



Financial Accounting & Reporting 1

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SOURCES OF GAAP AND BASIC FRAMEWORK AND CONCEPTS

I. INTRODUCTION

Generally accepted accounting principles (GAAP) are those accounting principles that have substantial authoritative support. Substantial authoritative support is a question of fact and a matter of judgment. The power to establish GAAP actually rests with the Securities and Exchange Commission (SEC); however, except for rare instances, it has essentially allowed the accounting profession itself to establish GAAP and self-regulate. Three bodies of the accounting profession have determined GAAP since 1939.

A. COMMITTEE ON ACCOUNTING PROCEDURE

The Committee on Accounting Procedure (CAP) was a part-time committee of the American Institute of Certified Public Accountants (AICPA) that promulgated Accounting Research Bulletins (ARB), which determined GAAP from 1939 until 1959.

B. ACCOUNTING PRINCIPLES BOARD

The Accounting Principles Board (APB) was another part-time committee of the AICPA. It issued Accounting Principles Board Opinions (APBO) and APB Interpretations, which determined GAAP from 1959 until 1973.

C. FINANCIAL ACCOUNTING STANDARDS BOARD

In 1973, an independent full-time organization called the Financial Accounting Standards Board (FASB) was established, and it has determined GAAP since then.

1. Statements of Financial Accounting Standards (SFAS)

These statements establish GAAP and define the specific methods and procedures for various accounting issues. Each statement is issued after extensive research, discussion memoranda, exposure drafts, and public comments.

2. FASB Interpretations

FASB Interpretations clarify GAAP by addressing issues that may be conflicting or ambiguous and may establish GAAP.

3. Technical Bulletins

Technical bulletins may expand upon or further clarify GAAP because of problems that may exist in accounting or reporting under the standard or interpretation.

4. Statements of Financial Accounting Concepts (SFAC)

Statements of Financial Accounting Concepts (SFAC) are intended to establish the objectives and concepts for use by the FASB in developing accounting and reporting standards. They provide a common foundation and basic reasoning on which to consider the merits of the alternatives and a coherent system of interrelated objectives and fundamentals; however, they do not establish GAAP.

5. Emerging Issues Task Force Statements (EITF)

EITF statements address emergent issues and may show how to account for specific or unusual applications of GAAP. They are less authoritative than Category A pronouncements (see *Hierarchy of Sources of GAAP*).

