

CHAPTER 2

CONCEPTUAL FRAMEWORK UNDERLYING FINANCIAL REPORTING

CHAPTER STUDY OBJECTIVES

1. *Indicate the usefulness and describe the main components of a conceptual framework for financial reporting.* A conceptual framework is needed to (1) create standards that build on an established body of concepts and objectives, (2) provide a framework for solving new and emerging practical problems, (3) increase financial statement users' understanding of and confidence in financial reporting, and (4) enhance comparability among different companies' financial statements.

The first level deals with the objective of financial reporting. The second level includes the qualitative characteristics of useful information and elements of financial statements. The third level includes foundational principles and conventions.

2. *Identify the qualitative characteristics of accounting information.* The overriding criterion by which accounting choices can be judged is decision usefulness; that is, the goal is to provide the information that is the most useful for decision making. Fundamental characteristics include relevance and faithful representation. These two characteristics must be present. Enhancing characteristics include comparability, verifiability, timeliness, and understandability. There may be trade-offs.

3. *Define the basic elements of financial statements.* The basic elements of financial statements are (1) assets, (2) liabilities, (3) equity, (4) revenues, (5) expenses, (6) gains, and (7) losses.

4. *Describe the foundational principles of accounting.* (1) Economic entity: the assumption that the activity of a business enterprise can be kept separate and distinct from its owners and any other business unit. (2) Control: the entity has the power to make decisions and reap the benefits or be exposed to the losses (which are variable). (3) Revenue recognition: revenue is generally recognized when it is (a) earned, (b) measurable, and (c) collectible (realizable). (4) Matching assists in the measurement of income by ensuring that costs (relating to long-lived assets) incurred in earning revenues are booked in the same period as the revenues earned. (5) Periodicity: the assumption that an enterprise's economic activities can be divided into artificial time periods to facilitate timely reporting. (6) Monetary unit: the assumption that money is the common denominator by which economic activity is conducted, and that the monetary unit gives an appropriate basis for measurement and analysis. (7) Going concern: the assumption that the business enterprise will have a long life. (8) Historical cost principle: existing GAAP requires that many assets and liabilities be accounted for and reported based on their acquisition price. Many assets are later revalued. (9) Fair value principle: assets and liabilities are valued at fair value—that is, an exit price—and viewed from a market participant perspective. (10) Full disclosure principle: accountants follow the general practice of providing information that is important enough to influence an informed user's judgement and decisions.

5. Explain the factors that contribute to choice and/or bias in financial reporting decisions.

Choice is the result of many things, including principles-based standards, measurement uncertainty, and increasingly complex business transactions. The conceptual framework is the foundation that GAAP is built on. If there is no primary source of GAAP for a specific decision, then professional judgement must be used, making sure that the accounting policies chosen are consistent with the primary sources of GAAP and the conceptual framework.

Financial engineering is the process of legally structuring a business arrangement or transaction so that it meets the company's financial reporting objective. This is a dangerous practice since it often results in biased information.

Fraudulent financial reporting often results from pressures on individuals or the company. These pressures may come from various sources, including worsening company, industry, or economic conditions; unrealistic internal budgets; and financial statement focal points related to contractual, regulatory, or capital market expectations. Weak internal controls and governance also contribute to fraudulent financial reporting.

6. Discuss current trends in standard setting for the conceptual framework. The IASB was in the stages of issuing a new conceptual framework, which was expected to be issued in final form in 2016. It was also working on projects relating to disclosure and materiality.

MULTIPLE CHOICE QUESTIONS

Answer	No.	Description
c	1.	Conceptual framework
d	2.	Objectives of financial reporting
d	3.	Conceptual framework
a	4.	Conceptual framework
c	5.	Fundamental qualitative characteristics
b	6.	Relevance
b	7.	Relevance
c	8.	Materiality
c	9.	Understandability
d	10.	Representational faithfulness
a	11.	Criterion for accounting information
c	12.	Enhancing qualitative characteristics
d	13.	Comparability
a	14.	Timeliness
a	15.	Comparability
c	16.	Timeliness
c	17.	Costs of providing useful information
b	18.	Common characteristic of assets and liabilities
b	19.	Asset characteristics
c	20.	Liabilities
c	21.	Equitable obligations
a	22.	Items included in equity under IFRS
d	23.	Definition of gains
b	24.	Other comprehensive income
c	25.	Statements prepared using ASPE
b	26.	Components of comprehensive income
d	27.	Economic entity assumption
c	28.	Timing of revenue recognition
a	29.	Example of full disclosure
d	30.	Economic entity assumption
c	31.	Recognition and measurement
b	32.	Periodicity assumption
d	33.	Going concern assumption
b	34.	Historical cost principle
b	35.	Matching principle
a	36.	Use of allowance for doubtful accounts
b	37.	Historical cost principle
a	38.	Economic entity assumption
b	39.	Matching principle
d	40.	Recording of depreciation
c	41.	Fair value of an asset
c	42.	Full disclosure principle
b	43.	Measurement uncertainty
b	44.	Full disclosure principle
c	45.	Management Discussion and Analysis
c	46.	Inflation
b	47.	Bankruptcy

Answer	No.	Description
a	48.	Items included in MD&A
c	49.	Matching
b	50.	Financial reporting
b	51.	Principles-based GAAP
c	52.	Financial engineering
d	53.	Fraudulent financial reporting
c	54.	Accounting policies
d	55.	IASB Exposure Draft
a	56.	IASB research project

