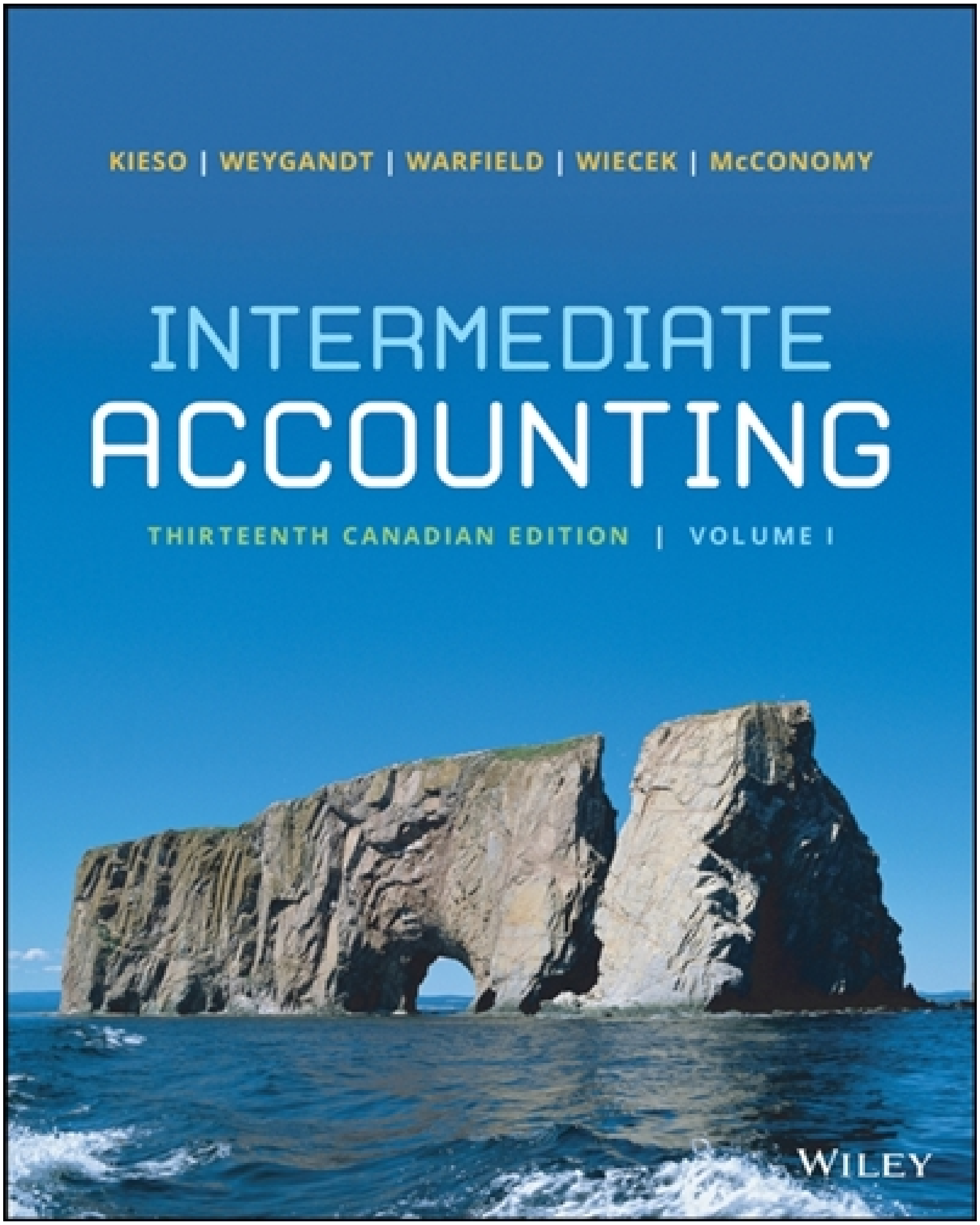
Test Bank for Intermediate Accounting Volume 1 13th Edition by Kieso



Test Bank

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 of the framework 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, and (6) gains/ losses. IFRS has fewer elements defined.

