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STATEMENT OF THE ACCOUNTING PRINCIPLES BOARD

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4

Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises

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Paragraph Numbers

Chapter 1

PURPOSE AND NATURE OF THE STATEMENT

PURPOSE OF THE STATEMENT

1. The American Institute of Certified Public Accountants through its Accounting Principles Board is engaged in a program of advancing the written expression of financial accounting principles for the purpose of increasing the usefulness of financial statements. The Board has been directed to devote its attention to the broad fundamentals of financial accounting as well as to specific accounting problems.[1] This Statement of basic concepts[2] and accounting principles underlying financial statements of business enterprises[3] states the Board's views in response to that directive.[4]

2. This Statement has two broad purposes, one educational and the other developmental. It is intended to provide a basis for enhanced understanding of the broad fundamentals of financial accounting. It is also intended to provide a basis for guiding the future development of financial accounting. To

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[1] See "Report to Council of the Special Committee on Research Program," *The Journal of Accountancy*, December 1958, pp. 62-68 and *Report of Special Committee on Opinions of Accounting Principles Board,* 1965, summarized in *The Journal of Accountancy,* June 1965, pp. 12, 14, and 16.

[2] The term *basic concepts* is used to refer to the observations concerning the environment, the objectives of financial accounting and financial statements, and the basic features and basic elements of financial accounting discussed in Chapters 3-5 of the Statement.

[3] See paragraph 51 for a discussion of business enterprises. Although this Statement applies to business enterprises, some of the contents may also apply to not-for-profit organizations.

[4] Three accounting research studies were among the sources used in preparing this Statement: Accounting Research Study No. 1, *The Basic Postulates of Accounting,* by Maurice Moonitz; Accounting Research Study No. 3, *A Tentative Set of Broad Accounting Principles for Business Enterprises,* by Robert T. Sprouse and Maurice Moonitz; and Accounting Research Study No. 7, *Inventory of Generally Accepted Accounting Principles for Business Enterprises,* by Paul Grady. (Accounting research studies are not pronouncements of this Board or of the Institute, but are published for the purpose of stimulating discussion on important accounting issues.)

achieve these purposes the Statement (1) discusses the nature of financial accounting, the environmental forces that influence it, and the potential and limitations of financial accounting in providing useful information, (2) sets forth the objectives of financial accounting and financial statements, and (3) presents a description of present generally accepted accounting principles.

NATURE OF THE STATEMENT

3. The Statement is primarily descriptive, not prescriptive. It identifies and organizes ideas that for the most part are already accepted. In addition to the summary in Chapter 2, the Statement contains two main sections that are essentially distinct—(a) Chapters 3 to 5 on the environment, objectives, and basic features of financial accounting and (b) Chapters 6 to 8 on present generally accepted accounting principles. The description of present generally accepted accounting principles is based primarily on observation of accounting practice. Present generally accepted accounting principles have not been formally derived from the environment, objectives, and basic features of financial accounting.

4. The aspects of the environment selected for discussion are those that appear to influence the financial accounting process directly. The objectives of financial accounting and financial statements discussed are goals toward which efforts are presently directed. The accounting principles described are those that the Board believes are generally accepted *today. The Board has not evaluated or approved present generally accepted accounting principles except to the extent that principles have been adopted in Board Opinions. Publication of this Statement does not constitute approval by the Board of accounting principles that are not covered in its Opinions.*

5. Chapter 9 describes the dynamic nature of financial accounting and the need for continual reexamination of generally accepted accounting principles. The chapter describes how present generally accepted accounting principles may be evaluated on the basis of the material in the first section of the Statement (Chapters 3 to 5). The chapter also indicates some of the proposals that have been made for improving financial account-

ing information. These proposals, which the Board has not evaluated, may also be evaluated on the basis of the material in the first section of the Statement.

6. The Statement is a step toward development of a more consistent and comprehensive structure of financial accounting and of more useful financial information. It is intended to provide a framework within which the problems of financial accounting may be solved, although it does not propose solutions to those problems and does not attempt to indicate what generally accepted accounting principles should be. Evaluation of present accounting principles and determination of changes that may be desirable are left to future pronouncements of the Board.

7. The status of Statements of the Board is defined in the note following paragraph 219. This Statement does not change, supersede, or interpret Accounting Research Bulletins or Opinions of the Accounting Principles Board currently in effect. The normal procedures established to maintain the effectiveness of these pronouncements and to interpret them continue in effect unchanged. The Statement does, however, modify some of the definitions of technical accounting terms in the Accounting Terminology Bulletins.[5] The following sections are superseded:

Accounting Terminology Bulletin No. 1, paragraphs:

9—*accounting*
21—*balance sheet*
26—*assets*
27—*liabilities*

Accounting Terminology Bulletin No. 4, paragraph 2, *cost.*

The following sections are amended:

Accounting Terminology Bulletin No. 2, paragraphs:

5—*revenue*
8—*income*

Accounting Terminology Bulletin No. 4, paragraph 3, *expense.*

These changes are noted by footnotes at appropriate places in the Statement.

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[5] The Accounting Terminology Bulletins do not have the same authoritative status as the Accounting Research Bulletins and the Opinions of the Accounting Principles Board but are useful guides to financial accounting terminology.

TERMINOLOGY

8. Technical language is used in financial accounting. Many technical terms used in financial accounting are words that have wide common usage but that are given special meanings by accountants. Many important technical terms are defined or discussed in this Statement. The meaning of these terms is best understood in the context of the discussions in which they appear. The terms and the paragraphs in which they are defined or discussed are:

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Chapter 2

SUMMARY OF THE STATEMENT

9. Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions. This Statement deals with financial accounting for business enterprises, the branch of accounting that focuses on the general-purpose reports on financial position and results of operations known as financial statements.

FINANCIAL STATEMENTS

10. Financial statements are the means by which the information accumulated and processed in financial accounting is periodically communicated to those who use it. They are designed to serve the needs of a variety of users, particularly owners and creditors. Through the financial accounting process, the myriad and complex effects of the economic activities of an enterprise are accumulated, analyzed, quantified, classified, recorded, summarized, and reported as information of two basic types: (1) financial position, which relates to a point in time, and (2) changes in financial position, which relate to a period of time. Notes to the statements, which may explain headings, captions, or amounts in the statements or present information that cannot be expressed in money terms, are an integral part of the statements.

Financial Position—The Balance Sheet

11. A balance sheet (or statement of financial position) presents three major categories: (a) assets, (b) liabilities, and (c) owners' equity, the difference between total assets and total liabilities. A balance sheet at any date presents an indication

in conformity with generally accepted accounting principles of the financial status of the enterprise at a particular point of time.

Changes in Financial Position— The Income Statement

12. The income statement for a period presents the revenue, expenses, gains, losses, and net income (net loss) recognized during the period and thereby presents an indication in conformity with generally accepted accounting principles of the results of the enterprise's profit-directed activities during the period. The information presented in an income statement is usually considered the most important information provided by financial accounting because profitability is a paramount concern to those interested in the economic activities of the enterprise.

Changes in Financial Position— Changes in Owners' Equity

13. An income statement is usually not sufficient to describe the total change in owners' equity during a period because changes arise from sources other than profit-directed activities. The total change in owners' equity is described by three statements: an income statement, a statement of retained earnings, and a statement of other changes in owners' equity. A statement of retained earnings presents net income (as shown in the income statement) and items such as dividends and adjustments of the net income of prior periods. A statement of other changes in owners' equity presents additional investments by owners, retirements of owners' interests (except for the part considered to be a distribution of earnings), and similar events. If these other changes are simple and few in number, they are often presented in notes to the other financial statements rather than in a separate statement.

Changes in Financial Position— Other Statements

14. A statement of source and application of funds is frequently presented. It shows the major sources of increases in

an enterprise's assets for a period in addition to net income, for example, from borrowing, owners' investments, and disposal of assets other than through normal operations. It also shows how the enterprise used its assets during the period, for example, in acquiring other assets, in paying debt, and in distributions to owners. This statement has other names, including *statement of working capital changes* and *statement of source and use of funds.*

15. Statements that analyze specific changes in financial position are occasionally presented, for example, changes in plant and equipment, changes in long-term liabilities, and cash receipts and disbursements. Statements that analyze changes in each asset, each liability, and each item of owners' equity could be prepared, but statements of changes in financial position in addition to those already discussed are seldom presented.

The Source of Financial Statements

16. Financial statements are the end product of the financial accounting process. This process is governed by generally accepted accounting principles, which determine the information that is included, how it is organized, measured, combined, and adjusted, and finally how it is presented in the financial statements. The principles reflect the objectives and the basic features of financial accounting (discussed below). All of financial accounting—principles, objectives, and basic features—is grounded in the environment of business enterprises.

THE ENVIRONMENT OF FINANCIAL ACCOUNTING

17. An understanding of financial accounting and an ability to evaluate the information it produces depend not only on delineation of accounting principles and the features and objectives of accounting, but also on an understanding of the environment within which financial accounting operates and which it is intended to reflect (Chapter 3). The users of financial accounting information and economic activity in society and in individual business enterprises are aspects of the environment important to an analysis of the problems of financial accounting.

Users

18. Needs and expectations of users of financial statements are a part of the environment that determines the type of information required of financial accounting. A knowledge of important classes of users, of their common and special needs for information, and of their decision processes is helpful in improving financial accounting information.

Economic Activity

19. Economic activity can be described in terms of (1) its general nature in highly developed economies, (2) the economic resources, obligations, and residual interest of a business enterprise and the economic activities that change them, and (3) the ways of measuring economic activity.

20. Describing economic resources, economic obligations, and residual interest and the economic activities that change them is important because the basic elements of financial accounting—assets, liabilities, owners' equity, revenue, expenses, and net income—are related to these economic elements. A discussion of the measurement of economic activity is also relevant because measurement difficulties underlie many of the problems of financial accounting.

OBJECTIVES OF FINANCIAL ACCOUNTING AND FINANCIAL STATEMENTS

21. The basic purpose of financial accounting and financial statements is to provide financial information about individual business enterprises that is useful in making economic decisions (Chapter 4). General and qualitative objectives aid in fulfilling this basic purpose and provide means for evaluating present and proposed accounting principles.

22. General objectives determine the appropriate content of financial accounting information. These objectives are to present reliable financial information about enterprise resources and obligations, economic progress, and other changes in resources and obligations, to present information helpful in estimating earnings potential, and to present other financial information needed by users, particularly owners and creditors.

23. Certain qualities or characteristics make financial information useful. Providing information that has each of these qualities is an objective of financial accounting. These qualitative objectives are relevance, understandability, verifiability, neutrality, timeliness, comparability, and completeness.

24. The objectives of financial accounting and financial statements are at least partially achieved at present, although improvement is probably possible in connection with each of them. Constraints on full achievement of the objectives arise from (1) conflicts of objectives, (2) environmental influences, and (3) lack of complete understanding of the objectives.

BASIC FEATURES AND BASIC ELEMENTS OF FINANCIAL ACCOUNTING

Basic Features

25. The basic features of financial accounting (Chapter 5) are determined by the characteristics of the environment in which financial accounting operates. The features are:

(1) *Accounting entity*—economic activities of individual entities are the focus of financial accounting.

(2) *Going concern*—continuation of entity operations is usually assumed in financial accounting in the absence of evidence to the contrary.

(3) *Measurement of economic resources and obligations*—financial accounting is primarily concerned with measurement of economic resources and obligations and changes in them.

(4) *Time periods*—financial accounting presents information about activities for relatively short time periods.

(5) *Measurement in terms of money*—financial accounting measures in terms of money.

(6) *Accrual*—determining periodic income and financial position depends on measurement of noncash resources and obligations.

(7) *Exchange price*—financial accounting measurements are primarily based on exchange prices.

(8) *Approximation*—approximations are inevitable in the allocations required in financial accounting.
(9) *Judgment*—financial accounting requires informed judgment.
(10) *General-purpose financial information*—financial accounting presents general-purpose financial information.
(11) *Fundamentally related financial statements*—statements of financial position and changes in financial position are fundamentally related.
(12) *Substance over form*—financial accounting emphasizes the economic substance of events even though the legal form may differ from the economic substance and suggest different treatment.
(13) *Materiality*—financial reporting is only concerned with significant information.

Basic Elements

26. The basic elements of financial accounting are assets, liabilities, owners' equity, revenue, expenses, and net income (Chapter 5). These elements are defined in terms of (a) economic resources, economic obligations, and residual interest and changes in resources, obligations, and residual interest and (b) generally accepted accounting principles.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

27. Generally accepted accounting principles (Chapters 6 to 8) incorporate the consensus[6] at any time as to which economic resources and obligations should be recorded as assets and liabilities, which changes in them should be recorded, when these changes should be recorded, how the recorded assets and liabilities and changes in them should be measured, what information should be disclosed and how it should be disclosed, and which financial statements should be prepared. In this Statement, generally accepted accounting principles are divided into three levels: pervasive principles, broad operating principles, and detailed principles.

[6] See paragraph 137, footnote 38.

28. Pervasive principles (Chapter 6) form the basis for much of the accounting process. They include pervasive measurement principles and modifying conventions. The pervasive measurement principles—for example, realization—broadly determine the events recognized in financial accounting, the basis of measurement used in financial accounting, and the way net income is determined. The modifying conventions—for example, conservatism—affect the application of the pervasive measurement principles.

29. Broad operating principles (Chapter 7) are general rules, derived from the pervasive principles, that govern the application of the detailed principles. They are described in this Statement in two groups, principles of selection and measurement and principles of financial statement presentation. The principles of selection and measurement include principles that guide selection of events to be accounted for and assignment of dollar amounts and principles that determine the effects of recorded events on assets, liabilities, owners' equity, revenue, and expenses of the enterprise.

30. Detailed principles are the numerous rules and procedures that are based on the broad principles and specify the way data are processed and presented in specific situations. Detailed principles are discussed but not listed in Chapter 8.

31. The three types of principles determine the operation of the financial accounting process. All three levels of principles are conventional. They have developed on the basis of experience, reason, and custom; they become generally accepted by agreement (often tacit agreement) and are not formally derived from a set of postulates.

DYNAMIC NATURE OF FINANCIAL ACCOUNTING

32. Present generally accepted accounting principles are the result of an evolutionary process that can be expected to continue (Chapter 9). Principles change in response to changes in economic and social conditions, to new knowledge and technology, and to demands by users for more serviceable financial information. Change is more pronounced in the detailed prin-

ciples than in the broad operating principles; the pervasive principles tend to be the most stable. Nevertheless, because the principles are conventional and have been developed in relation to a specific environment and with assumptions about needed financial information, they are all subject to review, evaluation, and possible change.

CHARACTERISTICS AND LIMITATIONS OF FINANCIAL ACCOUNTING AND FINANCIAL STATEMENTS

33. The environment, objectives, and basic features of financial accounting determine the structure of financial accounting and provide constraints and conditions on its operations. The accounting principles that are generally accepted at a particular time as the basis of reporting represent a response to these influences, constraints, and conditions as they exist at that time and determine not only the scope of financial accounting information at that time but also its relevance. These principles are the result of the historical development of financial accounting, the way in which needs of users of financial accounting information are perceived, and the way accountants interact with the environment.

34. The complexity of the economic activity that forms the subject matter of accounting gives financial accounting some definite limits. Taking one approach in financial accounting requires rejection of other approaches and limits the scope of accounting. The approach taken is reflected in certain characteristics of the financial accounting process and its product, the financial statements. In the midst of the continuous and complex interactions found in the economic environment of enterprises, periodic measurements are made based on a relatively simple classification system. Faced with the uncertainty and joint effects that characterize economic activity, accountants adopt conventional procedures that emphasize verifiable measures and are based on assumptions that certain causal relationships exist and can be traced.

35. Some of the more important present characteristics and limitations of financial accounting and financial statements are briefly described.

Historical Report. Financial accounting and financial statements are primarily historical in that information about events that have taken place provides the basic data of financial accounting and financial statements.

General-Purpose Financial Statements. Financial accounting presents information designed to serve the common needs of a variety of user groups with primary emphasis on the needs of present and potential owners and creditors.

Fundamentally Related Financial Statements. Financial statements are fundamentally related. Aspects of financial position presented in the balance sheet are related to changes in financial position presented in the income statement.

Classification. Information about financial position and results of operations is classified based on the presumed needs of owners, creditors, and other users.

Summarization. Transactions and other events of a business enterprise that have similar characteristics are grouped and presented in summary form.

Measurement in Terms of Money. Financial statements in the United States are expressed in terms of numbers of U.S. dollars. Changes in the general purchasing power of the dollar are not reflected in the basic financial statements.

Measurement Bases. Several measurement bases are used in financial accounting, for example, net realizable value (receivables), lower of acquisition cost and present market price (inventories), and acquisition cost less accumulated depreciation (plant and equipment). Financial statements in general do not purport to reflect the current value of the assets of the enterprise or their potential proceeds on liquidation under present generally accepted accounting principles.

Accrual. The effects of transactions and other events on the assets and liabilities of a business enterprise are recognized and reported in the time periods to which they relate rather than only when cash is received or paid.

Estimates and Judgment. The complexity and uncertainty of economic activity seldom permit exact measurement. Estimates and informed judgment must often be used to assign dollar amounts to the effects of transactions and other events that affect a business enterprise.

Verifiability. Although estimates are unavoidable in financial accounting, an attempt is made to keep the effects of estimates to a minimum by basing financial accounting measurements primarily on enterprise transactions and requiring corroboration by outside evidence before increases in value are recognized. Estimates included in financial accounting are usually related in some way to data derived from verifiable events and the estimates are accounted for in a consistent and systematic manner.

Conservatism. The uncertainties that surround the preparation of financial statements are reflected in a general tendency toward early recognition of unfavorable events and minimization of the amount of net assets and net income.

Substance Over Form. Although financial accounting is concerned with both the legal and economic effects of transactions and other events and many of its conventions are based on legal rules, the economic substance of transactions and other events are usually emphasized when economic substance differs from legal form.