EXERCISES

Item	Description
E2-57	Conceptual framework
E2-58	Levels of the conceptual framework
E2-59	Moral hazard
E2-60	Materiality
E2-61	Enhancing Qualitative Characteristics
E2-62	Accounting terminology – fill in the blanks
E2-63	Equitable obligations
E2-64	Constructive Obligations
E2-65	Comprehensive Income
E2-66	Foundational principles
E2-67	Identification of foundational accounting principles
E2-68	Identification of foundational accounting principles and qualitative characteristics
E2-69	Foundational accounting principles and qualitative characteristics – matching
E2-70	Fair value measurement
E2-71	Matching concept
E2-72	Forms of business organization
E2-73	Control and the economic entity assumption
E2-74	Principles vs. rules-based GAAP
E2-75	Financial engineering
E2-76	Fraudulent financial reporting
E2-77	Fraudulent financial reporting and the accountant's role
E2-78	Financial reporting pressures caused by budgets

MULTIPLE CHOICE QUESTIONS

1. Which of the following is NOT part of the conceptual framework for financial reporting?

- a) elements of financial statements
- b) qualitative characteristics of accounting information
- c) notes to financial statements
- d) foundational principles

Answer: c

Difficulty: Easy

Learning Objective: Indicate the usefulness and describe the main components of a conceptual framework for financial reporting.

Section Reference: Conceptual Framework

CPA: Financial Reporting

Bloomcode: Knowledge

2. Which of the following is NOT an objective of financial reporting?

- a) to provide information about an entity's economic resources, obligations and equity/net assets
- b) to provide information that is useful to investors and creditors and other users in making resource allocation decisions and/or assessing management stewardship
- c) to provide information that is useful in assessing the economic performance of the entity
- d) to provide the most useful information possible even if the costs exceed the benefits

Answer: d

Difficulty: Easy

Learning Objective: Indicate the usefulness and describe the main components of a conceptual framework for financial reporting.

Section Reference: Conceptual Framework

CPA: Financial Reporting

Bloomcode: Knowledge

3. Which of the following is NOT a component of a conceptual framework for financial reporting?

- a) accounting's goals and purposes
- b) qualitative characteristics of accounting information
- c) foundational principles
- d) All of the above are components of a conceptual framework.

Answer: d

Difficulty: Easy

Learning Objective: Indicate the usefulness and describe the main components of a conceptual framework for financial reporting.

Section Reference: Conceptual Framework

CPA: Financial Reporting

Bloomcode: Knowledge

4. Which of the following best describes why a conceptual framework is necessary?
- a) to build all standards and rules upon a common foundation and increase financial statement users' understanding and confidence
 - b) to make financial statement preparation an automated process requiring no human intervention
 - c) to completely eliminate the potential for companies to exercise professional judgement in preparation of financial information
 - d) to decrease the comparability of different companies' financial statements

Answer: a

Difficulty: Easy

Learning Objective: Indicate the usefulness and describe the main components of a conceptual framework for financial reporting.

Section Reference: Conceptual Framework

CPA: Financial Reporting

Bloomcode: Knowledge

5. Fundamental qualitative characteristics include
- a) relevance and comparability.
 - b) representational faithfulness and timeliness.
 - c) relevance and representational faithfulness.
 - d) verifiability and relevance.

Answer: c

Difficulty: Medium

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Financial Reporting

Bloomcode: Knowledge

6. Which of the following does NOT relate to the concept of relevance?
- a) The information must be capable of making a difference in a decision.
 - b) Both material and immaterial information is important.
 - c) The information has predictive value.
 - d) The information has feedback/confirmatory value.

Answer: b

Difficulty: Easy

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Financial Reporting

Bloomcode: Knowledge

7. Accounting information is considered to be relevant when it
- a) can be depended on to represent the economic conditions and events that it is intended to represent.
 - b) is capable of making a difference in a decision.
 - c) is understandable by reasonably informed users of accounting information.
 - d) is verifiable and neutral.

Answer: b

Difficulty: Easy

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Financial Reporting

Bloomcode: Knowledge

8. Materiality refers to
- a) the tangible nature of an item.
 - b) representational faithfulness.
 - c) the decision-making relevance of a piece of information.
 - d) None of these describe materiality.

Answer: c

Difficulty: Easy

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Financial Reporting

Bloomcode: Knowledge

9. Which of the following is true about understandability as a qualitative characteristic of financial statements?
- a) The onus to prepare understandable statements and to be able to understand them lies with the preparer.
 - b) Where the underlying transactions or economic events are more complex, the user is expected to understand them without the assistance of an advisor.
 - c) The onus to prepare understandable statements and to be able to understand them lies with the preparer and the user.
 - d) Users with no knowledge of business and financial accounting matters are expected to understand the financial statements.

Answer: c

Difficulty: Medium

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

Bloomcode: Knowledge

10. Representational faithfulness includes

- a) completeness, neutrality and comparability.
- b) neutrality, completeness, and understandability.
- c) relevance, completeness and freedom from material error.
- d) neutrality, completeness and freedom from material error.

Answer: d

Difficulty: Medium

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Financial Reporting

Bloomcode: Knowledge

11. The overriding criterion by which accounting information can be judged is that of

- a) usefulness for decision making.
- b) freedom from bias.
- c) timeliness.
- d) comparability.

Answer: a

Difficulty: Medium

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Financial Reporting

Bloomcode: Knowledge

12. Which statement is correct regarding enhancing qualitative characteristics?

- a) Full discussion of the information presented is a substitute for comparable information.
- b) Numbers that are easily verifiable with a reasonable degree of accuracy are called soft numbers.
- c) Information must be available before it loses its ability to influence users' decisions.
- d) Financial information must be of sufficient quality and clarity that even uninformed readers can understand it.

Answer: c

Difficulty: Medium

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Financial Reporting

Bloomcode: Knowledge

13. Comparability allows any financial statement user to

- a) make timely decisions.
- b) understand all the information presented.
- c) verify all the data provided.
- d) identify the real similarities and differences in economic phenomena.

Answer: d

Difficulty: Medium

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Financial Reporting

Bloomcode: Knowledge

14. Timeliness is increased by

- a) quarterly reporting.
- b) comparative financial statements.
- c) representational faithfulness.
- d) annual reporting.