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) under ASPE and when performance obligations are satisfied (control passes) under IFRS. (4) Matching: the assumption 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. (9) Fair value principle and value in use:

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 can be 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 IFRS Foundation is currently working on a technology initiative, the Primary Financial Statements project, and its disclosure project. The AcSB is reviewing its financial statement concepts.

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.	Conceptual framework
d	6.	Information asymmetry
c	7.	Fundamental qualitative characteristics
b	8.	Relevance
b	9.	Relevance
c	10.	Materiality
c	11.	Understandability
d	12.	Representational faithfulness
a	13.	Criterion for accounting information
c	14.	Enhancing qualitative characteristics
d	15.	Comparability
a	16.	Timeliness
a	17.	Comparability
c	18.	Timeliness
c	19.	Costs of providing useful information
b	20.	Dynamic materiality
a	21.	Conservatism
b	22.	Common characteristic of assets and liabilities
b	23.	Asset characteristics
c	24.	Liabilities
c	25.	Equitable obligations
a	26.	Items included in equity under IFRS
d	27.	Definition of gains
b	28.	Other comprehensive income
c	29.	Statements prepared using ASPE
b	30.	Components of comprehensive income
d	31.	Constructive obligation
c	32.	Liabilities
d	33.	Economic entity assumption
c	34.	Timing of revenue recognition
a	35.	Example of full disclosure
d	36.	Economic entity assumption
c	37.	Recognition and measurement
b	38.	Periodicity assumption
d	39.	Going concern assumption
b	40.	Historical cost principle
b	41.	Matching principle
a	42.	Use of allowance for expected credit losses
b	43.	Historical cost principle

Answer	No.	Description
a	44.	Economic entity assumption
b	45.	Matching principle
d	46	Recording of depreciation
c	47.	Fair value of an asset
c	48.	Full disclosure principle
b	49.	Measurement uncertainty
b	50.	Full disclosure principle
c	51.	Management Discussion and Analysis
c	52.	Inflation
b	53.	Bankruptcy
a	54.	Items included in MD&A
c	55.	Matching
a	56.	Fair value
b	57.	Financial reporting
b	58.	Principles-based GAAP
c	59.	Financial engineering
d	60	Fraudulent financial reporting
c	61.	Accounting policies
a	62.	Financial engineering
a	63.	Business environment

EXERCISES

Item	**Description**
E2-64	Conceptual framework
E2-65	Levels of the conceptual framework
E2-66	Moral hazard
E2-67	Materiality
E2-68	Enhancing qualitative characteristics
E2-69	Fundamental characteristics of useful information
E2-70	Accounting terminology – fill in the blanks
E2-71	Equitable obligations
E2-72	Constructive obligations
E2-73	Comprehensive income
E2-74	Foundational principles
E2-75	Identification of foundational accounting principles
E2-76	Identification of foundational accounting principles and qualitative characteristics
E2-77	Foundational accounting principles and qualitative characteristics – matching
E2-78	Fair value measurement
E2-79	Revenue Recognition
E2-80	Matching concept
E2-81	Forms of business organization
E2-82	Measurement, existence, and outcome uncertainties
E2-83	Recognizing and Measuring Financial Statement Uncertainty
E2-84	Current value measurement bases
E2-85	Going concern assumption
E2-86	Market-based measure versus entity-specific measure
E2-87	Control and the economic entity assumption
E2-88	Principles- vs. rules-based GAAP
E2-89	Financial engineering
E2-90	Fraudulent financial reporting
E2-91	Fraudulent financial reporting and the accountant's role
E2-92	Financial reporting pressures caused by budgets

PROBLEMS

Item	**Description**
P2-93	Sustainability Reporting
P2-94	Uncertainty trade-off
P2-95	IFRS/ASPE revenue recognition differences
P2-96	Types of Organizational Structures

MULTIPLE CHOICE

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
AACSB: Analytic

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
AACSB: Analytic

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
AACSB: Analytic

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
AACSB: Analytic

5. The second level of the conceptual framework relates to the
a) various items in financial statements.
b) objectives of financial reporting.
c) qualitative characteristics of accounting information.
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
AACSB: Analytic

6. Expert knowledge possessed by certain stakeholders that the rest of the capital market does NOT

have results in
a) management stewardship.
b) the use of general-purpose statements.
c) ethical issues.
d) a moral hazard.