Technical Terminology. Many of the terms used in financial statements are common words to which accountants have given technical meanings.

Audience. Financial statement users are presumed to be generally familiar with business practices, the technical language of accounting, and the nature of the information reported.

USE OF FINANCIAL ACCOUNTING INFORMATION

36. Appropriate use of financial accounting information requires a knowledge of the characteristics and limitations of financial accounting. Financial accounting information is produced for certain purposes by the use of conventional principles. Use of the information for other purposes or without a general knowledge of its characteristics and limitations may lead to misinterpretation and errors.

37. An important characteristic of financial statements, for

example, is that the information they contain describes the past, while decision making is oriented toward the future. A record of past events and a knowledge of past position and changes in position, however, help users evaluate prior decisions and this information is also a starting point for users in predicting the future. Decision makers should not assume, however, that the conditions that produced past results will necessarily continue in the future.

38. Financial statements are designed to provide an important part of the information that users need for many of their decisions. The information contained in the statements should not be relied on exclusively, however, and should be supplemented by other information about the specific prospects of the company, the industry in which it operates, and the economy in general.

39. A knowledge of the characteristics and limitations of financial statements also helps users avoid putting undue reliance on single measures or the results of a single year. Net income or earnings per share of a single year, for example, should not be overemphasized since these amounts are derived from complex computations, are based on estimates and judgments, and often have their meaning modified by information in the notes to the financial statements. In reaching decisions users should consider movements in the components of net income, the effects of estimates and judgments, the possible effects of information disclosed in notes, and similar factors.

Chapter 3

THE ENVIRONMENT OF FINANCIAL ACCOUNTING

40. Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions—in making reasoned choices among alternative courses of action. Accounting includes several branches, for example, financial accounting, managerial accounting, and governmental accounting.

41. Financial accounting for business enterprises is one branch of accounting. It provides, within limitations described below, a continual history quantified in money terms of economic resources and obligations of a business enterprise and of economic activities that change those resources and obligations.

42. Financial accounting is shaped to a significant extent by the environment, especially by:

1. The many uses and users which it serves,
2. The overall organization of economic activity in society,
3. The nature of economic activity in individual business enterprises, and
4. The means of measuring economic activity.

Environmental conditions, restraints, and influences are generally beyond the direct control of businessmen, accountants, and statement users. Understanding and evaluating financial accounting requires knowledge of this environment and of its impact on the financial accounting process. Aspects of the environment are reflected in the basic features and basic elements of financial accounting (see Chapter 5) and in generally accepted accounting principles (see Chapters 6 to 8).

USES AND USERS OF FINANCIAL ACCOUNTING INFORMATION

43. Financial accounting information[7] is used by a variety of groups and for diverse purposes. The needs and expectations of users determine the type of information required. User groups may be broadly classified into (1) those with direct interests in business enterprises and (2) those with indirect interests.

Users with Direct Interests

44. Some users have or contemplate having a direct economic interest in business enterprises. Examples of these users and of the types of evaluations and decisions for which they use financial accounting information are:

Owners—retain, increase, or decrease proportionate ownership; evaluate the use and stewardship of resources by management.

Creditors and suppliers—extend credit; determine terms of credit; require security or restrictive covenants in terms; enter suit or force bankruptcy or receivership; increase or decrease reliance on the enterprise as a customer.

Potential owners, creditors, and suppliers—commit resources to the enterprise; determine amount of commitment; evaluate the use and stewardship of resources by management.

Management (including directors and officers)—assess nature and extent of financing needs; evaluate results of past economic decisions; set dividend policy; project future financial position and income; assess merger and acquisition possibilities; recommend reorganization or dissolution.

Taxing authorities—evaluate tax returns; assess taxes or penalties; make investigations and audits.

Employees—negotiate wages; terminate employment; or, for prospective employees, apply for employment.

Customers—anticipate price changes; seek alternative sources or broader bases of supply.

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[7] The term *information* is sometimes applied only to relevant data. This Statement does not distinguish between the terms *information* and *data.*

Users with Indirect Interests

45. Some users of financial accounting information derive an interest because their function is to assist or protect those who have or contemplate having a direct interest. Examples are:

Financial analysts and advisors—advise investors and potential investors to retain, increase, decrease, or acquire an investment in the enterprise; evaluate prospects of investment in the enterprise relative to alternative investments.[8]

Stock exchanges—accept or cancel listings; suspend trading; encourage changes in accounting practices or additional disclosure of information.

Lawyers—determine whether covenants and contractual provisions are fulfilled; advise on legality of dividends and profit sharing and deferred compensation agreements; draft pension plan terms.

Regulatory or registration authorities—assess reasonableness of rate of return; allow or require increases or decreases in prices or rates; require or recommend changes in accounting or disclosure practices; issue cease-and-desist or stock-trading-suspension orders.

Financial press and reporting agencies—prepare descriptive analyses; combine, summarize, or select information to present in descriptions; conform information to uniform presentation arrangements; compute trends and ratios.

Trade associations—compile industry statistics and make comparisons; analyze industry results.

Labor unions—formulate wage and contract demands; assess enterprise and industry prospects and strengths.

Common and Special Needs

46. Financial accounting information may be directed toward the common needs of one or more of the user groups cited above or may be directed toward specialized needs. Examples of information directed toward common needs are the general-purpose reports on enterprise financial position and progress known

[8] Investment bankers are users with derived interests when they act as analysts and advisors to issuers of securities and investors in securities. They are users with direct interests when they purchase and sell securities on their own account.

as the balance sheet and the income statement. The emphasis in financial accounting on general-purpose information (see paragraph 125) is based on the presumption that a significant number of users need similar information. General-purpose information is not intended to satisfy specialized needs of individual users.

47. Examples of information that is derived from financial accounting records and directed toward specialized needs are some financial reports submitted to regulatory authorities, special financial reports prepared to obtain credit or loans, many reports to management, tax returns, and statistical financial information given to trade and industry associations. Information prepared for a particular purpose cannot be expected to serve other needs well. Furthermore, the problem of ascertaining specialized needs of a large number of users, the cost of attempting to serve these needs on an individual basis, and the confusion that might result from disseminating more than one set of information about the financial results of an enterprise's operations militate against attempting to serve all needs of users with special-purpose reports.

48. Improving financial accounting requires continuing research on the nature of user needs, on the decision processes of users, and on the information that most effectively serves user needs.

THE ORGANIZATION OF ECONOMIC ACTIVITY IN SOCIETY

49. All societies engage in certain fundamental economic activities:

Production—the process of converting economic resources into outputs of goods and services that are intended to have greater utility than the required inputs. In this Statement the term *production* is used in this broad sense and encompasses the provision of services and the movement and storage of goods as well as changes in physical form of goods. The term *production* therefore is not used in this Statement synonymously with the term *manufacturing*.[9]

[9] See paragraph 62 for further discussion of production.

Income distribution—the process of allocating rights to the use of output among individuals and groups in society.

Exchange—the process of trading resources or obligations for other resources or obligations.

Consumption—the process of using the final output of the production process.

Saving—the process by which individuals and groups set aside rights to present consumption in exchange for rights to future consumption.

Investment—the process of using current inputs to increase the stock of resources available for future output as opposed to immediately consumable output.

50. In less developed economies each form of economic activity is relatively simple and many of the processes are merged into one another. Individuals or groups produce for their own consumption; the distribution of claims to output and income is direct and obvious; exchange is the exception rather than the rule; and saving and investment occur together as some individuals or groups set aside part of the product of their current effort for future rather than present consumption.

51. In contrast, economic activity is specialized and complex in highly developed economies like the United States. Goods and services are produced by specialized units. These units may be government owned, but in the United States most productive activity is carried on through investor owned business enterprises. Business enterprises are individuals or associations of individuals that control and use resources for a variety of purposes including the purpose of yielding a return to the owners of the enterprise. They produce for sale rather than their own consumption and generally engage in market exchanges to acquire inputs for the production process and to dispose of goods and services produced.

52. Within producing units, the production process itself is often specialized and complex. Modern organization permits and modern technology requires long, continuous, and intricate processes in which products and services are often the joint result of several productive resources. Rapid changes in technology change patterns of inputs and of outputs and contribute

to changes in their relative prices. Likewise, shifts in consumer demands and preferences affect the prices of outputs and through these the prices of inputs used in the production process.

53. Savings and investment are also separate, specialized activities. Savings are invested through a complex set of intermediaries which offer the saver diverse types of ownership or creditor claims, most of which can be freely traded.

54. The complexity and diversity of modern economic organization have implications for financial accounting:

(1) Since economic activity of business enterprises tends to be continuous, relationships associated with intervals of time like a year or a quarter of a year can be measured only on the basis of assumptions or conventional allocations.

(2) Because of the complexity of modern production and the joint nature of economic results, the relative effects of the various productive resources are intertwined, not only with each other but with external market events. Computing the precise effects of a particular input unit or a particular external event is therefore impossible except on an arbitrary basis.

(3) In a dynamic economy, the outcome of economic activity is uncertain at the time decisions are made and financial results often do not correspond to original expectations.

55. On the other hand, certain elements of modern economic organization help to provide an underlying continuity and stability to some aspects of economic activity and hence to the task of measuring that activity. In particular:

(1) Several forms of enterprise, especially the corporate form, continue to exist as legal entities for extended periods of time.

(2) The framework of law, custom, and traditional patterns of action provides a significant degree of stability to many aspects of the economic environment. In a society in which property rights are protected, contracts fulfilled, debts paid, and credit banking and transfer opera-

tions efficiently performed, the degree of uncertainty is reduced and the predictability of the outcome of many types of economic activities is correspondingly increased.

ECONOMIC ACTIVITY IN INDIVIDUAL BUSINESS ENTERPRISES

56. The economic activities of a business enterprise increase or decrease (1) its economic resources, (2) its economic obligations, and (3) the residual interest in its resources.

Economic Resources

57. Economic resources are the scarce means (limited in supply relative to desired uses) available for carrying on economic activities. The economic resources of a business enterprise include:

1. *Productive resources*

   These resources are the means used by the enterprise to produce its product:

   a. Productive resources of the enterprise—
      These include raw materials, plant, equipment, natural resource deposits, patents and similar intangibles, goodwill, services, and other resources used in production.

   b. Contractual rights to productive resources—
      These include contractual rights to the use of resources of other entities (including individuals) as well as rights to delivery of materials, plant, and equipment from other entities. Contractual rights to resources of other entities often arise in mutual commitments in which payment is to be made as, or shortly after, the goods or services are used or received.

2. *Products*

   These resources are outputs of the enterprise, consisting of (a) goods awaiting exchange, and (b) partially completed goods still in the process of production.[10]

3. *Money*
4. *Claims to receive money*
5. *Ownership interests in other enterprises.*

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[10] The products of an enterprise also include services provided to other entities. Services provided to others cannot be inventoried, however, and therefore are not resources of the enterprise.

Economic Obligations

58. The economic obligations of an enterprise at any time are its present responsibilities to transfer economic resources or provide services to other entities in the future. Obligations usually arise because the enterprise has received resources from other entities through purchases or borrowings. Some obligations, however, arise by other means, for example, through the imposition of taxes or through legal action. Obligations are general claims against the enterprise rather than claims to specific resources of the enterprise unless the terms of the obligation or applicable legal rules provide otherwise. Economic obligations include:

1. *Obligations to pay money*
2. *Obligations to provide goods or services*
   These are normally contractual obligations calling for the transfer of resources other than money according to specified conditions. The obligations may arise because payment for the goods or services to be provided has already been received or as the result of a mutual commitment.

Residual Interest

59. The residual or owners' interest is the interest in the economic resources of an enterprise that remains after deducting economic obligations. It is the interest of those who bear the ultimate risks and uncertainties and receive the ultimate benefits of enterprise operations. At the start of the enterprise the residual interest equals the owners' initial investment of resources. Increases or decreases in enterprise resources that are not offset by equal changes in enterprise obligations change the residual interest.

Relationship Among Economic Resources, Economic Obligations, and Residual Interest

60. The relationship among the resources of an enterprise and the claims and interests in those resources implicit in the definition of residual interest is:

Economic Resources − Economic Obligations = Residual Interest[11]

[11] Expressing the relationship in a mathematical equation goes beyond descriptions of terms and assumes appropriate measurement. Measurement of economic activity is discussed in paragraphs 66-72.

The resources, obligations, and residual interest of an enterprise are the basis for the basic elements of financial position—assets, liabilities, and owners' equity—dealt with in financial accounting (see paragraphs 132 and 133).

Changes in Economic Resources, Economic Obligations, and Residual Interest

61. Resources, obligations, and residual interest of an enterprise change over time. Changes in resources and obligations include acquisitions and dispositions of resources, incurrence and discharge of obligations, and changes in the utility or prices of resources held. Because resources, obligations, and residual interest are related, changes in them are also related and a change in total resources is always accompanied by a change in obligations or residual interest. Events that change resources, obligations, and residual interest are the basis for the basic elements of results of operations—revenue, expenses, and net income (see paragraphs 134 and 135)—and other changes in financial position with which financial accounting is concerned.

62. Events that change the resources, obligations, or residual interest of an enterprise may be classified in many ways. The following classification is intended to be complete, to avoid overlapping, and to highlight differences that are important to financial accounting. This classification of events is used in Chapter 7 of this Statement as the basis for presenting the principles of selection and measurement.

I. External events: events that affect the enterprise and in which other entities participate.

  A. Transfers of resources or obligations to or from other entities.

    1. Exchanges—

       These events are reciprocal transfers of resources or obligations between the enterprise and other entities in which the enterprise either sacrifices resources or incurs obligations in order to obtain other resources or satisfy other obligations. Exchanges occur if each party to the transaction values that which he will receive more than that which he must give up and if the particular exchange is evaluated as preferable to alternative actions. Exchanges encompass many of the economic interactions of entities; they include contractual commitments as well as transfers of goods, services, money, and the exchange of one obligation for another. Some exchanges take place on a continuous basis over time instead of being consummated at a moment of time—for example, accumulations of interest and rent.

2. Nonreciprocal transfers—

   These events are transfers in one direction of resources or obligations, either from the enterprise to other entities or from other entities to the enterprise.

   a. Transfers between the enterprise and its owners—

      These are events in which the enterprise receives resources from owners and the enterprise acknowledges an increased ownership interest, or the enterprise transfers resources to owners and their interest decreases.[12] These transfers are not exchanges from the point of view of the enterprise. The enterprise sacrifices none of its resources and incurs no obligations in exchange for owners' investments, and it receives nothing of value to itself in exchange for the resources it distributes.[13] Transfers of this type also include declaration of dividends and substituting ownership interest for obligations.

   b. Nonreciprocal transfers between the enterprise and entities other than owners—

      In these transfers one of the two entities is often passive, a mere beneficiary or victim of the other's

[12] Interactions of enterprises with owners acting as customers, suppliers, employees, debtors, creditors, donors, etc., rather than as owners are excluded from this category.

[13] The distinction between exchanges and transfers between an enterprise and its owners is important in financial accounting today because resources are normally recorded at the cost (see paragraph 164) in an exchange; owners' investments have no cost to the enterprise and are recorded at the fair value of the assets received (see paragraph 182, M-2). Furthermore, revenue and expenses can result from exchanges but not from transfers between an enterprise and its owners.

actions. Examples are gifts, dividends received, taxes, loss of a negligence lawsuit, imposition of fines, and theft.

B. External events other than transfers of resources or obligations to or from other entities.

Enterprise resources may be changed by actions of other entities that do not involve transfers of enterprise resources or obligations. Examples are changes in specific prices of enterprise resources, changes in interest rates, general price-level changes, technological changes caused by outside entities, and vandalism. In addition to their direct effects on the enterprise, these types of events also introduce an element of uncertainty into production and exchange activities. Unfavorable effects of these events may at best be insured or hedged against or provided for through policies that promote orderly adaptation to changed conditions.

II. Internal events: events in which only the enterprise participates.

A. Production.

Production in a broad sense is the process by which resources are combined or transformed into products (goods or services). Production does not necessarily alter the physical form of the items produced; it may involve simply a change in location or the holding of items over a period of time. Production encompasses a broad range of activities, including manufacturing, exploration, research and development, mining, agriculture, transportation, storage, marketing and distribution, merchandising, and provision of services. Each of these activities is intended to result in a product with an exchange price greater than the cost of the resources used in its production. Production includes all the internal events of an enterprise except casualties. (The term *production* therefore is *not* used in this Statement synonymously with the term *manufacturing*.)

B. Casualties.

Casualties are sudden,[14] substantial, unanticipated reductions in enterprise resources not caused by other entities.[15] Examples are fires, floods, and other events ordinarily termed acts of God. Some events in this category are similar to those in category IB in that they introduce an element of uncertainty and may be insured against.

63. Net income or loss can result from each of the types of events listed except transfers between an enterprise and its owners.

64. *Discussion of Classification of Events.* Classifying events involves problems regardless of the system of classification chosen. First, the distinctions between classes probably cannot be made clear enough to make the class in which every event belongs obvious. For example, the distinctions between external and internal events and between production and casualties involve borderline situations which require judgment in assigning events to classes. Second, more than one event can occur at the same time and place. For example, when employees are at work, exchanges are taking place between the enterprise and the employees (wages and salaries are accruing) and production is taking place at the same time. Single occurrences must sometimes be analyzed into component events that fit into separate classes. Finally, the economic substance of some events may differ from their legal form. Classification of this kind of event may differ depending on whether its form or its substance is considered to govern (see paragraph 127).

65. *Cost.* Changes in resources, obligations, and residual interest often involve economic cost to the enterprise. Economic cost is the sacrifice (that which is given up or foregone) incurred in economic activities (see paragraph 164 for treatment of cost under generally accepted accounting principles).

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[14] Casualties also include concealed progressive changes in assets that are discovered after substantial change has taken place, for example, damage from settling of a building foundation.