Answer: a

Difficulty: Medium

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Financial Reporting

Bloomcode: Knowledge

15. Burton Ltd. operates in both Canada and the United States. The company wants to improve the qualitative characteristics of its financial statements. Which of the following would most likely improve the *comparability* of Burton's financial statements?

- a) the restatement of its financial statements from Canadian GAAP to US GAAP for its American investors
- b) the preparation of monthly financial statements
- c) the introduction of a policy that specifies how Sunbury's capital assets should be depreciated
- d) the use of U.S.-trained accountants

Answer: a

Difficulty: Hard

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Financial Reporting

Bloomcode: Knowledge

16. You want to improve the qualitative characteristics of your firm's financial statements. Which of the following options would most likely improve the *timeliness* of your company's financial statements?

- a) increasing the number of disclosures

- b) changing the timing of when revenues are recognized
- c) increasing the frequency of statements from annually to quarterly
- d) decreasing the useful life of property, plant and equipment from ten years to five

Answer: c

Difficulty: Hard

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Financial Reporting

Bloomcode: Knowledge

17. The costs of providing useful information do NOT include

- a) collecting, processing and distributing information.
- b) auditing financial statements.
- c) disclosure to competitors.
- d) users' allocation of resources.

Answer: c

Difficulty: Hard

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Financial Reporting

Bloomcode: Knowledge

18. The common characteristic of both assets and liabilities is that they both

- a) provide an economic benefit.
- b) result from a past transaction or event.
- c) represent a present responsibility.
- d) represent contractual or other rights.

Answer: b

Difficulty: Easy

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

CPA: Financial Reporting

Bloomcode: Knowledge

19. Which of the following does NOT represent an essential characteristic of an asset?

- a) There is some economic benefit to the entity.
- b) The entity is able to transfer the economic benefit if it so chooses.
- c) The entity has control over the economic benefit.
- d) The benefits result from a past transaction or event.

Answer: b

Difficulty: Medium

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

CPA: Financial Reporting

Bloomcode: Knowledge

20. Which of the following statements regarding liabilities is true?

- a) They must arise through a contractual obligation.
- b) They may be attributable to a future transaction or event.
- c) The duty or responsibility obligates the entity.
- d) The entity often has reasonable discretion to avoid the obligation.

Answer: c

Difficulty: Medium

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

CPA: Financial Reporting

Bloomcode: Knowledge

21. Equitable obligations arise due to

- a) statutory requirements.
- b) contractual obligations.
- c) moral or ethical considerations.
- d) union agreements.

Answer: c

Difficulty: Easy

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

CPA: Financial Reporting

Bloomcode: Knowledge

22. Under IFRS, equity does NOT include

- a) long term leases.
- b) common and/or preferred shares.
- c) accumulated other comprehensive income.
- d) retained earnings.

Answer: a

Difficulty: Medium

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

CPA: Financial Reporting

Bloomcode: Knowledge

23. Gains are defined as

- a) increases in economic resources resulting from an entity's ordinary activities.
- b) decreases in economic resources resulting from an entity's ordinary activities.
- c) the residual interest remaining after liabilities are deducted from assets.
- d) increases in equity resulting from an entity's peripheral or incidental transactions.

Answer: d

Difficulty: Medium

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

CPA: Financial Reporting

Bloomcode: Knowledge

24. Under IFRS, "other comprehensive income" does NOT include

- a) unrealized holding gains and losses on certain securities.
- b) gains and losses on disposal of property, plant and equipment.
- c) gains and losses related to certain types of hedges.
- d) certain gains and losses related to foreign exchange transactions.

Answer: b

Difficulty: Hard

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

CPA: Financial Reporting

Bloomcode: Knowledge

25. Financial statements prepared under ASPE include a

- a) statement of comprehensive income.
- b) statement of cash flows and a statement of changes in shareholders' equity.
- c) balance sheet and a statement of retained earnings.
- d) statement of retained earnings and a statement of comprehensive income.

Answer: c

Difficulty: Hard

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

CPA: Financial Reporting

Bloomcode: Knowledge

26. Which of the following elements of financial statements is NOT a component of comprehensive income?

- a) Revenues
- b) Distributions to owners
- c) Losses

d) Expenses

Answer: b

Difficulty: Easy

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

CPA: Financial Reporting

Bloomcode: Knowledge

27. A local businessman owns several different companies. His accountant prepares separate financial statements for each of these businesses. This is an application of the

- a) full disclosure principle.
- b) periodicity assumption.
- c) going concern assumption.
- d) economic entity assumption.

Answer: d

Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

28. Generally, under ASPE, revenue from sales should be recognized at a point when

- a) management decides it is appropriate to do so.
- b) the product is available for sale.
- c) an exchange has taken place and the earnings process is substantially complete.
- d) the entire amount receivable has been collected from the customer and there remains no further warranty liability.

Answer: c

Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

29. During a major renovation project of its head office, a worker was seriously injured. While the company believes that it was not at fault, it does include the incident in the notes to its financial statements. This is consistent with the

- a) full disclosure principle.
- b) periodicity assumption.
- c) going concern assumption.
- d) economic entity assumption.

Answer: a

Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

30. The economic entity assumption

- a) is inapplicable to unincorporated businesses.
- b) recognizes the legal aspects of business organizations.
- c) requires periodic income measurement.
- d) is applicable to all forms of business organizations.

Answer: d

Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

31. When deciding whether to recognize a financial statement element (or not), and how to measure it, the accountant should

- a) always use estimates.
- b) record “hard” numbers and ignore “soft” numbers.
- c) determine an acceptable level of uncertainty.
- d) recognize a financial statement element even if it cannot be measured.

Answer: c

Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

32. During the lifetime of an entity, accountants produce financial statements at arbitrary points in time in accordance with the

- a) full disclosure principle.
- b) periodicity assumption.
- c) going concern assumption.
- d) economic entity assumption.

