SUMMARY OF LEARNING OBJECTIVES BY QUESTION TYPE

Item	Type	Item	Type	Item	Type	Item	Type	Item	Type	Item	Type
Learning Objective 1											
1.	MC	2.	MC	53.	Ex						
Learning Objective 2											
3.	MC	5.	MC	7.	MC	9.	MC	11.	MC	13.	MC
4.	MC	6.	MC	8.	MC	10.	MC	12.	MC	54.	Ex
Learning Objective 3											
14.	MC	16.	MC	18.	MC	20.	MC	55.	Ex		
15.	MC	17.	MC	19.	MC	54.	Ex				
Learning Objective 4											
21.	MC	26.	MC	31.	MC	36.	MC	56.	Ex	60.	Ex
22.	MC	27.	MC	32.	MC	37.	MC	57.	Ex	61.	Ex
23.	MC	28.	MC	33.	MC	38.	MC	58.	Ex		
24.	MC	29.	MC	34.	MC	39.	MC	59.	Ex		
25.	MC	30.	MC	35.	MC	40.	MC	54.	Ex		
Learning Objective 5											
41.	MC	42.	MC	43.	MC	62.	Ex	63.	Ex	64.	Ex
Learning Objective 6											
44.	MC	45.	MC	46.	MC						
Learning Objective 7											
*47.	MC	*48.	MC	*49.	MC	*50.	MC	*51.	MC	*52.	MC

Note: MC = Multiple Choice Ex = Exercise

*This topic is dealt with in an Appendix to the chapter.

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 and FASB will continue to work toward a common conceptual framework. The project on objectives and qualitative characteristics is complete. The boards are focusing on defining elements and the recognition/measurement frameworks.

MULTIPLE CHOICE—Conceptual

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

a	*48.	Definition of the cost model
b	*49.	Definition of the income model
c	*50.	Definition of the market model
d	*51.	Use of discounted cash flow model
c	*52.	Remeasuring a liability at fair value

*This topic is dealt with in an Appendix to the chapter.

EXERCISES

Item	Description
2-53	Conceptual framework
2-54	Accounting terminology – fill in the blanks
2-55	Equitable obligations
2-56	Foundational principles
2-57	Identification of foundational accounting principles
2-58	Identification of foundational accounting principles and qualitative characteristics
2-59	Foundational accounting principles and qualitative characteristics – matching
2-60	Fair value measurement
2-61	Matching concept
2-62	Principles vs. rules based GAAP
2-63	Financial engineering
2-64	Fraudulent financial reporting

MULTIPLE CHOICE—Conceptual

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

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

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

4. 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.

5. 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.

6. 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.

7. 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.

8. 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.

9. 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.

10. Timeliness is increased by
a) quarterly reporting.
b) comparative financial statements.
c) representational faithfulness.
d) annual reporting.

11. Sunbury 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 Sunbury'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.

12. 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

13. 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.

14. 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.

15. Equitable obligations arise due to
a) statutory requirements.
b) contractual obligations.
c) moral or ethical considerations.
d) union agreements.

16. Under IFRS, equity does NOT include
a) long term leases.
b) common and/or preferred shares.
c) accumulated other comprehensive income.
d) retained earnings.

17. 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.

18. 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.

19. 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.

20. 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

21. 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.

22. Generally, 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.

23. 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.

24. 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.

25. 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.

26. 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.

27. 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.

28. 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.

29. 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.

30. 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.

31. 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.

32. Preparation of consolidated financial statements when a parent-subsidiary relationship exists is an example of
   a) the economic entity assumption.
   b) the matching principle.
   c) comparability.
   d) reliability.

33. 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.

34. 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

35. 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.

36. 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.

37. 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.

38. 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.

39. 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.

40. 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).

41. 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.

42. 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

43. 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

44. The IASB and FASB are currently working on a joint project to complete a common conceptual framework. Which of the following statements best describes the *proposed* (new) definition of an asset?
   a) The asset must involve future economic resources and the entity has a right or access to the resources, while others do not.
   b) The asset must involve future economic resources and the resource must be freely available to all.
   c) The asset must involve present economic resources and the entity has a right or access to the resources, while others do not.
   d) The asset must involve present economic resources and the resource must be freely available to all.