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: Comprehension
AACSB: Analytic

7. 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: Easy
Learning Objective: Identify the qualitative characteristics of accounting information.
Section Reference: Qualitative Characteristics of Useful Information
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

8. 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

AACSB: Analytic

9. 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
AACSB: Analytic

10. 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
AACSB: Analytic

11. 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: Easy
Learning Objective: Identify the qualitative characteristics of accounting information.
Section Reference: Qualitative Characteristics of Useful Information
CPA: Communication
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Communication

12. 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: Easy
Learning Objective: Identify the qualitative characteristics of accounting information.
Section Reference: Qualitative Characteristics of Useful Information
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

13. The overriding criteria 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: Easy
Learning Objective: Identify the qualitative characteristics of accounting information.
Section Reference: Qualitative Characteristics of Useful Information
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

14. 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: Easy
Learning Objective: Identify the qualitative characteristics of accounting information.
Section Reference: Qualitative Characteristics of Useful Information
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

15. 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: Easy
Learning Objective: Identify the qualitative characteristics of accounting information.
Section Reference: Qualitative Characteristics of Useful Information
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

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

Answer: a

Difficulty: Easy
Learning Objective: Identify the qualitative characteristics of accounting information.
Section Reference: Qualitative Characteristics of Useful Information
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

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

Answer: a

Difficulty: Easy
Learning Objective: Identify the qualitative characteristics of accounting information.
Section Reference: Qualitative Characteristics of Useful Information
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

18. 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: Easy
Learning Objective: Identify the qualitative characteristics of accounting information.
Section Reference: Qualitative Characteristics of Useful Information
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

19. 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: Easy
Learning Objective: Identify the qualitative characteristics of accounting information.
Section Reference: Qualitative Characteristics of Useful Information
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

20. The idea of taking an accounting perspective that includes long-term value creation and includes a discussion related to a broader perspective of all stakeholders is referred to as
a) relevance
b) dynamic materiality
c) conservatism
d) faithful representation

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
AACSB: Analytic

21. What standard did the IASB recently reintroduce in order to address the pre-existing tendency that companies have to overstate net assets and net income?
a) conservatism
b) sustainability reporting
c) dynamic materiality
d) representational faithfulness

Answer: a

Difficulty: Easy
Learning Objective: Identify the qualitative characteristics of accounting information.
Section Reference: Qualitative Characteristics of Useful Information
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

22. A common characteristic of both assets and liabilities is that both
a) provide an economic resource.
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
AACSB: Analytic

23. Which of the following does NOT represent an essential characteristic of an asset?
a) It represents a present economic resource.
b) The entity is able to transfer the economic benefit if it so chooses.
c) The entity has control over the resource.
d) The resource results from a past transaction or event.

Answer: b

Difficulty: Easy
Learning Objective: Define the basic elements of financial statements.
Section Reference: Elements of Financial Statements
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

24. Which of the following statements regarding liabilities is true?
a) Liabilities arise through a contractual obligation.
b) Liabilities 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: Easy
Learning Objective: Define the basic elements of financial statements.
Section Reference: Elements of Financial Statements
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

25. 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
AACSB: Ethics

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

Answer: a

Difficulty: Easy
Learning Objective: Define the basic elements of financial statements.
Section Reference: Elements of Financial Statements
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

27. 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: Easy
Learning Objective: Define the basic elements of financial statements.
Section Reference: Elements of Financial Statements
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

28. 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: Easy
Learning Objective: Define the basic elements of financial statements.
Section Reference: Elements of Financial Statements
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