Answer: b

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles
CPA: Financial Reporting
Bloomcode: Knowledge

33. The assumption that a business enterprise will NOT be sold or liquidated in the near future is known as the
- a) economic entity assumption.
 - b) monetary unit assumption.
 - c) fair value principle.
 - d) going concern assumption.

Answer: d

Difficulty: Easy
Learning Objective: Describe the foundational principles of accounting.
Section Reference: Foundational Principles
CPA: Financial Reporting
Bloomcode: Knowledge

34. Valuing assets at their liquidation values rather than their cost is inconsistent with the
- a) periodicity assumption.
 - b) historical cost principle.
 - c) matching principle.
 - d) economic entity assumption.

Answer: b

Difficulty: Medium
Learning Objective: Describe the foundational principles of accounting.
Section Reference: Foundational Principles
CPA: Financial Reporting
Bloomcode: Knowledge

35. Which of the following is NOT a good example of the matching principle?
- a) A machine that produces certain goods is depreciated over its useful life. The depreciation expense is matched with the proceeds from the sale of those goods.
 - b) The entire amount of a two-year insurance premium is expensed in the first year.
 - c) An uncollectible receivable is written off in the year that the sale was made.
 - d) Recognition of revenue for which associated expenses cannot yet be determined is delayed until such determination can be made.

Answer: b

Difficulty: Hard
Learning Objective: Describe the foundational principles of accounting.
Section Reference: Foundational Principles
CPA: Financial Reporting
Bloomcode: Knowledge

36. Use of an allowance for doubtful accounts is an application of the

- a) matching principle.
- b) revenue recognition principle.
- c) historical cost principle.
- d) full disclosure principle.

Answer: a

Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

37. Which of the following statements does NOT apply to the historical cost principle?

- a) Historical cost represents a value at a point in time.
- b) The principle does not apply to financial instruments.
- c) Historical cost results from a reciprocal or two-way exchange.
- d) Over time, historical cost becomes irrelevant in terms of predictive value.

Answer: b

Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

38. Preparation of consolidated financial statements when a parent-subsidary relationship exists is an example of

- a) the economic entity assumption.
- b) the matching principle.
- c) comparability.
- d) reliability.

Answer: a

Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

39. The matching principle is best demonstrated by

- a) not recognizing any expense unless some revenue is realized.
- b) associating effort (expense) with accomplishment (revenue).

- c) recognizing prepaid rent received as revenue.
- d) measuring expenses correctly.

Answer: b

Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

40. Which of the following serves as the justification for the periodic recording of depreciation expense?

- a) association of efforts (expense) with accomplishments (revenue)
- b) minimization of income tax liability
- c) immediate recognition of an expense
- d) systematic and rational allocation of cost over the periods benefited

Answer: d

Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

41. Fair value (of an asset) is

- a) an entry price.
- b) an entity-specific measure.
- c) an exit price.
- d) not used when following IFRS.

Answer: c

Difficulty: Hard

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

42. Application of the full disclosure principle

- a) is theoretically desirable but not practical because the costs of complete disclosure exceed the benefits.
- b) is violated when important financial information is buried in the notes to the financial statements.
- c) is demonstrated by the inclusion of information such as information about contingencies.
- d) requires that the financial statements be consistent and comparable.

Answer: c

Difficulty: Hard

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

43. Where there is a significant uncertainty with respect to the measurement of an item,
- a) do not record anything in the financial statements.
 - b) recognize the item in the financial statements and disclose the measurement uncertainty in the notes to the financial statements.
 - c) do not record anything in the financial statements but disclose the measurement uncertainty in the notes to the financial statements.
 - d) record the maximum amount in the financial statements.

Answer: b

Difficulty: Hard

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

44. The operations of a resource company's oil sands operations results in environmental damage. While the extent of the damage cannot be determined at this time, the situation is disclosed in its financial statements. This best demonstrates
- a) the application of professional judgement.
 - b) the full disclosure principle.
 - c) representational faithfulness.
 - d) good management stewardship.

Answer: b

Difficulty: Hard

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

45. Management Discussion and Analysis (MD&A) is
- a) notes on meetings between management and auditors.
 - b) internal documents not released to shareholders.
 - c) supplementary information included in the annual report.
 - d) supplementary information included in the notes to the financial statements.

Answer: c

Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

46. Under GAAP, inflation has been historically ignored due to the

- a) economic entity assumption.
- b) going concern assumption.
- c) monetary unit assumption.
- d) periodicity assumption.

Answer: c

Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

47. Which basic assumption may NOT be followed when a firm in bankruptcy reports financial results?

- a) economic entity assumption
- b) going concern assumption
- c) periodicity assumption
- d) monetary unit assumption

Answer: b

Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

48. Management Discussion and Analysis (MD&A) does NOT include

- a) notes to the financial statements.
- b) key performance drivers.
- c) the company's vision and strategy.
- d) the company's capabilities (capital and other resources).

Answer: a

Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

49. The practice of matching

- a) dictates that efforts (expenditures) be matched with associated cash flow.
- b) requires arbitrary allocation of an asset's contribution to a revenue stream.
- c) illustrates the cause and effect relationship between money spent to earn revenues and the revenues themselves.
- d) is required by GAAP to approximate an asset's contribution to an entity's periodic cash flow.

Answer: c

Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

50. Financial reporting is

- a) independent of the environment in which it operates.
- b) the result of carefully applied professional judgement.
- c) influenced by the decisions of individuals who act in the interest of stakeholders at the expense of themselves.
- d) completely free of bias.

Answer: b

Difficulty: Medium

Learning Objective: Explain the factors that contribute to choice and/or bias in financial reporting decisions.

Section Reference: Financial Reporting Issues

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Knowledge

51. Principles-based GAAP is sometimes criticized for being

- a) too inflexible.
- b) too flexible.
- c) too inconsistent.
- d) too difficult for the reader to understand.