[15] This definition of casualties differs from that in the Internal Revenue Code, which includes some external events as casualties.

MEASURING ECONOMIC ACTIVITY

66. Comparison and evaluation of diverse economic activities are facilitated by measurement[16] of enterprises' resources and obligations and the events that change them.

Measurement Problems

67. The complexity, continuity, and joint nature of economic activity (see paragraphs 51 to 54) present problems in measuring the effects of enterprise activities and associating them with specific products and services and with relatively short time periods. The need to relate measurements to each other also presents problems because it requires selecting like quantitative attributes and ignoring others. Attributes are selected on the basis of concepts that specify the attribute to be measured and how and when measurements are to be made. Disagreements over measurement concepts are the source of many of the differences of opinion about how to achieve the objectives of financial accounting and financial statements. (The objectives are discussed in Chapter 4.)

68. Because the resources and obligations of an enterprise and changes in them are inseparably connected, measuring the resources and obligations and measuring changes in them (including those changes that are the source of net income for a period) are two aspects of the same problem.

Exchange Prices

69. The effects of economic activities are measured in terms of money in a monetary economy. Money measurements are used to relate economic activities that use diverse types of resources to produce diverse types of products and services. Fluctuations in the general purchasing power of money cause problems in using money as a unit of measure (see paragraphs 166 to 168 in Chapter 6).

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[16] The terms *measurement* and *valuation* are often used interchangeably in accounting to mean simply the quantification of resources, obligations, and changes in them in money terms. An accounting research study on measurement and valuation in financial accounting is now in progress. The technicalities of differences between measurement and valuation, if any, will be examined in that study.

70. Resources are measured in terms of money through money prices, which are ratios at which money and other resources are or may be exchanged. Several types of money prices can be distinguished based on types of markets (purchase prices and sales prices) and based on time (past prices, present prices, and expected future prices). Four types of money prices are used in measuring resources in financial accounting.

1. *Price in past purchase exchanges of the enterprise*
   This price is usually identified as *historical cost* or *acquisition cost* because the amount ascribed to the resource is its cost, measured by the money or other resources exchanged by the enterprise to obtain it.
2. *Price in a current purchase exchange*
   This price is usually identified as *replacement cost* because the amount ascribed to the resource is measured by the current purchase price of similar resources that would now have to be paid to acquire it if it were not already held or the price that would now have to be paid to replace assets held.
3. *Price in a current sale exchange*
   This price is usually identified as *current selling price* because the amount ascribed to the resource is measured by the current selling price of the resource that would be received in a current exchange.
4. *Price based on future exchanges*
   This price is used in several related concepts—*present value of future net money receipts, discounted cash flow, (discounted) net realizable value,* and *value in use.* Each indicates that the amount ascribed to the resource is measured by the expected net future money flow related to the resource in its present or expected use by the enterprise, discounted for an interest factor.[17]

71. Each of these concepts has at least some current applica-

[17] *Current selling price* and *net realizable value* differ conceptually, although they may give the same amount under certain conditions: (1) future sales price is expected to be the same as current sales price (or no better estimate of future sales price than current price is available), (2) no future costs are expected, and (3) discounting is ignored.

tion in financial accounting. Their application is discussed in connection with present generally accepted accounting principles in Chapter 7, paragraph 179.

72. Measuring economic activities in terms of exchange prices has certain limitations because some important changes that affect these activities are not changes in monetary attributes of resources. Examples are (1) physical changes in resources during production, (2) certain external events, such as technological changes and changes in consumer tastes, and (3) certain broad forces in the economy, such as changes in governmental attitudes toward business operations. Reporting these changes in terms of exchange prices when they occur requires certain assumptions, for example, assumptions concerning the presumed effect of these changes on prices of enterprise resources. The alternative is to wait to report these changes until they affect aspects of resources that are directly related to exchange prices or until exchanges occur.

Chapter 4

OBJECTIVES OF FINANCIAL ACCOUNTING AND FINANCIAL STATEMENTS

73. The basic purpose of financial accounting and financial statements is to provide quantitative financial information about a business enterprise that is useful to statement users, particularly owners and creditors, in making economic decisions. This purpose includes providing information that can be used in evaluating management's effectiveness in fulfilling its stewardship and other managerial responsibilities. Within the framework of these purposes financial accounting and financial statements have a number of objectives that (1) determine the appropriate content of financial accounting information (general objectives) and (2) indicate the qualities that make financial accounting information useful (qualitative objectives). The objectives provide means to evaluate and improve generally accepted accounting principles (see paragraph 213).

74. The content of financial accounting information can be examined on two levels. First, the appropriate content of particular financial statements prepared at a given date may be examined. Second, the appropriate content of financial accounting information in general, without regard for the conventions at any particular date, may be examined.

OBJECTIVES OF PARTICULAR FINANCIAL STATEMENTS

75. The objectives of particular financial statements are to present fairly in conformity with generally accepted accounting principles[18] (1) financial position, (2) results of operations, and (3) other changes in financial position. Financial position

[18] See paragraphs 137-140 for a discussion of the nature of generally accepted accounting principles. See paragraph 189 for a discussion of fair presentation in conformity with generally accepted accounting principles.

and changes in financial position of an enterprise are defined in terms of its economic resources and obligations and changes in them that are identified and measured in conformity with accounting principles that are generally accepted at the time the statements are prepared.[19]

GENERAL OBJECTIVES

76. The objectives of particular financial statements are stated in terms of the accounting principles that are generally accepted at the time the financial statements are prepared. These principles may change in response to a variety of forces.[20] General objectives that give direction to the development of accounting principles are therefore required. These general objectives are broader or longer range than those for particular financial statements and indicate the appropriate content of financial accounting information in general. They are independent of generally accepted accounting principles at any particular time. Improving financial accounting to better achieve the general objectives involves difficulties, which are discussed in paragraphs 110 to 113.

Statement of the General Objectives

77. A general objective of financial accounting and financial statements is to provide reliable financial information about economic resources and obligations of a business enterprise. This information is important in evaluating the enterprise's strengths and weaknesses. It indicates how enterprise resources are financed and the pattern of its holdings of resources. It aids in evaluating the enterprise's ability to meet its commitments. The information indicates the present resource base available to exploit opportunities and make future progress. In short, information about economic resources and obligations of a business enterprise is needed to form judgments about the ability of the enterprise to survive, to adapt, to grow, and to prosper amid changing economic conditions.

[19] See paragraphs 130-135 in Chapter 5.

[20] See paragraphs 208-209 for a discussion of the dynamic nature of financial accounting.

78. Another general objective, of prime importance, is to provide reliable information about changes in net resources (resources less obligations) of an enterprise that result from its profit-directed activities.[21] Almost all who are directly concerned with the economic activities of an enterprise are interested in its ability to operate successfully. Investors expect a dividend return or increases in the price of ownership shares or both. An enterprise that operates successfully is more likely to be able to pay creditors and suppliers, provide jobs for employees, pay taxes, and generate funds for expansion. Management of the enterprise also needs information about economic progress to plan operations and evaluate progress in comparison with previously established goals. To survive, the enterprise needs some minimum level of success in its profit-directed activities over the long run.

79. A related general objective is to provide financial information that assists in estimating the earning potential of the enterprise. Information about the past and present may help users of the information in making predictions. Trend figures usually (though not invariably) are better aids to prediction than the results of a single year. Extrapolations of financial data, however, should be made only in conjunction with the best additional information available about the enterprise, its circumstances, and its prospects.

80. Another general objective is to provide other needed information about changes in economic resources and obligations. Examples are information about changes in residual interest from sources other than profit-directed activities and information about working capital or fund flows.

81. A further general objective is to disclose, to the extent possible, other information related to the financial statements that is relevant to statement users' needs. Examples of disclosures of this type are information about the enterprise's accounting policies, such as depreciation and inventory methods, and information about contingent obligations of the enterprise.

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[21] The term *profit-directed activities* is used in this Statement to refer to all activities of an enterprise except transfers between the enterprise and its owners.

82. Underlying the preceding discussion is the recognition that decisions of financial statement users involve the process of choosing among alternative courses of action. Owners make choices on whether to increase, retain, or dispose of holdings in various enterprises. Creditors often must choose between enterprises in deciding whether to extend credit. Management makes choices, for example, between alternative business activities and between alternative investments. Generally, statement users compare performance both between enterprises and over two or more reporting periods for the same enterprise. (See paragraphs 93 and 95 to 105 for a discussion of comparability in financial accounting.)

Discussion of General Objectives

83. The general objectives aid in improving accounting principles by relating the content of the information to the underlying activities of business enterprises and to the interests and needs of users of the information.

84. The general objectives do not specify which resources and obligations and changes should be measured and reported as assets, liabilities, revenue, and expenses in financial accounting. They contain no implication that assets and liabilities ideally should include *all* resources and obligations or that *all* changes in assets and liabilities ideally should be reported.[22] Furthermore, they do not specify how the resources and obligations to be recorded should be measured. A complementary set of objectives, the qualitative objectives, aid in determining which resources and obligations and changes should be measured and reported and how they should be measured and reported to make the information most useful.

QUALITATIVE OBJECTIVES

85. Certain qualities or characteristics make financial information useful. Providing information that has each of these

[22] Not all resources and obligations and changes in them are presently reported. For example, rights under executory contracts, obligations whose amounts are indeterminate, and changes in market price of productive resources are generally not recorded as assets, liabilities, revenue, and expenses, although they may be disclosed. (See Chapters 6-8 on generally accepted accounting principles.)

qualities is an objective of financial accounting. These qualitative objectives are at least partially achieved at present, although improvement is probably possible in connection with each of them. Constraints on full achievement of the qualitative objectives are caused by conflicts of objectives, by environmental influences, and by lack of complete understanding of the objectives (see paragraphs 110 to 113).

86. The qualitative objectives are related to the broad ethical goals of truth, justice, and fairness that are accepted as desirable goals by society as a whole. To the extent that the objectives are met, progress is made toward achieving the broad ethical goals as well as toward making financial information more useful. The qualitative objectives are less abstract than the ethical goals of truth, justice, and fairness and can therefore be applied more directly to financial accounting. Nevertheless, they are also generalizations that require judgment in using them to evaluate and improve accounting principles.

Statement of the Qualitative Objectives

87. The Board believes that financial accounting has seven qualitative objectives (0-1 to 0-7). The primary qualitative objective is relevance.

88. 0-1. *Relevance.* Relevant financial accounting information bears on the economic decisions for which it is used.

The objective of relevance helps in selecting methods of measuring and reporting in financial accounting that are most likely to aid users in making the types of economic decisions for which they use financial accounting data.[23] In judging relevance of general-purpose information attention is focused on the common needs of users and not on specific needs of particular users. A vital task is to determine these common needs and the information that is relevant to them (see paragraphs 46 and 48). Relevance is the primary qualitative objective because information that does not bear on the decisions for which it is used is useless, regardless of the extent to which it satisfies the other objectives.

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[23] See discussion on uses and users in Chapter 3, paragraphs 43-48.

89. 0-2. *Understandability.* Understandable financial accounting information presents data that can be understood by users of the information and is expressed in a form and with terminology adapted to the users' range of understanding.

Understandability is important because accounting information must be intelligible if it is to be useful. Users of financial statements can understand the information only if the data presented and their method of presentation are meaningful to them. Understandability also requires that the users have some understanding of the complex economic activities of enterprises, the financial accounting process, and the technical terminology used in financial statements.

90. 0-3. *Verifiability.* Verifiable financial accounting information provides results that would be substantially duplicated by independent measurers using the same measurement methods.

Measurements cannot be completely free from subjective opinions and judgments. The process of measuring and presenting information must use human agents and human reasoning and therefore is not founded solely on an "objective reality." Nevertheless, the usefulness of information is enhanced if it is verifiable, that is, if the attribute or attributes selected for measurement and the measurement methods used provide results that can be corroborated by independent measurers.

91. 0-4. *Neutrality.* Neutral financial accounting information is directed toward the common needs of users and is independent of presumptions about particular needs and desires of specific users of the information.

Measurements not based on presumptions about the particular needs of specific users enhance the relevance of the information to common needs of users. Preparers of financial accounting information should not try to increase the helpfulness of the information to a few users to the detriment of others who may have opposing interests.

92. 0-5. *Timeliness.* Timely financial accounting information is communicated early enough to be used for the

economic decisions which it might influence and to avoid delays in making those decisions.

93. 0-6. *Comparability.* Comparable financial accounting information presents similarities and differences that arise from basic similarities and differences in the enterprise or enterprises and their transactions and not merely from differences in financial accounting treatments.

Problems in achieving comparability are discussed in paragraphs 95 to 105.

94. 0-7. *Completeness.* Complete financial accounting information includes all financial accounting data that reasonably fulfill the requirements of the other qualitative objectives (0-1 to 0-6).

The first six qualitative objectives specify qualities that are desirable in reported financial information. The objective of completeness specifies that all information that has the six qualities in reasonable degree should be reported.

Comparability

95. Comparability means the ability to bring together for the purpose of noting points of likeness and difference. Comparability of financial information generally depends on like events being accounted for in the same manner. Comparable financial accounting information facilitates conclusions concerning relative financial strengths and weaknesses and relative success, both between periods for a single enterprise and between two or more enterprises.

96. *Comparability Within a Single Enterprise.* A comparison of the financial statements of one enterprise at one date or for one period of time with those of the same enterprise at other dates or for other periods of the same length is more informative if the following conditions exist:

(1) The presentations are in the same form—that is, the arrangement within the statements is identical.

(2) The content of the statements is identical—that is, the same items from the underlying accounting records are classified under the same captions.

(3) Accounting principles are not changed or, if they are changed, the financial effects of the changes are disclosed.

(4) Changes in circumstances or in the nature of the underlying transactions are disclosed.

97. If these four conditions are satisfied, a comparison of the financial statements furnishes useful information about differences in the results of operations for the periods involved or in the financial positions at the dates specified. To the extent, however, that any one of the conditions is not met, comparisons may be misleading.

98. *Consistency*—Consistency is an important factor in comparability within a single enterprise. Although financial accounting practices and procedures are largely conventional, consistency in their use permits comparisons over time. If a change of practice or procedure is made, disclosure of the change and its effect permits some comparability, although users can rarely make adjustments that make the data completely comparable.

99. *Regular reporting periods*—Regular reporting periods are also an important factor in comparability within a single enterprise. Periods of equal length facilitate comparisons between periods. Comparing the results of periods shorter than a year, even though the periods are of equal length, however, may require consideration of seasonal factors.

100. *Comparability Between Enterprises.* Comparability between enterprises is more difficult to attain than comparability within a single enterprise. Widespread public interest in investment opportunities in recent years has focused attention on the desirability of achieving greater comparability of financial statements.

101. To make comparisons between enterprises as meaningful as possible, the four conditions outlined in paragraph 96 as well as other conditions should be satisfied. The most important of the other conditions is that, ideally, differences between enterprises' financial statements should arise from basic differences in the enterprises themselves or from the nature of their transactions and not merely from differences in financial accounting practices and procedures. One of the most important

unsolved problems at present, therefore, is the general acceptance of alternative accounting practices under circumstances which themselves do not appear to be sufficiently different to justify different practices.

102. Achieving comparability between enterprises depends on accomplishing two difficult tasks: (1) identifying and describing the circumstances that justify or require the use of a particular accounting practice or method, (2) eliminating the use of alternative practices under these circumstances. If these tasks can be accomplished, basic differences under which enterprises operate can be reflected by appropriate, and possibly different, practices.

103. Pending accomplishment of these tasks, users of financial statements should recognize that financial statements of different enterprises may not be fully comparable; that is, they may to an unknown extent reflect differences unrelated to basic differences in the enterprises and in their transactions. Evaluation of differences is not completely effective in the absence of criteria governing the applicability of various practices and methods.

104. Supplemental disclosures are sometimes directed toward overcoming this present weakness in financial reporting, but disclosure does not necessarily make financial statements comparable. For example, a statement user may not safely assume that he has made comparable the financial statements of two enterprises which use different accounting methods even though he has been able to put them on the same inventory or depreciation method through the use of disclosed information, because the circumstances may differ to such an extent that similar methods may not be appropriate.

105. The Accounting Principles Board and others in the accounting profession are continuing to work on problems of comparability between enterprises. The Board has, for example, developed criteria for application of practices and procedures in some problem areas and expects to deal with others in the future. The great variety of business enterprises and the large number of different circumstances in which enterprises operate, even within the same industry, make the task

a difficult one. The Board ranks comparability among the most important of the objectives of financial accounting, however, and is attempting to narrow areas of difference in accounting practices that are not justified by differences in circumstances.

Adequate Disclosure

106. Financial information that meets the qualitative objectives of financial accounting also meets the reporting standard of adequate disclosure.[24] Adequate disclosure relates particularly to objectives of relevance, neutrality, completeness, and understandability. Information should be presented in a way that facilitates understanding and avoids erroneous implications. The headings, captions, and amounts must be supplemented by enough additional data so that their meaning is clear but not by so much information that important matters are buried in a mass of trivia.

Reliability of Financial Statements

107. Achievement of the qualitative objectives of financial accounting enhances the reliability of financial statements. Reliability of information is important to users because decisions based on the information may affect their economic well-being. Reliability does not imply precision of the information in financial statements because financial accounting involves approximation and judgment (see paragraphs 123 and 124).

108. The responsibility for the reliability of an enterprise's financial statements rests with its management. This responsibility is discharged by applying generally accepted accounting principles that are appropriate to the enterprise's circumstances, by maintaining effective systems of accounts and internal control, and by preparing adequate financial statements.

109. The users of financial statements also look to the reports of independent auditors to ascertain that the financial statements have been examined by independent experts who have expressed their opinion as to whether or not the information

[24] Statements on Auditing Procedure No. 33, *Auditing Standards and Procedures*, p. 16.

is presented fairly in conformity with generally accepted accounting principles consistently applied.

