Intermediate Accounting Vol 1 (Canadian) 3rd edition Lo Solutions Manual

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Chapter 2
Conceptual Frameworks for Financial Reporting

K. Problems

P2-1. ***Suggested solution:***

Three reasons for having a conceptual framework for accounting standards include the following:

1. The framework helps to organize the numerous concepts that financial statement preparers and users have found to be important.
2. The framework provides general guidance for standard setters when they deliberate new standards or changes to existing standards.
3. The framework helps financial statement preparers to choose among accounting alternatives when such alternatives exist.

P2-2. ***Suggested solution:***

	Concept	Demand	Supply
a.	User needs	√	
b.	Measurement criteria		√
c.	Assumptions for the preparation of financial statements		√
d.	Objectives of financial reporting	√	
e.	Definitions of the elements of financial statements		√
f.	Recognition criteria		√
g.	Constraints		√
h.	Desirable qualitative characteristics	√	

P2-3. ***Suggested solution:***

	Concept	Qualitative characteristics	Assumption	Constraint
a.	Understandability	√		
b.	Going concern		√	
c.	Relevance	√		
d.	Benefits vs. costs			√
e.	Verifiability	√		
f.	Representational faithfulness	√		
g.	Comparability	√		
h.	Financial capital maintenance		√	

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P2-4. ***Suggested solution:***

	Concept	Representational faithfulness	Recognition	Measurement
a.	Current cost			√
b.	Completeness	√		
c.	Historical cost			√
d.	Revenue recognition		√	
e.	Probable and measurable future flows of resources		√	
f.	Neutrality	√		
g.	Present value			√
h.	Realizable value			√

P2-5. ***Suggested solution:***

An asset is:
– a resource controlled by an entity
– as a result of past events, and
– from which future economic benefits are expected to flow to the entity.

P2-6. ***Suggested solution:***

A liability is:
– a present obligation of the entity,
– arising from past events,
– the settlement of which is expected to result in an outflow from the entity of economic resources embodying economic benefits.

P2-7. ***Suggested solution:***

* Equity is defined as assets net of liabilities. It is not independently defined because the balance sheet and double-entry bookkeeping requires A = L + E.
* Income involves increases in equity (other than from capital transactions with owners). Since equity is defined in terms of assets and liabilities, income ultimately involves increases in assets or decreases in liabilities.
* Expenses involve decreases in equity (other than from capital transactions with owners). Since equity is defined in terms of assets and liabilities, expenses ultimately involve decreases in assets or increases in liabilities.

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P2-8. ***Suggested solution:***

Reasons for the lack of general acceptance of the current cost accounting model include:

Cost and benefits constraint: The cost to collect current cost information and to prepare current cost financial statements outweighs the likely benefits. Developing a system to produce current cost information for firms' assets and liabilities on an ongoing basis is an expensive undertaking. Auditors will also need to develop methods to independently verify the current cost data, which also entails substantial costs.

Understandability: Current cost arguably provides better information to users for decision making, in particular regarding the maintenance of physical capital. However, the complexity of the calculations and even the principle of current cost are difficult to understand, such that only the very sophisticated reader will be able to understand the financial statements. This lack of understanding could be so significant as to render the information useless, or at least significantly impair the benefits of having such information.

Predictive value: Virtually all prediction models involve extrapolation from past patterns. Historical cost accounting reflects the past and is verifiable, providing a solid base for trend analysis.

Articulation: Historical cost accounting produces internally consistent data that are articulated among the financial statements. Current cost accounting information is not necessarily articulated.

P2-9. ***Suggested solution:***

a. Considering the qualitative characteristics, investments in employees should not be recorded as assets for several reasons. First, the benefits of the training lack verifiability; different people will come up with vastly different estimates of the value of training. Second, the amount would lack representational faithfulness due to the incompleteness and biasedness of the figures. The amounts are likely to be incomplete because there are many different activities that could improve the value of employees and it is not practical to track these activities. Due to the lack of verifiability of the value of employees, the amounts are likely to be biased to serve management's interests.

b. Considering the elements of financial statement and the recognition, of those elements, there are several reasons for not recording assets for the investment in employees. First, the employees are not under the full control of the company since they can seek employment elsewhere, so they cannot be considered to be assets of the company. Second, since there are outflows of resources associated with employee training, those outflows should be reflected as expenses. Third, even if one argues that investments in employees are assets, they cannot be recognized on the financial statements—the future benefits associated with better trained employees may be probable, but those benefits are not measurable with a sufficient degree of accuracy.

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P2-10. ***Suggested solution:***
It is true that financial statements are complicated by accounting methods, such as the method of accounting for deferred income taxes, financial instruments, and so on. However, some of these complexities cannot be avoided. The business environment and business transactions are themselves more complex. Since the financial statements try to reflect these business events, it is inevitable that the financial statements will be more complex. Thus, it is not accounting methods per se that make financial statements difficult to understand.

Financial statements are not directed at the average person, so they cannot be criticized on the grounds that they are beyond the comprehension of the "average person." Instead, they are intended for users with a reasonable understanding of financial statements. The question then becomes: should additional explanations be provided for users who have a reasonable understanding of financial information? The answer depends on what type of information the "explanation" will contain.

Usefulness of additional information
Explanations could be of three types:

- They could make information that is now in the financial statements easier to understand by explaining technical accounting terms and concepts used.
- They could provide more detail on information that is already contained in the financial statements. For example, certain dollar amounts might be broken down in more detail, or the significance of certain amounts might be spelled out.
- They could provide new information not now included in financial statements.

Additional information for the latter two categories may relate to the past or future. Future-oriented information would obviously be of considerable interest to someone with, say, a cash flow prediction objective. The difficulty, obviously, is that such information is very subjective and could be subject to biases. Auditors would find it difficult to provide any assurance on such future-oriented information.

It can be argued that additional information is already being provided in some financial statement packages (i.e., the remainder of the annual report outside of the financial statements). This information can include factual background relating to the year's results, or it can include subjective projections of the company's future.

There is significant evidence in support of the idea that capital markets are informationally efficient, thereby lessening the need for information that merely clarifies the financial statements or accounting methods used. However, even in efficient markets there will be a role for information that is not currently presented in the financial statements, to the extent that such information is not available elsewhere. The obvious disadvantage is that information disclosed could also be useful to competitors or other interest groups, to the detriment of the reporting company.

We should also consider whether providing more information would overload users and whether the incremental benefit is worth the incremental cost of the information. One of the additional costs is the potential delay in the reporting time.

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Preparers of additional information
We should also consider the issue of who prepares this additional information and the implications for its quality. While management is knowledgeable about the company's events, they can bias the information they provide, particularly with respect to subjective and forward-looking information that is difficult for auditors to verify.

Role of standards
Having standards for this additional disclosure will help to promote comparability between companies. However, the risk of attempting to control the provision of additional information via standards is that information may be restricted to that which is historically based, factual, and objective, making it less relevant for purposes such as forecasting and performance evaluation.

P2-11. ***Suggested solution:***

This question requires the demonstration of understanding of the interrelationships among the concepts of fair presentation, materiality, and users' needs. The following points could be raised:

Fair presentation: Fairness is an abstract concept and, therefore, is open to debate and interpretation. Although it would be impossible to develop a general rule that would apply to all circumstances, fairness has a particular connotation when considered in relation to financial statements. The determination of what constitutes fair presentation in a particular case requires the exercise of professional judgment. Auditors assess whether financial statements present fairly in relation to generally accepted accounting principles (IFRS, *CICA Handbook,* or other). Auditors also use judgment to evaluate the selection of accounting policies from among acceptable alternatives.

Users of financial statements expect that recommended practices have been followed and that variations from accepted practice have been disclosed. However, auditors also have an obligation to go beyond determining technical compliance to accounting standards; they must ensure that any information required for fair presentation has been disclosed in the financial statements (completeness). It is essential that published financial statements do not lead users to conclusions that preparers and auditors know to be unlikely or incorrect (i.e., not true and fair). Auditors should use judgment not only in the evaluation of individual items, but also in their assessment of the combined effect of these items.

Materiality: Materiality is based on the premise that financial statements should contain or disclose information that is relevant to users. An item is material if its omission or misstatement would influence users' economic decisions. Quantifying materiality is a matter of professional judgment and depends on management and the auditor's assessment of the firm's operations, industry, reporting requirements, and most importantly, the users.

Users: Financial statements are prepared for users. Accordingly, they should meet the needs of users and be understandable to them. However, there are challenges to defining the users and their needs: Who are the user groups? What kinds of information do they need? What other information do users have access to? How do users' needs change over time?