29. 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: Easy
Learning Objective: Define the basic elements of financial statements.
Section Reference: Elements of Financial Statements
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

30. 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
AACSB: Analytic

31. Appliance World does not extend any type of warranty for its products. However, in its advertising campaign it claims to stand behind all of its products and will provide repairs at no cost to the customer. What type of obligation does this create for Appliance World?
a) a moral obligation
b) an ethical obligation
c) an equitable obligation
d) a constructive obligation

Answer: d

Difficulty: Medium
Learning Objective: Define the basic elements of financial statements.
Section Reference: Elements of Financial Statements
CPA: Financial Reporting
Bloomcode: Analysis
AACSB: Analytic

32. Which of the following activities would NOT create a liability for a company?
a) illegal dumping of hazardous waste
b) a commitment to long-term employees to provide counseling services during a lay-off
c) extending an employment offer
d) offering free repairs to customers on purchased products

Answer: c

Difficulty: Easy
Learning Objective: Define the basic elements of financial statements.
Section Reference: Elements of Financial Statements
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

33. 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: Easy
Learning Objective: Describe the foundational principles of accounting.
Section Reference: Foundational Principles
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

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

35. During a major renovation project of a company's head office, a worker was seriously injured. While the company believes that it is 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: Easy
Learning Objective: Describe the foundational principles of accounting.
Section Reference: Foundational Principles
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

36. The economic entity assumption
a) does not apply 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: Easy
Learning Objective: Describe the foundational principles of accounting.
Section Reference: Foundational Principles
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

37. Under ASPE, 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: Easy
Learning Objective: Describe the foundational principles of accounting.
Section Reference: Foundational Principles
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

38. 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
AACSB: Analytic

39. 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
AACSB: Analytic

40. Valuing assets at liquidation values rather than cost is inconsistent with the
a) periodicity assumption.
b) historical cost principle.
c) matching principle.
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
AACSB: Analytic

41. 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: Easy

Learning Objective: Describe the foundational principles of accounting.
Section Reference: Foundational Principles
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

42. Use of allowance for expected credit losses is an application of the
a) matching principle.
b) revenue recognition principle.
c) historical cost principle.
d) full disclosure principle.

Answer: a

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

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

44. 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.

Answer: a

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

45. 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: Easy
Learning Objective: Describe the foundational principles of accounting.
Section Reference: Foundational Principles
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

46. Which of the following serves as the justification for the periodic recording of depreciation expense?
a) the matching of effort (expense) with accomplishment (revenue)
b) the minimization of income tax liability
c) the immediate recognition of an expense
d) the systematic and rational allocation of cost over the periods benefited

Answer: d

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

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

48. 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 contingencies.
d) requires that the financial statements be consistent and comparable.

Answer: c

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

49. Under ASPE, 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: Easy
Learning Objective: Describe the foundational principles of accounting.
Section Reference: Foundational Principles
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

50. The operation of a resource company's oil sands activities 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: Easy
Learning Objective: Describe the foundational principles of accounting.
Section Reference: Foundational Principles
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

51. Management Discussion and Analysis (MD&A) is best described as
a) notes on meetings between management and auditors.
b) an internal document 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: Easy
Learning Objective: Describe the foundational principles of accounting.
Section Reference: Foundational Principles
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

52. 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: Easy
Learning Objective: Describe the foundational principles of accounting.

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

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

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

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

56. Which of the following statements is true regarding the emerging “fair value principle”?
a) Fair value is an exit price rather than an entry price.
b) Fair value is an entity-specific measure rather than a market-based measure.
c) Historical cost is lower than fair value upon acquisition.
d) Fair value is more objective than historical cost.

