, and (5) enhance comparability."

80. The task of developing the conceptual framework was so enormous that the FASB had to divide it into several projects.

Required:

Identify each of the projects by name and provide a brief description of their results.

The Objectives Project resulted in the issuance of Statements of Financial Accounting Concepts No. 1, "Objectives of Financial Reporting by Business Enterprises." The Accounting Projects provided definitions for the accounting elements, identification of which elements should be reported, when they should be recognized, and how they should be measured. The Reporting Projects dealt with how the elements of the financial statements are displayed, as well as what information should be provided, who should be required to provide the information, and where the information should be presented. Also dealt with were specific questions about income and cash flows. The Qualitative Characteristics Project provided SFAC No. 2, "Qualitative Characteristics of Accounting Information," which serves as a link between the Accounting and Reporting Projects.

81. GAAP lists and describes the qualitative characteristics that make accounting information useful for decision-making purposes. The FASB viewed the characteristics as a hierarchy of qualities that make accounting information useful. The FASB stated that accounting information must possess both relevance and reliability qualities to be useful, but it was noted that relevance and reliability may conflict with each other in some instances. For example, to increase relevance, reliability may have to be sacrificed, or vice versa.

Required:

- a. Define "relevance" and "reliability" and list the components or "ingredients" of each quality.
- b. Give an example in financial accounting that illustrates the following tradeoffs:
 - (1) Relevance is sacrificed in order to make accounting information more reliable.
 - (2) Reliability is sacrificed in order to make accounting information more relevant.

a. Relevance is defined as information that is capable of making a difference in the decision-making process. Relevant information helps users predict the outcomes of past, present, and future events or confirms or corrects prior expectations. The ingredients of relevance are (1) predictive value, (2) feedback value, and (3) timeliness.

Reliable information is information that is reasonably free from error and bias, and it must faithfully represent what it purports to represent. The ingredients of reliability are (1) verifiability, (2) representational faithfulness, and (3) neutrality.

- b. (1) The use of historical cost in financial accounting is an example of a sacrifice of relevance for reliability. Historical cost is reliable information, but it may not be as relevant as current cost information.
- (2) The issuance of quarterly (interim) financial statements is an example of a sacrifice of reliability for relevance. The preparation of quarterly financial statements is relevant because of their timeliness, but quarterly financial statements may require the use of more estimates and judgments than annual financial statements.

82. The CFA's Comprehensive Business Reporting Model Subcommittee reported that current financial statements do not provide the information necessary to analyze and value securities or make optimal financial decisions.

Required:

Discuss the objectives of changes identified by the Subcommittee that need to be made to the current system of reporting.

Changes need to be made to the current system in order to

- a. present more complete information in the correct form
- b. provide enough information so that investors can understand how the numbers reported in the financial statements were generated
- c. provide full descriptions of any estimation models and assumptions that were used to generate the numbers
- d. explain risk exposures and possible future occurrences that may affect investors' wealth

83. The IASB/FASB tentative joint conceptual framework includes two "fundamental qualitative characteristics" that must be present for financial reporting information to be useful.

Required:

Name and describe the two joint conceptual framework fundamental characteristics.

1. Information must have the quality of relevance. Relevant information must be capable of making a difference in the decisions made by external users in their capacity as capital providers. To be relevant, information must have predictive value, confirmatory value, or both.
2. Information must have the quality of faithful representation. Faithful representation of economic phenomena occurs when the related information is complete, neutral, and free from material error.