Study Unit 1 – The Financial Reporting Environment

Pages 21-22 and 27-29: SFAC 8, which replaces SFAC 1 and 2, is testable on the CPA exam beginning in the April/May 2011 testing window. We have replaced the outlines for Subunits 1.2 and 1.6 to reflect the new pronouncement. The new outlines are below.

1.2 THE OBJECTIVE OF GENERAL-PURPOSE FINANCIAL REPORTING

<table>
<thead>
<tr>
<th>Background</th>
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</thead>
<tbody>
<tr>
<td>In 1973, the FASB developed a conceptual framework. The result was a series of Statements of Financial Accounting Concepts (SFACs). However, SFACs are not authoritative and are not included in the Codification. Instead, they are intended to influence the development and application of GAAP.</td>
</tr>
<tr>
<td>This subunit is based on SFAC No. 8, Chapter 1, The Objective of General Purpose Financial Reporting, and Chapter 3, Qualitative Characteristics of Useful Financial Information.</td>
</tr>
</tbody>
</table>

1. The objective is to report financial information that is **useful** in making decisions about providing resources to the reporting entity.
   a. **Primary users** of financial information are current or prospective investors and creditors who cannot obtain it directly.
      1) Their decisions depend on expected returns.
         a) Accordingly, primary users need information that helps them to assess the entity’s future net cash inflows.
      2) Primary users cannot obtain all necessary information solely from general-purpose financial reports. These reports
         a) Do not suffice to determine the value of the entity
         b) Are significantly based on estimates, judgments, and models
   b. The information reported relates to the entity’s **economic resources and claims** to them (financial position) and to **changes** in those resources and claims.
      1) Information about economic resources and claims helps to evaluate liquidity, solvency, financing needs, and the probability of obtaining financing.
   c. Users need to differentiate between changes in economic resources and claims arising from (1) the entity’s performance and (2) other events and transactions (e.g., issuing debt and equity). Information about financial performance is useful for
      1) Understanding the return on economic resources, its variability, and its components;
      2) Evaluating management; and
      3) Predicting future returns.
d. The **accrual basis of accounting** is preferable to the cash basis for evaluating past performance and predicting future performance.

1) An entity should increase its economic resources **other than by obtaining resources from investors and creditors**.
   a) Information about this performance is useful in evaluating potential operating net cash inflows.

2) Information about financial performance is useful in determining how external factors (e.g., interest rate changes) affected economic resources and claims.

e. Information about **cash flows** is helpful in
   1) Understanding operations;
   2) Evaluating financing and investing activities, liquidity, and solvency;
   3) Interpreting other financial information; and
   4) Assessing the potential for net cash inflows.

Stop and review! You have completed the outline for this subunit. Study multiple-choice questions 5 through 8 beginning on page 40.

### 1.6 QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION

#### Background

The characteristics described in this subunit are those that make accounting information useful for decision making. They apply to both for-profit and not-for-profit nongovernmental entities.

This subunit is based on SFAC No. 8.

#### Fundamental Qualitative Characteristics

1. **Relevance.** Relevant information is able to make a difference in user decisions. To do so, it must have **predictive value, confirmatory value, or both**.
   a. Something has predictive value if it can be used as an input in a predictive process.
   b. Something has confirmatory value with respect to prior evaluations if it provides feedback that confirms or changes (corrects) them.
   c. Predictive value and confirmatory value are interrelated. For example, current revenue may confirm a prior prediction and also be used to predict the next period’s revenue.
   d. **Materiality.** Information is material if its omission or misstatement can influence user decisions based on a specific entity’s financial information. Thus, it is an **entity-specific** aspect of relevance.

2. **Faithful representation.** Useful information faithfully represents the economic phenomena that it purports to represent. A representation is perfectly faithful if it is **complete** (containing what is needed for user understanding), **neutral** (unbiased in its selection and presentation), and **free from error** (but not necessarily perfectly accurate).
3. Useful information is relevant and faithfully represented. The process for applying these characteristics is to
   a. Identify a phenomenon that may be useful to users,
   b. Identify the relevant information, and
   c. Determine whether the information is available and can be faithfully represented.