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P2-12. ***Suggested solution:***

Concepts, principles, and ideas supporting treatment as *Asset.*	Concepts, principles, and ideas supporting treatment as *Expense.*
▪ The training program has future benefits since employees would be able to operate new high-tech machinery. ▪ The training has already occurred. ▪ Management has the ability to direct employees to complete assigned tasks with the newly acquired skills, so this satisfies the criterion of control over future benefits. ▪ Therefore, all three criteria in the definition of an asset have been satisfied. ▪ The amount of $45 million is definitively quantifiable. ▪ The future amortization period is also quantifiable as the estimated average remaining service lives of the employees (similar to an estimate used for pension accounting; see Ch. 17). ▪ Amortization over future years better matches expenses to revenues that will be recognized in future years. ▪ Recognition as an asset provides relevant information to users to determine the potential productivity of employees. ▪ Doing so also encourages better management stewardship by investing in employee development. Expense treatment would lead to underinvestment since the expense will negatively affect current profits (and thus management compensation) while the benefits are realized in the future. ▪ Investment in employee development increases morale and commitment from employees, increasing productivity and retention.	▪ The $45 million expenditure fails to meet the definition of an asset (see below). ▪ Public Company has no control over the employees since they are free to leave the company. ▪ Indeed, the additional training makes the employees more attractive to competitors and other employers, increasing the opportunities for the employees to leave. ▪ The 15 years of estimated average remaining service lives of the employees is not reliable given the increased outside opportunities of the employees. ▪ While the amount of the expenditure is known to be $45 million, the amount of future benefits is unknown and difficult to estimate. Without a reliable basis of measurement, this fails the recognition criterion. ▪ Given the uncertainty of the future benefits, prudence (conservatism) suggests that the costs should be expensed. ▪ Information about the program can be disclosed in the notes as this information is relevant to users of the financial statements for assessing management stewardship and the potential productivity of employees. ▪ The ability to invest a significant amount on employee development even though the costs must be expensed is a credible signal that Public Company is strong; this signal should help increase stock price and equity-based compensation for management.

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P2-13. ***Suggested solution:***

* Does knowledge have future economic benefits? Possibly.
* Due to past transactions? Yes.
* Do companies control employees? No, since slavery is not legally permitted.
* How can intellectual capital be measured? Are the measurements reliable?
* Estimated values are likely to be unverifiable.
* There will be severe problems with comparisons between companies.
* It will be difficult to come up with sensible amortization policies. How should the expenses be matched with future benefits?
* Provides opportunities for management manipulation (impairs reliability) and increases moral hazard problems.
* Information is relevant for predicting future cash flows if knowledge results in new products (revenue) or new processes (cost reduction).
* Information is not relevant because high intellectual capital may not reflect ability to generate future cash flows since employees can leave.
* Could lead to unintended reactions and behaviour from employees; e.g., "we're valued less highly than another company's employees."
* Could also lead to high valuations for public and internal relations purposes, to show that the firm highly values employees.

P2-14. ***Suggested solution:***

- Each acquisition on average is $11 million, so they are immaterial.
- However, materiality should be assessed on a class of transactions, so the acquisitions are material as a group.
- $8 billion is material relative to the market value of equity ($60b) and earnings ($5b).
- Materiality is defined with respect to users of the financial statements.
- The large negative stock price reaction is an indication that information on the acquisitions is material to investors.
- Information on how Tyco spends its money and what kinds of businesses it is buying is relevant to investors for predicting future cash flows.
- Summary disclosure of the net cash amount paid may be inadequate for investors; full disclosure of the nature of the acquisitions (e.g., line of business, price paid relative to book value) would be useful for predictions.
- Full disclosure may be very costly and impractical given the large number of acquisitions; management may have determined that the costs exceed the benefits of disclosure.
- Management may have selectively concealed information on acquisitions, disclosing information on those that may be viewed favourably and hiding the bad acquisitions.
- Such concealed information, if it exists, would bias the financial statements and make them unreliable.
- Unreliable financial statements increase the moral hazard problem by allowing management to cover up its mistakes.
- Market efficiency suggests that the WSJ article provided new information to investors—the information was not what they had expected.

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- The WSJ's revelation could indicate to investors that Tyco has been hiding bad news (adverse selection); therefore, they are now more skeptical of Tyco (it is now considered a "lemon").

P2-15. ***Suggested solution:***

Pros:

* The alternative income number Amazon is using could be more relevant for predicting future cash flows by removing items that are not recurring; e.g., restructuring charges.
* Amazon provides full disclosure of the accounting policies that have been used to come up with the alternative income numbers.
* Given the full disclosure, sophisticated readers can interpret these numbers and undo Amazon's policies if they wish.
* Information is provided in addition to GAAP income, so at least the GAAP number is reliable as it is audited.
* The accounting method is popular in the high-tech industry so the information is comparable to those of similar firms.

Cons:

* The alternative numbers are less reliable because management has discretion over how "pro forma operating profit" and "pro forma net profit" are defined.
* The alternative numbers are biased because they "inevitably make the numbers look a lot better"—only expenses and losses (and not gains) are being excluded.
* Lower reliability increases moral hazard; management can present good results even if things don't turn out to be so good.
* Measuring income excluding certain costs provides management with the incentive to classify costs into those categories.
* The income numbers could mislead naïve investors who interpret them as if they are GAAP income numbers.
* Could also mislead investors if there is inadequate disclosure of how the non-GAAP income number is derived.
* Comparability of non-GAAP numbers is lower because different firms could define their income measures differently.
* Consistency is also lower because Amazon can change the income definitions from year to year.

The non-GAAP numbers are not based on standards and are not auditable, lowering their quality (reliability, comparability, consistency).

P2-16. ***Suggested solution:***

Graduates:

* They have a tendency to favour the school they attended.
* This increases the prestige of their degree, which is better for their careers.
* They will be biased.
* BUT, all graduates face the same incentives, so they are all biased.
* If bias is constant, it does not affect the results.

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* However, responses from some schools may be more biased than others (e.g., if a school lobbies its students to answer the survey positively).
* Students at schools with a stronger emphasis on ethics may answer the surveys with less bias, and such schools would be unjustifiably harmed in the rankings.

Recruiters:
* Not as much incentive to be biased toward a particular school.
* Could be biased toward the schools from which they graduated (MBA or other degree).
* Could be biased in favour of the schools from which they hire the most in order to justify their past hiring decisions. (This is related to an effect called confirmation bias in psychology.)
* Again, the bias incentive affects everyone.
* Recruiters can only rank schools they recruit from; many smaller schools would be ranked lowly by this exclusion.
* Geography affects where firms recruit. Only very large global firms would recruit from a diverse range of locations.
* Schools with long histories and large programs (e.g., Harvard, with 900 full-time MBAs per year) will have more grads who are recruiters, so there may be more bias toward these schools.
* Past reputation of schools can bias recruiters' rankings.

General comments:
* Consistent rankings year to year suggests that the rankings are reliable—not just noise.
* Large swings in rankings could reflect events causing extreme bias in a particular school that year (e.g., deliberate efforts to have students bias their surveys).
* Response rates are fairly high for surveys.
* Samples are large enough so that errors cancel out.

P2-17. ***Suggested solution:***

* In the age of the Internet, there is high demand for up-to-date information.
* Policy makers, businesses, consumers, and unions are some of the potential users of this information.
* This information is more timely than official statistics, making it more useful and increasing its ability to influence decision.
* However, the information is based on incomplete data.
* The index assumes that items tracked (those sold on the Internet) are representative of aggregate consumer purchases.
* The index lacks neutrality because the non-representative sample could lead to biases in the price index, although the bias may not be intentional as in the case earnings management in financial reporting.
* Certain items are bought and sold more frequently on the Internet than other.
* For example, electronics and computers are often sold online, and it is widely known that the prices of these products decline rapidly with technological advances. This decline is not representative of most other products.
* Biased information could lead users to make wrong decisions.

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P2-18. ***Suggested solution:***

Since the R-word index provides an alternative to Gross Domestic Product (GDP) as a gauge of economic activity, it is useful to evaluate the merits of the R-word index relative to GDP. In this light, the R-word index has both good and bad attributes:

* This index is more valuable or useful because it is more timely than official GDP figures.
* The R-word index aggregates information from only two sources (Financial Times and Wall Street Journal), so it is incomplete--the index may not reflect broader sentiments about the economy.
* On the other hand, there are many different writers who contribute to these newspapers, so the index is actually aggregating information from many different sources.
* In general, information that is aggregated over many different people/sources is more accurate. (This is the foundation of the theory of efficient securities markets.)
* Aggregation helps because it pools common beliefs while minimizing the effect of idiosyncratic beliefs held by some individuals.
* Counting "recession" can be a problem in terms of representational faithfulness: both affirmative and negative uses of the term ("we are going into a recession" or "we will not go into a recession") are counted the same way.
* Likewise, an article may discuss historical instances of recession, or recession in a small foreign country, both of which have little bearing on recession in the U.S. (the focus of the article and the R-word index).

