

SOLUTIONS**Learning Goal 18****Multiple Choice**

1. d
2. b The Internal Revenue Service has rules, but they are about determining the correct amount of tax. This is not an objective of financial reporting.
3. d Remember the cost rule. An appraiser would have to restate the balance sheet to estimate current values. Even this can be quite subjective.
4. c
5. a
6. c
7. a The general rule for recording revenue is when it is earned. This is when a valid sale of a service or product is made.
8. c
9. a The historical cost principle requires that original cost be used. No exceptions apply here.
10. c
11. d
12. c
13. b
14. b
15. d
16. b
17. a
18. d
19. a The merchandise has not been delivered to the customer.
20. c
21. a
22. c When subtracted from the related revenues, this results in the correct net income.

Answers to Discussion Questions and Brief Exercises for Learning Goal 18

1. GAAP stands for “generally accepted accounting principles.” A principle is a rule or guideline; therefore, GAAP refers to the rules and guidelines that businesses must use when recording accounting transactions and preparing financial statements.
2. The two general categories of GAAP are broad GAAP and specific GAAP. Broad GAAP refers to general rules that are applied first in all situations. Examples of broad GAAP are the reliability principle, the cost principle, the revenue recognition principle, the matching principle, and the full disclosure principle. Specific GAAP are rules that apply to specific kinds of transactions or situations. There are many specific GAAP rules. You will learn these as you progress through your study of accounting.
3. GAAP comes from several sources. The most important source is the Financial Accounting Standards Board (FASB). This is the highest standard-setting authority in the accounting profession. The Financial Accounting Standards Board issues official pronouncements called Statements of Financial Accounting Standards (SFAS).

Other sources of GAAP within the profession are technical bulletins, audit and accounting rules by the AICPA (American Institute of Certified Public Accountants), and Emerging Issues Task Force (EITF) positions and recommendations. Also, long-standing industry practice that is not superseded by official pronouncements becomes a source of GAAP.

SOLUTIONS

Learning Goal 18, continued

4. The three objectives of financial reporting are to provide financial information that:
- is useful in making good financial decisions.
 - helps understand cash flows.
 - identifies assets and claims on assets and the causes of changes in them.

Examples of decision making:

- Are we charging enough for our services?
- Are we controlling expenses?

Examples of cash flows:

- Why cash has been decreasing
- Determining if customers are paying on time

Examples of identifying assets and claims on assets and causes of changes:

- The amount of inventory available
- The amount of debts that are owed
- The effect of business operations and owner investments and withdrawals.

5. The cost principle is the GAAP requirement for how to apply a value to a transaction. Follow two rules:

- The value to use when initially recording a transaction is the cash equivalent value agreed upon at the time of the transaction. *AND*
- This value is to be permanently maintained in the accounting records unless another GAAP rule requires it to be changed.

The key advantage of the cost principle is reliability. Another advantage is that it reduces confusion and does not create erratic gains and losses that result from changes in market value. The key disadvantage of using historical cost is that the balance sheet often does not come close to indicating the fair market value of assets and liabilities.

6. The equipment should be recorded at \$900. This is the cash equivalent value that was agreed upon at the time of the transaction (original transaction value). No other specific GAAP rule supersedes this. The land donation is a more subjective value because it is not a “reciprocal” transaction (property or services being both given and received). In this situation, the corporation will have to obtain a reliable appraisal as the best alternative to record for the value of the asset.
7. The revenue recognition principle is the GAAP guideline for determining how to record revenue. The rule to apply is that revenue cannot be recorded (“recognized”) until it is earned.
8. • Revenue has not been earned because you never asked for the service.
 • The equipment has not been delivered to you. I should not record the revenue yet.
 • My company should not record revenue for the sale because you cannot reasonably be expected to pay for it. There is a high probability that all or most of it will be returned.
Note: In “real life” some companies estimate the amount of returns and reduce the net amount of recorded sales.
 • It does not appear that this transaction is really part of a genuine revenue-earning process. We are not really customers of each other. Revenue should not be recorded. *Note:* This is not to say that all “barter” transactions are not genuine. However, this example appears to simply be a manipulation in which the interest of each party is *not* to receive what the other party is selling, but rather to manipulate the amount of recorded revenue.
9. Reliability refers to the quality of information that makes it dependable. In other words, reliable information is information that really represents what it claims to represent. If information is reliable, it generally can be verified. For example, information that a sale was made for \$500 is reliable if the sale really occurred at that price. This can be verified by the sales invoice and the collection from the customer. Relevance refers to the quality of information that makes the information useful. Information that is relevant is useful. For example, knowing the cost of paper clips is probably not relevant. Knowing the amount paid to employees is relevant.

SOLUTIONS**Learning Goal 18, continued**

10. The three elements of the operating guidelines in accounting are:
 - GAAP (broad and specific): GAAP means the rules and guidelines that accountants must follow when recording transactions and preparing financial statements.
 - Modifying constraints on GAAP: Modifying constraints are rules that ensure that GAAP is applied in a way that does not result in meaningless distinctions or foolish results.
 - Underlying assumptions upon which GAAP and the constraints are based: Underlying assumptions are essential conditions that must exist before GAAP can be applied. Without these conditions, accounting as we know it could not exist.
11. Full disclosure means disclosing all information that is necessary for users of financial statements to fully understand the statements. This is important because different specific GAAP methods and calculations may give different outcomes. The user must know how GAAP rules are being applied. As well, knowing the timing of events reported on financial statements can be essential in the correct interpretation of the statements. Finally, the disclosure of unusual or non-recurring items is important. Both the financial statements and the financial statement footnotes provide these types of disclosure.
12. Underlying assumptions are the essential conditions that must exist before GAAP can be applied. Without these conditions, accounting as we know it could not exist. Examples of underlying assumptions are:
 - The economic entity can be identified. (For whom is the accounting being done?)
 - Transactions are measured in money value.
 - The value of the money remains stable.
 - The life of the entity is divided into time periods. (Financial reporting relates to each time period.)
 - The entity is a going concern. (The entity will continue to operate in the foreseeable future.)