Answer: a

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

57. 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: Easy
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
AACSB: Analytic

58. 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: Easy
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
AACSB: Analytic

59. 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: Easy
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
AACSB: Analytic

60. 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 the 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: Easy
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: Comprehension
AACSB: Analytic

61. 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

Difficulty: Easy
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
AACSB: Analytic

62. Which of the following statements best describes financial engineering?
a) It is the process of legally structuring a business arrangement or transaction so that it meets the company's financial reporting objective.
b) It is the process of remeasurement of assets using the fair value principle.
c) It is the process of knowingly misleading stakeholders with false information.
d) It results from a complete disregard of ethical behaviour.

Answer: a

Difficulty: Easy
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
AACSB: Analytic

63. Which of the following activities might a company engage in to make future earnings appear more

favourable during an economic downturn?
a) large write-downs in assets
b) manipulation of the budget
c) recognition of revenues before earned
d) deferral of the recognition of expenses

Answer: a

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
Bloomcode: Analysis
AACSB: Analytic

EXERCISES

Ex. 2-64 Conceptual framework
Briefly describe the objectives of a soundly developed conceptual framework.

Solution 2-64
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: 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: Knowledge
AACSB: Communication

Ex. 2-65 Levels of the conceptual framework
Provide a brief overview of the levels of a conceptual framework.

Solution 2-65
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: 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: Knowledge
AACSB: Communication

Ex. 2-66 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 2-66
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 because 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
AACSB: Communication

Ex. 2-67 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?

Solution 2-67
Current auditing standards (CAS 320.A8) consider 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 consider the cost/benefit to the company in providing details of events and transactions relating to its operations.

Difficulty: Easy
Learning Objective: Identify the qualitative characteristics of accounting information.
Section Reference: Qualitative Characteristics of Useful Information
CPA: Communication
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Communication

Ex. 2-68 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 2-68
Enhancing qualitative characteristics include *comparability, verifiability, timeliness,* and *understandability.*

Comparability enables users to identify real similarities and differences in economic phenomena because these items 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: Easy
Learning Objective: Identify the qualitative characteristics of accounting information.
Section Reference: Qualitative Characteristics of Useful Information
CPA: Communication
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Communication

Ex. 2-69 Fundamental characteristics of useful information
What steps should be taken to ensure that both fundamental characteristics of useful information, relevance and representational faithfulness, are present?

Solution 2-69
In order to ensure that both fundamental characteristics of useful information (relevance and representational faithfulness) are present, the following steps should be taken:
1. **Identify the economic event or transaction.** For instance, assume that an investment in shares of a publicly traded company has increased in value. This is an economic event.
2. **Identify the type of information about that transaction or event that would be relevant and can be faithfully represented.** The type of information that would be relevant might be the fair value of the investment.

3. **Assess whether the information is available and can be faithfully represented**. Since the shares are publicly traded, fair value is available and could easily be presented faithfully in the financial statements.

Difficulty: Easy
Learning Objective: Identify the qualitative characteristics of accounting information.
Section Reference: Qualitative Characteristics of Useful Information.
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

Ex. 2-70 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. Collectibility is one of the three conditions of the revenue recognition principle. Assuming the other two conditions are met, revenue should only be recognized if collectibility 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 ______-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 2-70

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-based, flexible

9. matching, expenses, revenues

10. going concern assumption

11. historical cost principle

12. fair value

13. fair value

Difficulty: Easy
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: Knowledge

AACSB: Communication

Ex. 2-71 Equitable obligations
Due to the current poor economic conditions, Inferno Corp., a medium-size manufacturer in Burnaby, is downsizing its shipping department and has terminated two of the employees, Chevron and Shell. Both are excellent workers and have been with the company for several years. The department's 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 workforce is not unionized. What type of obligation is this? Discuss.

Solution 2-71
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 terminate them without any further ado. However, it appears that both Ms. Roberts and the CEO feel they have 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
AACSB: Communication

Ex. 2-72 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 it will continue to stand behind its products. Owners of the vehicle thus expect that Agrarium will replace or repair their vehicles. What type of obligation is this? Discuss.

Solution 2-72
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
AACSB: Communication

Ex. 2-73 Comprehensive income
Describe the income concept of comprehensive income and what is included in this notion of income under IFRS? What is included in it under ASPE?