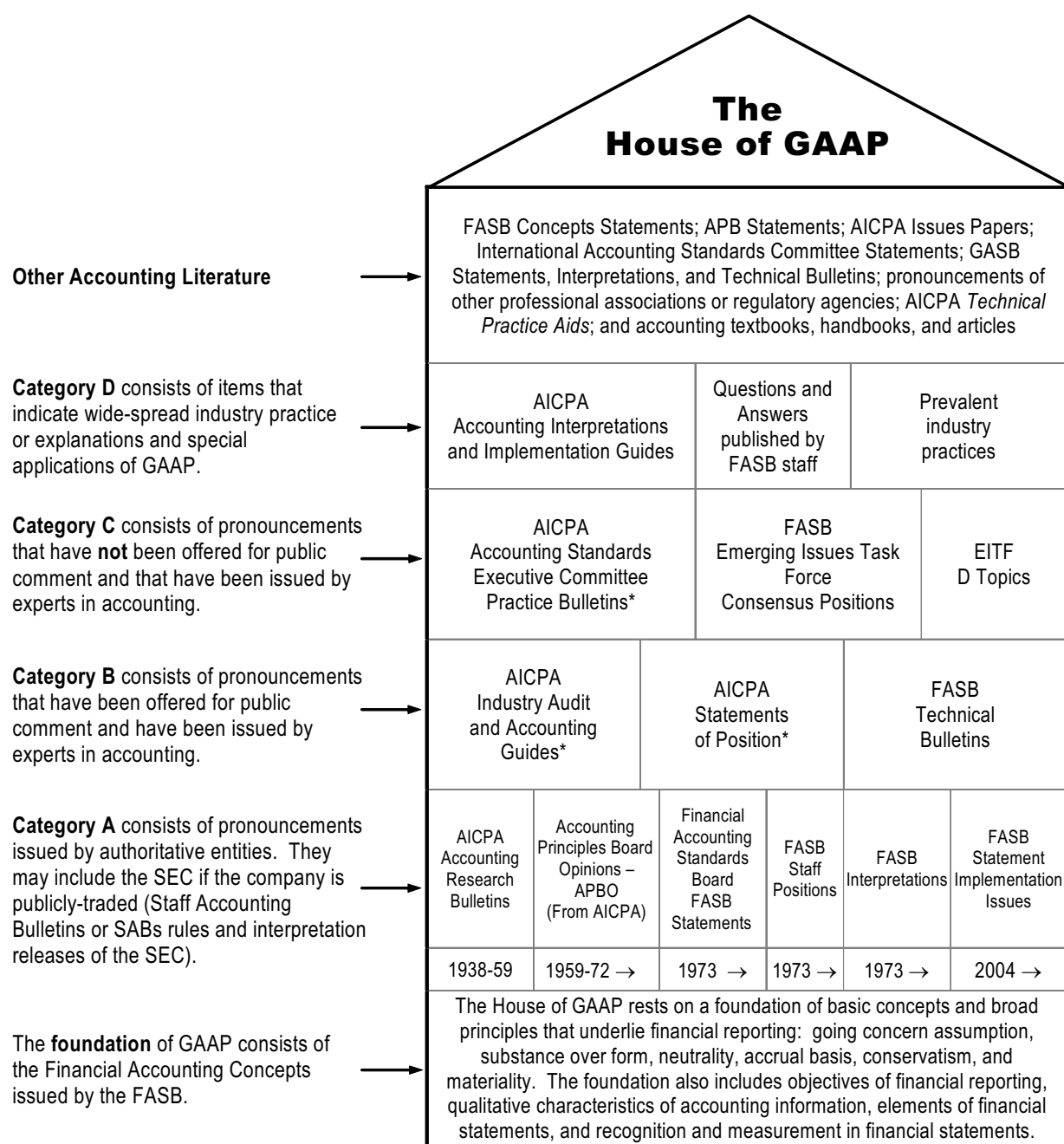
6. FASB Implementation Guides

The FASB may also issue implementation guides (in a question/answer format) on certain accounting issues that the public may have questions on. These are even less authoritative than EITF Statements.

II. HIERARCHY OF SOURCES OF GAAP

In 2007, the Hierarchy of Generally Accepted Accounting Principles replaced Statement on Auditing Standards (SAS) No. 69 as the source of the hierarchy of sources of GAAP. This statement indicates the six most authoritative GAAP pronouncements (provided they are not superseded by another pronouncement). It is permissible, but extremely rare, to deviate from one of the six pronouncements if compliance would cause the financial statements to be misleading.

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- ☐ A. Accounting Research Bulletins (ARBs)
 - ☐ B. Accounting Principles Board Opinions (APBOs)
 - ☐ C. FASB Statements of Financial Accounting Standards
 - ☐ D. FASB Staff Positions
 - ☐ E. FASB Interpretations
 - ☐ F. FASB Statement Implementation Issues



*AICPA Industry Audit and Accounting Guides and AICPA Statements of Position are included in Category B only if the FASB has cleared the pronouncements. AICPA Practice Bulletins are included in Category C only if cleared by the FASB. If not cleared by the FASB, AICPA Industry Audit and Accounting Guides and AICPA Statements of Position are included in Category D.

NOTE: If the accounting treatment of a transaction or event is **not** specified by a pronouncement in "**Category A**" (first floor), the auditor should consider whether one or more sources in Category (B), (C), or (D) is relevant to the circumstances. The auditor should be prepared to justify a conclusion that another treatment is generally accepted.

If there is a conflict between accounting principles relevant to the circumstances from one or more sources in Category (B), (C), or (D), the auditor should follow the treatment specified by the source in the more authoritative category – for example, follow Category (B) treatment over Category (C) – or be prepared to justify a conclusion that a treatment specified by a source in the less authoritative category **better** presents the substance of the transaction in the circumstances.

III. CONCEPTUAL FRAMEWORK UNDERLYING FINANCIAL ACCOUNTING

As discussed earlier, the FASB has created a conceptual framework (set forth in pronouncements called Statements of Financial Accounting Concepts, or SFAC) that serves as a basis for all FASB pronouncements. Six SFAC provide a basis for financial accounting concepts for business enterprises (SFAC No. 4 relates to non-business enterprises).

A. SFAC NO. 1 "OBJECTIVES OF FINANCIAL REPORTING BY BUSINESS ENTERPRISES"

SFAC No. 1 defines the potential users of financial reporting as those who base their decisions on their relationships to and knowledge about the business enterprise. This group includes external users (e.g., investors, creditors, and customers) and those who advise these users.