* In terms of macroeconomics, the immediate availability of the index on a continuous basis has a significant drawback: publication and use of the index may lead to a self-fulfilling prophecy.
* If some writers become pessimistic about the economy and so use "recession" more frequently, the R-word index will increase immediately, and people who see an increase in this index will become more worried about the economy and spend less, causing a decrease in economic activity, which then affects other people writing about the economy.
* It may only take a few writers to start this vicious cycle.
* To avoid this cycle, it may be better to not have this index continuously calculated, but released only periodically and with some delay just like the publication of GDP figures.

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P2-19. ***Suggested solution:***

Similarities:

* Both the IFRS Conceptual Framework and a constitution set the foundation for more specific standards / laws. That is, the specific standards and laws are built on the general principles by the Framework or constitution.
* Neither the IFRS Conceptual Framework nor a constitution provides standards / laws that have sufficient detail to define specific practices.
* Specific laws that are inconsistent a constitution can be ruled to be illegal (unconstitutional) by a court of law, and citizens governed by the laws can go against a law that is unconstitutional. Likewise, IFRS (in IAS 1 paragraph 19) permits an enterprise to depart from a specific accounting standard if following that standard would conflict with the objective set out in the IFRS Conceptual Framework, that objective being the provision of information useful to investors, lenders, and other creditors.

P2-20. ***Suggested solution:***

Arguments for keeping prudence:

* Conservatism contributes to reliable information; information that is more reliable is more useful for evaluating managers' performance.
* Management, which prepares the financial statements, has a tendency to be optimistic; applying conservatism helps to counteract that optimism.
* Conservatism also increases reliability by demanding a higher degree of verifiability for gains (than for losses) when there is uncertainty.
* Conservatism does not allow deliberate understatement, so there is no undue pessimistic bias in the financial statement numbers.

Arguments for excluding prudence:

* Conservatism involves a pessimistic bias and reduces neutrality of information.
* Less neutral information is less reliable and consequently less useful.
* Conservatism information is not representationally faithful, again reducing the reliability of financial reports.
* Excluding conservatism would allow write-ups (as well as write-downs), which is information that is relevant for valuation.
* Different managers/accountants will apply a different amount of conservatism, making it difficult for users to know how much conservatism is embedded in the reported numbers.
* Users are better able to apply their own standard of conservatism given their own risk tolerance.

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P2-21. ***Suggested solution:***

* First it is necessary to make an assumption that genetically modified (GM) food is perceived to be bad, so that consumers will pay more for good (non-GM) food. If there is no difference to the consumer, then there is no demand for information/labelling.
* Manufacturers know whether the food is GM or not, and consumers know that they know.
* Consumers will assume unlabelled food to be GM products, which are inferior, so they are willing to pay less for these.
* So non-GM foods will be labelled to be distinguished from GM foods.
* This is an application of adverse selection and disclosure principle.
* The role for standard setting is not clear. Market forces should lead to labelling of non-GM products, which imposes costs on traditional non-GM producers. Standards to require labelling GM products would shift the cost to those products and away from the non-GM products.
* There are possible litigation costs for not labelling (for example, due to allergic reactions).

P2-22. ***Suggested solution:***

a. Paragraphs 4.37 – 4.53 of Part I of the *CPA Canada Handbook – Accounting* establish the requirements for the recognition of the elements of financial statements.

b. The substance of these requirements can be summarized as follows:

- Recognition involves including items on the balance sheet or income statement that meets the definition of an element (e.g. an asset) and satisfies the criteria for recognition.
- An element should be recognized if the future inflows or outflows of resources are probable and can be reliably measured.
- Items that otherwise meet the criteria of an element are only recognized if they are material.

P2-23. ***Suggested solution:***

a. Paragraphs 4.54 – 4.56 of Part I of the *CPA Canada Handbook – Accounting* establish the requirements for measuring the elements of financial statements.

b. The substance of these requirements can be summarized as follows:

- Measurement is the quantification of the amounts to be reported on the financial statements using one or more bases of measurement.
- The most common measurement bases are: historical cost; current cost; realizable (settlement) value; and present value.
- The most widely used measurement bases is historical cost which is usually combined with another measurement basis e.g. inventory is valued at the lower of cost and net realizable value.

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P2-24. ***Suggested solution:***

a. In addition to accounting, the collection also includes standards and guidance for
- assurance
- public sector accounting
- management's discussion and analysis, and
- several other areas.

b. The five definitions identify the five types of entities to which Parts I to V of the *Accounting Handbook* apply. For example, the first definition (publicly accountable enterprise) identifies the types of entities that would fall under the scope of Part I (IFRS). The second definition (private enterprise) identifies the types of entities that would fall under the scope of Part II (ASPE).

c. Paragraphs OB1 to OB21 discuss the objectives of financial statements. ParagraphsQC5 to QC18 discuss the fundamental qualitative characteristics. Paragraphs QC19 to QC34 discuss the enhancing qualitative characteristics.

d. The standards are as follows:
- IAS 1 Presentation of Financial Statements
- IAS 2 Inventories
- IAS 16 Property, Plant and Equipment
- IFRS 6 Exploration for and Evaluation of Mineral Resources
- IAS 18 Revenue

e. There is no logical ordering of the IFRS/IAS. The standards are numbered chronologically according to when the particular standard was first issued. There are no meaningful differences between IFRS and IAS other than the fact that IAS preceded IFRS; new standards will be labelled IFRS ##.

P2-25. ***Suggested solution:***

a. Paragraphs 15 to 21 discuss the qualitative characteristics of financial statements. Paragraphs 36 to 47 discuss recognition criteria.

b. The standards are as follows:
- 1100 – Generally Accepted Accounting Principles
- 1400 – General Standards of Financial Statement Presentation
- 1521 – Balance Sheet
- 3031 – Inventories
- 3061 – Property, Plant and Equipment
- 3400 – Revenue

c. The ASPE section numbers are distinguished between "General accounting" (Sections 1000 to 1800) and "Specific items" (Sections 3000 to 3870). Within each of these two broad categories, related items are grouped together. For example, standards for the income statement, balance sheet, and cash flow statement are placed together as Sections 1520, 1521, and 1540, respectively). Likewise, share capital, equity, and reserves are together in Sections 3240, 3251, and 3260.

d. Paragraph 1100.02 defines primary sources of GAAP as Sections 1400-3870 of ASPE including their appendices, and Accounting Guidelines including their appendices, with the former having higher authority than the latter. Paragraph 1100.03 indicates that "an

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entity shall apply every primary source of GAAP that deals with the accounting and reporting in financial statements of transactions or events encountered by the entity." Entities may consult other sources of GAAP should the primary sources not deal with a particular circumstance.

e. A search for "inventories" results in numerous hits. The numbers of instances are summarized on the left side in the table of contents. The right side shows excerpts of the documents that contain the search term.

P2-26. ***Suggested solution:***

For uniformity:

* Increases comparability of financial reports for companies in different countries.
* Decreases costs to users; they don't need to learn many different GAAPs.
* Investors need to be less sophisticated to understand financial statements of companies from different countries, thereby decreasing information asymmetry, increasing the size of the pool of potential investors.
* Increased geographical diversification of investments reduces risk and lowers the cost of capital.
* Resources can be focused on developing and refining one set of standards, resulting in a superior set of standards.

Against uniformity:

* Uniform standards do not imply uniform application; differing circumstances in each country lead to different interpretations of standards and different reporting outcomes.
* Global accounting standards result in conflict with local laws and regulations.
* Uniformity does not respect diversity of cultures, history, and legal structures.
* Uniformity hinders innovation by eliminating competition.
* Flaws in standards have potentially catastrophic effects around the world.
* Increases systemic risk since most of the world is covered by the same set of standards.

P2-27. ***Suggested solution:***

* The *CICA Handbook* provides guidance in general circumstances to service the largest numbers of situations and users. Although these standards provide definitive guidance under certain circumstances, it is impossible to deal specifically with all possible situations. Therefore, standards are general in order not to restrict the exercise of professional judgment.
* Where there is no authoritative guidance, accountants rely on their professional training and judgment to fairly present the economic reality of the situation. In such cases, they can consider basic concepts and principles from the conceptual frameworks as well as the spirit and intent of the related standards. They can also consider current prevailing practice in the profession.
* Leaving application open to judgment, however, in the presence of client pressure, may result in general acceptance of a minimal amount and quality of reporting. The eventual outcome may be a lack of comparability of financial statements. With no standards at all, these problems would be even more acute.

