

The Measurement Fundamentals of Financial Accounting

Pratt, Financial Accounting 7e, Chapter 3

Basic Assumptions in Financial Accounting:

- Economic Entity Assumption – business entities are separate and distinct from their owners and other entities
- Fiscal Period – the performance and financial position of business entities can be measured in discrete fiscal periods
 - Timeliness vs. Objectivity
 - Calendar Year vs. Fiscal Year
- Going Concern Assumption – business entities are assumed to continue indefinitely
- Stable Dollar Assumption – the dollar (or other relevant currency) is assumed to be a stable unit of measurement
 - Inflation

Valuation and the Balance Sheet

Valuation Basics:

- Input prices
- Output prices

Common Valuation Bases:

- Present Value – discounted future cash flows
- Fair Market Value – current sales prices in output markets
- Replacement Cost – current purchase price in input markets
- Original Cost – historical cost in input market

Common Balance Sheet Valuation Bases:

Assets

- Current Assets
 - Cash, Short-term Investments, Accounts Receivable – FMV
 - Inventory – LCM
 - Prepaid Expenses – OC
- Long-Term Investments
 - Long-Term Notes – PV
 - Land and Securities – OC
- Property, Plant & Equipment – OC
- Intangible Assets - OC

Liabilities

- Current Liabilities – FMV
- Long-Term Liabilities – PV

Stockholders' Equity – Residual Measurement

Principles of Financial Accounting Measurement:

- Objectivity – Objective methods should be used in financial measurement
 - Present Values
 - Market Values
 - Original Cost
- Matching – Expenses should be matched against revenues
- Revenue Recognition – Revenue should be recognized when all of the following are true:
 - Persuasive evidence of an arrangement exists
 - Delivery has occurred or services have been provided
 - The seller's price to the buyer is fixed or determinable and any remaining costs can be reasonably estimated
 - Collection is reasonably assured
- Consistency

Exceptions to Basic Principles:

- Materiality
 - Quantitative
 - Qualitative
- Conservatism – when in doubt choose amounts that result in lower assets (higher liabilities) and lower revenues (higher expenses)
 - Not an excuse for understatement

International Perspectives

- IFRS GAAP generally provides more flexibility than U.S. GAAP
- Differences are shrinking quickly