**Enhancing Qualitative Characteristics**

4. The following enhance the usefulness of relevant and faithfully represented information:
   a. **Comparability.** Information should be comparable with similar information for (1) other entities and (2) the same entity for another period or date. Thus, comparability allows users to understand similarities and differences.
      1) Consistency is a means of achieving comparability. It is the use of the same methods, for example, accounting principles, for the same items.
   b. **Verifiability.** Information is verifiable (directly or indirectly) if knowledgeable and independent observers can reach a consensus (but not necessarily unanimity) that it is faithfully represented.
   c. **Timeliness.** Information is timely when it is available in time to influence decisions.
   d. **Understandability.** Understandable information is clearly and concisely classified, characterized, and presented.
      1) Information should be readily understandable by reasonably knowledgeable and diligent users, but information should not be excluded because of its complexity.

**Cost Constraint**

5. This pervasive constraint is that the costs of reporting should be justified by its benefits.
   a. Provider costs (collection, processing, verification, and distribution) ultimately are incurred by users as reduced returns.
   b. Other user costs include those to analyze and interpret the information provided or to obtain or estimate information not provided.
5. According to the FASB’s conceptual framework, the objectives of general-purpose financial reporting for business enterprises are most likely based on

A. Generally accepted accounting principles.
B. Reporting on how well management's stewardship has discharged its responsibilities.
C. The need for conservatism.
D. The needs of the users of the information.

Answer (D) is correct. (CPA, adapted)

**REQUIRED:** The objectives of financial reporting for business enterprises.

**DISCUSSION:** One of the objectives of general-purpose financial reporting is to provide information that is useful to present existing and potential investors, creditors, lenders, and other users in making rational investment, credit, and similar decisions about providing resources to the entity.

Answer (A) is incorrect. GAAP govern how to account for items in the financial statements. Answer (B) is incorrect. Financial reporting provides information that is helpful, among other things, in evaluating how well management’s stewardship. But it does not directly provide information about that performance. Conservatism is a qualitative characteristic constraint on recognition in the statements. It is a response to uncertainty.
Pages 45 and 46, Subunit 1.6, Questions 22 through 25: The following questions have been rewritten to reflect the new SFAC 8. Replace current questions 22-25 in your book with these.

22. According to Statements of Financial Accounting Concepts, predictive value relates to

<table>
<thead>
<tr>
<th>Relevant</th>
<th>Reliable</th>
<th>Faithful Representation</th>
</tr>
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<tbody>
<tr>
<td>A. No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>B. Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>C. No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>D. Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

   Answer (D) is correct. (CPA, adapted)

   REQUIRED: The primary quality of which predictive value is an ingredient.

   DISCUSSION: Relevance is a fundamental qualitative characteristic of useful financial information. It is the capacity of information to make a difference in a decision. It is composed of must have (1) predictive value, (2) feedback value, and (3) timeliness of confirmatory value, or both. Predictive value is the quality of information that helps users increase the likelihood of correctly forecasting the outcome of past and present events. The ingredients of reliability are verifiability, neutrality, and representational faithfulness. Moreover, materiality is an entity-specific aspect of relevance. Information has predictive value if it can be used in a predictive process. Something has confirmatory value with respect to prior evaluations if it provides feedback that confirms or changes (corrects) them.

23. According to the FASB’s conceptual framework, what does the concept of reliability faithful representation in financial reporting include?

   A. Effectiveness Predictive value.
   B. Certainty.
   C. Precision Perfectly accurate.
   D. Neutrality.

   Answer (D) is correct. (CPA, adapted)

   REQUIRED: The item included in the concept of reliability faithful representation.

   DISCUSSION: Reliability and relevance are the primary decision-specific qualitative characteristics of accounting information. Reliable information is “reasonably free from error and bias and faithfully represents what it purports to represent.” Reliability includes the ingredients of representational faithfulness and verifiability and the secondary and interactive quality of neutrality. Neutrality is “absence in reported information of bias intended to attain a predetermined result or to induce a particular mode of behavior.” Faithful representation and relevance are the fundamental qualitative characteristics of accounting information. A perfectly faithful representation is complete, neutral, and free from error. Faithfully represented information is neutral if it is unbiased in its selection or presentation of information.