Answer: b

Difficulty: Hard

Learning Objective: Explain the factors that contribute to choice and/or bias in financial reporting decisions.

Section Reference: Financial Reporting Issues

CPA: Financial Reporting

Bloomcode: Knowledge

52. Which of the following situations does NOT demonstrate an attempt at financial engineering?

- a) creating complex legal arrangements and financial instruments
- b) structuring debt financing so that it meets the GAAP definition of equity rather than debt
- c) accounting for bona fide business transactions in a transparent manner
- d) aggressively interpreting GAAP so that the impact on critical ratios is minimized

Answer: c

Difficulty: Hard

Learning Objective: Explain the factors that contribute to choice and/or bias in financial reporting decisions.

Section Reference: Financial Reporting Issues

CPA: Financial Reporting

Bloomcode: Knowledge

53. Fraudulent financial reporting is a business reality. While it cannot be eliminated, the risk of fraudulent reporting can be decreased. Which of the following considerations is least likely to lessen that risk?

- a) an independent audit committee
- b) an internal audit function
- c) vigilant management
- d) an increased focus on tying bonuses to short-term company performance

Answer: d

Difficulty: Hard

Learning Objective: Explain the factors that contribute to choice and/or bias in financial reporting decisions.

Section Reference: Financial Reporting Issues

CPA: Financial Reporting

Bloomcode: Knowledge

54. In the absence of specific GAAP guidance, an entity should adopt accounting policies that are

- i. consistent with specific GAAP guidance.
 - ii. consistent with the most conservative reporting choices.
 - iii. collaboratively developed with the assistance of all business units.
 - iv. developed through exercising professional judgement and applying the conceptual framework.
- a) i, ii, and iii
 - b) i and iii
 - c) i and iv
 - d) ii and iv

Answer: c

Learning Objective: Explain the factors that contribute to choice and/or bias in financial reporting decisions.

Section Reference: Financial Reporting Issues

CPA: Financial Reporting

Bloomcode: Knowledge

55. The IASB issued an Exposure Draft relating to the conceptual framework in 2015.

Regarding presentation and disclosure, what change does this draft propose?

- a) renaming the balance sheet to the periodic statement of performance
- b) renaming the statement of profit or loss to the statement of income or deficit
- c) renaming the balance sheet to the statement of financial health
- d) renaming the statement of profit or loss to the statement of financial performance

Answer: d

Difficulty: Hard

Learning Objective: Discuss current trends in standard setting for the conceptual framework.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

56. Regarding the concept of materiality, what does the current IASB research project hope to accomplish?

- a) Augment IAS1 with a paragraph that sets out key characteristics of materiality.
- b) Develop a broadly applicable quantitative materiality threshold that all reporting entities will use.
- c) Identify and develop an IAS 25, a distinct section discussing the concept of materiality.
- d) A review of existing standards to identify conflicts, duplication, and overlaps.

Answer: a

Difficulty: Hard

Learning Objective: Discuss current trends in standard setting for the conceptual framework.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

EXERCISES

Ex. 2-57 Conceptual framework

Briefly describe the objectives of a soundly developed conceptual framework.

Solution 2-57

A soundly developed conceptual framework should

1. increase financial statement users' understanding of and confidence in financial reporting,
2. enhance comparability among companies' financial statements,
3. allow new and emerging practical problems to be solved more quickly.

Difficulty: Medium

Learning Objective: Indicate the usefulness and describe the main components of a conceptual framework for financial reporting.

Section Reference: Conceptual Framework

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

Bloomcode: Knowledge

Ex. 2-58 Levels of the conceptual framework

Provide a brief overview of the levels of a conceptual framework.

Solution 2-58

First Level: The “why” – The conceptual framework’s building blocks. Objectives identifying accounting’s goals and purposes.

Second Level: Bridge between levels 1 and 3 -- Qualitative characteristics that make accounting information useful and elements of the financial statements (assets, liabilities, equity, revenues, expenses, gains, and losses)

Third Level: The “how” – Foundational principles used in establishing and applying accounting standards.

A graphic similar to Illustration 2-1 may also be presented.

Difficulty: Medium

Learning Objective: Indicate the usefulness and describe the main components of a conceptual framework for financial reporting.

Section Reference: Conceptual Framework

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

Bloomcode: Knowledge

Ex. 2-59 Moral hazard

In Chapter 1, the issue of information asymmetry, and the concept of moral hazard were

introduced. Explain why the moral hazard issue is worse where some users (such as accountants and bankers) have expert knowledge.

Solution 2-59

The moral hazard issue is worse where certain stakeholders such as accountants and bankers have expert knowledge that the rest of the capital marketplace does not as they may use their expertise to act in their own self-interest to the detriment of other capital marketplace participants such as investors.

Difficulty: Easy

Learning Objective: Indicate the usefulness and describe the main components of a conceptual framework for financial reporting.

Section Reference: Conceptual Framework

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

Bloomcode: Knowledge

Ex. 2-60 Materiality

The concept of materiality is extremely important to the process of financial statement preparation and audit. Briefly explain the benchmarking approach to arriving at a materiality figure. What other factors might be considered in deciding whether an item is material?

Ex. 2-60 Solution

Current auditing standards (CAS 320.A7) considers 5% of pre-tax income from continuing operations for manufacturing companies and 1% of revenues for not-for-profit entities to be material. This is not definitive and is a fairly simplistic view of materiality. The item's impact on financial statement ratios and management compensation also needs to be considered. Materiality is also a function of qualitative factors such as illegal acts, failure to comply with regulations, or inadequate/inappropriate description of an accounting policy. The materiality constraint must be sensibly applied and also consider the cost/benefit to the company in providing detail of events and transactions relating to their operations.

Difficulty: Medium

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

Bloomcode: Knowledge

Ex. 2-61 Enhancing Qualitative Characteristics

Although fundamental qualitative characteristics of relevance and reliability are considered most important, financial statement preparers also place value upon certain enhancing qualitative characteristics. Briefly describe each of these characteristics and their contribution to providing decision-useful accounting information.