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Points favouring the existence of standards:

* In a complex world, standards are a means of transmitting wisdom and avoiding unintentional error due to ignorance. They present the "aggregate wisdom" of the accounting profession on complex issues.
* Many standards arose because market and other mechanisms failed to prevent the occurrence of serious errors or misinterpretations.
* The fact that certain legal requirements, such as the *Canada Business Corporations Act,* refer to GAAP in the *CICA Handbook* as authoritative practice indicates that the standards are filling a need.
* GAAP are so important to our financial reporting system that the codification of best practices is legally and administratively essential.
* Proactively setting standards may be a more efficient way of creating a body of GAAP than the development of case law after specific reporting failures.
* Compliance with a documented set of standards can provide a better defence against legal liability.
* In some instances, prevailing practice may not be well thought out conceptually. Adopting standards can result in new practices that are conceptually more sound.
* Standards instil confidence in the fairness and reliability of financial statements to users.

Points against the existence of standards:

* Many people believe that there is a free market for information. If the market were unrestricted by standards, information would be available to the extent that it was demanded.
* Capital market research suggests that accounting numbers prepared in accordance with many standards do not assist the operation of the market.
* Users' information needs are diverse and not well understood, so it may be presumptuous of the accounting profession to design information standards for these users.
* Standards interfere with management's freedom to report to shareholders in the way it believes is in the best interest of the company (i.e., to best alleviate adverse selection).
* Some standards encourage uneconomic decisions merely to improve the appearance of financial statements.
* Compliance with more stringent reporting standards is expensive for companies.
* Standard setting is expensive for the accounting profession.
* The existence of standards reduces the exercise of professional judgment by constraining their choices and eliminating options that, in accountants' judgment, may be the most appropriate for the circumstance.
* General standards have a tendency to evolve into narrow, restrictive rules.
* Given the complexity of the economic reality that financial statements attempt to portray, no set of standards can be theoretically correct nor deal appropriately with all situations.

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L. Mini-Cases

Case 1: West Pacific's Mortgage-Backed Securities. ***Suggested solution:***

Issue	Supporting WP	Supporting OSC
#1	Mortgages receivable can be removed because they are no longer assets. * WP no longer controls the mortgages. * WP does not retain future benefits from the mortgages.	Receivables cannot be removed because they are assets to WP. * WP retains risks and rewards of mortgages. * 0.6% fee is a future benefit to WP. * WP maintains control of mortgages since it manages the collection of mortgage payments. Asset cannot be removed if corresponding liability remains on books. * WP's guarantee of timely payment to investors is an unavoidable obligation.
#2	PV of 0.6% fee can be recognized when MBS is sold because earnings process is largely complete at that time; most of the work required has been completed. CMHC guarantee ensures that future payments will be received, so the future benefits are probable and measurable with reasonable accuracy.	Revenue should be recognized as the earnings process is completed, which is over the duration of the mortgage contracts. There is uncertainty in the amount and timing of future payments, so revenue should be delayed until the time when payment is received.
#3	The short amount of time that the mortgages are held suggests that cost is a good reflection of value at year-end. Any differences between cost and market value at year-end are likely to be immaterial. The costs of revaluation are high and likely to exceed any benefits.	Since WP regularly sells these mortgages, they are short-term investments or inventory; therefore, they should be revalued to reflect market prices (especially declines).

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Case 2: Financial Reporting, Fraud, and Accounting Theory. ***Suggested solution:***

* The fraud demonstrates that significant information asymmetry existed between insiders and outside investors in this case.
* Insiders used their information advantage to divert funds from the company/shareholders.
* Having lost significant amounts, investors lost trust in the company.
* Skeptical investors would have demanded a high cost of capital to invest in the technology.
* The high cost of capital prevented further development of this technology until this century.
* As a consequence, the history of public transportation was changed forever, probably for the worse.
* Battery technology would probably have developed more rapidly had these electric buses been commercially viable.
* This article illustrates that information asymmetry and the lack of trust can destroy markets and substantially alter the allocation of resources in the economy.
* Better standards and regulations could have prevented the frauds.
* Better disclosure of related party transactions would have alerted investors to be suspect of the company.
* Better disclosure requirements would have made it more difficult for insiders to perpetrate the fraud.
* Having an independent audit would also have made the fraud more difficult.
* Independent audits also alleviate skepticism from investors about the veracity of the company's financial reports.
* The article also illustrates the importance of aligning the interests of owners and managers.

A compensation system that better rewards managers for the company's success would have provided them with more incentive to make the company successful instead of siphoning money using the fraudulent scheme.

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Case 3: More Disclosure Equals More Pain? ***Suggested solution:***

a.

* "Real" earnings are more reliably measured.
* "Real" earnings are subject to a set of standards of measurement (i.e., GAAP), whereas "pro forma" earnings could be defined in ways that best suit management.
* "Pro forma" earnings lead to confusion among investors.
* "Real" earnings could be less relevant if they poorly predict future earnings and cash flows.
* "Real" earnings could lack comparability with past results if they contain one-time items.
* "Pro forma" earnings could lack comparability because management can change the definition from year to year.

b.

* Stock options involve an economic sacrifice from the shareholders and should be expensed.
* They should be expensed in the period they are granted because they are a form of compensation to pay employees for services (benefits) received. This matches expenses to economic benefits.
* Some or most of the benefit to the company is realized subsequent to the grant date in the form of employee motivation, so matching can be used to argue that the expense should be recorded later.
* These future benefits suggest that the value of these options should be recorded as an asset.
* The value of stock options is difficult to measure, so the criteria for recognition in the financial statements are arguably not satisfied.

c.

* Whether to consolidate depends on whether the company has control over the assets of the SPEs and whether it is obligated to satisfy the liabilities of the SPEs (i.e., are the definitions of assets and liabilities satisfied?).
* If the company is responsible for the SPEs' debts, that would argue for consolidation.
* The entity concept in the conceptual framework suggests that SPEs should be consolidated if the company exercises control, enjoys substantial benefits, and faces most of the risk of SPEs.
* Shareholders need to know the full extent of the company's activities to properly estimate future cash flows and risks in order to make informed investment decisions.

d.

* If one believes markets are fairly efficient, these comments don't make sense, especially because the author believes that most of the information is already available.
* More information would not lead to dramatic downward price adjustments if investors form expectations rationally.
* Based on adverse selection, the lack of information would actually depress stock prices, so more information would dispel some uncertainty and lift stock prices.

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* Less information asymmetry would encourage more investors to trade equities (instead of some other securities), thus increasing demand and liquidity in the market.
* Additional debts reported on balance sheets may affect contracts that companies have (particularly debt contracts), increasing costs to the company; therefore, shareholder value may decrease.

Case 4: Wicon Waste. ***Suggested solution:***

To: Partner
From: CA
Date: September 18, 2016
Subject: Wicon Waste Engagement

Overview
The Wicon Waste engagement has considerable risk associated with it. In reviewing the file, I noted a number of events that raise concerns about the integrity of WWF's management. These events include:

* management's refusal to notify the bank of its error in converting foreign funds and the inclusion of the amount of the error in income;
* the change in the accounting estimate of the useful lives of assets, which has the effect of increasing income;
* the patent infringement suit; and

No single one of these circumstances provides compelling evidence of questionable management integrity. Changing accounting estimates is commonplace and often justifiable. There has been no conviction on the patent infringement suit and nuisance lawsuits are not unusual. Collectively however, these events give a hint that management may lack integrity, which could result in biased financial statements. We must bear this risk of bias in mind in evaluating individual issues and the financial statements as a whole. The following will discuss the more specific issues individually.

A. Bank error

The treatment of the bank error results in income being increased by $9,997,500 ($10,000,000 – GNF 20,000,000 / GNF 8,000/CAD), an amount that is material. This misstatement of income could influence the decisions of potential buyers and bond-rating agencies. Clearly, including the amount in income is not correct accounting and unethical. The money does not belong to WWF, and the bank will ask for repayment once they discover the error. The amount of the error should be set up as a liability, not included as revenue. Of course, the liability may never be paid if the bank does not notice the error. There is a small chance that the bank does not notice the error; in that case the money would legally become WWF's after a number of years (due to the statute of limitations), but for now treatment as income is not acceptable.