   Answer (A) is incorrect. Accounting information is effective if it is relevant. Reliable information is not necessarily relevant. Relevant information has predictive value, confirmatory value, or both. Faithfully represented information is not necessarily relevant. Answer (B) is incorrect. Certainty and precision perfect accuracy are not implied by reliability faithful representation. The financial statements are a model of the reporting entity. This model may be representationally faithful for its intended purposes without corresponding precisely to the real-world original. Thus, uncertainty that does not reach the materiality threshold does not impair reliability faithful representation. Answer (C) is incorrect. Information may be reliable within materiality limits but lack precision represented faithfully, that is, complete, neutral, and free from error, without being perfectly accurate.
24. According to the FASB's conceptual framework, the usefulness of providing information in financial statements is subject to the constraint of

A. Consistency.
B. Cost-benefit.
C. Reliability Relevance.
D. Representational faithfulness.

Answer (B) is correct. (CPA, adapted)

**REQUIRED:** The constraint on financial reporting.

**DISCUSSION:** The cost-benefit principle is a pervasive constraint on the information provided by financial reporting. Financial information will not be sought unless its The benefits of financial information should exceed the costs of reporting.

Answer (A) is incorrect. Consistency is a quality of useful-information, not constraints means of achieving comparability, an enhancing qualitative characteristic. It is the use of the same methods, for example, accounting principles, for the same items. Answer (C) is incorrect. Reliability is a quality. Relevance is a fundamental qualitative characteristic of useful information, not a constraint. Answer (D) is incorrect. Representational faithfulness is a quality fundamental qualitative characteristic of useful information, not a constraint.

25. According to the FASB's conceptual framework, which of the following situations most likely does not violate the concept of reliability faithful representation?

A. Financial statements were issued 9 months late.
B. Report data on segments having the same expected risks and growth rates to analysts estimating future profits.
C. Financial statements included property with a carrying amount increased to management's estimate of market value.
D. Management reports to shareholders regularly refer to new projects undertaken, but the financial statements never report project results.

Answer (C B) is correct. (CPA, adapted)

**REQUIRED:** The violation of the concept of reliability faithful representation.

**DISCUSSION:** The ingredients of reliability are verifiability, neutrality, and representational faithfulness. - Verifiability is the “ability through consensus among measurers to ensure that information represents what it purports to represent or that the chosen method of measurement has been used without error or bias.” Management's estimate of market value may not be verifiable because it may not reflect a consensus and may be biased or in error. Useful information faithfully represents the economic phenomena that it purports to represent. A representation is perfectly faithful if it is complete (containing what is needed for user understanding), neutral (unbiased in its selection or presentation), and free from error (but not necessarily perfectly accurate). The faithful representation of any given information is logically unrelated to whether the segments have the same expected risks and growth rates (assuming freedom from error) or the identity of the users.

Answer (A) is incorrect. Late issuance is a matter of timeliness, which is an ingredient of relevance, not reliability. Timeliness is a qualitative characteristic that enhances relevance and faithful representation. Information is timely when it is available in time to influence decisions. Answer (B C) is incorrect. The reliability of any given information is logically unrelated to the identity of the users. Management's estimate of market value may not be verifiable. Verifiability is a qualitative characteristic that enhances relevance and faithful representation. Information is verifiable (directly or indirectly) if knowledgeable and independent observers can reach a consensus (but not necessarily unanimity) that it is faithfully represented. Answer (D) is incorrect. Failure to report results is a matter of relevance, in particular, timeliness. Timeliness is a qualitative characteristic that enhances relevance and faithful representation. Information is timely when it is available in time to influence decisions.
Page 54, Practice Simulation: Tab 2 was updated to reflect the new SFAC 8.

<table>
<thead>
<tr>
<th>Reporting Objective</th>
<th>Answer</th>
<th>Entity Type</th>
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<tbody>
<tr>
<td>1. Assessing management stewardship and performance</td>
<td></td>
<td>A) Business entities</td>
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<td>2. Assessing services provided</td>
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<td>General-purpose</td>
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<td>3. Entity resources, claims to those resources, and changes in them</td>
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<td>financial reporting</td>
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<tr>
<td>4. Factors that may affect an organization’s liquidity</td>
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<td>B) Not-for-profit entities</td>
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<td>5. Investment and credit decisions</td>
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<td>C) Governmental entities</td>
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<td>6. Public accountability</td>
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Page 55, Practice Simulation: Tab 5 was updated to reflect the new SFAC 8.