ACHIEVING THE OBJECTIVES

110. The objectives of financial accounting and financial statements are at least partially achieved at present, although improvement is probably possible in connection with each of them. The objectives are often difficult to achieve, however, and are usually not equally capable of attainment. Constraints on full achievement of the objectives arise from (1) conflicts of objectives, (2) environmental influences, and (3) lack of complete understanding of the objectives.

111. The pursuit of one objective or one set of objectives may conflict with the pursuit of others. It is not always possible, for example, to have financial statements that are highly relevant on the one hand and also timely on the other. Nor is it always possible to have financial accounting information that is both as verifiable and as relevant as desired. Only if all other objectives are not affected will a change in information that increases compliance with one objective be certain to be beneficial. Conflicts between qualitative objectives might be resolved by arranging the objectives in order of relative importance and determining desirable trade-offs, but, except for the primacy of relevance, neither accountants nor users now agree as to their relative importance. Determining the trade-offs that are desirable requires judgment.

112. Constraints on achieving the objectives may stem from influences of the environment on accounting. First, the objectives, which are based largely on the needs of users of financial information, are not necessarily compatible with environmental influences. The inherent difficulties of measurement in terms of money, for example, mean that information produced by accounting will necessarily fall short to some extent of objectives of verifiability and comparability. Second, financial accounting costs money. Anticipated benefits from proposed changes in financial accounting information that are intended to better achieve the objectives must be weighed against the additional cost involved. Finally, changing financial account-

ing practices to better achieve the objectives involves user costs and dislocations that may tend to offset the advantages to be obtained. For example, changing practices may affect business arrangements that were initiated on the basis of practices before the change. Also, the costs of learning how to use new types of information and the reluctance to change ways of using information may reduce the benefits otherwise obtainable from improvements.

113. The Board believes that the objectives discussed in this chapter are helpful in evaluating and improving financial accounting information even though they are stated in general terms. Obtaining clearer understanding of the nature and implications of the objectives is an important prerequisite to further improvement of financial accounting and financial statements.

Chapter 5

BASIC FEATURES AND BASIC ELEMENTS OF FINANCIAL ACCOUNTING

BASIC FEATURES OF FINANCIAL ACCOUNTING

114. The basic features of financial accounting are a distillation of the effects of environmental characteristics (described in Chapter 3) on the financial accounting process. These features underlie present generally accepted accounting principles, discussed in Chapters 6 to 8, but they could also serve as a foundation for other accounting principles that are based on the same environmental characteristics.

Statement of the Basic Features of Financial Accounting

115. The following thirteen statements (F-1 to F-13) describe the basic features of financial accounting. Each statement contains a parenthetical reference to environmental characteristics from which it is, at least in part, derived.

116. F-1. *Accounting entity.* Accounting information pertains to entities, which are circumscribed areas of interest. In financial accounting the entity is the specific business enterprise. The enterprise is identified in its financial statements. (Paragraphs 51, 56)

Attention in financial accounting is focused on the economic activities of individual business enterprises. The boundaries of the accounting entity may not be the same as those of the legal entity, for example, a parent corporation and its subsidiaries treated as a single business enterprise.

117. F-2. *Going concern.* An accounting entity is viewed as continuing in operation in the absence of evidence to the contrary.[25] (Paragraph 55)

Because of the relative permanence of enterprises, financial accounting is formulated basically for going concerns. Past experience indicates that continuation of operations is highly probable for most enterprises although continuation cannot be known with certainty. An enterprise is not viewed as a going concern if liquidation appears imminent.

118. F-3. *Measurement of economic resources and obligations.* Financial accounting is primarily concerned with measurement of economic resources and obligations and changes in them. (Paragraphs 49, 56-58, 61-63, 66)

The subject matter of financial accounting is economic activity and financial accounting therefore involves measuring and reporting on the creation, accumulation, and use of economic resources. Economic activities that can be quantified are emphasized in financial accounting. Accounting does not deal directly with subjective concepts of welfare or satisfactions; its focus is not sociological or psychological.

119. F-4. *Time periods.* The financial accounting process provides information about the economic activities of an enterprise for specified time periods that are shorter than the life of the enterprise. Normally the time periods are of equal length to facilitate comparisons. The time period is identified in the financial statements. (Paragraphs 52, 54-55, 67)

Interested parties make evaluations and decisions at many points in the lives of enterprises. The continuous activities of enterprises are therefore segmented into relatively short periods of time so that information can be prepared that will be useful in decisions.

120. F-5. *Measurement in terms of money.* Financial accounting measures monetary attributes of eco-

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[25] The corollary observation is that if liquidation appears imminent, financial information may be prepared on the assumption that liquidation will occur.

nomic resources and obligations and changes in them. The unit of measure is identified in the financial statements. (Paragraphs 51, 56, 66, 69-70)

Measurement in terms of money focuses attention on monetary attributes of resources and obligations; other aspects, such as physical attributes, are not emphasized. Money measurement entails significant problems (see paragraphs 67, 68, and 72).

121. F-6. *Accrual.* Determination of periodic income and financial position depends on measurement of economic resources and obligations and changes in them as the changes occur rather than simply on recording receipts and payments of money. (Paragraphs 56, 59-61, 63, 66, 68, 70)

Enterprise economic activity in a short period seldom follows the simple form of a cycle from money to productive resources to product to money. Instead, continuous production, extensive use of credit and long-lived resources, and overlapping cycles of activity complicate the evaluation of periodic activities. As a result, noncash resources and obligations change in time periods other than those in which money is received or paid. Recording these changes is necessary to determine periodic income and to measure financial position. This is the essence of accrual accounting.

122. F-7. *Exchange price.* Financial accounting measurements are primarily based on prices at which economic resources and obligations are exchanged. (Paragraphs 51, 67, 69-72)

Measurement in terms of money is based primarily on exchange prices. Changes in resources from other than exchanges (for example, production) are measured by allocating prices in prior exchanges or by reference to current prices for similar resources. The multiple concepts of exchange price (paragraph 70) require decisions about the prices relevant to the uses of financial accounting information.

123. F-8. *Approximation.* Financial accounting measurements that involve allocations among relatively short periods of time and among complex and joint

activities are necessarily made on the basis of estimates. (Paragraphs 51-52, 54-55, 67, 72)

The continuity, complexity, uncertainty, and joint nature of results inherent in economic activity often preclude definitive measurements and make estimates necessary.

124. F-9. *Judgment.* Financial accounting necessarily involves informed judgment. (Paragraphs 43, 46-47, 54-55, 67-68, 71-72)

The estimates necessarily used in financial accounting (F-8) involve a substantial area of informed judgment. This precludes reducing all of the financial accounting process to a set of inflexible rules.

125. F-10. *General-purpose financial information.* Financial accounting presents general-purpose financial information that is designed to serve the common needs of owners, creditors, managers, and other users, with primary emphasis on the needs of present and potential owners and creditors. (Paragraphs 44-47, 63)

General-purpose financial statements are prepared by an enterprise under the presumption that users have common needs for information (see paragraph 46). Although special-purpose information may be prepared from financial accounting records, it is not the primary product of financial accounting and is not discussed in this Statement.

126. F-11. *Fundamentally related financial statements.* The results of the accounting process are expressed in statements of financial position and changes in financial position, which are based on the same underlying data and are fundamentally related. (Paragraphs 61, 63, 68)

The basic interrelationships between economic resources and economic obligations and changes in them make measurement of periodic net income and of assets and liabilities part of the same process and require that the financial statements be fundamentally related. The measurement bases used to quantify changes in financial position are necessarily related to the measurement bases of the resources and obligations used in representations of financial position.

127. F-12. *Substance over form.* Financial accounting emphasizes the economic substance of events even though the legal form may differ from the economic substance and suggest different treatment. (Paragraphs 41, 64, 66)

Usually the economic substance of events to be accounted for agrees with the legal form. Sometimes, however, substance and form differ. Accountants emphasize the substance of events rather than their form so that the information provided better reflects the economic activities represented.

128. F-13. *Materiality.* Financial reporting is only concerned with information that is significant enough to affect evaluations or decisions. (Paragraphs 43-45)

Basic Features and the Environment

129. The basic features of financial accounting described above are the result of environmental factors and influence the financial accounting process. The relationships between the features and the environment and among the features themselves are complex. The relationships between environmental conditions and the basic features of financial accounting can be illustrated with examples. The importance of money in a highly developed economy is the basis for the feature of measurement in terms of money (F-5). The complexity and continuity of economic activity, the joint nature of economic results, and the uncertain outcome of economic activity are important factors in the features of approximation (F-8) and judgment (F-9).

BASIC ELEMENTS OF FINANCIAL ACCOUNTING

130. The basic elements of financial accounting—assets, liabilities, owners' equity, revenue, expenses, and net income (net loss)—are related to the economic resources, economic obligations, residual interest, and changes in them which are discussed in Chapter 3. Not all economic resources and obligations and changes in them are recognized and measured in financial

accounting. The objectives of financial accounting (Chapter 4) provide broad criteria that aid in selecting economic resources, obligations, and changes in them for recognition and measurement. The basic features are additional factors in determining which economic elements and changes in them are recognized and measured. The particular economic elements and changes to be recognized and measured at any time as the basic elements of financial accounting are determined by generally accepted accounting principles in effect at that time. The basic elements of financial accounting therefore are defined in terms of both (1) economic resources and obligations of enterprises, and (2) generally accepted accounting principles.

131. Because generally accepted accounting principles change, the concepts of assets, liabilities, owners' equity, revenue, expenses, and net income also change, subject to the constraints of the economic elements referred to in their definitions. The definitions themselves, therefore, provide criteria for determining those economic resources, economic obligations, and changes in them that *are* included in the basic elements at any particular time but do not provide criteria for determining from a broader or longer-range perspective those economic elements that *should be* included in the basic elements. Under the definitions given, determining the items that should be included in the basic elements is part of the overall problem of determining what generally accepted accounting principles should be. Criteria intended to help solve that problem are provided by the general and qualitative objectives of financial accounting and financial statements (Chapter 4).

Financial Position

132. The basic elements of the financial position of an enterprise are assets, liabilities, and owners' equity:

Assets—economic resources of an enterprise that are recognized and measured in conformity with generally accepted accounting principles. Assets also include certain deferred charges that are not resources[26] but that are recognized and

[26] Deferred charges from income tax allocation are an example of deferred charges that are not resources. The term *deferred charges* is also sometimes used to refer to certain resources, for example, prepaid insurance.

measured in conformity with generally accepted accounting principles.[27]

Liabilities—economic obligations of an enterprise that are recognized and measured in conformity with generally accepted accounting principles. Liabilities also include certain deferred credits that are not obligations[28] but that are recognized and measured in conformity with generally accepted accounting principles.[29]

Owners' equity—the interest of owners in an enterprise, which is the excess of an enterprise's assets over its liabilities.[30]

Owners' equity is defined in terms of assets and liabilities, just as residual interest is defined in terms of economic resources and obligations (see paragraph 59). The relationship among assets, liabilities, and owners' equity implicit in the definition of owners' equity is:

Assets — Liabilities = Owners' Equity[31]

133. The *financial position* of an enterprise at a particular time comprises its assets, liabilities, and owners' equity and the relationship among them, plus those contingencies, commitments, and other financial matters that pertain to the enterprise at that time and are required to be disclosed under generally accepted accounting principles. The financial position of an

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[27] This definition differs from that in Accounting Terminology Bulletin No. 1, paragraph 26, which defines assets as debit balances carried forward upon a closing of books of account that represent property values or rights acquired.

[28] Deferred credits from income tax allocation are an example of deferred credits that are not obligations. The term *deferred credits* is also sometimes used to refer to certain obligations, for example, subscriptions collected in advance.

[29] This definition differs from that in Accounting Terminology Bulletin No. 1, paragraph 27, in that (1) it defines liabilities primarily in terms of obligations rather than as credit balances carried forward upon closing the books, and (2) it excludes capital stock and other elements of owners' equity.

[30] This definition isolates owners' equity as a separate element. Owners' equity is included in the definition of liabilities in Accounting Terminology Bulletin No. 1, paragraph 27. Owners' equity is conventionally classified into several categories, see paragraph 198.

[31] Expressing the relationship in a mathematical equation goes beyond descriptions of terms and assumes appropriate measurement. Measurement of economic activity is discussed in paragraphs 66-72.

enterprise is presented in the *balance sheet*[32] and in notes to the financial statements.

Results of Operations

134. The basic elements of the results of operations of an enterprise are revenue, expenses, and net income:

Revenue—gross increases in assets or gross decreases in liabilities recognized and measured in conformity with generally accepted accounting principles that result from those types of profit-directed activities[33] of an enterprise that can change owners' equity.[34]

Increases in assets and decreases in liabilities designated as revenue are related to changes in resources and obligations discussed in paragraph 61. Revenue does not, however, include all recognized increases in assets or decreases in liabilities. Revenue results only from those types of profit-directed activities that can change owners' equity under generally accepted accounting principles. Receipt of the proceeds of a cash sale is revenue under present generally accepted accounting principles, for example, because the net result of the sale is a change in owners' equity.[35] On the other hand, receipt of the proceeds of a loan or receipt of an asset purchased for cash, for example, is not revenue under present generally accepted accounting principles because owners' equity can not change at the time of the loan or purchase.

Expenses—gross decreases in assets or gross increases in liabilities recognized and measured in conformity with gener-

[32] The definition of balance sheet in this paragraph differs from that in Accounting Terminology Bulletin No. 1, paragraph 21, in that it defines the content in terms of assets, liabilities, and owners' equity, rather than balances carried forward after closing books kept according to principles of accounting.

[33] See paragraph 78, footnote 21, for the definition of profit-directed activities.

[34] The definition of revenue in this paragraph differs from that in Accounting Terminology Bulletin No. 2, paragraphs 5-7, in that (1) it emphasizes the nature of revenue rather than the usual point of recognition—the sale, (2) it includes the proceeds rather than only the gain from sale or exchange of assets "other than stock in trade." Gain is defined in this Statement as a net concept, the result of deducting expenses from revenue. See paragraph 198 for a discussion of gains in financial accounting.

[35] If by coincidence the proceeds of a sale are equal to the cost and owners' equity does not change, receipt of the proceeds is nevertheless revenue because a sale is a type of event in which owners' equity can change under present generally accepted accounting principles.

ally accepted accounting principles that result from those types of profit-directed activities of an enterprise that can change owners' equity.[36]

Decreases in assets and increases in liabilities designated as expenses are related to changes in resources and obligations discussed in paragraph 61. Expenses, like revenue, result only from those types of profit-directed activities that can change owners' equity under generally accepted accounting principles. Delivery of product in a sale is an expense under present generally accepted accounting principles, for example, because the net result of the sale is a change in owners' equity. On the other hand, incurring a liability for the purchase of an asset is not an expense under present generally accepted accounting principles because owners' equity can not change at the time of the purchase.

Net income (net loss)—the excess (deficit) of revenue over expenses for an accounting period, which is the net increase (net decrease) in owners' equity (assets minus liabilities) of an enterprise for an accounting period from profit-directed activities that is recognized and measured in conformity with generally accepted accounting principles.

The relationship among revenue, expenses, and net income (net loss) implicit in the definition of net income (net loss) is:

Revenue — Expenses = Net Income (Net Loss)[37]

135. The *results of operations* of an enterprise for a period of time comprises the revenue, expenses, and net income (net loss) of the enterprise for the period. The results of operations of an enterprise is presented in the *income statement.*

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[36] This definition of expenses differs from that given in Accounting Terminology Bulletin No. 4, paragraphs 3-4, and 6. It is similar to the "broad" definition in the Terminology Bulletin except that it includes the cost of assets "other than stock in trade" disposed of rather than only the loss (see paragraph 198 for a discussion of losses in financial accounting). The "narrow" definition of expenses recommended in the Terminology Bulletin for use in financial statements excludes "cost of goods or services sold" from expenses and is incompatible with the definition in this Statement. Expense in this "narrow" sense should always be modified by appropriate qualifying adjectives, for example, *selling and administrative expense* or *interest expense.*

[37] Expressing the relationship in a mathematical equation goes beyond descriptions of terms and assumes appropriate measurement. Measurement of economic activity is discussed in paragraphs 66-72.

Interrelationship of Financial Position and Results of Operations

136. The financial position and results of operations of an enterprise are fundamentally related. Net income (net loss) for an accounting period, adjustments of income of prior periods, and investments and withdrawals by owners during the period constitute the change during the period in owners' equity, an element of financial position. Other relationships between the income statement and the balance sheet, for example, the relationship of cost of goods sold to inventory and of depreciation to fixed assets, are further indications of the interrelatedness of the statements.

Chapter 6

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES—PERVASIVE PRINCIPLES

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

137. Financial statements are the product of a process in which a large volume of data about aspects of the economic activities of an enterprise are accumulated, analyzed, and reported. This process should be carried out in accordance with generally accepted accounting principles. Generally accepted accounting principles incorporate the consensus[38] at a particular time as to which economic resources and obligations should be recorded as assets and liabilities by financial accounting, which changes in assets and liabilities should be recorded, when these changes should be recorded, how the assets and liabilities and changes in them should be measured, what information should be disclosed and how it should be disclosed, and which financial statements should be prepared.

138. *Generally accepted accounting principles* therefore is a technical term in financial accounting. Generally accepted accounting principles encompass the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. The standard[39] of "generally accepted ac-

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[38] Inasmuch as generally accepted accounting principles embody a consensus, they depend on notions such as *general acceptance* and *substantial authoritative support,* which are not precisely defined. The Securities and Exchange Commission indicated in Accounting Series Release No. 4 that when financial statements are "prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate. . . ." The AICPA Special Committee on Opinions of the Accounting Principles Board defines *generally accepted accounting principles* as those "having substantial authoritative support." Problems in defining substantial authoritative support are discussed in Marshall Armstrong, "Some Thoughts on Substantial Authoritative Support," *The Journal of Accountancy,* April 1969, pp. 44-50.