The objectives essentially identify the purposes and goals of financial accounting and focus on providing information that is useful in making business and economic decisions to persons with reasonable knowledge of business and the economy.

The objectives provide:

1. Information useful in investment and credit decisions.
2. Information useful in assessing future cash flow prospects.
3. Information useful in assessing an enterprise's resources, the debt and equity claims to those resources, and the changes in them.

B. SFAC NO 2 "QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION"

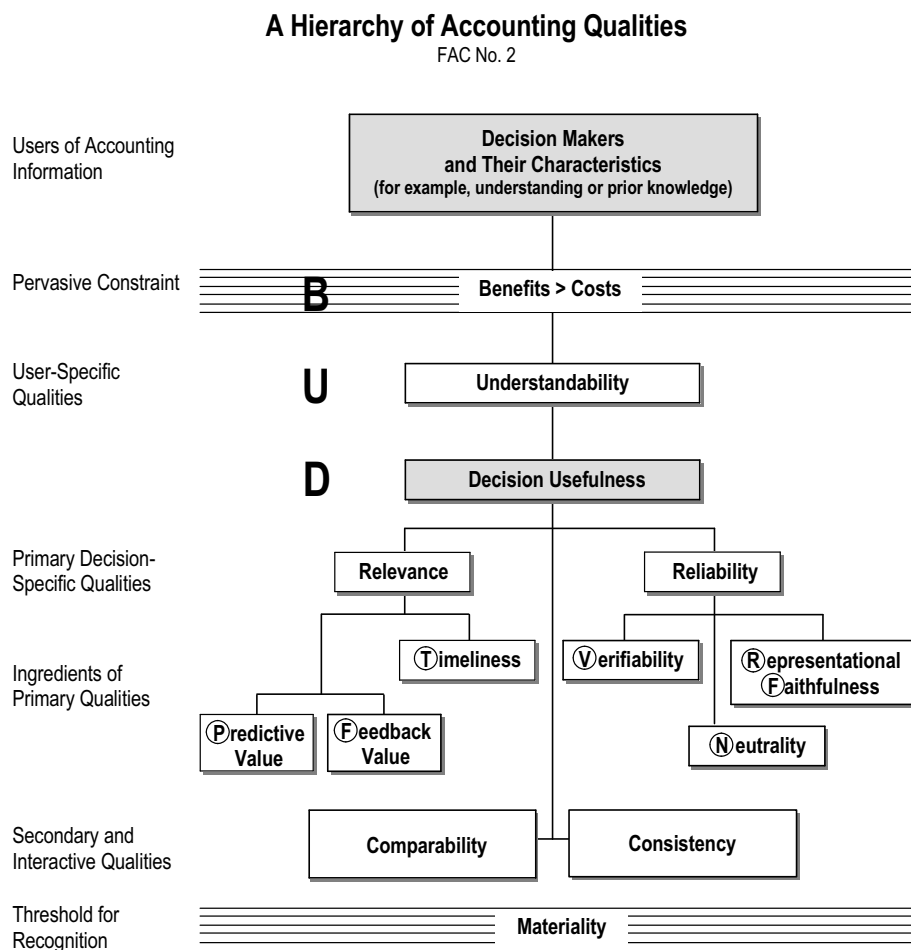
The qualitative characteristics of accounting information provide the criteria used to select and evaluate accounting information so that it will meet the objectives set forth in SFAC No.

1. This statement identifies the hierarchy of qualitative characteristics that are to be considered when accounting alternatives are available in order to choose the alternative that produces the most useful information.

Financial information must be:

- (i) Understandable to decision makers,
- (ii) Relevant (timely information with predictive or feedback value),
- (iii) Reliable (verifiable, faithfully representable, and neutral),
- (iv) Comparable,
- (v) Consistent,
- (vi) Material, and
- (vii) Less costly than the benefit provided.

1. Illustration of Hierarchy of Accounting Qualities



2. Constraints

Two pervasive constraints (one on the top and one on the bottom of the illustration) must be considered.

a. Costs and Benefits

The benefits of accounting information must be greater than the costs of obtaining and presenting the information.

b. Materiality

The information must be material with respect to the financial statements (so that the lack of the information could make a difference in decisions made by the users).

3. Understandability

The accounting information presented should be understandable to a wide variety of users who possess a reasonable amount of knowledge about the economy and are willing to exert a reasonable amount of effort to study the information presented. Understandability serves as a link between the characteristics of users and the decision-specific qualities of information.