Solution 2-61

Enhancing qualitative characteristics include *comparability*, *verifiability*, *timeliness*, and

understandability.

Comparability enables users to identify real similarities and differences in economic phenomena because they have not been obscured by accounting methods that cannot be compared.

Verifiability exists when knowledgeable, independent users can achieve similar results or reach consensus regarding the accounting for a particular transaction.

Timeliness means information is available to decision-makers before it loses its ability to influence their decisions.

Understandability means financial information is of sufficient quality and clarity that reasonable informed users will see its significance.

Difficulty: Medium

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

Bloomcode: Knowledge

Ex. 2-62 Accounting terminology – fill in the blanks

Fill in the blanks below with the accounting term(s) that best completes each sentence.

1. A soundly developed conceptual framework is a _____ set of standards and rules. _____ and _____ are the fundamental qualitative characteristics that make accounting information useful for decision making.
2. Enhancing qualitative characteristics are _____, _____, _____ and _____.
3. Liabilities have three essential characteristics:
1. They represent a _____, 2. the entity has a _____, and 3. _____.
4. While consolidated financial statements are prepared from the perspective of the _____, taxes are paid from the perspective of the _____.
5. Collectability is one of the three conditions of the revenue recognition principle. Assuming the other two conditions are met, revenue should only be recognized if collectability is _____.
6. The _____ stipulates that anything that is relevant to decisions should be included in the financial statements.
7. A company's Management Discussion and Analysis (MD&A) is an example of _____.
8. A _____ - based approach, as used in Canadian GAAP and IFRS, is sometimes criticized for being too _____.
9. Under the _____ principle, _____ incurred during a particular period are matched with

_____ earned during that same period.

10. The _____ is based on the assumption that a business enterprise will continue to operate for the foreseeable future.
11. One of the assumptions of the _____ is valuation at a particular point in time.
12. _____ is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”
13. Standard setters have given companies the option to use _____ instead of historical costs.

Solution 2-62

1. coherent, relevance, representational faithfulness
2. comparability, verifiability, timeliness, understandability
3. present duty or obligation, present enforceable obligation, the liability results from a past transaction or event
4. economic entity, legal entity
5. reasonably assured
6. full disclosure principle
7. supplementary information
8. principles, flexible
9. matching, expenses, revenues
10. going concern assumption
11. historical cost principle
12. fair value
13. fair value

Difficulty: Hard

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Communication
 CPA: Financial Reporting
 Bloomcode: Comprehension
 Bloomcode: Knowledge

Ex. 2-63 Equitable obligations

Due to the current poor economic conditions, Inferno Corp, a medium-size manufacturer in Burnaby, is downsizing its Shipping Dept. and has to let go two of the employees, Chevron and Shell. Both are excellent workers and have been with the company for several years. The Shipping Dept. supervisor, Jo-Ann Roberts, goes to the company CEO to see if there is another alternative for these employees (other than termination of their employment). Jo-Ann suggests that Chevron could be retrained to learn how to operate a forklift and Shell would like to learn how to be a first aid attendant. Since Inferno always needs employees with these skills, the CEO agrees to try this. Inferno's work force is not unionized. What type of obligation is this? Discuss.

Solution 2-63

This would be an equitable obligation, which does not arise from a contractual obligation, but rather from moral or ethical considerations. Theoretically (since there is no union contract with attendant language regarding layoffs and terminations), the company has no obligation to Chevron and Shell and could let them go without any further ado. However, it appears that both Ms. Roberts and the CEO feel a moral obligation to help the employees by retraining them. This will have future benefits for Inferno. For example, the company will not lose good workers; it will benefit from their new skills; and it will improve morale among other workers who may feel threatened by potential future job losses.

Difficulty: Medium
 Learning Objective: Define the basic elements of financial statements.
 Section Reference: Elements of Financial Statements
 CPA: Communication
 CPA: Strategy & Governance
 Bloomcode: Analysis
 Bloomcode: Comprehension
 Bloomcode: Knowledge

Ex. 2-64 Constructive Obligations

It was recently found that a fleet of vehicles produced by Agrarium Automotive Corp possess a manufacturing defect relating to emissions compliance. In the past, Agrarium has issued recalls to owners of such vehicles, and paid for the associated repair cost. Agrarium has announced that they will continue to stand behind their products. Owners of the vehicle thus expect that Agrarium will replace or repair their vehicles. What type of obligation is this? Discuss.

Solution 2-64

This would be a constructive obligation, which arises from the contract between Agrarium and its vehicle owners as well as the policy to stand behind its products. There are moral and ethical considerations associated with the defect itself; however, the obligation in and of itself is constructive.

Difficulty: Medium

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

CPA: Communication

CPA: Strategy & Governance

Bloomcode: Analysis

Bloomcode: Comprehension

Bloomcode: Knowledge

Ex. 2-65 Comprehensive Income

Describe the income concept of comprehensive income. That is included in this notion of income under IFRS? What is included in it under ASPE?

Solution 2-65

Under IFRS comprehensive income includes net income and other comprehensive income (all other changes in equity except for owners' investments and distributions). Other comprehensive income is made up of revenues, expenses, gains and losses that, in accordance with primary sources of GAAP, are recognized in comprehensive income, but excluded from net income. For example:

- unrealized holding gains and losses on certain securities
- changes in revaluation surplus when using the revaluation method to account for capital assets
- certain gains and losses related to the translation of foreign operations, and cash flow hedges
- certain gains and losses related to re-measurement of defined benefit plans and liabilities measured at fair value

The concepts of comprehensive income and other comprehensive income do not exist under ASPE. Items would either be booked through net income or straight to shareholders' equity.