[39] The independent auditor's report gives the auditor's opinion as to whether the financial statements "present fairly the financial position . . . and the results of . . . operations, in conformity with generally accepted accounting principles. . . ."

counting principles" includes not only broad guidelines of general application, but also detailed practices and procedures.[40]

139. Generally accepted accounting principles are conventional—that is, they become generally accepted by agreement (often tacit agreement) rather than by formal derivation from a set of postulates or basic concepts. The principles have developed on the basis of experience, reason, custom, usage, and, to a significant extent, practical necessity.

140. In recent years Opinions of the Accounting Principles Board have received considerable emphasis as a major determinant of the composition of generally accepted accounting principles. All of the Accounting Research Bulletins and the early Opinions of the Accounting Principles Board include the statement that ". . . the authority of the bulletins [or Opinions] rests upon their general acceptability. . . ." Beginning with Opinion No. 6 (October 1965), however, Opinions of the Accounting Principles Board include a statement to reflect the adoption in October 1964 by Council of the American Institute of Certified Public Accountants of a resolution that provides in essence that accounting principles accepted in Opinions of the Accounting Principles Board constitute, per se, generally accepted accounting principles for Institute members. The Council also recognizes that accounting principles that differ from those accepted in Opinions of the Accounting Principles Board can have substantial authoritative support and, therefore, can also be considered to be generally accepted accounting principles.

141. In this Statement the discussion of present generally accepted accounting principles is divided into three sections: (1) pervasive principles, which relate to financial accounting as a whole and provide a basis for the other principles, (2) broad operating principles, which guide the recording, measuring, and communicating processes of financial accounting, and (3) detailed principles, which indicate the practical application

[40] "The term 'principles of accounting' as used in reporting standards is construed to include not only accounting principles and practices but also the methods of applying them." Statements on Auditing Procedure No. 33, *Auditing Standards and Procedures*, p. 40.

of the pervasive and broad operating principles. This classification provides a useful framework for analysis, although the distinctions between the types of principles, especially between the broad operating and detailed principles, are somewhat arbitrary. This chapter discusses the pervasive principles. The broad operating and detailed principles are discussed in Chapters 7 and 8, respectively.

142. The three types of principles form a hierarchy. The pervasive principles are few in number and fundamental in nature. The broad operating principles derived from the pervasive principles are more numerous and more specific, and guide the application of a series of detailed principles. The detailed principles are numerous and specific. Detailed principles are generally based on one or more broad operating principles and the broad operating principles are generally based on the pervasive principles. No attempt is made in this Statement to indicate specific relationships between principles.

PERVASIVE PRINCIPLES

143. The pervasive principles specify the general approach accountants take to recognition and measurement of events that affect the financial position and results of operations of enterprises. The pervasive principles are divided into (1) pervasive measurement principles and (2) modifying conventions.

Pervasive Measurement Principles

144. The pervasive measurement principles (P-1 to P-6) establish the basis for implementing accrual accounting. They include the initial recording principle, the realization principle, three pervasive expense recognition principles, and the unit of measure principle. These principles broadly determine (1) the types of events to be recognized by financial accounting, (2) the bases on which to measure the events, (3) the time periods with which to identify the events, and (4) the common denominator of measurement.

145. *Initial Recording.* The principle for initial recording of assets and liabilities is important in financial accounting because it determines (1) the data that enter the accounting process,

(2) the time of entry, and (3) generally the amounts at which assets, liabilities, revenue, and expenses are recorded.

P-1. *Initial recording of assets and liabilities.* Assets and liabilities generally are initially recorded on the basis of events in which the enterprise acquires resources from other entities or incurs obligations to other entities.[41] The assets and liabilities are measured by the exchange prices[42] at which the transfers take place.

146. The initial recording of assets and liabilities may also reflect the elimination of other assets or liabilities, for example, the payment of cash in acquiring equipment. The amounts at which assets and liabilities are initially recorded may be carried without change, may be changed, for example, by amortization or write off, or may be shifted to other categories. The effects of transactions or other events to which the entity is not a party are usually not recognized in the accounting records until transactions of the enterprise occur, although there are significant exceptions to this general principle (see paragraph 183). The effects of executory contracts also are generally not recognized until one of the parties at least partially fulfills his commitment.

147. *Income Determination.*[43] Income determination in accounting is the process of identifying, measuring, and relating revenue and expenses of an enterprise for an accounting period. Revenue for a period is generally determined independently by applying the realization principle. Expenses are determined by applying the expense recognition principles on the basis of

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[41] This principle does not cover the first recording of assets produced or constructed by the enterprise from other assets that previously have been initially recorded. Accounting for produced or self-constructed assets is discussed in paragraph 159.

[42] In transfers that do not involve money prices, such as barter transactions or investments by owners, assets are usually measured at "fair value," that is, at the amount of money that would be involved if the assets were received in exchanges that involved money prices. For exceptions to this general rule see paragraph 182, M-2B and M-2C.

[43] The term *matching* is often used in the accounting literature to describe the entire process of income determination. The term is also often applied in accounting, however, in a more limited sense to the process of expense recognition or in an even more limited sense to the recognition of expenses by associating costs with revenue on a cause and effect basis (see paragraph 157). Because of the variety of its meanings, the term *matching* is not used in this Statement.

relationships between acquisition costs[44] and either the independently determined revenue or accounting periods. Since the point in time at which revenue and expenses are recognized is also the time at which changes in amounts of net assets are recognized, income determination is interrelated with asset valuation. From the perspective of income determination, costs are divided into (1) those that have "expired" and become expenses and (2) those that are related to later periods and are carried forward as assets in the balance sheet. From the perspective of asset valuation, those costs that no longer meet the criteria of assets become expenses and are deducted from revenue in determining net income.

148. *Revenue and Realization.* Revenue is a gross increase in assets or a gross decrease in liabilities recognized and measured in conformity with generally accepted accounting principles that results from those types of profit-directed activities of an enterprise that can change owners' equity (see paragraph 134). Revenue under present generally accepted accounting principles is derived from three general activities: (a) selling products, (b) rendering services and permitting others to use enterprise resources, which result in interest, rent, royalties, fees, and the like, and (c) disposing of resources other than products—for example, plant and equipment or investments in other entities. Revenue does not include receipt of assets purchased, proceeds of borrowing, investments by owners, or adjustments of revenue of prior periods.

149. Most types of revenue are the joint result of many profit-directed activities of an enterprise and revenue is often described as being "earned" gradually and continuously by the whole of enterprise activities. *Earning* in this sense is a technical term that refers to the activities that give rise to the revenue—purchasing, manufacturing, selling, rendering service, delivering goods, allowing other entities to use enterprise assets, the occurrence of an event specified in a contract, and so forth. All of the profit-directed activities of an enterprise that com-

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[44] See paragraph 65 for a general discussion of the term *cost* and paragraph 164 for a discussion of the meaning of the term *cost* under present generally accepted accounting principles.

prise the process by which revenue is earned may be called the *earning process.*

150. Revenue is conventionally recognized at a specific point in the earning process of a business enterprise, usually when assets are sold or services are rendered. This conventional recognition is the basis of the pervasive measurement principle known as realization.

> P-2. *Realization.* Revenue is generally recognized when both of the following conditions are met: (1) the earning process is complete or virtually complete, and (2) an exchange has taken place.

151. The exchange required by the realization principle determines both the time at which to recognize revenue and the amount at which to record it. Revenue from sales of products is recognized under this principle at the date of sale, usually interpreted to mean the date of delivery to customers. Revenue from services rendered is recognized under this principle when services have been performed and are billable. Revenue from permitting others to use enterprise resources, such as interest, rent, and royalties is also governed by the realization principle. Revenue of this type is recognized as time passes or as the resources are used. Revenue from sales of assets other than products is recognized at the date of sale. Revenue recognized under the realization principle is recorded at the amount received or expected to be received.

152. Revenue is sometimes recognized on bases other than the realization rule. For example, on long-term construction contracts revenue may be recognized as construction progresses. This exception to the realization principle is based on the availability of evidence of the ultimate proceeds and the consensus that a better measure of periodic income results. Sometimes revenue is recognized at the completion of production and before a sale is made. Examples include certain precious metals and farm products with assured sales prices.[45] The assured price, the difficulty in some situations of determining costs of

[45] This increase in assets is often reported in the income statement as a reduction of cost of goods sold rather than as sales revenue.

products on hand, and the characteristic of unit interchangeability are reasons given to support this exception.

153. The realization principle requires that revenue be earned before it is recorded. This requirement usually causes no problems because the earning process is usually complete or nearly complete by the time of the required exchange. The requirement that revenue be earned becomes important, however, if money is received or amounts are billed in advance of the delivery of goods or rendering of services. For example, amounts for rent or magazine subscriptions received in advance are not treated as revenue of the period in which they are received but as revenue of the future period or periods in which they are "earned." These amounts are carried as "unearned revenue"—that is, liabilities to transfer goods or render services in the future—until the earning process is complete. The recognition of this revenue in the future period results in recording a decrease in a liability rather than an increase in an asset.

154. *Expense Recognition.* Expenses are gross decreases in assets or gross increases in liabilities recognized and measured in conformity with generally accepted accounting principles that result from those types of profit-directed activities of an enterprise that can change owners' equity (see paragraph 134). Important classes of expenses are (1) costs of assets used to produce revenue (for example, cost of goods sold, selling and administrative expenses, and interest expense), (2) expenses from nonreciprocal transfers and casualties (for example, taxes, fires, and theft), (3) costs of assets other than products (for example, plant and equipment or investments in other companies) disposed of, (4) costs incurred in unsuccessful efforts, and (5) declines in market prices of inventories held for sale. Expenses do not include repayments of borrowing, expenditures to acquire assets, distributions to owners (including acquisition of treasury stock), or adjustments of expenses of prior periods.

155. Expenses are the costs that are associated with the revenue of the period, often directly but frequently indirectly through association with the period to which the revenue has been assigned. Costs to be associated with future revenue or otherwise to be associated with future accounting periods are

deferred to future periods as assets. Costs associated with past revenue or otherwise associated with prior periods are adjustments of the expenses of those prior periods.[46] The expenses of a period are (a) costs directly associated with the revenue of the period, (b) costs associated with the period on some basis other than a direct relationship with revenue, and (c) costs that cannot, as a practical matter, be associated with any other period.

156. Three pervasive expense recognition principles specify the bases for recognizing the expenses that are deducted from revenue to determine the net income or loss of a period. They are "associating cause and effect," "systematic and rational allocation," and "immediate recognition."

157. P-3. *Associating cause and effect.*[47] Some costs are recognized as expenses on the basis of a presumed direct association with specific revenue.

Although direct cause and effect relationships can seldom be conclusively demonstrated, many costs appear to be related to particular revenue and recognizing them as expenses accompanies recognition of the revenue. Examples of expenses that are recognized by associating cause and effect are sales commissions and costs of products sold or services provided.

158. Several assumptions regarding relationships must be made to accumulate the costs of products sold or services provided. For example, manufacturing costs are considered to "attach" to products on bases of association such as labor hours, area or volume of facilities used, machine hours, or other bases presumed to indicate the relationship involved. "Attaching" costs to products often requires several allocations and reallocations of costs. Also, assumptions regarding the "flow" of costs or of physical goods (LIFO, FIFO, average) are often made to determine which costs relate to products sold and which remain in inventory as assets.

159. P-4. *Systematic and rational allocation.* In the absence of a direct means of associating cause and effect,

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[46] See paragraph 174.

[47] The term *matching* is often applied to this process (see paragraph 147, footnote 43).

some costs are associated with specific accounting periods as expenses on the basis of an attempt to allocate costs in a systematic and rational manner among the periods in which benefits are provided.

If an asset provides benefits for several periods its cost is allocated to the periods in a systematic and rational manner in the absence of a more direct basis for associating cause and effect. The cost of an asset that provides benefits for only one period is recognized as an expense of that period (also a systematic and rational allocation). This form of expense recognition always involves assumptions about the pattern of benefits and the relationship between costs and benefits because neither of these two factors can be conclusively demonstrated. The allocation method used should appear reasonable to an unbiased observer and should be followed systematically. Examples of items that are recognized in a systematic and rational manner are depreciation of fixed assets, amortization of intangible assets, and allocation of rent and insurance. Systematic and rational allocation of costs may increase assets as product costs or as other asset costs rather than increase expenses immediately, for example, depreciation charged to inventory and costs of self-constructed assets. These costs are later recognized as expenses under the expense recognition principles.

160. P-5. *Immediate recognition.* Some costs are associated with the current accounting period as expenses because (1) costs incurred during the period provide no discernible future benefits, (2) costs recorded as assets in prior periods no longer provide discernible benefits or (3) allocating costs either on the basis of association with revenue or among several accounting periods is considered to serve no useful purpose.

Application of this principle of expense recognition results in charging many costs to expense in the period in which they are paid or liabilities to pay them accrue. Examples include officers' salaries, most selling costs, amounts paid to settle lawsuits, and costs of resources used in unsuccessful efforts. The principle of immediate recognition also requires that items carried as assets in prior periods that are discovered to have no discernible future benefit be charged to expense, for example, a patent that is determined to be worthless.

161. *Application of Expense Recognition Principles.* To apply expense recognition principles, costs are analyzed to see whether they can be associated with revenue on the basis of cause and effect. If not, systematic and rational allocation is attempted. If neither cause and effect associations nor systematic and rational allocations can be made, costs are recognized as expenses in the period incurred or in which a loss is discerned. Practical measurement difficulties and consistency of treatment over time are important factors in determining the appropriate expense recognition principle.

162. *Effect of the Initial Recording, Realization, and Expense Recognition Principles.* The essential effect of these principles as they now exist is that measurement of the assets, liabilities, revenue, and expenses of a business enterprise is based primarily on its own exchanges. Resources and obligations that result from executory contracts are generally not recorded as assets and liabilities until one of the parties at least partially fulfills his commitment. Furthermore, not all changes in the utility or price of assets are recognized. Increases in assets and the related revenue are usually not recorded if they result from events wholly internal to the enterprise. For example, revenue that is earned during the production process is generally not recorded until the goods and services produced are exchanged. Also, increases or decreases in assets and related revenue and expenses that result from events in which the enterprise does not participate directly are usually not recorded.[48] For example, most changes in prices of productive resources are not recognized until enterprise transactions take place.

163. Under the initial recording, realization, and expense recognition principles assets are generally carried in the accounting records and presented in financial statements at acquisition cost or some unexpired or unamortized portion of it. When assets are sold, the difference between the proceeds

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[48] Exceptions include the cost or market rule for inventories (see paragraph 183).

realized and the unamortized portion of acquisition cost is recognized as an increase (or decrease) in the enterprise's net assets.

164. The initial recording and realization conventions are the basis for the "cost principle" (which is more accurately described as the acquisition-price or historical-cost rule). Cost can be defined in several ways—for example, as the amount of money that would be required to acquire assets currently (replacement cost) or as the return from alternative uses of assets, such as selling them (opportunity cost). However, "cost" at which assets are carried and expenses are measured in financial accounting today usually means historical or acquisition cost because of the conventions of initially recording assets at acquition cost and of ignoring increases in assets until they are exchanged (the realization convention).[49] The term *cost* is also commonly used in financial accounting to refer to the amount at which assets are initially recorded, regardless of how the amount is determined.

165. *Unit of Measure.* In the United States, the U. S. dollar fulfills the functions of medium of exchange, unit of account, and store of value. It provides the unit of measure for financial accounting. Stating assets and liabilities and changes in them in terms of a common financial denominator is prerequisite to performing the operations—for example, addition and subtraction—necessary to measure financial position and periodic net income.

166. Defining the unit of measure in terms of money presents problems because of decreases (inflation) or increases (deflation) in the general purchasing power of money over time. The effects of inflation in the United States are not considered sufficiently important at this time to require recognition in financial accounting measurements.

> P-6. *Unit of measure.* The U. S. dollar is the unit of measure in financial accounting in the United

[49] See paragraph 65 for a general discussion of the term *cost*. The discussions of cost in paragraphs 65 and 164 are broader than that in Accounting Terminology Bulletin No. 4, paragraph 2, which defines only historical or acquisition cost.

States. Changes in its general purchasing power are not recognized in the basic financial statements.

167. *Effect of the Unit of Measure Principle.* The basic effect of this principle is that financial accounting measures are in terms of numbers of dollars, without regard to changes in the general purchasing power of those dollars.

168. The unit of measure principle is applied together with the other pervasive measurement principles. Costs are therefore measured in terms of the number of dollars initially invested in assets. If moderate inflation or deflation persists for several years or if substantial inflation or deflation occurs over short periods, the general purchasing power of the dollars in which expenses are measured may differ significantly from the general purchasing power of the dollars in which revenue is measured. Methods of accounting which tend to minimize this effect in the determination of periodic income—most notably the last-in, first-out method of inventory pricing and accelerated depreciation of plant and equipment—have become generally accepted and widely used in the United States. Methods of restating financial statements for general price-level changes have been used in some countries that have experienced extreme inflation but are not now used in the basic financial statements in the United States.[50]

Modifying Conventions

169. The pervasive measurement principles are largely practical responses to problems of measurement in financial accounting and do not provide results that are considered satisfactory in all circumstances. Certain widely adopted conventions modify the application of the pervasive measurement principles. These modifying conventions, discussed in the following paragraphs, have evolved to deal with some of the most difficult and controversial problem areas in financial accounting. They are applied because rigid adherence to the pervasive measurement principles (1) sometimes produces results that are not con-

[50] Accounting Principles Board Statement No. 3, *Financial Statements Restated for General Price-Level Changes,* issued in June 1969, recommends supplementary disclosure of general price-level information.

sidered to be desirable, (2) may exclude from financial statements some events that are considered to be important, or (3) may be impractical in certain circumstances.