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B. Patent infringement award

The award against WWF made by the court in the patent infringement case is unusual. Aggrieved parties normally receive a straightforward payment as compensation. The payment is usually treated as an expense for accounting purposes. In this case, however, WWF is receiving something that may or may not have value, so the accounting is more complex. Various accounting approaches could reasonably be used. First, since the purchase is a court-imposed penalty, the $18 million share purchase could be considered to be an $18 million fine and shares to have been acquired at zero cost. This approach would be unattractive to WWF since it would have a significant effect on the income statement at a time when it is very concerned about the bottom line (because of the potential sale of the shares and the alert placed on WWF's credit rating). An alternative approach would be to record the shares as an asset on the balance sheet at $18 million. This approach would be attractive to WWF's management because the income statement would be unaffected.

To determine whether WWF is receiving an asset because of the court decision, the first step would be to determine whether the shares meet the definition of an asset. According to the IFRS Conceptual Framework, paragraph 4.4, "An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity." The shares will be controlled by WWF and are the result of a past event (the court ruling), however whether or not there will be any future benefits depends on the performance of Waste Systems. If WWF is likely to derive a future benefit from the shares, then the definition of an asset has been met.

The next question to be resolved is how much the asset is worth. If the shares are to be recorded on the balance sheet at $18 million, they need to have a value of $18 million to arm's length parties (i.e., fair value). If the fair value is less than $18 million, then the amount in excess of the fair value should be expensed since that amount represents a penalty. Since Waste Systems Integrated Limited is a private company, it could be difficult to arrive at a reasonable estimate of its fair market value. I strongly suggest that WWF obtain an independent valuation of Waste Systems so that we have authoritative support for the company's value. Such support is especially important in view of WWF management's concern about the income-statement figures at the present time. That Waste Systems had been in financial difficulty is an indication that its market value is low.

C. Waste-disposal sites

WWF has significantly lengthened the estimated lives of its waste disposal sites and decreased the estimated cost of sealing and cleaning up the sites. The change has a significant effect on income, which is important because the owners are considering selling their shares. Waste-disposal sites represent 64% of WWF's assets and 41% of operating expenses. The disposal sites will be an important consideration for prospective purchasers, and they may rely on the financial statements. Thus we must exercise great care in this highly risky part of the audit.

Compounding the problem is the fact that WWF changed consulting engineers this year and the new engineers, Cajanza Consulting Engineers (Cajanza), recommended the changes. It is not

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clear why WWF changed engineers for this purpose, but a possible reason is to obtain more favourable estimates to improve the company's financial reports. It is difficult to understand how the costs of sealing and cleaning up sites can decrease at a time when environmental regulation is increasing, so the reduction in estimated costs requires additional attention.

WWF uses three different methods for determining amortization expense. We should examine whether using three methods is justifiable. To enhance comparability, the IFRS Conceptual Framework requires consistent treatment of transactions and items that are similar. It is therefore possible that using these different methods is not acceptable unless different circumstances justify the different methods. Therefore, the company should identify the rationale for each amortization policy and if it is unable to do so, then one consistent accounting policy should be chosen.

Given the circumstances and the incentives for management to increase earnings, additional audit steps should be taken to satisfy ourselves that the estimated lives and clean-up costs are reasonable. One approach would be for us to engage an engineering firm to assess the lives and clean-up costs of the sites.

D. Locating and negotiating costs

WWF amortizes the costs of locating new waste-disposal sites and negotiating agreements with municipalities, this approach is not reasonable. Under IFRS, the cost associated with negotiating a contract would be considered transaction costs and would be expensed as incurred. According to IAS 16.19 "Examples of costs that are not costs of an item of property, plant and equipment are…administration and other general overhead costs." The company will need to make this adjustment in the current year.

E. Overall conclusion

The above discussion identifies several issues that have a material impact on WWF's financial statements. We should consider whether our audit report should be qualified if management does not agree to adjust the statements for material errors and misstatements discussed in this memo. The effects of the bank error and the treatment of the waste disposal sites raise the possibility that the financial statements may be materially misstated. Management seems to have taken steps that have had the effect of increasing net income and the assets on the balance sheet. In the extreme case, we should consider whether we should resign from the engagement altogether because of the questionable integrity of management. Among other integrity concerns, the company's handling of the bank error and changes in accounting estimates, apparently to window-dress the financial statements, should make us question whether we want to be associated with this client.

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Case 5: Douglas Décor Company. ***Suggested Solution:***

a. The management at PDI would need reliable financial information to assess the financial performance of the company. In particular, they would need to look at cash flows, earnings as well as the capital structure of DDC when analyzing the financial statements. Cash flow information is important for PDI to evaluate the cash flow trend and cash generating ability of DDC. Earnings are also important because they indicate whether revenue of the company can adequately cover expenses. Furthermore, the examination of earnings can also help PDI management to assess the overall financial performance of the company and to compare the performance of DDC with industry peers. Finally, as PDI is the potential buyer who would acquire the company, the management would also care about the financial position of DDC (i.e., components of assets, liabilities and equity).

   The accounting records provided by DDC did not fulfill those needs. Since there was no accounting statements produced over the years of operations, PDI was unable to reliably measure the financial performance of DDC. In this situation, it would be very difficult for PDI to generate reliable estimates of the value of the DDC business. Furthermore, DDC has been accounting for the company on a cash basis, which may omit useful accrual information.

b. Based on the cost versus benefit constraint, it could be argued that producing sophisticated financial statements for a small private company such as DDC would incur greater costs than benefits. However, considering Doug and Dez want to sell the company, they should be aware of the needs of potential buyers, and prepare a proper set of financial statements accordingly in the more recent years.

c. The IFRS Conceptual Framework enumerates six qualitative characteristics, categorized as either fundamental or enhancing characteristics. While the fundamental qualitative characteristics describe whether information is useful for decision-making (relevance and representational faithfulness), the enhancing qualitative characteristics affect the information's *degree* of usefulness (understandability, comparability, verifiability, and timeliness). For example, understandability is important for the users of the financial statements to understand the information presented in DDC's financial records. Relevance is important because of its ability to influence users' economic decision. Representational faithfulness is important because it signifies that the financial statements faithfully represent the economic reality. Comparability is important to allow users to compare the financial position of DDC with other similar companies in the industry.

d. Considering DDC would have produced their financial statements under ASPE and PDI is a publicly traded company, PDI would have to re-evaluate many of the items on the balance sheet and account for them using IFRS.

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CHAPTER 2
Conceptual Frameworks for Financial Reporting

CPA COMPETENCIES ADDRESSED IN THIS CHAPTER

1.1.1 Evaluates financial reporting needs (Level B)
   a. Framework of standard setting
1.1.1 Evaluates financial reporting needs (Level B)
   b. Financial statement users and their broad needs, standard setting, and requirement accountability
1.1.1 Evaluates financial reporting needs (Level B)
   c. Objectives of fi nancial reporting
1.1.2 Evaluates the appropriateness of the basis of financial reporting (Level B)
   a. Fundamental accounting concepts and principles (qualitative characteristics of accounting information, basic elements)
1.1.2 Evaluates the appropriateness of the basis of financial reporting (Level B)
   b. Methods of measurement
1.2.1 Develops or evaluates appropriate accounting policies and procedures – Ethical professional judgment (Level B)

LEARNING OBJECTIVES

2-1. Explain the role of a conceptual framework for financial reporting and the reasons for having conceptual frameworks.
2-2. Explain the rationale for each of the eight major components of these frameworks and synthesize these components into an integrated whole.
2-3. Apply the conceptual frameworks in IFRS and ASPE to specific circumstances and evaluate the trade-offs among different concepts within the frameworks.
2-4. Describe the standard-setting environment in Canada.

OVERALL APPROACH

The overall objective of financial reporting is to provide useful information to financial statement users. When determining what is useful, we need to consider what information is important to financial statement users. Conceptual frameworks help to identify and organize concepts that are important.

Conceptual frameworks are an important set of foundational concepts in intermediate financial accounting. Many of the terms, concepts, and principles covered in this chapter provide a foundation for upcoming chapters. Students often struggle with this chapter because conceptual frameworks are a set of *concepts* rather than concrete objects.

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This chapter builds on the ideas of supply and demand for information as discussed in Chapter 1. This chapter describes conceptual frameworks (there is more than one such as one for IFRS, one for ASPE) as business plans that lay out the demand for financial information and how accounting should supply information that responds to that demand.

Since supply and demand should be second nature to accounting / business students, this linkage makes conceptual frameworks understandable. Another benefit of portraying conceptual frameworks as business plans is that doing so makes apparent that more than one framework can be valid, and that these frameworks are not set in stone, they can and do change over time.