Solution 2-73
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 remeasurement 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: Easy
Learning Objective: Define the basic elements of financial statements.
Section Reference: Elements of Financial Statements
CPA: Communication
CPA: Strategy & Governance
Bloomcode: Knowledge
AACSB: Communication

Ex. 2-74 Foundational principles
Briefly explain the foundational principles of recognition, measurement, and presentation and disclosure that underlie financial accounting.

Solution 2-74
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: Easy
Learning Objective: Describe the foundational principles of accounting.
Section Reference: Foundational Principles
CPA: Audit & Assurance
CPA: Communication
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Communication

Ex. 2-75 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 collectibility 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 2-75

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: Easy
Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles
CPA: Communication
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Communication

Ex. 2-76 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. Given the low e company net income 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 Expected Credit Losses Account, even though there are a significant number of its accounts that are either slow paying or are not paid in full.

Solution 2-76

1. Representational Faithfulness/ Neutrality

2. Periodicity Assumption

3. Matching Principle

4. Economic Entity Assumption

5. Matching Principle

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

Ex. 2-77 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
f. Revenue recognition principle
g. Matching principle
h. Full disclosure principle
i. Relevance
j. Reliability
k. Comparability
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. A 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 prior year.
___ 12. Presentation of timely information with predictive and feedback value.

Solution 2-77

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

Ex. 2-78 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 2-78
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, 20 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: Easy
Learning Objective: Describe the foundational principles of accounting.
Section Reference: Foundational Principles
CPA: Communication
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Communication

Ex. 2-79 Revenue Recognition
Explain the theory behind revenue recognition. Compare and contrast how this is applied under ASPE versus IFRS.

Solution 2-79
Revenue recognition is governed by the revenue recognition principle. Revenues are realized when products, merchandise, or other assets are exchanged for cash. Revenues are realizable if the assets received or held can be readily converted into cash or claims to cash. Historically revenue is recognized when the risks and rewards of ownership have been transferred or the earnings process is

substantially complete, the revenue is measurable, and the revenue is collectible. This is an income statement approach that focuses on the earnings process and continues to be used under ASPE. This is very different from IFRS takes a balance sheet approach that a transaction has occurred when an entity enters into a contract. The entity has rights and obligations under the contract. Collectible revenues are recognized when the performance obligation is settled. There is the presumption that the contract is measurable.

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

Ex. 2-80 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 expense recognition. How does this relate to revenue recognition?

Solution 2-80
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: Easy
Learning Objective: Describe the foundational principles of accounting.
Section Reference: Foundational Principles
CPA: Communication
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Communication

Ex. 2-81 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 2-81

	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

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

Ex. 2-82 Measurement, existence, and outcome uncertainties
Explain the difference between measurement uncertainty, existence uncertainty, and outcome uncertainty.

Solution 2-82
When a company cannot objectively identify a value (for instance, the value of a share that is not

publicly traded) and therefore they must estimate the value, the resulting imprecision is called **measurement uncertainty**.

Existence uncertainty refers to the question as to whether something exists or not.

Outcome uncertainty is the uncertainty surrounding future inflows and outflows for assets and liabilities.

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

Ex. 2-83 Recognizing and Measuring Financial Statement Uncertainty
Angeles has just invested $10,000 in his brother's new start-up company. In exchange for the $10,000, Angeles has received 5,000 preferred shares with $0.50 / share cumulative dividend. Is this investment an asset? Why or why not? What types of uncertainty exist with accounting for the investment?

Solution 2-83
Angeles controls the shares related to the sales transaction and the shares entitle Angeles to future dividend payments. This is a new start-up company with no current sales, as a result there is outcome uncertainty, which in turn contributes to measurement uncertainty. The company may or may not make sales into the future and since there is no market for the shares, Angeles will need to estimate the value of the shares going forward to determine if an asset still exists. This contributes to measurement uncertainty, since there is significant risk the investment could be written down. Since the initial transaction has taken place there is no existence uncertainty.