170. The modifying conventions are applied through generally accepted rules that are expressed either in the broad operating principles or in the detailed principles. The modifying conventions are a means of substituting the collective judgment of the profession for that of the individual accountant.

171. *Conservatism.* Frequently, assets and liabilities are measured in a context of significant uncertainties. Historically, managers, investors, and accountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets. This has led to the convention of conservatism, which is expressed in rules adopted by the profession as a whole such as the rules that inventory should be measured at the lower of cost and market and that accrued net losses should be recognized on firm purchase commitments for goods for inventory. These rules may result in stating net income and net assets at amounts lower than would otherwise result from applying the pervasive measurement principles.

172. *Emphasis on Income.* Over the past century businessmen, financial statement users, and accountants have increasingly tended to emphasize the importance of net income and that trend has affected the emphasis in financial accounting. Although balance sheets formerly were presented without income statements, the income statement has in recent years come to be regarded as the most important of the financial statements. Accounting principles that are deemed to increase the usefulness of the income statement are therefore sometimes adopted by the profession as a whole regardless of their effect on the balance sheet or other financial statements. For example, the last-in, first-out (LIFO) method of inventory pricing may result in balance sheet amounts for inventories that become further removed from current prices with the passage of time. LIFO, however, is often supported on the grounds that it usually produces an amount for cost of goods sold in determining net income that more closely reflects current prices. This result is

believed to compensate for the effect under the LIFO method of presenting inventories in the balance sheet at prices substantially different from current prices.

173. *Application of Judgment by the Accounting Profession as a Whole.* Sometimes strict adherence to the pervasive measurement principles produces results that are considered by the accounting profession as a whole to be unreasonable in the circumstances or possibly misleading. Accountants approach their task with a background of knowledge and experience. The perspective provided by this background is used as the basis for modifying accounting treatments when strict application of the pervasive measurement principles yields results that do not appear reasonable to the profession as a whole.

174. The exception to the usual revenue realization rule for long-term construction-type contracts, for example, is justified in part because strict adherence to realization at the time of sale would produce results that are considered to be unreasonable. The judgment of the profession is that revenue should be recognized in this situation as construction progresses. Similarly, the most meaningful concept of net income in the judgment of the profession is one that includes all items of revenue and expense recorded during the period except for certain items that can be clearly identified with prior periods under carefully specified conditions. Extraordinary items are segregated in the current income statement so that their effects can be distinguished. Also, avoiding undue effects on the net income of a single period is judged by the profession to be important in certain circumstances. For example, actuarial gains and losses recognized in accounting for pension cost may be spread over the current year and future years.

Chapter 7

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES—BROAD OPERATING PRINCIPLES

175. The broad operating principles guide in selecting, measuring, and reporting events in financial accounting. They are grounded in the pervasive principles discussed in Chapter 6 and are applied to specific situations through the detailed principles discussed in Chapter 8. The broad operating principles are broader and less specific than the detailed principles. For example, the detailed principle of first-in, first-out inventory pricing is one application of the broad operating principles of product cost determination and asset measurement, and straight-line depreciation is one of the detailed principles through which the broad operating principles that deal with systematic and rational expense allocation are applied. Although the broad operating principles are more specific than the pervasive principles, they are also generalizations. Consequently, exceptions to the broad operating principles may exist in the detailed principles through which they are applied.

176. The financial accounting process consists of a series of operations that are carried out systematically in each accounting period. The broad operating principles guide these operations. The operations are listed separately although they overlap conceptually and some of them may be performed simultaneously:

(1) *Selecting* the events. Events to be accounted for are identified. Not all events that affect the economic resources and obligations of an enterprise are, or can be, accounted for when they occur.

(2) *Analyzing* the events. Events are analyzed to determine their effects on the financial position of an enterprise.

(3) *Measuring* the effects. Effects of the events on the finan-

cial position of the enterprise are measured and represented by money amounts.

(4) *Classifying* the measured effects. The effects are classified according to the individual assets, liabilities, owners' equity items, revenue, or expenses affected.

(5) *Recording* the measured effects. The effects are recorded according to the assets, liabilities, owners' equity items, revenue, and expenses affected.

(6) *Summarizing* the recorded effects. The amounts of changes recorded for each asset, liability, owners' equity item, revenue, and expense are summed and related data are grouped.

(7) *Adjusting* the records. Remeasurements, new data, corrections, or other adjustments are often required after the events have been initially recorded, classified, and summarized.

(8) *Communicating* the processed information. The information is communicated to users in the form of financial statements.

The broad operating principles, which guide these eight operations, are divided into (1) principles of selection and measurement and (2) principles of financial statement presentation.

PRINCIPLES OF SELECTION AND MEASUREMENT

177. The principles of selection and measurement are conventions that (1) guide selection of events to be accounted for by an enterprise, (2) determine how selected events affect the assets, liabilities, owners' equity, revenue, and expenses of the enterprise, and (3) guide assignment of dollar amounts to the effects of these events. They are classified in this chapter according to the types of economic events that affect the economic resources, economic obligations, and residual interests of enterprises, as discussed in Chapter 3 (see paragraph 62). The types of events are

I. External Events
   A. Transfers of resources or obligations to or from other entities:
      1. Exchanges (reciprocal transfers)

2. Nonreciprocal transfers
   a. Transfers between an enterprise and its owners
   b. Nonreciprocal transfers between an enterprise and entities other than owners

B. External events other than transfers

II. Internal Events
   A. Production
   B. Casualties

Each type of event is explained briefly in the list of principles in paragraphs 181 to 185 and more fully in paragraph 62.

178. Additional principles other than those that guide recognition of events govern accounting for those assets and liabilities that are not resources and obligations (see paragraph 132) and the related revenue and expenses.

Measurement Bases

179. Four measurement bases are currently used in financial accounting: (1) price in a past exchange of the enterprise (historical cost), which is the primary basis of measurement in financial accounting and is usually used in measuring inventory, plant and equipment, and many other assets, (2) price in a current purchase exchange, used, for example, in applying the lower of cost and market rule to inventories, (3) price in a current sale exchange, which may be used, for example, in measuring precious metals that have a fixed monetary price with no substantial cost of marketing, and (4) price based on future exchanges, used, for example, to estimate future costs when revenue is recognized on the percentage-of-completion basis. The measurement bases are described more fully in paragraph 70.

STATEMENT OF THE PRINCIPLES OF SELECTION AND MEASUREMENT

180. The principles of selection and measurement are presented in three sections:

1. The principles of selection of events and the principles of measurement (assignment of dollar amounts) are pre-

sented together for each type of event in paragraphs 181 to 185. Principles of selection (S-1 to S-7) and measurement (M-1 to M-7) that deal with the same items are identified by the same number (e.g., S-4 and M-4). Other important principles that constitute amplifications of or exceptions to the general rule are listed under it and identified with the general principle (e.g., S-4A). The statement of a principle is followed by a short discussion if further clarification is needed.

2. Principles that govern accounting for those assets and liabilities that are not resources or obligations are discussed in paragraph 186.
3. The principles (E-1 to E-10) of determination of the effects of events on the basic elements are presented in paragraph 187.

Principles That Guide Selection of Events and Assignment of Dollar Amounts

I. *External Events*

A. *Transfers of Resources or Obligations to or from Other Entities*

181. 1. *Exchanges* are reciprocal transfers between the enterprise and other entities that involve obtaining resources or satisfying obligations by giving up other resources or incurring other obligations. Exchanges may take place over time rather than at points of time (for example, accumulations of interest and rent).

S-1. *Exchanges recorded.* Exchanges between the enterprise and other entities (enterprises or individuals) are generally recorded in financial accounting when the transfer of resources or obligations takes place or services are provided.

M-1. *Exchange prices.* The effects of exchanges on assets, liabilities, revenue, and expenses are measured at the prices established in the exchanges.

S-1A. *Acquisitions of assets.* Resources acquired in exchanges are recorded as assets of the enterprise. Some assets that are not carried forward to future periods are immediately charged to expense (see S-6C).

M-1A. *Acquisition cost of assets.* Assets acquired in exchanges are measured at the exchange price, that is, at acquisition cost. Money and money claims acquired are measured at their face amount or sometimes at their discounted amount.
Discussion. Cash, accounts receivable, and other short-term money claims are usually measured at their face amount. A long-term noninterest bearing note receivable is measured at its discounted amount.

M-1A(1). *Fair value.* In exchanges in which neither money nor promises to pay money are exchanged, the assets acquired are generally measured at the fair value of the assets given up. However, if the fair value of the assets received is more clearly evident, the assets acquired are measured at that amount.

Discussion. Fair value is the approximation of exchange price in transfers in which money or money claims are not involved. Similar exchanges are used to approximate what the exchange price would have been if an exchange for money had taken place. The recorded amount (as distinguished from the fair value) of assets given up in a trade is generally not used to measure assets acquired.

M-1A(2). *Acquisition of a group of assets in one exchange.* A group of assets acquired in a single exchange is measured at the exchange price. The total price is allocated to the individual assets based on their relative fair values.

Discussion. Fair value of assets acquired is used primarily as a device for allocating total cost, not as the measurement basis of the assets acquired.

M-1A(3). *Acquisition of a business in an exchange.* A business acquired in an exchange is measured at the exchange price. Each individual asset acquired (other than goodwill) is measured at its fair value. If the total exchange price exceeds the amounts assigned to the individual assets, the excess is recorded as goodwill. If the total amount assigned to individual assets exceeds the exchange price, the difference is recorded as a reduction of the amounts assigned to the assets (also see S-2A and S-2B).

S-1B. *Dispositions of assets.* Decreases in assets are recorded when assets are disposed of in exchanges.

M-1B. *Asset dispositions measured.* Decreases in assets are measured by the recorded amounts that relate to the assets. The amounts are usually the historical or acquisition costs of the assets (as adjusted for amortization and other changes).

Discussion. In partial dispositions, measurement of the amount removed is governed by detailed principles (e.g., first-in, first-out; last-in, first-out; and average cost for inventories) that are based on the presumed "flow" of goods or the presumed "flow" of costs.

S-1C. *Liabilities recorded.* Liabilities are recorded when obligations to transfer assets or provide services in the future are incurred in exchanges.

M-1C. *Amount of liabilities.* Liabilities are measured at amounts established in the exchanges, usually the amounts to be paid, sometimes discounted.

Discussion. Conceptually, a liability is measured at the amount of cash to be paid discounted to the time the liability is incurred. Most short-term liabilities are simply measured at the amount to be paid. Discounted present values are often used if the obligations require payments at dates that are relatively far in the future. Pension obligations and liabilities under capitalized long-term leases are measured at discounted amounts. Bonds and other long-term liabilities are in effect measured at the discounted amount of the future cash payments for interest and principal. The difference between the recorded amount of a liability and the amounts to be paid is amortized over the periods to maturity.

S-1D. *Liability decreases.* Decreases in liabilities are recorded when they are discharged through payments, through substitution of other liabilities, or otherwise.

M-1D. *Liability decrease measured.* Decreases in liabilities are measured by the recorded amounts that relate to the liabilities. A partial discharge of liabilities is measured at a proportionate part of the recorded amount of the liabilities.

S-1E. *Commitments.* Agreements for the exchange of resources in the future that at present are unfulfilled commitments on both sides are not recorded until one of the parties at least partially fulfills its commitment, except that (1) some leases and (2) losses on firm commitments are recorded.

Discussion. An exception to the general rule for recording exchanges is made for most executory contracts. An exchange of promises between the contracting parties is an exchange of something of value, but the usual view in accounting is that the promises are off-setting and nothing need be recorded until one or both parties at least partially perform(s) under the contract. The effects of some executory contracts, however, are recorded, for example, long-term leases that are recorded as assets by the lessee with a corresponding liability (see discussion after M-1C).

S-1F. *Revenue from exchanges.* Revenue is recorded when products are sold, services are provided, or enterprise resources are used by others. Revenue is also recorded when an enterprise sells assets other than products (usually presented as part of a gain or loss—see paragraph 198).

M-1F. *Revenue measurement.* Revenue from exchanges is initially measured at prices established in the exchanges. The revenue amounts are reduced (or expenses recorded) for discounts, returns, and allowances.

Discussion. Revenue is usually recognized at the time of exchanges in which cash is received or new claims arise against other entities. However, exceptions are made, for example, for certain products that have an assured selling price (see S-6D) and long-term construction-type contracts (see S-6E). Revenue is not recognized on purchases.

S-1F(1). *Recognizing revenue and expenses if proceeds are collectible over a long period without reasonable assurance of collection.* The terms of an exchange transaction or other conditions related to receivables collectible over a long period may preclude a reasonable estimate of the collectibility of the receivables. Either an installment method or a cost recovery method of recognizing revenue and expenses may be used as long as collectibility is not reasonably assured.

M-1F(1). *Measuring revenue and expenses on installment or cost recovery methods.* Under both installment and cost recovery methods the proceeds collected measure revenue. Under an installment method expenses are measured at an amount determined by multiplying the cost of the asset sold by the ratio of the proceeds collected to the total selling price. Under a cost recovery method, expenses are measured at the amounts of the proceeds collected until all costs have been recovered.

S-1G. *Expenses directly associated with revenue from exchanges.* Costs of assets sold or services provided are recognized as expenses when the related revenue is recognized (see S-1F).

M-1G. *Expense measurement.* Measurement of expenses directly associated with revenue recognized in exchanges is based on the recorded amount (usually acquisition cost) of the assets that leave the enterprise or the costs of the services provided (see S-6A(1) for a discussion of product and service costs).

Discussion. Revenue is usually accompanied by related expenses. For example, sale of a product leads to recording of revenue from the sale and an expense for the cost of the product sold. If an asset other than normal product, such as a building, is sold, the undepreciated cost of the asset is an expense to be subtracted from the revenue on the sale.

182. 2. *Nonreciprocal transfers* are transfers in one direction of resources or obligations, either from the enterprise to other entities or from other entities to the enterprise.

a. *Transfers between an enterprise and its owners.* Examples are investments of resources by owners, declaration of cash or property dividends, acquisition of treasury stock, and conversion of convertible debt.

S-2. *Owners' investments and withdrawals recorded.* Transfers of assets or liabilities between an enterprise and its owners are recorded when they occur.

M-2. *Owners' investments and withdrawals measured.* Increases in owners' equity are usually measured by (a) the amount of cash received, (b) the discounted present value of money claims received or liabilities cancelled, or (c) the fair value of noncash assets received.[51] Decreases in owners' equity are usually measured by (a) the amount of cash paid, (b) the recorded amount of noncash assets transferred, or (c) the discounted present value of liabilities incurred.

Discussion. Measurement of owners' investments is generally based on the fair value of the assets or the discounted present value of liabilities that are transferred. The market value of stock issued may be used to establish an amount at which to record owners' investments but this amount is only an approximation when the fair value of the assets transferred cannot be measured directly.

S-2A. *Acquisition of a business as a whole through issuance of stock.* The acquisition of a business as a whole by an enterprise through the issuance of stock is recorded when it occurs. (See S-2B for a discussion of poolings of interests.)

M-2A. *Acquisition of a business through issuance of stock measured.* A business acquired through issuance of stock is measured at the fair value of the business acquired. Each individual asset acquired (other than goodwill) is measured at its fair value. If the fair value of the whole business exceeds the amounts assigned to the individual assets, the excess is recorded as goodwill. If the total assigned to individual assets exceeds the fair value of the whole business, the difference is recorded as a reduction of the amounts assigned to the assets.

S-2B. *Poolings of interests.* Business combinations effected by issuance of voting common stock that also meet other specified criteria are accounted for as poolings of interests and not as acquisitions of one business by another. A business

[51] The fair value of assets received is often measured by the fair value of the shares of stock issued.

combination accounted for as a pooling of interests is accounted for when it occurs.

M-2B. *Poolings of interests measured.* The assets, liabilities, and elements of owners' equity of the separate companies generally become the assets, liabilities, and elements of owners' equity of the combined corporation. They generally are measured at the time of combination by the combined corporation at the amounts at which they were then carried by the separate companies. The revenue and expenses of the combined corporation for the period in which the companies are combined include the revenue and expenses of the separate companies from the beginning of the period to the date of combination. Financial statements for prior periods presented in reports of the combined corporation combine the financial statements of the separate companies.

S-2C. *Investments of noncash assets by founders or principal stockholders of a corporation.* Transfers of noncash assets to a corporation by its founders or principal stockholders are recorded when they occur.

M-2C. *Founders or principal stockholders investments of noncash assets measured.* Transfers of noncash assets to a corporation by its founders or principal stockholders are sometimes measured at their costs to the founders or principal stockholders rather than at their fair value at the date of transfer.

b. *Nonreciprocal transfers between an enterprise and entities other than owners.* Examples are gifts and donations, taxes, loss of a negligence lawsuit, imposition of fines, and theft.

S-3. *Nonreciprocal transfers recorded.* Nonreciprocal transfers with other than owners are recorded when assets are acquired (except that some noncash assets received as gifts are not recorded), when assets are disposed of or their loss is discovered, or when liabilities come into existence or are discovered.

M-3. *Nonreciprocal transfers measured.* Those noncash assets received in nonreciprocal transfers with other than owners that are recorded are measured at their fair value on the date received. Noncash assets given are usually accounted for at their recorded amount. Liabilities imposed are measured at the amount to be paid, sometimes discounted.

183. B. *External events other than transfers of resources or obligations to or from other entities.* Examples are changes in specific prices of enterprise assets, changes in interest rates, general price-level changes, technological changes caused by outside entities, and damage to enterprise assets caused by others.

S-4. *Favorable external events other than transfers generally not recorded.* External events other than transfers that increase market prices or utility of assets or decrease amounts required to discharge liabilities are generally not recorded when they occur. Instead their effects are usually reflected at the time of later exchanges.

M-4. *Retention of recorded amounts.* Assets whose prices or utility are increased by external events other than transfers are normally retained in the accounting records at their recorded amounts until they are exchanged. Liabilities that can be satisfied for less than their recorded amounts because of external events generally are retained in the records at their recorded amounts until they are satisfied.