KEY POINTS

The chapter focuses on the concept of **supply and demand for information** as discussed in Chapter 1. The chapter focuses the discussion using the conceptual framework in IFRS. Exhibit 2-7 (page 42) provides a summary comparison of the conceptual frameworks in IFRS and ASPE.

Similar to many other business situations, it is useful to separately analyze the demand and the supply. From the standpoint of accounting standard setters and financial statement preparers, the demand for information is external and largely out of their control. The supply side, on the other hand, is more directly managed by accountants.

The diagrams in Exhibits 2-1, 2-2, and 2-3 convey this separation and other logical connections among the eight major components of the IFRS Framework. In particular:

- The five supply side components are encased in an arrowhead pointing toward demand to show the need to have supply meet demand.
- Constraints can be thought of as limits, so the diagrams position them at the top. Meanwhile, underlying assumptions are positioned at the bottom.
- Constraints and assumptions are positioned on the periphery; while they are important considerations, they are not at the "core" of what accountants do. The core involves the elements of the financial statements, recognition, and measurement.

Once the IFRS Framework has been introduced in the context of supply and demand, the remaining details of the framework flow naturally.

Section D of this chapter, beginning on page 43, provides a description of the standard setting process internationally and in Canada. In this context, it is important to distinguish a publicly accountable enterprise from a private enterprise, particularly because the latter term has a more restrictive meaning in accounting than in business and economics. Exhibit 2-8 on page 44 provides an illustration of the standards that are applicable to different types of reporting entities.

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Some instructors may find the assumption of the capital maintenance concept worthy of additional exploration, and the Appendix to this chapter (Section F, pages 50-52) does so with a detailed numerical example.

USE OF END-OF-CHAPTER PROBLEMS AND CASES

In addition to lectures, discussion of some of the end-of-chapter problems and cases will help students apply the concepts. The following table identifies all of problems and cases that can be used in class, and problems and cases that can be used for homework assignments. (Depending on the time allocation between lectures and questions, it may not be feasible to cover all of the suggested items.)

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Table 2-1: Summary of learning objectives, chapter content, and suggested problems and cases

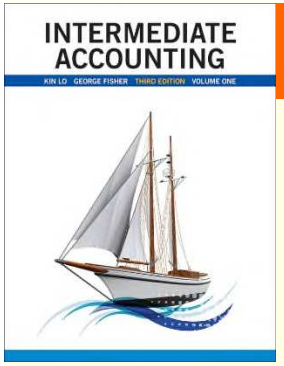
L.O. number	Learning objective	Pages	Suggestions for in-class discussion	Suggestions for assignments
2-1.	Explain the role of a conceptual framework for financial reporting and the reasons for having conceptual frameworks.	28-30	P2-1	
2-2.	Explain the rationale for each of the eight major components of these frameworks and synthesize these components into an integrated whole.	30-40	P2-3 P2-8 P2-9 P2-11	P2-2 P2-4 P2-5 P2-6 P2-7 P2-10
2-3.	Apply the conceptual frameworks in IFRS and ASPE to specific circumstances and evaluate the trade-offs among different concepts within the frameworks.	40-43	P2-12 P2-14	P2-13 P2-15 P2-16 P2-17 P2-18 P2-19 P2-22 P2-23
2-4.	Describe the standard-setting environment in Canada.	43-50	P2-20 P2-26 P2-27	P2-21 P2-24 P2-25
--	Integrative		Case 1 Case 5	Case 2 Case 3 Case 4

Case 1 presents scenarios that a public financial institution is facing. Students are asked to provide arguments, using ideas from the conceptual framework in IFRS, to address concerns that are raised by the Ontario Securities Commission.

Case 5 is a practical question that looks at a public company that is considering whether to acquire a private company. Students are asked to consider the reporting requirements for a private company and to explain the qualitative characteristics that will help to meet the needs of the financial statement users.

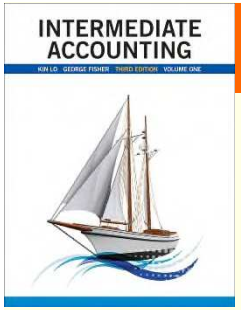
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Chapter 2
Conceptual Frameworks for Financial Reporting

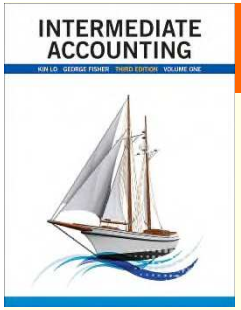
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LEARNING OBJECTIVES

- L.O. 2-1. Explain the role of a conceptual framework for financial reporting and the reasons for having conceptual frameworks.
- L.O. 2-2. Explain the rationale for each of the eight major components of these frameworks and synthesize these components into an integrated whole.
- L.O. 2-3. Apply the conceptual frameworks in IFRS and ASPE to specific circumstances and evaluate the trade-offs among different concepts within the frameworks.
- L.O. 2-4. Describe the standard-setting environment in Canada.

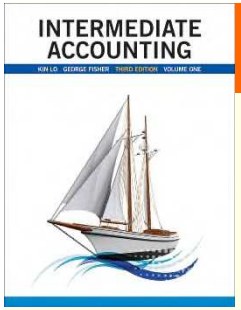
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CPA competencies addressed in this chapter:

- 1.1.1 Evaluates financial reporting needs (Level B)
- a. Framework of standard setting
- 1.1.1 Evaluates financial reporting needs (Level B)
- b. Financial statement users and their broad needs, standard setting, and requirement for accountability
- 1.1.1 Evaluates financial reporting needs (Level B)
- c. Objectives of financial reporting

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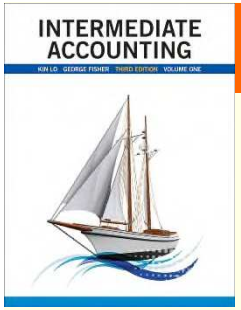
- 1.1.2 Evaluates the appropriateness of the basis of financial reporting (Level B)
- a. Fundamental accounting concepts and principles (qualitative characteristics of accounting information, basic elements)
- 1.1.2 Evaluates the appropriateness of the basis of financial reporting (Level B)
- b. Methods of measurement
- 1.2.1 Develops or evaluates appropriate accounting policies and procedures – Ethical professional judgment (Level B)

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Financial Reporting Frameworks

- "... business plan to anticipate the demand for information and to structure a reporting system to supply information that meets that demand."

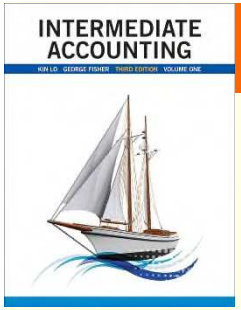
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A. CONCEPTUAL FRAMEWORKS FOR FINANCIAL ACCOUNTING AS STRATEGIES TO MEET MARKET DEMANDS FOR INFORMATION (L.O. 2-1)

- Abstract in nature
- Example – business plan for a carmaker

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1. Sketch of a business plan for a carmaker

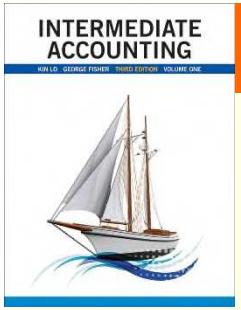
- a. Assessing demand
  - Choose a target market
  - Understand the needs
  - Identify the desirable product characteristics
- b. Supply planning
  - Identify potential product components
  - Consider technological and economic feasibility
  - Make simplifying assumptions

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2. Outline of a conceptual framework for financial reporting (L.O. 2-2)