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

Ex. 2-84 Current value measurement bases
Identify and describe three current value measurement bases in the IFRS conceptual framework.

Solution 2-84
Fair value and fair value in use are two identified measurement bases within the framework. Define these measurement bases and describe how they are used and applied.
Fair value is defined under IFRS 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. This is a

market-based measure as opposed to an entity specific value. A market-based value such as this seeks to determine how market participants would value the item in question. Whereas, the value in use for assets and the fulfilment value for liabilities are entity specific values. There is a trade-off between these two. The entity specific value may be more relevant for operating assets when the entity plans to hold on to the assets and use them to produce revenues, but this is more subjective. The market-based view is more objective and verifiable and when fair value is called for under IFRS the market-based view must be applied.

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

Ex. 2-85 Going concern assumption
The going concern assumption applies in most, but not all, business situations. When would it not apply?

Solution 2-85
The only time when the assumption would not apply is when there is intent to liquidate the company's net assets and cease operations or cease trading in the company's shares or when the company has no realistic alternative but to liquidate or cease operations.

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

Ex. 2-86 Market-based measure versus entity-specific measure
Fair value is a market-based measure, as opposed to an entity-specific measure. Explain the difference between an entity-specific value and a market-based value.

Solution 2-86
An entity-specific value represents how the company might value the item in question. This is often called value in use and reflects the present value of the future cash flows the entity expects to receive from use of the asset. A market-based value seeks to determine value by looking at how market participants would value the item in question. It does not look at value from the perspective of the entity itself and as such it does not consider company-specific synergies.

Difficulty: Easy
Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles
CPA: Financial Reporting
Bloomcode: Application
AACSB: Analytic

Ex. 2-87 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 2-87
IFRS 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 entitles 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: Easy
Learning Objective: Describe the foundational principles of accounting.
Section Reference: Foundational Principles
CPA: Communication
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Communication

Ex. 2-88 Principles-based vs. rules-based GAAP
There has been much discussion about principles-based standards versus rules-based standards. Compare and contrast the advantages and disadvantages of a principles-based approach.

Solution 2-88
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: Analysis
AACSB: Communication

Ex. 2-89 Financial engineering
Explain the practice of financial engineering and how it relates to fraudulent financial reporting.

Solution 2-89
Financial engineering is a process whereby a business arrangement or transaction is structured legally in a way 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: 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
AACSB: Communication

Ex. 2-90 Fraudulent financial reporting
Identify several factors that contribute to fraudulent financial reporting.

Solution 2-90
Factors that contribute to fraudulent financial reporting include:
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 downturn

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
AACSB: Communication

Ex. 2-91 Fraudulent financial reporting and the accountant's role
Explain what the accountant's responsibility is in the preparation of a company's financial records.

Solution 2-91
The accountant's role is to capture business and economic events and transactions as they occur and communicate them to interested parties. The accountant 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 worsening economic conditions or industry downturn for example.

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
AACSB: Communication

Ex. 2-92 Financial reporting pressures caused by budgets
Explain why budgets might exert negative influence into accounting decisions. Offer some examples to illustrate why this might be the case.

Solution 2-92
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: 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
AACSB: Communication

PROBLEMS

Pr. 2-93 Sustainability Reporting
Magnum Corporation is a mining company in Northern Ontario. The company is under increasing pressure from multiple community and government stakeholders to decrease its economic footprint and engage in more "environmentally friendly" business activities. The company has heard of something called sustainability reporting and dynamic materiality. Magnum wonders if using this type of reporting might satisfy stakeholder concerns. The company has asked you to provide an explanation of what this is, how it can be used and how this compares to financial reporting materiality.