Difficulty: Hard

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

CPA: Communication

CPA: Strategy & Governance

Bloomcode: Analysis

Bloomcode: Comprehension

Bloomcode: Knowledge

Ex. 2-66 Foundational principles

Briefly explain the foundational principles of recognition, measurement, presentation and disclosure that underlie financial accounting.

Solution 2-66

These concepts help explain which, when, and how financial elements and events should be disclosed.

Recognition focuses on whether something should be included in a company's financial statements. It includes the economic entity assumption, control, revenue recognition and

matching principles.

Measurement relates to the "conversion" of information into numbers. It includes the periodicity, monetary unit and going concern assumptions, and the historical cost and fair value principles.

Presentation/disclosure relates to how (and how much) information is conveyed to the user. It includes the general practice of providing information that is important enough to influence an informed user's judgement and decisions.

Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Audit & Assurance

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

Bloomcode: Knowledge

Ex. 2-67 Identification of foundational accounting principles

State the accounting principle or assumption that is most applicable in the following situations:

1. A company prepares consolidated financial statements for a subsidiary that it owns.
2. The decision to remove an asset from the balance sheet
3. A large sale on account is not recognized as revenue because collectability is an issue.
4. Disclosure of the liability from a lawsuit in the financial statements
5. Preparation of monthly financial statements
6. Using the Canadian dollar in financial statements
7. An energy company includes detailed information about its reserves in its notes to the financial statements.

Solution 2-67

1. Control or economic entity assumption
2. Derecognition
3. Revenue recognition principle
4. Full disclosure principle
5. Periodicity assumption
6. Monetary unit assumption
7. Full disclosure principle

Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

Bloomcode: Knowledge

Ex. 2-68 Identification of foundational accounting principles and qualitative characteristics
Presented below are a number of accounting procedures and practices followed by January Corp. For each of these items, list the assumption, principle, or qualitative characteristic that is NOT being followed.

1. Because the company's income is low this year, January switched from accelerated depreciation to straight-line depreciation.
2. The president of January believes it is foolish to report financial information on a yearly basis. She believes that financial information should be disclosed only when significant new information is available related to the company's operations.
3. January decides to establish a large loss and related liability this year because of the possibility that it may lose a pending lawsuit. The possibility of loss is considered remote by the corporation's lawyers.
4. One of the corporation's executives purchased a new home computer for personal use with company money, charging Miscellaneous Expense.
5. The corporation has not established an Allowance for Doubtful accounts, even though there are a significant number of their accounts that are either slow paying or may not pay their debts in full.

Solution 2-68

1. Representational Faithfulness/ Neutrality
2. Periodicity assumption
3. Matching principle
4. Economic entity assumption
5. Matching principle

Difficulty: Hard

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

Bloomcode: Knowledge

Ex. 2-69 Foundational accounting principles and qualitative characteristics – matching
Listed below are several foundational accounting principles and qualitative characteristics. Match the letter of each with the appropriate phrase describing its application. Note that each item may be used more than once or not at all.

- | | |
|-------------------------------|------------------------------|
| a. Economic entity assumption | g. Matching principle |
| b. Going concern assumption | h. Full disclosure principle |
| c. Monetary unit assumption | i. Relevance |

- | | |
|----------------------------------|----------------------------------|
| d. Periodicity assumption | j. Reliability |
| e. Historical cost principle | k. Comparability |
| f. Revenue recognition principle | l. Representational faithfulness |

- _____ 1. Using the Canadian dollar in the financial statements
- _____ 2. The earning process is completed and realized or realizable.
- _____ 3. Accounting information reflects the economic substance of the event or transaction.
- _____ 4. Quarterly financial reports
- _____ 5. The use of accruals and deferrals in adjusting the accounts
- _____ 6. Useful standard measuring unit for business transactions
- _____ 7. Including explanatory notes as part of the financial statements
- _____ 8. The affairs of the business are distinguished from those of its owners.
- _____ 9. A business enterprise is assumed to have a long life.
- _____ 10. Valuing assets at amounts originally paid for them
- _____ 11. Application of the same accounting principles as in the preceding year
- _____ 12. Presentation of timely information with predictive and feedback value

Solution 2-69

- 1. c
- 2. f
- 3. l
- 4. d
- 5. g
- 6. c
- 7. h
- 8. a
- 9. b
- 10. e
- 11. k
- 12. i

Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

Bloomcode: Knowledge

Ex. 2-70 Fair value measurement

The ongoing trend toward using fair value has both its supporters and its critics. Briefly explain arguments in favour of and against the use of fair value.

Solution 2-70

Arguments in favour:

Fair values are current and therefore more relevant. The cost at which an asset is carried (using the cost at which it was acquired, say, twenty years ago) may bear little resemblance to its current replacement cost.

Arguments against:

Fair values may be difficult to ascertain, especially when markets for the underlying assets do not exist. Fair values may subject financial statements to a significant degree of variability in volatile markets.

Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

Bloomcode: Knowledge

Ex. 2-71 Matching concept

A concept is a group of related ideas. Matching could be considered a concept because it includes ideas related to both revenue recognition and expense recognition. Briefly explain the theory behind a) revenue recognition and b) expense recognition.

Solution 2-71

a) The basis of revenue recognition includes the following:

1. Revenues are inflows of net assets from delivering or producing goods or services or other earning activities that are the major operations of an enterprise during a period.
2. Recognition is recording and reporting in the financial statements.
3. Revenues are *realized* when goods or services are exchanged for cash or claims to cash.
4. Revenues are *earned* when the earnings process is complete or virtually complete.

The revenue recognition principle says that revenue is recognized when performance is achieved (earned) and measurability and collectability are reasonably assured (realized/realizable).

b) The basis of expense recognition includes "expense" and "matching":

1. Expenses are outflows of net assets during a period from delivering or producing goods or services or other activities that are the major operations of the entity.
2. Expenses are recognized when the goods or services (efforts) make their contribution to revenue.