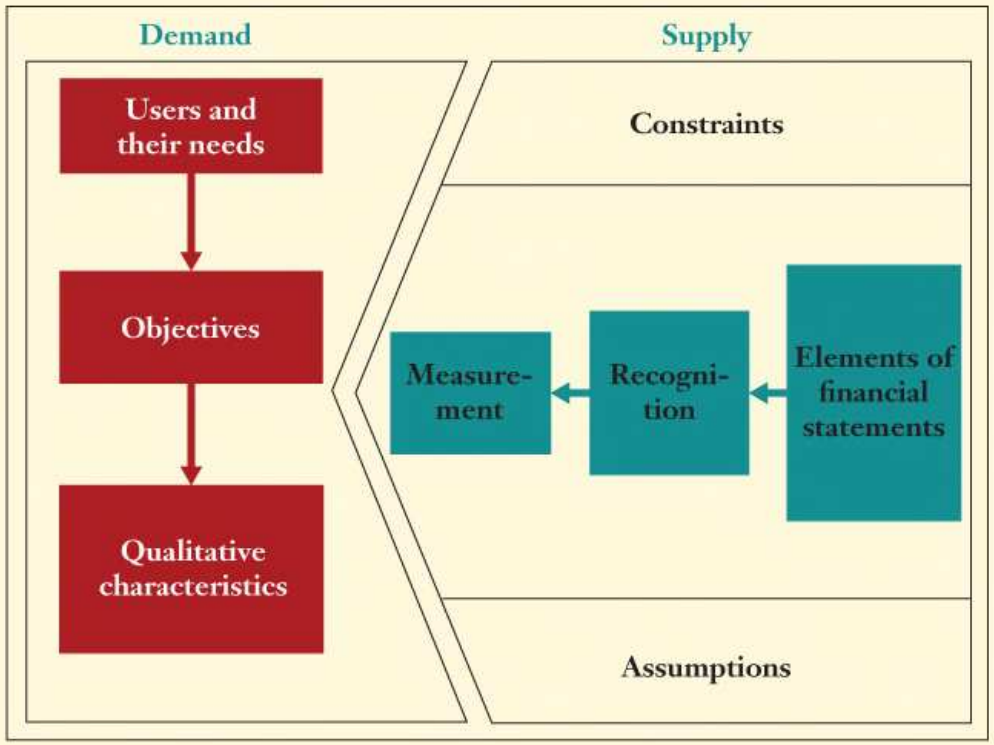
- a. Demand side
  - Choose users of financial reporting
  - Understand the information needs
  - Identify the information characteristics
- b. Supply side
  - Identify elements of financial statements
  - Consider whether these elements are reported
  - Consider how these elements should be measured

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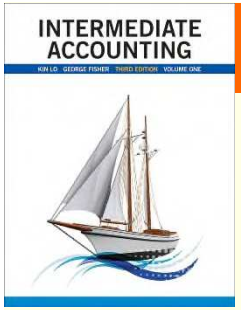
2. Outline of a conceptual framework for financial reporting (L.O. 2-2)

Exhibit 2-2 Outline of a conceptual framework for financial reporting



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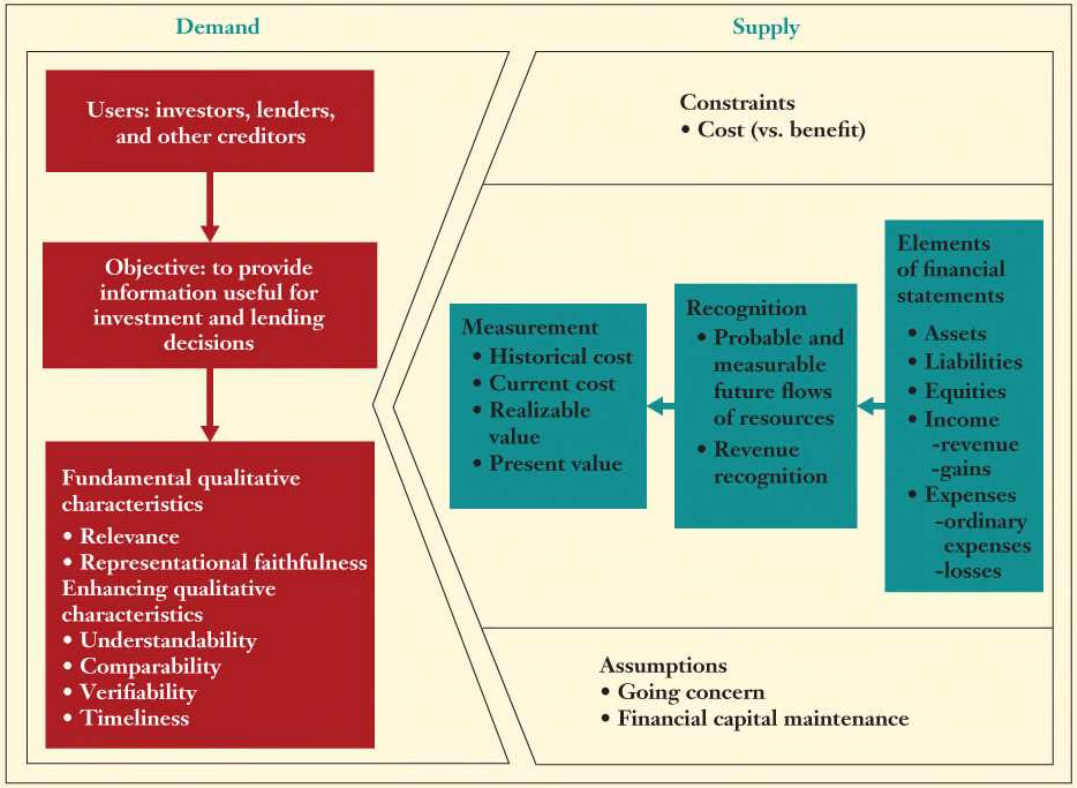
B. COMPONENTS OF THE IFRS CONCEPTUAL FRAMEWORK

- the "Conceptual Framework for Financial Reporting" under IFRS
- Also referred to as "IFRS Conceptual Framework"

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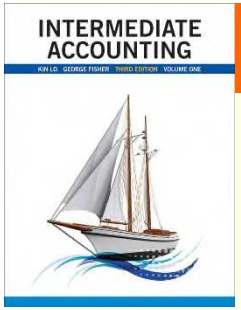
B. COMPONENTS OF THE IFRS CONCEPTUAL FRAMEWORK

Exhibit 2-3 The IFRS Framework



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1. Users and their needs

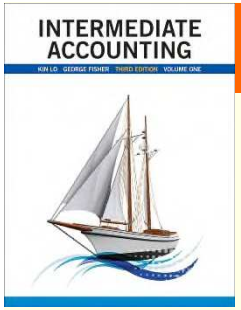
- Existing investors, lenders, and other creditors
- Generally all parties who have provided financial resources to the firm
- The needs of other potential users (employees, suppliers, customers, and governments) are less well served

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2. Objectives of financial reporting

- To provide financial information about the reporting entity that is useful to existing and potential users in making decisions
- Aims to reduce information asymmetry
- Decisions include investment and lending decisions
- Information includes amount, timing, and uncertainty of cash flows, and the entity's resources, claims, and performance
- Accrual Accounting : A basis of accounting that records economic events when they happen rather than only when cash exchanges occur.

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3. Qualitative characteristics

- Desirable characteristics of financial reports that help meet the user's information needs

a. Fundamental qualitative characteristics (must haves)

b. Enhancing qualitative characteristics (nice to have)

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a. Fundamental qualitative characteristics

1. Relevance: The ability to influence users' economic decisions. Information is relevant if it has:

–Confirmatory value: Provide feedback on past events

–Predictive value: Future outcomes

–Materiality: Whether omission or misstatement of a particular piece of information about the reporting entity would influence user's economic decisions

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a. Fundamental qualitative characteristics

2. Representational faithfulness: the extent to which financial information reflects the underlying transaction, resources, and claims of an enterprise.
   - Completeness: Inclusion of all material items
   - Neutrality: Extent to which information is free from bias
   - Freedom from error: Extent to which information is absent of errors/omissions

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b. Enhancing qualitative characteristics

1. Understandability: The ease with which users are able to comprehend financial reports

2. Comparability: Ability to compare one set of financial statements with another. The comparison may be with the financial statements of the same enterprise in a different year or with those of a different enterprise.

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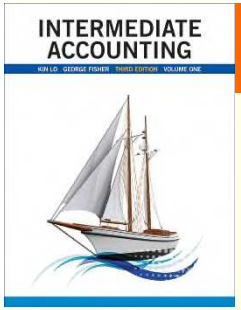
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b. Enhancing qualitative characteristics

3. Verifiability: Degree to which different people would agree with the chosen representation

4. Timeliness: How soon the information becomes available to decision makers

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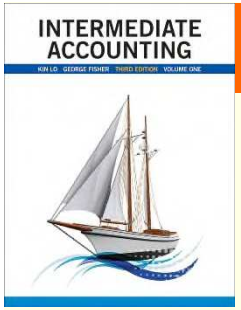
4. Elements of financial statements

- Items or categories that appear in the financial statements

a. Elements relating to measuring financial position

b. Elements relating to measuring performance

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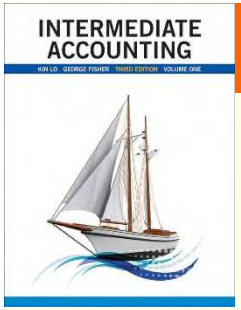


4. Elements of financial statements

- Financial position
  - Asset
  - Liability
  - Equity (The residual interest in the assets of an entity after deducting all its liabilities)
- Performance
  - Income: Revenues and gains
  - Expenses (ordinary expense and losses)

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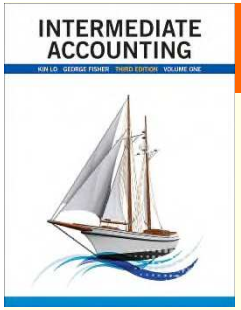
Strong Focus on Assets and Liabilities Under IFRS

Exhibit 2-5 Definitions of asset and liability

An asset is …	A liability is …
a resource controlled by an entity	a present obligation of the entity
as a result of past events and	arising from past events,
from which future economic benefits are expected to flow to the entity.	the settlement of which is expected to result in an outflow from the entity of economic resources embodying economic benefits.