<table>
<thead>
<tr>
<th>Concept</th>
<th>Answer</th>
<th>Description</th>
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<tbody>
<tr>
<td>1. Benefits &gt; costs</td>
<td>A) Interactive quality</td>
<td>Enhancing qualitative characteristic</td>
</tr>
<tr>
<td>2. Comparability</td>
<td>B) Threshold for recognition</td>
<td></td>
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<tr>
<td>3. Conservatism</td>
<td>C) Ingredient of Relevance</td>
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</tr>
<tr>
<td>4. Consistency</td>
<td>D) User-specific quality</td>
<td>Fundamental qualitative characteristic</td>
</tr>
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<td>5. Decision usefulness</td>
<td>E) Ingredient of reliability</td>
<td>Faithful representation</td>
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<td>6. Economic entity</td>
<td>F) Constraint</td>
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<tr>
<td>7. Feedback</td>
<td>G) Assumption</td>
<td></td>
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<tr>
<td>8. Full disclosure</td>
<td>H) Principle</td>
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<tr>
<td>9. Going concern</td>
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<tr>
<td>10. Historical cost</td>
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<td></td>
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<tr>
<td>11. Industry practices</td>
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</tbody>
</table>
Page 56, Unofficial Answers, 2. Reporting Objectives: This update was made to reflect the changes in Tab 2.

2. Reporting Objectives (6 Gradable Items)

1. B) Not-for-profit entities. A reporting objective of not-for-profit (nongovernmental) entities is to provide information useful in assessing management stewardship.

2. C) Governmental entities. A reporting objective of governmental entities is to assist in assessing services provided.

3. A) Business entities General-purpose financial reporting. A reporting objective of business entities is to provide general-purpose financial reporting to report financial information that is useful in making decisions about providing economic resources to the reporting entity. The information about relates to entity resources, claims to those resources, and changes in them.

4. B) Not-for-profit entities. A reporting objective of not-for-profit (nongovernmental) entities is to provide information about factors that may affect an organization’s liquidity.

5. A) Business entities General-purpose financial reporting. A reporting objective of business entities is to provide information useful in investment and credit decisions.

6. C) Governmental entities. A reporting objective of governmental entities is to assist in public accountability.

Page 58, Unofficial Answers, 5. Concepts II: This update was made to reflect the changes in Tab 5.

5. Concepts II (11 Gradable Items)

1. F) Constraint. Constraints are the following: cost-benefit, materiality, industry practice, and conservatism.

2. A) Interactive quality Enhancing qualitative characteristic. Qualitative characteristics of accounting information consist of user-specific qualities (understandability, decision usefulness), decision-specific qualities (relevance, reliability, and faithful representation), and secondary and interactive qualities and enhancing characteristics (comparability, consistency, verifiability, timeliness, and understandability).

3. F) Constraint. Constraints are the following: cost-benefit, materiality, industry practice, and conservatism.

4. A) Interactive quality Enhancing qualitative characteristic. Qualitative characteristics of accounting information consist of user-specific qualities (understandability, decision usefulness), decision-specific qualities (relevance, reliability), and secondary and interactive qualities (comparability, consistency, fundamental characteristics (relevance and faithful representation) and enhancing characteristics (comparability, verifiability, timeliness, and understandability). Consistency is a means of achieving comparability.

5. D) User-specific quality Fundamental qualitative characteristics. Qualitative characteristics of accounting information consist of user-specific qualities (understandability, decision usefulness), decision-specific qualities (relevance, reliability), and secondary and interactive qualities (comparability, consistency, fundamental characteristics (relevance and faithful representation) and enhancing characteristics (comparability, verifiability, timeliness, and understandability).

6. G) Assumption. Assumptions are the following: economic entity, going concern, monetary unit, and periodicity.

7. C) Ingredient of Relevance. Primary decision-specific qualities Fundamental qualitative characteristics include relevance and reliability faithful representation. Ingredients of relevance include feedback value, predictive value, and timeliness. Ingredients of reliability include verifiability, neutrality, and representational faithfulness. Relevant information has predictive value, confirmatory value, or both. Materiality is an entity-specific aspect of relevance.

8. H) Principle. Principles are the following: historical cost, revenue recognition, matching, and full disclosure.

9. G) Assumption. Assumptions are the following: economic entity, going concern, monetary unit, and periodicity.

10. H) Principle. Principles are the following: historical cost, revenue recognition, matching, and full disclosure.

11. F) Constraint. Constraints are the following: cost-benefit, materiality, industry practice, and conservatism.