Solution 2-93
Sustainability reporting has a broader set of stakeholders. Dynamic materiality considers not only financial information but also information related to environmental, social and governance matters. The dynamic materiality model frames the materiality discussion by considering the needs of this broader stakeholder group that encompasses investors and creditors, but also employees, the community, customers, governments and others. This idea of materiality has a long-term value creation perspective. The main differences between financial reporting and dynamic / sustainability materiality include:

1. Broader set of stakeholders
2. A broader set of stakeholder consideration and information needs (including environmental, social and governance issues)
3. A longer time frame

It is a good sign that Magnum Corporation is actually concerned about meeting the needs of stakeholders such as the community and government. While sustainability reporting may be an excellent first step in being more transparent and providing these stakeholders with relevant information, the company should be prepared to be held to a higher level of accountability around the business decisions it makes relevant to these areas (environmental, social and governance).

Difficulty: Medium
Learning Objective: Identify the qualitative characteristics of financial reporting.
Section Reference: Qualitative Characteristics of Useful Information
CPA: Financial Reporting
Bloomcode: Analysis
AACSB: Analytic

Pr. 2-94 New 1 Uncertainty trade-off
Explain the trade-off related to uncertainty.

Solution 2-94
Too much uncertainty (existence, outcome, or measurement) may make it inappropriate to recognize a financial statement element because it undermines the usefulness of the financial statements. Estimates with high measurement uncertainty provide information that is less relevant for decision making than those with low measurement uncertainty. However, if the element is not recognized at

all in the financial statements, then some relevant information is not included and the statements are incomplete. A compromise is to measure and recognize the elements in the body of the financial statements and to disclose the measurement uncertainty and its significance in the notes to the financial statements.

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

Pr. 2-95 IFRS/ASPE revenue recognition differences
Distinguish between the IFRS balance sheet approach and the ASPE income statement approach to revenue recognition.

Solution 2-95
Revenue has generally been recognized when the following three conditions are met, which is an income statement approach followed under ASPE:
1. risks and rewards have passed and/or the earnings process is substantially complete (significant acts have been performed and there is no continuing involvement);
2. the revenue is measurable; and
3. the revenue is collectible (realized or realizable).

IFRS 15 standard (*Revenue from Contracts with Customers)* is a balance sheet approach where five-steps are followed in determining when revenue is recognized:
1. Identify the contract with the customer.
2. Identify the performance obligations in the contract (promises to transfer goods and/or services that are distinct).
3. Determine the transaction price.
4. Allocate the transaction price to each performance obligation.
5. Recognize revenue when each performance obligation is satisfied.

The IFRS approach recognizes that a transaction has occurred when the entity enters into a contract where it has rights and performance obligations under the contract which is in contrast to the ASPE approach, which focuses more on the earnings process.

Difficulty: Easy
Learning Objective: Describe the foundational principles of accounting.
Section Reference: Foundational Principles
CPA: Financial Reporting
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Pr. 2-96 Types of Organizational Structures
You are a newly designated CPA and are contemplating opening your own accounting firm with two of your colleagues from your graduating class. The three of you have been debating what type of business structure to use. All three of you are concerned about liability and want to have some flexibility for tax planning purposes. You seem to the think that the three of you could incorporate, but one of your colleagues is equally sure that the only available option is a partnership, but she is not sure what kind. You decide to consult with your former law professor to determine what business structure options are available for your new firm. What do you discover as part of your research? What option should be chosen and why?

Solution 2-96
There are two additional types of organizational structures that can be used by professionals in Canada. These include professional corporations and limited liability partnerships. The LLP legislation provides that a partner is not personally liable for any debts, obligations, or liabilities of the LLP that has arisen from negligence by another partner or anyone under the direct supervision or control of that partner. However, this does not limit or reduce the liability of the firm. All of the firm's assets and insurance protection remain at risk. Professional corporations are similar, shareholders are not personally responsible for obligations incurred by the firm. Partners are responsible for their own actions just not those of the other partners. An added benefit of the corporate structure is that it may provide greater flexibility for tax planning. Given the goals of the three partners, a professional corporation will likely better meet their needs. Both options limit liability, however as mentioned, the corporate structure is likely to provide more flexibility related to tax planning.

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

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