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5. Recognition

- Definition: The process of presenting an item in the financial statements, as opposed to merely disclosing that item in the notes.
- Generally accounting elements are recognized in the financial statements if the future inflows or outflows of resources are ***probable*** and the amounts are reasonably ***measurable.***
- Where to recognize items: recognition criteria
  - In the financial statements
  - In the notes
- How to recognize: the measurement basis

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6. Measurement

- Quantification of amounts reported
- Most common basis is historical cost: The amount of cash or cash equivalents paid or received in a transaction.
- Other measurement basis
  - Current cost
  - Realizable value: Asset
  - Settlement value: Liability
  - Present value

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7. Constraints

a. Benefits vs. costs

b. Timeliness vs. reliability

c. Balance among qualitative characteristics

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8. Assumptions

- Simplified generalizations deemed to be appropriate in most circumstances

a. Going concern: continue to operate in the foreseeable future

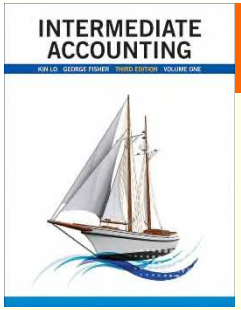
b. Financial capital maintenance refers to the amount of resources required to ensure the economic sustainability of an entity.

  – Physical capital: focus on production

  – Financial capital: focus on resources in monetary terms

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9. Example for illustrating the application of the IFRS Framework (L.O. 2-3)

Consider alternatives using the Framework

	Arguments for alternative	Arguments against alternative
Charge against current period income	Provides information to financial statement readers relevant to the monetary costs of Elmo's pollution	Recognizing expense in the current period is not representationally faithful because the pollution that led to the penalty occurred in past periods.
	Significantly reduces current year reported performance, which can result in reduced income-based compensation to management, giving incentive to avoid pollution in the future	The large expense recorded in the current period would reduce the comparability of the income statement with other periods.

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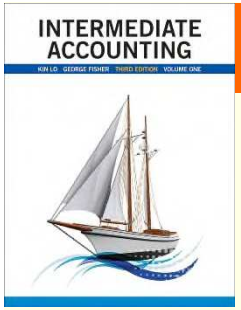
Capitalize expenditure and amortize over future years	Arguments for alternative	Arguments against alternative
	The penalty is an asset: it has future economic benefits because the payment allows Elmo to remain in operation to generate future cash flows from operations. The payment arose from past events and the company has control over whether it continues to operate in Elmotown	The Pollution Control Agency assessed the penalty for past pollution, so there are no future benefits associated with this cost. Any future benefits are unclear, so should not capitalize to be conservative.

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C. OTHER CONCEPTUAL FRAMEWORKS

- IFRS is one of many frameworks
- Alternative: Accounting Standards for Private Enterprises (ASPE), Financial Accounting Standards Board (FASB)
- Common conceptual framework: Goal of IASB to work with U.S. to continue convergence into one set of standards

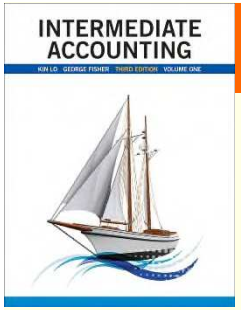
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Differences and Similarities in the IFRS & ASPE Frameworks

- Considerable degree of similarity
- ASPE is shorter than IFRS
- Length differs from
  - 9 pages to 22 pages
  - 52 paragraphs to 136 paragraphs
- Differences due to standard-setting approaches

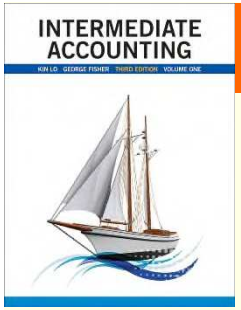
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D. STANDARD SETTING: INTERNATIONALLY AND IN CANADA (L.O. 2-4)

- Standard setting using the following:
  1. Standards internationally
  2. Standards in Canada
  3. Setting accounting and auditing standards in accounting
  4. Globalization of standard setting

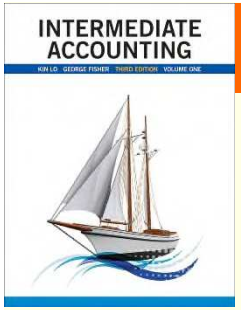
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1. Standards internationally

- IFRS: issued by International Accounting Standards Board (IASB)
- Broad range of users
- Authority given by countries' legislation or regulation

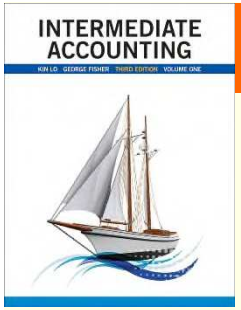
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2. Standards in Canada

- Issued by the CPA Canada
- Contained in the Handbook
- Five parts to the Handbook
  - Part I – IFRS: publicly accountable enterprises
  - Part II – ASPE: private enterprises
  - Part III – NFPOs: Not-for-profit enterprises
  - Part IV – Pension plans
  - Part V – Legacy standards prior to Jan. 1, 2011

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3. Organization and authority for setting accounting and auditing standards in Canada

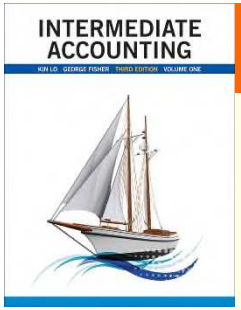
- Canada Business Corporations Act grants the authority for the CPA Canada
- AcSB responsible for non-public sector standards
- PSAB responsible for public sector
- AASB issues auditing and other assurance engagements standards

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Establishing Independence in Standard Setting

- CPA Canada has two independent governance bodies
- Two bodies oversee three standard-setting bodies
  - AcSOC oversees the AcSB and PSAB
  - AASOC oversees the AASB
- Representation from outside accounting and auditing
- Non-GAAP basis may be a choice in some circumstances

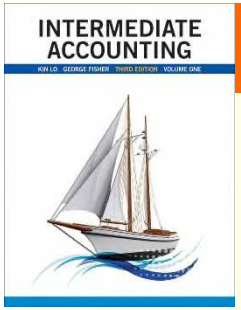
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4. Globalization of standard setting

- The debate continues
- Consider benefits vs. costs
- Benefits for global standard setting
  - Increase comparability
  - Reduce reporting costs
  - Provide a common "language"

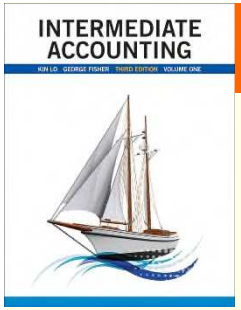
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E. STANDARDS IN TRANSITION

- IASB has an eight-phase project to revise the framework.
- IASB was expected to issue in the spring of 2015 an exposure draft (ED).
- The ED is expected to propose increased prominence for the objective of assessing stewardship, and reintroduction of the concept of prudence as a qualitative characteristic.

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F. APPENDIX: ILLUSTRATION OF CAPITAL MAINTENANCE CONCEPTS

- Zero-inflation environment
  - Payout can equal net income
- Inflationary environment
  - Net income overstates profitability
  - Payouts equalling net income negatively affects ability to continue
- Physical capital maintenance considers price level changes
  - More complex
  - Not used in North America

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G. SUMMARY

- L.O. 2-1. Explain the role of a conceptual framework for financial reporting and the reasons for having conceptual frameworks.
- L.O. 2-2. Explain the rationale for each of the eight major components of these frameworks and synthesize these components into an integrated whole.
- L.O. 2-3. Apply the conceptual frameworks in IFRS and ASPE to specific circumstances and evaluate the trade-offs among different concepts within the frameworks.
- L.O. 2-4. Describe the standard-setting environment in Canada.

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