S-4A. *Some favorable events recorded.* Examples of the few exceptions to principle S-4 are (1) increases in market prices of marketable securities held by investment companies and (2) decreases in the amounts required currently to satisfy liabilities to provide services or deliver resources other than U.S. dollars, for example, foreign currency obligations and obligations under warranties.

M-4A. *Measuring favorable events.* Recorded increases in market prices are measured by the difference between the recorded amount of the securities and the higher market price. Recorded decreases in liabilities are measured by the difference between the recorded amounts of the liabilities and the lower amounts estimated to be required to satisfy them.

S-5. *Unfavorable external events other than transfers recorded.* Certain unfavorable external events, other than transfers, that decrease market prices or utility of assets or increase liabilities are recorded.

M-5. *Measuring unfavorable events.* The amounts of those assets whose decreased market price or utility is recorded are adjusted to the lower market price or recoverable cost resulting from the external event.

Discussion. Recording unfavorable external events other than transfers varies depending on the type of asset or liability and is governed by specific rules. The major rules are described below.

S-5A. *Cost or market rule for inventories.* A loss is recognized by application of the rule of lower of cost and market to inventories when their utility is no longer as great as their cost.

M-5A. *Measuring inventory losses under the cost or market rule.* Replacement price is used in measuring the decline in price of inventory except that the recorded decline should not result in carrying the inventory at an amount that (1) exceeds net realizable value or (2) is lower than net realizable value reduced by an allowance for an approximately normal profit margin.

S-5B. *Decline in market price of certain marketable securities.* If market price of marketable securities classified as current assets is less than cost and it is evident that the decline is not due to a temporary condition a loss is recorded when the price declines.

M-5B. *Measuring losses from decline in price of marketable securities.* The loss on a price decline of marketable securities is measured by the difference between the recorded amount and the lower market price.

S-5C. *Obsolescence.* Reductions in the utility of productive facilities caused by obsolescence due to technological, economic, or other change are usually recognized over the remaining productive lives of the assets. If the productive facilities have become worthless the entire loss is then recognized.

M-5C. *Measuring obsolescence.* Obsolescence of productive facilities is usually measured by adjusting rates of depreciation, depletion, or amortization for the remaining life (if any) of the assets. If productive facilities have become worthless, unamortized cost is recognized as a current loss.

Discussion. In unusual circumstances persuasive evidence may exist of impairment of the utility of productive facilities indicative of an inability to recover cost although the facilities have not become worthless. The amount at which those facilities are carried is sometimes reduced to recoverable cost and a loss recorded prior to disposition or expiration of the useful life of the facilities.

S-5D. *Damage caused by others.* The effects of damage to enterprise assets caused by others are recorded when they occur or are discovered.

M-5D. *Measuring damage caused by others.* When enterprise assets are damaged by others, asset amounts are written down to recoverable costs and a loss is recorded.

S-5E. *Decline in market prices of noncurrent assets generally not recorded.* Reductions in the market prices of noncurrent assets are generally not recorded until the assets are disposed of or are determined to be worthless.

M-5E. *Retention of recorded amount.* Noncurrent assets whose market prices have declined are generally retained in accounting records at their recorded amounts until they are disposed of or have become worthless.

Discussion. In unusual circumstances a reduction in the market price of securities classified as noncurrent assets may provide persuasive evidence of an inability to recover cost although the securities have not become worthless. The amount at which those securities are carried is sometimes reduced and a loss recognized prior to disposition of the securities.

S-5F. ***Increases in amounts required to liquidate liabilities other than those payable in U.S. dollars recorded.*** Increases in the amounts required currently to satisfy liabilities to provide services or deliver resources other than U.S. dollars, for example, foreign currency obligations and obligations under warranties, are often recorded. Increases in amounts required currently to liquidate liabilities payable in U.S. dollars because of changes in interest rates or other external factors are generally not recorded until the liabilities are liquidated, converted, or otherwise disposed of.

M-5F. *Liability increases measured.* Recorded increases in liabilities from external events other than transfers are measured at the difference between the recorded amount of the liabilities and the higher amounts estimated to be required to satisfy them.

II. *Internal Events*

184. A. ***Production.*** Production in a broad sense is the economic process by which inputs of goods and services are combined to produce an output of product which may be either goods or services. Production in this sense is therefore ***not*** restricted to manufacturing operations, but includes activities such as merchandising, transporting, and holding goods.

S-6. *Production recorded.* Utility added to assets by the internal profit-directed activities of the enterprise is generally not recorded at the time of production. Instead, historical or acquisition costs, including costs of the production process, are shifted to different categories of assets or to expenses as events in the enterprise indicate that goods and services have been used (either partially or completely) in production operations of the period. The costs that continue to appear in asset categories are deducted from revenue when the products or services to which they have been related are sold at a later date (see S-1G).

M-6. *Production measurement.* Utility created by production is generally not measured at the time of production. Instead, previously recorded amounts (usually acquisition costs) are shifted or allocated between asset categories or between activities or periods in a systematic and rational manner.

Discussion. Accounting for production encompasses much of the internal accounting for the enterprise. Accounting to determine costs of manufacturing products and providing services (cost accounting) is a part of production accounting in general. The purpose of production accounting is to relate costs to revenue when the product is sold or services provided or to relate costs to particular accounting periods.

S-6A. *Costs of manufacturing products and providing services.* Costs of manufacturing products and providing services during a period include (1) costs of assets that are completely used during the period in manufacturing products and providing services and (2) allocated portions of the costs of assets that are partially used during the period in manufacturing products and providing services, assigned in a systematic and rational manner to those activities.

M-6A. *Measuring costs of manufacturing products and providing services.* Costs of manufacturing products and providing services are measured at the recorded amounts (usually acquisition costs) of assets used directly and by allocations in a systematic and rational manner of recorded amounts of assets used indirectly.

Discussion. Cost accounting often involves shifts and allocations of acquisition costs. The shifts and allocations are based on observed or assumed relationships between the assets used and the activities of manufacturing products or providing services. An example of a shift to a different category is the shift of costs from raw materials inventory to work in process inventory. Examples of allocated costs are overhead costs such as power, indirect labor, repair costs, and depreciation of plant and equipment.

S-6A(1). *Product and service costs.* Costs assigned to products and services provided are those costs of manufacturing products and providing services that are considered productive, including direct costs and indirect costs (absorbed overhead). Costs of manufacturing products and providing services for a period that are not assigned to product or service costs are charged to expense during the period, for example, unabsorbed overhead.

M-6A(1). *Measuring product and service costs.* Product and service costs are measured by the sum of productive costs of manufacturing products and providing services assigned to units of product or service in a rational and systematic manner.

S-6B. *Expenses from systematic and rational allocation.* Some expenses are associated with accounting periods by allocating costs of assets over their useful lives.

M-6B. *Determination of expenses by systematic and rational allocation.* These expenses are allocations of the recorded amount of assets in a systematic and rational manner to the period or periods of the assets' lives.

Discussion. If all the benefits of an asset are related to one period, the recorded amount of the asset is charged as expense in that period. If the asset will benefit several periods, the recorded amount is charged to expense in a systematic and rational manner over the periods involved. Depreciation, depletion, and amortization of long-lived assets are examples of amounts allocated to periods as expenses (excluding amounts allocated to costs of manufacturing products and providing services, see S-6A).

S-6C. *Expenses recognized immediately.* The costs of some assets are charged to expense immediately on acquisition.

M-6C. *Measurement of expenses recognized immediately.* Expenses from immediate recognition are measured at the acquisition prices of the assets acquired.

Discussion. Enterprises never acquire expenses per se; they always acquire assets. Costs may be charged to expenses in the period goods or services are acquired either under this principle of immediate recognition or, if they only benefit the period in which they are acquired, under the principle of systematic and rational allocation (see S-6B). Examples of costs that often are charged to expense immediately are salaries paid to officers and payments for advertising.

S-6D. *Revenue at completion of production.* Revenue may be recorded at the completion of production of precious metals that have a fixed selling price and insignificant marketing costs. Similar treatment may also be accorded certain agricultural, mineral, and other products characterized by inability to determine unit acquisition costs, immediate marketability at quoted prices that cannot be influenced by the producer, and unit interchangeability.

M-6D. *Revenue measured by net realizable value of product.* Revenue recorded at completion of production is measured by the net realizable value of the product.

Discussion. Recognition of revenue at completion of production is an exception to principles

S-1F and S-6. The net realizable value of product is its selling price less expected costs to sell.[52]

S-6E. *Revenue as production progresses.* Revenue from cost-plus-fixed-fee and long-term construction-type contracts is recognized as production progresses using the percentage-of-completion method if the total cost and the ratio of performance to date to full performance can be reasonably estimated and collection of the contract price is reasonably assured. When the current estimate of total contract costs indicates a loss on long-term construction-type contracts, in most circumstances provision is made for the loss on the entire contract.

M-6E. *Measuring revenue as production progresses* Under cost-plus-fixed-fee contracts, revenue recognized as production progresses includes either reimbursable costs and an allocated portion of the fee or an allocated portion of the fee alone. Under long-term construction-type contracts, revenue recognized as production progresses is measured at an allocated portion of the predetermined selling price. Product or service cost is subtracted from revenue as an expense as production progresses for long-term construction-type contracts and for those cost-plus-fixed-fee contracts for which recorded revenue includes reimbursable costs.

Discussion. Recognition of revenue as production progresses is another exception to principles S-1F and S-6.

185. B. *Casualties.* Casualties are sudden, substantial, unanticipated reductions in enterprise assets not caused by other entities. Examples are fires, floods, and abnormal spoilage.

S-7. *Casualties.* Effects of casualties are recorded when they occur or when they are discovered.

M-7. *Measuring casualties.* When casualties occur or are dis-

[52] See paragraph 152, footnote 45, for a discussion of income statement treatment of revenue recognized at completion of production.

covered, asset amounts are written down to recoverable costs and a loss is recorded.

Accounting for Those Assets and Liabilities That Are Not Resources or Obligations

186. Accounting for those assets and liabilities that are not resources or obligations (see paragraph 132) and the related revenue and expenses is governed by detailed principles, for example, principles for accounting for deferred federal income taxes in APB Opinion No. 11. The principles are generally related to the modifying conventions, especially emphasis on income (see paragraphs 169 to 174).

Principles That Determine Effects on Assets, Liabilities, Owners' Equity, Revenue, and Expenses of an Enterprise

187. Principles (E-1 to E-10) that summarize the effects of selection and measurement on the basic elements of financial accounting are related to changes in assets, liabilities, owners' equity, revenue, and expenses rather than to types of events. The first of these principles recognizes the interrelated effects of events.

E-1. *Dual effects.* Each recorded event affects at least two items in the financial accounting records. The double entry system of recording is based on this principle.

In the following principles, the changes in assets, liabilities, owners' equity, revenue, and expenses that are recognized in conformity with generally accepted accounting principles are listed, together with some indication of the dual effect. Recognized changes are derived from the preceding principles of selection of events and assignment of dollar amounts.

E-2. *Increases in assets* arise from (1) exchanges in which assets are acquired, (2) investments of assets in the enterprise by owners, (3) nonreciprocal transfers of assets to an enterprise by other than owners, (4) shifts of costs to different asset categories in production, and, occasionally, (5) increases in amounts ascribed to produced assets. Increases in assets rarely arise from external events other than transfers.

In exchanges, asset increases may be accompanied by decreases in other assets (e.g., a purchase for cash), increases in liabilities (e.g., a purchase on account), or recognition of revenue (e.g., a sale for cash). In production, costs may be shifted from one asset classification to another with no change in total assets. If production increases are recorded (e.g., at the completion of production of precious metals), the increase is recognized as revenue or reduction of expenses. Increases in the market prices of securities held by investment companies is an example of asset increases recognized on external events other than transfers.

E-3. *Decreases in assets* arise from (1) exchanges in which assets are disposed of, (2) withdrawals of assets from the enterprise by owners, (3) nonreciprocal transfers of assets from the enterprise other than to owners, (4) certain external events other than transfers that reduce the market price or utility of assets, (5) shifts or allocations of costs to different asset categories or to expense in production, and (6) casualties.

In exchanges, asset decreases may be accompanied by increases in other assets (e.g., a purchase for cash or a sale for cash or on account), decreases in liabilities (e.g., payment of a debt), or increases in expenses. An increase of expenses in an exchange may result if an asset acquired is used up almost immediately or if future benefits of an expenditure cannot be determined and it is therefore written off to expense immediately. The sale of products results in a decrease in product held by the enterprise and reduces an asset and increases an expense.

E-4. *Increases in liabilities* arise from (1) exchanges in which liabilities are incurred, (2) transfers between an enterprise and its owners (dividend declaration), and (3) nonreciprocal transfers with other than owners in which liabilities arise.

In exchanges, liability increases may be accompanied by decreases in other liabilities (e.g., a note given on an account payable), increases in assets (e.g., a purchase on account), or an expense (e.g., office salaries incurred but unpaid).

E-5. *Decreases in liabilities* arise from (1) exchanges in which liabilities are reduced, (2) transfers between an enterprise and its owners (debt converted into capital stock), and (3) nonreciprocal transfers with other than owners in which liabilities are reduced (forgiveness of indebtedness).

In exchanges, liability decreases may be accompanied by increases in other liabilities (e.g., a note given on an account payable), decreases in assets (e.g., payment of an account), or revenue (e.g., goods delivered or services rendered to satisfy a customer prepayment).

E-6. *Increases in owners' equity* arise from (1) investments in an enterprise by its owners, (2) the net result of all revenue and expenses recognized during a period (net income), and (3) nonreciprocal transfers to an enterprise from other than owners (gifts and donations). Owners' equity may also be increased by prior period adjustments.

E-7. *Decreases in owners' equity* arise from (1) transfers from an enterprise to its owners (dividends, treasury stock acquisitions), and (2) net losses for a period. Owners' equity may also be decreased by prior period adjustments.

E-8. *Revenue* arises primarily from exchanges. Occasionally revenue arises from production, and rarely from nonreciprocal transfers and from external events other than transfers.

Revenue from exchanges is usually accompanied by asset increases but may be accompanied by decreases in liabilities ("unearned revenue").

E-9. *Expenses* arise from (1) exchanges, (2) nonreciprocal transfers with other than owners, (3) external events other than transfers, (4) production, and (5) casualties.

Expenses that arise in exchanges are costs associated directly with revenue recognized when assets are sold or services are provided [including product and service costs, see S-6A(1)]. Expenses that arise in production are (1) costs of manufacturing products and providing services not included in product or service costs (for example, unabsorbed overhead), (2) expenses from systematic and rational allocation of the cost of assets over their useful lives (excluding amounts allocated to costs of manufacturing products and providing services, see S-6A), (3) expenses recognized immediately on the acquisition of goods and services, and (4) costs of products for which revenue is recognized at the completion of production or as production progresses (see S-6D and S-6E).

E-10. *Effects of accounting for assets and liabilities that are not resources or obligations* (see paragraphs 132 and 186). Accounting for these assets and liabilities results in increases and decreases in assets and increases and decreases in liabilities. The income statement effects are usually confined to increases and decreases in expenses.

PRINCIPLES OF FINANCIAL STATEMENT PRESENTATION

188. The principles of financial statement presentation guide the communication of the information provided by the financial accounting process. They are related to the principles of selection and measurement and the pervasive principles but are not derived directly from them. The presentation principles are more closely related to the objectives of financial accounting and financial statements. The general objectives that deal with the type of information to be provided (for example, reliable information about economic resources and obligations and economic progress) and the qualitative objectives based on characteristics of useful information (such as comparability, completeness, and understandability) directly influence the content of some of the presentation principles. The basic features of financial accounting, particularly accounting entity, approximation, and fundamentally related financial statements, also influence these principles.

Fair Presentation in Conformity with Generally Accepted Accounting Principles

189. The qualitative standard of *fair presentation in conformity with generally accepted accounting principles* of financial position and results of operations is particularly important in evaluating financial presentations. This standard guides preparers of financial statements and is the subjective benchmark against which independent public accountants judge the propriety of the financial accounting information communicated. Financial statements "present fairly in conformity with generally accepted accounting principles" if a number of conditions are met: (1) generally accepted accounting principles applicable in the circumstances have been applied in accumulating and processing the financial accounting information, (2) changes from period to period in generally accepted accounting principles have been appropriately disclosed, (3) the information in the underlying records is properly reflected and described in the financial statements in conformity with generally accepted accounting principles, and (4) a proper balance has been achieved between the conflicting needs to disclose important aspects of financial position and results of operations in accordance with conventional concepts and to summarize the voluminous underlying data into a limited number of financial statement captions and supporting notes.

STATEMENT OF THE PRINCIPLES OF FINANCIAL STATEMENT PRESENTATION

190. The principles of financial statement presentation guide reporting of financial accounting information. They are conventional and subject to change in the same manner as the principles of selection and measurement. Eleven principles (R-1 to R-11) of financial statement presentation are stated; two are amplified by related principles; several are followed by explanations of their characteristics or applications.

191. R-1. *Basic financial statements.* A balance sheet, a statement of income, a statement of changes in retained earnings, disclosure of changes in other categories of stockholders' equity, and related notes is the minimum presentation required to present fairly

the financial position and results of operations of an enterprise in conformity with generally accepted accounting principles.

The basic financial statements are usually presented for two or more periods to enhance their usefulness. Historical summaries are also often presented. Other information may be provided as supplementary to the basic statements, for example, a statement of source and application of funds, data as to revenue and net income by lines of business, information regarding physical output, and financial statements restated for changes in the general price level. These kinds of information, however, are not now considered necessary for a fair presentation of financial position and results of operations in conformity with generally accepted accounting principles.

192. R-2. *Complete balance sheet.* The balance sheet or statement of financial position should include and properly describe all assets, liabilities, and classes of owners' equity as defined by generally accepted accounting principles.