The matching principle says that expenses are matched with revenues. Expenses are matched three ways:

1. When there is an association with revenue, expenses are matched with revenues in the period the revenues are recognized.
2. When no association with revenue is evident, expenses are allocated on some systematic and rational basis.
3. When no association with revenue is evident and no future benefits are expected, expenses are recognized immediately.

Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

Bloomcode: Knowledge

Ex. 2-72 Forms of business organization

Identify at least two (2) common forms of business organization. For each business structure name an associated pro and con.

Solution 2-72

	Brief Description	Pros	Cons
Proprietorship	Small business owned and run by one person (sole proprietor)	– Simple to set up and maintain records – Does not have to file separate tax return	– Not a separate legal entity; lawsuits would be directed against the proprietor – Personal assets may be required to pay off business debts
Partnership	Business usually owned and/or run by more than one person (the partners)	– At the basic level, simple to set up and maintain records – Does not have to file separate income tax returns (may need to for GST/HST)	– Not a separate legal entity; lawsuits would be directed against the partners – Personal assets may be required to pay off business debts
Corporation	Business is incorporated as a separate legal entity	– Limited liability protection – Any obligations are obligations of the corporation and not the owners	– More complex to set up and maintain records – Separate tax returns must be completed and filed – Covered by the Canada Business Corporations Act or

			provincial corporations act
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Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

Bloomcode: Knowledge

Ex. 2-73 Control and the economic entity assumption

Consolidated financial statements are prepared from the perspective of the economic entity. Determination of which business units, or subsidiaries, are to be included in the entity is rooted in the definition of control. Describe how this concept is interpreted under IFRS and ASPE, respectively. Discuss the significance of this difference in interpretation.

Solution 2-73

IFRA 10 notes that the investor has control over an investee when it has the following:

1. power over the investee;
2. exposure, or rights, to variable returns from its involvement with the investee; and
3. the ability to use its power over the investee to affect the amount of the investors' returns.

Under ASPE, the standards are similar where the company owns voting shares in another company (consistent with the traditional interpretation of control as >50% voting common shares). In some situations, such as those involving sales of financial instruments to certain trusts or other legal entities), ASPE standards are significantly different. ASPE focuses on whether the entity is demonstrably distinct from the company. In assessing this, the company looks at:

- whether the entity in question can be unilaterally dissolved by the company, and
- whether others have more than 10% ownership interest.

This distinction is important because it determines which entities are included as part of the economic entity for financial reporting purposes. This will have an impact on the entity's appearance to stakeholders.

Difficulty: Medium

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

Bloomcode: Knowledge

Ex. 2-74 Principles vs. rules-based GAAP

There has been much discussion about principles-based standards versus rules-based standards. Discuss the advantages and disadvantages of a principles-based approach.

Solution 2-74

Advantages of a principles-based approach:

1. Decisions are based on the conceptual framework – so they should be consistent.
2. Flexibility – allows for making decisions about new or unusual transactions based on principles.
3. Allows accountants to use their professional expertise and professional judgement.

Disadvantages of a principles-based approach:

1. Flexibility may result in reduced comparability between different firms.
2. Flexibility may be abused and bias may creep into decisions.

Difficulty: Medium

Learning Objective: Explain the factors that contribute to choice and/or bias in financial reporting decisions.

Section Reference: Financial Reporting Issues

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

Bloomcode: Knowledge

Ex. 2-75 Financial engineering

Explain the practice of financial engineering and how it relates to fraudulent financial reporting.

Solution 2-75

Financial engineering is a process whereby a business arrangement or transaction is structured legally such that it meets the company's financial reporting objective within GAAP. This is often done by using complex legal arrangements and financial instruments. This produces a transaction or item that may have the form of one kind of transaction or item when the substance is something different. Enron was involved in many transactions of this type. Since the substance of these arrangements is to obscure the real nature of the transactions or items involved, they are potentially fraudulent.

Difficulty: Medium

Learning Objective: Explain the factors that contribute to choice and/or bias in financial reporting decisions.

Section Reference: Financial Reporting Issues

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

Bloomcode: Knowledge

Ex. 2-76 Fraudulent financial reporting

Identify several factors that contribute to fraudulent financial reporting.

Solution 2-76

1. unrealistic internal budgets and financial statement focal points arising from contractual, regulatory, or capital market expectations
2. weak internal control and governance
3. worsening economic conditions or industry

Difficulty: Easy

Learning Objective: Explain the factors that contribute to choice and/or bias in financial reporting decisions.

Section Reference: Financial Reporting Issues

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

Bloomcode: Knowledge

Ex. 2-77 Fraudulent financial reporting and the accountant's role

Explain what the accountant's responsibility is in preparation of a company's financial records.

Solution 2-77

The accountant's role is to capture business and economic events and transactions as they occur and communicate them to interested parties. They should not use the financial statements to portray something that is not there. Good financial reporting should be a result of reasoned and supported analysis that is grounded in a conceptual framework. It should not be influenced by external pressures such as those identified in Exercise 2-76.

Difficulty: Easy

Learning Objective: Explain the factors that contribute to choice and/or bias in financial reporting decisions.

Section Reference: Financial Reporting Issues

CPA: Audit & Assurance

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

Bloomcode: Knowledge

Ex. 2-78 Financial reporting pressures caused by budgets

Explain why budgets might exert negative influence into accounting decisions. Offer some examples to illustrate where this might be the case.

Solution 2-78

Budgets put tremendous pressure on company management since bonuses and even jobs might depend on meeting budget targets. For example, if a manager's year-end bonus depends upon reaching a certain sales target, he might create some artificial sales near year-end to inflate the sales figure.

Difficulty: Medium

Learning Objective: Explain the factors that contribute to choice and/or bias in financial reporting decisions.

Section Reference: Financial Reporting Issues

CPA: Audit & Assurance

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

Bloomcode: Knowledge

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