45. The IASB and FASB are currently working on a joint project to complete a common conceptual framework. According to the *proposed* (new) definition, which of the following would be considered *assets*?
   a) accounts receivable, accounts payable, and patents
   b) insurance contracts and accounts receivable
   c) land, accounts receivable and unearned revenue
   d) property, plant and equipment and constructive obligations

46. The IASB and FASB are currently working on a joint project to complete a common conceptual framework. According to the *proposed* (new) definition, which of the following would be considered *liabilities*?
   a) accounts receivable and accounts payable
   b) constructive obligations, long term leases and insurance contracts
   c) accounts payable, unearned revenue, and copyrights
   d) lawsuits – both settled and in progress

*47. Which of the following statements is correct regarding the levels of inputs required for estimating fair value of financial statement elements?
   a) Level 3 inputs are the highest quality inputs.
   b) The lower the level of input, the greater the required disclosures.
   c) Level 2 inputs are generally not observable and hence more subjective.
   d) Level 1 inputs are the lowest quality inputs.

*48. Valuation models may be categorized into three groups. Cost models
   a) attempt to reflect the amount that would be required to replace the asset's service capacity.
   b) convert future amounts to current amounts, using, for example, discounted cash flows or options pricing models.
   c) use prices and other information generated from market transactions involving identical or similar transactions.
   d) use either discounted cash flows methods, or prices and other information generated from market transactions involving identical or similar transactions.

*49. Valuation models may be categorized into three groups. Income models
   a) attempt to reflect the amount that would be required to replace the asset's service capacity.
   b) convert future amounts to current amounts, using, for example, discounted cash flows or options pricing models.
   c) use prices and other information generated from market transactions involving identical or similar transactions.
   d) use either discounted cash flows methods or prices and other information generated from market transactions involving identical or similar transactions.

*50. Valuation models may be categorized into three groups. Market models
   a) attempt to reflect the amount that would be required to replace the asset's service capacity.
   b) convert future amounts to current amounts, using, for example, discounted cash flows or options pricing models.
   c) use prices and other information generated from market transactions involving identical or similar transactions.
   d) use either discounted cash flows methods or prices and other information generated from market transactions involving identical or similar transactions.

*51. Fair value estimates arrived at by using discounted cash flow models would NOT use
a) estimates of cash flows.
b) time value of money.
c) uncertainty (risk).
d) original cost of an asset.

*52. A formerly profitable company is currently experiencing losses and, as a result, is cash-squeezed. Thus, it may not be able to repay its bank debt according to the loan's terms. If fair value is being used to measure this liability, then
a) the company's credit risk has decreased.
b) the debit to equity ratio will increase.
c) the present value of the liability will decrease, resulting in a gain booked through other comprehensive income.
d) the present value of the liability will decrease, resulting in a gain booked through profit and loss.

MULTIPLE CHOICE ANSWERS—CONCEPTUAL

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
1.	c	9.	d	17.	d	25.	c	33.	b	41.	b	*49.	b
2.	d	10.	a	18.	b	26.	b	34.	d	42.	c	*50.	c
3.	c	11.	a	19.	c	27.	d	35.	c	43.	d	*51.	d
4.	b	12.	c	20.	b	28.	b	36.	c	44.	c	*52.	c
5.	b	13.	c	21.	d	29.	b	37.	b	45.	b		
6.	d	14.	b	22.	c	30.	a	38.	b	46.	d		
7.	a	15.	c	23.	a	31.	b	39.	c	*47.	b		
8.	c	16.	a	24.	d	32.	a	40.	a	*48.	a		

EXERCISES

Ex. 2-53 Conceptual framework
Briefly describe the objectives of a soundly developed conceptual framework.

Solution 2-53
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.

Ex. 2-54 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 2-54

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

Ex. 2-55 Equitable obligations

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

What type of obligation is this? Discuss.

Solution 2-55
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 Jinder and Tang and could let them go without any further ado. However, it appears that both Ms Kowalski and the CEO feel a moral obligation to help the employees by retraining them. This will have future benefits for Latimer. 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.

Ex. 2-56 Foundational principles
Briefly explain the foundational principles of recognition, measurement, presentation and disclosure that underlie financial accounting.

Solution 2-56
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.

Ex. 2-57 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 2-57
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

Ex. 2-58 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 2-58

1. Representational Faithfulness/ Neutrality

2. Periodicity assumption

3. Matching principle

4. Economic entity assumption

5. Matching principle

Ex. 2-59 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
b. Going concern assumption
c. Monetary unit assumption
d. Periodicity assumption
e. Historical cost principle
g. Matching principle
h. Full disclosure principle
i. Relevance
j. Reliability
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 2-59

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

Ex. 2-60 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 2-60

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.

Ex. 2-61 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 2-61

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.

Ex. 2-62 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 2-62
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.

Ex. 2-63 Financial engineering
Explain the practice of financial engineering and how it relates to fraudulent financial reporting.

Solution 2-63
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.

Ex. 2-64 Fraudulent financial reporting
Identify several factors that contribute to fraudulent financial reporting.

Solution 2-64

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