193. R-3. *Complete income statement.* The income statement of a period should include and properly describe all revenue and expenses as defined by generally accepted accounting principles.

Under narrowly specified conditions an income statement should exclude a few items that represent adjustments of prior periods' net income.

194. R-4. *Accounting period.* The basic time period for which financial statements are presented is one year; "interim" financial statements are commonly presented for periods of less than a year.

195. R-5. *Consolidated financial statements.* Consolidated financial statements are presumed to be more meaningful than the separate statements of the component legal entities. Consolidated statements are usually necessary for fair presentation in conformity with generally accepted accounting principles if one of the enterprises in a group directly

or indirectly owns over 50% of the outstanding voting stock of the other enterprises.

Consolidated financial statements present the financial position and results of operations of a parent company and its subsidiaries essentially as if the group were a single enterprise comprised of branches or divisions. The resulting accounting entity is an economic rather than a legal unit, and its financial statements are considered to reflect the substance of the combined economic relationships to an extent not possible by merely providing the separate financial statements of the corporate entities comprising the group.

196. R-6. *Equity basis.* Domestic unconsolidated subsidiaries should be presented in consolidated financial statements on the equity basis. Foreign unconsolidated subsidiaries and investments in 50% owned companies and certain jointly owned companies may be presented on the equity basis.

Under the equity basis, consolidated net income during a period includes the parent company's proportionate share of the net income reported by the subsidiary or affiliate for the period (subsequent to acquisition in the period of acquisition). The effect is that net income for the period and owners' equity at the end of the period are the same as if the companies presented on the equity basis had been consolidated. Dividends received are treated as adjustments of the amount of the investment under the equity basis.

197. R-7. *Translation of foreign balances.* Financial information about the foreign operations of U. S. enterprises should be "translated" into U. S. dollars by the use of conventional translation procedures that involve foreign exchange rates.

198. R-8. *Classification and segregation.* Separate disclosure of the important components of the financial statements is presumed to make the information more useful. Examples in the income statement are sales or other source of revenue, cost of sales, depreciation, selling and administrative expenses, interest expense, and income taxes. Examples in the

balance sheet are cash, receivables, inventories, plant and equipment, payables, and categories of owners' equity.

Owners' equity of corporations is conventionally classified into categories including par or stated amount of capital stock, additional paid-in capital, and retained earnings. Net income or net loss, prior period adjustments, dividends, and certain transfers to other categories of owners' equity are among the changes in owners' equity that affect retained earnings.

R-8A. *Working capital.* Disclosure of components of working capital (current assets less current liabilities)[53] is presumed to be useful in manufacturing, trading, and some service enterprises. Current assets and current liabilities are distinguished from other assets and liabilities.

Disclosure of working capital is normally accomplished by classifying current assets and liabilities separately. Current assets include cash and other assets that are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business or within one year if the operating cycle is shorter than one year. Current liabilities include those expected to be satisfied by either the use of assets classified as current in the same balance sheet or the creation of other current liabilities, or those expected to be satisfied within a relatively short period of time, usually one year. (See Accounting Research Bulletin No. 43, Chapter 3A.)

R-8B. *Offsetting.* Assets and liabilities in the balance sheet should not be offset unless a legal right of setoff exists.

R-8C. *Gains and losses.* Revenue and expenses from other than sales of products, merchandise, or services may be separated

[53] Because the term *working capital* is sometimes used to describe current assets alone, the difference between current assets and current liabilities is sometimes described as *net working capital.*

from other revenue and expenses and the net effects disclosed as gains or losses.[54]

Revenue and expense result from dispositions of assets other than products of the enterprise as well as from sales of products or services. For disclosure purposes, revenue (proceeds received) and expenses (cost of assets relinquished) on dispositions of assets other than products are separated from other revenue and expenses and the net amounts (revenue less expense) are shown as gains or losses. If these gains or losses are not material in amount they may be combined with other income statement amounts.

Other examples of gains and losses are sizable write-downs of inventories, receivables, and capitalized research and development costs, sizable gains and losses on sale of temporary investments, and gains and losses on foreign currency devaluations. Gains and losses include items that are of a character typical of the customary business activities of the entity, which may be disclosed separately if their effects are material, and extraordinary gains and losses, which should be presented separately (see the following principle).

R-8D. *Extraordinary items.* Extraordinary gains and losses should be presented separately from other revenue and expenses in the income statement.

Extraordinary items are of a character significantly different from the typical or customary business activities of the enterprise. They are transactions and other events of material effect that are not expected to recur frequently and that are not normally considered in evaluating the ordinary operating processes of the business. (See APB Opinion No. 9.)

R-8E. *Net income.* The net income of an enterprise for a period should be separately disclosed and clearly identified in the income statement.

Identifying the amount of the net income is considered neces-

[54] Losses are sometimes defined in the accounting literature as expired costs that produce no revenue. "Losses" of that type are a subclassification of expenses in this Statement.

sary for fair presentation in conformity with generally accepted accounting principles.

199. R-9. *Other disclosures.* In addition to informative classifications and segregation of data, financial statements should disclose all additional information that is necessary for fair presentation in conformity with generally accepted accounting principles. Notes that are necessary for adequate disclosure are an integral part of the financial statements.

Financial statements cannot provide all of the information available about an enterprise. They are essentially summaries of a large quantity of detailed information. Furthermore, the information given on the face of the statements is largely restricted to that which can be represented by a number described by a very few words. Normally information of that type needs amplification to make it most useful, and both the financial statements and the notes are necessary for adequate disclosure. In addition to the three types of disclosure specified below that are considered necessary, additional disclosures are commonly made, for example, disclosure of nonarm's-length transactions.

In general, information that might affect the conclusions formed by a reasonably informed reader of the financial statements should be disclosed. Disclosure principles carry an implied responsibility to present information so that its significance is apparent to a reasonably informed reader. A mass of detailed information, overly compressed information, and language that may be a barrier to communication are unsatisfactory. Financial statements should inform the reader of matters that may affect his interpretation of them, and may provide additional information that will facilitate his understanding and use of the statements.

R-9A. *Customary or routine disclosure.* Information about measurement bases of important assets, restrictions on assets and of owners' equity, contingent liabilities, contingent assets, important long-term commitments not recognized in the body of the statements, information on terms of owners' equity and long-term debt, and certain other disclosures required by pronouncements of the Accounting Principles Board and the Committee on Auditing Procedure of the American Institute of Certified Public Accountants and regulatory bodies that have jurisdiction are necessary for full disclosure.

R-9B. *Disclosure of changes in accounting principles.* Disclosure of changes in accounting principles, practices, or the methods of applying them, together with the financial effect, is necessary.

R-9C. *Disclosure of subsequent events.* Disclosure of events that affect the enterprise directly and that occur between the date of, or end of the period covered by, the financial statements and the date of completion of the statements is necessary if knowledge of the events might affect the interpretation of the statements, even though the events do not affect the propriety of the statements themselves.

200. R-10. *Form of financial statement presentation.* No particular form of financial statements is presumed better than all others for all purposes, and several forms are used.

201. R-11. *Earnings per share.* Earnings per share information is most useful when furnished in conjunction with net income and its components and should be disclosed on the face of the income statement.

A single figure for earnings per share involves the same limitations of usefulness as does a single figure for net income. Unless earnings per share statistics are presented in conjunction with financial statements and with other historical information, their usefulness in evaluating past performance of an enterprise and attempting to formulate an opinion as to its future potential is limited. Furthermore, earnings per share should be disclosed for (a) income before extraordinary items, and (b) net income. Earnings per share disclosure should take into consideration matters such as changes in the number of shares outstanding, contingent changes, and possible dilution from potential conversions of convertible debentures, preferred stock, options, or warrants.

Chapter 8

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES—DETAILED ACCOUNTING PRINCIPLES

202. The detailed principles of accounting are the large body of practices and procedures that prescribe definitively how transactions and other events should be recorded, classified, summarized, and presented. They are the means of implementing the pervasive and broad operating principles discussed in Chapters 6 and 7.

203. The detailed accounting principles are not enumerated in this Statement for several reasons:

1. Many detailed accounting principles are already found in Opinions of the Accounting Principles Board and in the Accounting Research Bulletins.
2. The pervasive principles and the broad operating principles that underlie the detailed accounting principles tend to evolve slowly. The detailed principles, on the other hand, change relatively frequently. A comprehensive statement of detailed principles therefore would need continual revision to avoid becoming obsolete.
3. A comprehensive statement of detailed accounting principles would include material that the Board cannot, as as practical matter, consider at this time.

204. The Opinions of the Accounting Principles Board and the Accounting Research Bulletins are the most authoritative sources of generally accepted accounting principles for members of the American Institute of Certified Public Accountants.[55]

[55] Special Bulletin, *Disclosure of Departures From Opinions of Accounting Principles Board,* October 1964, presents recommendations adopted by Council; see especially recommendations 1, 2, and 4. *APB Accounting Principles,* published for the Institute by Commerce Clearing House, Inc., is a looseleaf service which includes all of the Opinions and Statements of the Accounting Principles Board and the Accounting Research Bulletins currently in effect and is kept up-to-date. The service is classified by subject matter and is cross-referenced and indexed.

Opinions of the Accounting Principles Board and Accounting Research Bulletins deal with specific subjects but do not constitute a comprehensive list of detailed accounting principles. No comprehensive authoritative list of detailed accounting principles is presently available.[56]

205. Securities and Exchange Commission pronouncements are an important source of detailed principles in some areas. These pronouncements specify requirements for Securities and Exchange Commission reports and influence financial accounting and reporting practices. Actual accounting and reporting practices are another important source of detailed accounting principles in areas not covered by Accounting Principles Board Opinions or the Accounting Research Bulletins. Publications of professional organizations, for example Industry Audit Guides published by the American Institute of CPAs, and surveys that disclose predominant or preferred accounting practices may also provide evidence of authoritative support. On the other hand, isolated instances of actual practice cannot be regarded as authoritative.

206. Accounting textbooks and other accounting writings may also be referred to as sources of detailed accounting principles in areas that are not covered by Accounting Principles Board Opinions or the Accounting Research Bulletins. The information from these sources must be regarded as tentative. No one textbook or other writing may be regarded as authoritative in itself. The consensus of a number of writers, however, may be a good indication of existing detailed principles not covered by Accounting Principles Board pronouncements.

[56] Accounting Research Study No. 7, *Inventory of Generally Accepted Accounting Principles for Business Enterprises,* by Paul Grady, is a valuable source of those detailed accounting principles that existed at the time of its publication in 1965. This is an "unofficial" source, however, because Accounting Research Studies are not pronouncements of the Accounting Principles Board or of the Institute, and the fact that the study quotes extensively from the Board Opinions and the Accounting Research Bulletins in no way changes the status of either the pronouncements or the study.

Chapter 9

FINANCIAL ACCOUNTING IN THE FUTURE

207. Description of the environment, objectives, and basic features of financial accounting and financial statements and of broad generally accepted accounting principles has been an important objective of the Accounting Principles Board since its inception. Issuance of this Statement is a basic step in the Board's program of determining appropriate practice and narrowing areas of difference and inconsistency.

DYNAMIC NATURE OF FINANCIAL ACCOUNTING

208. Present generally accepted accounting principles are the result of an evolutionary process that can be expected to continue in the future. Changes may occur at any level of generally accepted accounting principles. The pervasive and broad operating principles are relatively stable but may change over time. Changes occur more frequently in the detailed principles used to apply broad principles to specific situations.

209. Generally accepted accounting principles change in response to changes in economic and social conditions, to new knowledge and technology, and to demands of users for more serviceable financial information. The dynamic nature of financial accounting—its ability to change in response to changed conditions—enables it to maintain and increase the usefulness of the information it provides.

BASIS FOR EVALUATION

210. Although this Statement does not specify what generally accepted accounting principles should be in the future, it is intended to provide a basis for evaluating principles and guiding changes in financial accounting. Orderly change in financial accounting is promoted by evaluation of present and proposed principles in terms of their internal consistency and practical

operation and in the light of observations concerning the environment and objectives of financial accounting and financial statements.

Practical Operation and Internal Consistency of Generally Accepted Accounting Principles

211. Present generally accepted accounting principles can be analyzed to determine if they are operational and internally consistent.[57] Analysis can focus on individual principles and on their implications for and consistency with other principles. Evaluations of this type can aid in narrowing areas of difference and promoting the usefulness of financial accounting information.

The Environment

212. Generally accepted accounting principles can also be evaluated by relating the financial accounting information they produce to the economic activities that the information attempts to represent. The significant constraints placed on accounting measurement by the complexity, continuity, and joint nature of economic activities are important in this evaluation.

Objectives of Financial Accounting and Financial Statements

213. Understanding the objectives of financial accounting and financial statements (Chapter 4) is vital in evaluating and improving generally accepted accounting principles. The general objectives relate the content of financial accounting information to the interests and needs of users. The content of financial accounting information can therefore be appraised by determining the extent to which it serves these interests and needs. The qualitative objectives indicate the characteristics of useful information and thus provide criteria for appraising the usefulness of financial accounting information. The objectives are now achieved with varying degrees of success but improvement is probably possible in achieving each of them. Some objectives may conflict, however, so that improvement in

[57] Although consistency of principles is desirable, improving financial accounting may require changes that temporarily increase inconsistency among principles.

one area may be at the expense of another area. Generally accepted accounting principles should therefore be evaluated to determine the degree to which the objectives are met and the extent to which present principles represent an optimum practical solution to the problem of resolving conflicts between objectives.

PROPOSALS FOR CHANGE

214. Suggestions have been made that present generally accepted accounting principles be changed (1) to eliminate differences in accounting practices that are not justified by differences in circumstances, (2) to make them more internally consistent, (3) to improve their effectiveness in accomplishing the objectives of financial accounting, and (4) to reflect more adequately the economic activities represented. These suggestions have resulted in a number of proposals in recent years which have not been fully evaluated but which, if accepted, would result in significant changes in generally accepted accounting principles and the resulting financial statements. Brief mention of some of these proposals in the following paragraphs does not, of course, imply a degree of present acceptance nor constitute a forecast of future acceptance. Reference to them in this Statement does not give them substantial authoritative support.

215. Some proposals contemplate change within the basic historical-cost-based accounting described in this Statement in connection with present generally accepted accounting principles. The proposed changes, for example, would broaden the measurement and recognition criteria so that some items, such as contracts, commitments, and leases, that are not now recorded as assets and liabilities would be included in financial statements; also, criteria would be established for associating inventory costs and the costs of long-lived productive assets (plant and equipment) with the related revenue, both to narrow the range of acceptable procedures and to reduce the necessity of making essential arbitrary choices among procedures. Although adopting these kinds of proposals would introduce significant changes, financial accounting for the most part would still rely on relating acquisition costs with revenue to

determine income and on acquisition prices as the basic recorded amount of assets.

216. Other proposals contemplate more sweeping changes in the financial accounting structure or the content of financial statements. For example, they would revise the realization principle to permit accrual of increases in value of resources during production, substitute current replacement prices, current selling prices, estimated future selling prices, or discounted present-value concepts for acquisition prices as the basis of measurement, recognize changes in the general level of prices, and incorporate budgets as part of the basic financial statements.

217. Still other proposals would change the presentation of financial accounting information rather than its accumulation and processing. New financial statements and new forms of existing financial statements have been proposed. The use of ratios instead of money amounts has been suggested, pointing to an emphasis on information such as trends, relationships, rates of return, and statements expressed in terms of percentages, rather than on absolute dollar amounts. Development of ways of disclosing information more effectively than in narrative notes has been proposed, including more use of graphs, charts, and other visual aids.

218. Considerable interest has been shown in international accounting standards or "international generally accepted accounting principles." Prerequisite to the development of accounting standards on an international scale is not only knowledge of accounting practices and principles in various countries but also some attempts on the part of the accounting profession of each country to formalize and codify the accounting practices used in the country.

219. These proposals are mentioned in this Statement not to give them recognition or support but to indicate the general nature of potential changes in ideas and conditions in the future. Financial accounting promises to be as dynamic in the future as it has been in the past. The Accounting Principles Board will be involved in guiding future changes in generally accepted accounting principles. It invites all those interested in continued improvement in financial accounting to participate actively.

The Statement entitled "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises" was adopted by the assenting votes of seventeen members of the Board. Mr. Catlett dissented.

George R. Catlett dissents to this Statement because in his view it fails to provide what purports to be "a basis for guiding the future development of financial accounting." He believes that guidelines for the future are urgently required, but the Accounting Principles Board is looking backward to what has occurred rather than forward to what is needed. As a result, the concepts and principles set forth in this Statement are based upon ineffective foundations, along the lines of the following: (1) vague generalizations which are noncontroversial but serve no useful purpose; (2) circular reasoning, with undefined terms being defined by other undefined terms, such as the description of assets and liabilities as those items "recognized and measured in conformity with generally accepted accounting principles;" and (3) reverse logic, by summarizing a wide variety of customs and practices, many of which need to be changed and improved, and then rationalizing back to principles that presumably support what now exists. The Board in this Statement is establishing a new acceptability on behalf of the accounting profession for many accounting practices which have not previously been covered by pronouncements of the Board and which have not been studied or even seriously considered by the Board. Mr. Catlett also believes that this Statement—by providing a conceptual basis for, and by giving authoritative status to, current accounting practices—will represent an unfortunate deterrent to the achievement of improvements in practice. Thus, rather than setting forth effective guidelines for progress, this Statement creates a significant roadblock which will seriously impede the efforts of the business community and the accounting profession to establish sound principles for financial accounting and reporting.

NOTE

Statements of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board, which is the senior technical body of the Institute authorized to issue pronouncements on accounting principles. This Statement is not an "Opinion of the Accounting Principles Board" covered by action of the Council of the Institute in the Special Bulletin, Disclosure of Departures from Opinions of Accounting Principles Board, *October 1964.*

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