4. Primary Qualities of Decision Usefulness

Decision usefulness is the primary quality of accounting information. It can be broken down into two specific categories:

a. Relevance

In order for information to be useful, it has to be relevant (i.e., make a difference) to the decision-making process. The quality of relevance has three sub-categories:

☐ (1) **Predictive Value**

When information has predictive value, it has the ability to assist users in evaluating past, present, or future events.

☐ (2) **Feedback Value**

Feedback value enables decision-makers to confirm prior expectations or to adjust or correct the assessment made.

☐ (3) **Timeliness**

Timeliness is having the information available while it is able to influence decisions.

b. Reliability

In order for information to be reliable, the users must be able to reasonably depend on it to be free from error and bias and to be faithfully representative of what it claims to represent. The quality of reliability has three sub-categories:

☐ (1) **Neutrality**

Neutrality means that the information is free from bias and free from outside influences.

☐ ☐ (2) **Representational Faithfulness**

Representational faithfulness is agreement between financial reporting and the resources or events represented. It means that the information is valid (e.g., economic substance over legal form).

☐ (3) **Verifiability**

If the information is verifiable (i.e., objective), it means that the same results could be duplicated with the same measurement techniques (which is the primary concern for auditors of financial statements).



5. Secondary Characteristics

Comparability and consistency are secondary characteristics, which means that they apply to BOTH relevance and reliability.

a. Comparability

Comparability is the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena. It allows users to compare the information with similar information for other business enterprises.

b. Consistency

In order for users to be able to compare the performance of a company in one period with the performance of a company in another period, consistent accounting policies and procedures must be applied by the company from period to period. This does not mean that the company cannot change accounting policies if the new method more fairly presents the information; however, the cumulative effect of the change must be accounted for and disclosed in the financial statements (discussed later in this lecture).

C. SFAC NO. 3 "ELEMENTS OF FINANCIAL STATEMENTS OF A BUSINESS"

This statement was replaced by SFAC No. 6.

D. SFAC NO. 5 "RECOGNITION AND MEASUREMENT IN THE FINANCIAL STATEMENTS"

This statement sets forth the recognition criteria and guidance on what and when information should be incorporated in the financial statements.

1. Full Set of Financial Statements

- a. Statement of Financial Position (the Balance Sheet)
- b. Statement of Earnings (the Income Statement)
- c. Statement of Comprehensive Income
- d. Statement of Cash Flows
- e. Statement of Changes in Owners' Equity

2. Fundamental Recognition Criteria

Recognition is the process of formally recording or incorporating an item in the financial statements of an entity and classifying it as asset, liability, equity, revenue, or expense.

- a. Definitions (i.e., Does it meet the definition of an element defined in SFAC No. 6?)
- b. Measurability
- c. Relevance
- d. Reliability

3. Measurement Attributes for Assets and Liabilities

- a. Historical Cost
- b. Current Cost
- c. Net Realizable Value
- d. Current Market Value
- e. Present Value of Future Cash Flows

4. Fundamental Assumptions

a. Entity Assumption

Economic activity can be accounted for when considering an identifiable set of activities (e.g., a separate corporation, division, etc.).

b. Going Concern Assumption

For financial accounting, it is presumed (subject to rebuttal by evidence to the contrary) that the entity will continue to operate in the foreseeable future.

c. Monetary Unit Assumption

It is assumed that money is an appropriate basis by which to measure economic activity. The assumption is that the monetary unit does not change over time; thus, the effects of inflation are not reflected in the financial statements.

d. Periodicity Assumption

Economic activity can be divided into meaningful time periods.

e. Historical Cost Principle

As a general rule, financial information is accounted for and based on cost, not current market value.

f. Revenue Recognition Principle

As a general rule, revenue should be recognized when it is earned and when it is realized or realizable.

(1) Earned

Revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.

(2) Realized or Realizable

Revenues and gains are recognized when products, merchandise, or other assets are exchanged for cash or claims to cash or when related assets received or held are readily convertible to known amounts of cash or claims to cash.

g. Matching Principle

Expenses are necessarily incurred to generate revenue. In accordance with the matching principle, all expenses incurred to generate a specific amount of revenue in a period are **matched** against that revenue. The matching principle does not govern the recognition of losses since they result from unusual events.

h. Accrual Accounting

Revenues are recognized when they are earned and expenses are recognized in the same period as the related revenue (matching or using a systematic and rational allocation or expensing in the period in which they expire), not necessarily in the period in which the cash is received or expended by the company.

i. Full Disclosure Principle

It is important that the user be given information that would make a difference in the decision process but not so much information that the user is impeded in analyzing what is important.