CHAPTER 2

CONCEPTUAL FRAMEWORK UNDERLYING FINANCIAL REPORTING

MULTIPLE CHOICE—Conceptual

Answer	No.	Description
c	1.	GAAP defined.
d	2.	Purpose of conceptual framework.
d	3.	Objectives of financial reporting.
c	4.	Purpose of understandable information.
a	5.	Decision-usefulness criterion.
c	6.	Full disclosure principle.
b	7.	Definition of relevance.
b	8.	Comparability characteristic.
a	9.	Timeliness characteristic.
c	10.	Economic entity.
d	11.	Fair value principle
a	12.	Definition of a liability.
c	13.	Definition of a loss.
c	14.	Materiality constraint.
b	15.	Full disclosure principle.
c	16.	Quality of representational faithfulness.
d	17.	Comparability.
b	18.	Comparability.
a	19.	Principles based GAAP.
c	20.	Definition of an asset.
d	21.	Elements of financial statements.
c	22.	Distinction between revenues and gains.
c	23.	Definition of a loss.
b	24.	Principles-based GAAP.
b	25.	Components of comprehensive income.
d	26.	Economic entity assumption.
a	27.	Economic entity assumption.
b	28.	Periodicity assumption.
a	29.	Going concern assumption.
d	30.	Going concern assumption.
d	31.	Implications of going concern assumption.
a	32.	Historical cost principle.
d	33.	Historical cost principle.
d	34	Valuation model.
c	35.	Revenue recognition principle.
d	36.	Revenue recognition principle.

MULTIPLE CHOICE—Conceptual (cont.)

Answer	No.	Description
d	37.	Revenue recognition principle.
d	38.	Timing of revenue recognition.
a	39.	Definition of an asset.
a	40.	Matching principle.
b	41.	Matching principle.
b	42.	Matching principle.
b	43.	Expense recognition.
c	44.	Full-disclosure principle.
b	45.	Uncertainty constraint.
c	46.	Full disclosure.
b	47.	Full disclosure principle.
c	48.	Materiality constraint.
d	49.	Materiality.
c	50.	Fraudulent financial reporting.
d	51.	Representational faithfulness.
a	52.	Qualitative characteristics.
a	53.	Comparability characteristic
a	54.	Timeliness characteristic.
a	55.	Recognition of gains and losses.

EXERCISES

Item	Description
E2-56	Foundational principles.
E2-57	Fair value measurement.
E2-58	Accounting concepts—identification.
E2-59	Accounting concepts—identification.
E2-60	Accounting concepts—matching.
E2-61	Accounting concepts—fill in the blanks.
E2-62	Matching concept.
E2-63	Examination of the conceptual framework.
E2-64	Principles vs. rules based GAAP.
E2-65	Financial engineering.
E2-66	Fraudulent financial reporting

MULTIPLE CHOICE—Conceptual

1. Generally accepted accounting principles
   a. are fundamental truths or axioms that can be derived from laws of nature.
   b. derive their authority from legal court proceedings.
   c. derive their credibility and authority from general recognition and acceptance by the accounting profession.
   d. have been specified in detail in the CICA conceptual framework.

2. A soundly developed conceptual framework of concepts and objectives should
   a. increase financial statement users' understanding of and confidence in financial reporting.
   b. enhance comparability among companies' financial statements.
   c. allow new and emerging practical problems to be more quickly solvable.
   d. all of these.

3. 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 helpful 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. All of these are objectives of financial reporting.

4. Decision makers vary widely in the types of decisions they make, the methods of decision making they employ, the information they already possess or can obtain from other sources, and their ability to process information. Consequently, for information to be useful there must be a linkage between these users and the decisions they make. This link is
   a. relevance.
   b. reliability.
   c. understandability.
   d. materiality.

5. The overriding criterion by which accounting information can be judged is that of
   a. usefulness for decision making.
   b. freedom from bias.
   c. timeliness.
   d. comparability.

6. During a major renovation project of its head office, a worker was seriously injured. While the company believes that it was not at fault, it does include the incident in the notes to its financial statements. This is consistent with which of the following principles:
   a. Economic entity
   b. Control
   c. Full disclosure
   d. Periodicity

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

8. The adoption of international GAAP can be seen as an application of which of the following quality enhancing characteristics:
   a. Verifiability
   b. Comparability
   c. Understandability
   d. Timeliness

9. Enhancing qualitative characteristics are an essential part of the conceptual framework of accounting. These include, among others, timeliness. Which of the items below would be *most* indicative of timeliness?
   a. The preparation of quarterly financial statements
   b. The preparation of annual financial statements
   c. The large volume of data to be included.
   d. The choice of the best accounting principle

10. A local business man owns several different companies. His accountant prepares separate annual financial statements for each of these businesses. This is an application of which of the following principles:
    a. Full disclosure
    b. Periodicity
    c. Economic entity
    d. Matching

11. To measure the fair value of an asset, an entity should determine
    a. The asset's nature, condition and location
    b. The asset's valuation premise
    c. The availability of data
    d. All of the above

12. Under the currently proposed definition of a liability, what is the *most* important aspect to consider when deciding whether the item should be recognized as a liability?
    a. The item represents an economic obligation for which a present obligation exists
    b. The item is shown on the balance sheet
    c. The transaction underlying the obligation has occurred
    d. The item is measurable

13. Which of the following independent business transactions would *most* likely be recorded as an accounting loss?
    a. A decrease in a retail store's sales
    b. A decrease of a bank's interest income
    c. A decrease in net assets from a company's incidental transactions.
    d. All of the above

14. MAX Auto Repair has implemented a policy that requires all expenditures below $10 to be expensed. This is an application of
    a. The full disclosure principle
    b. The matching principle
    c. The materiality constraint
    d. Representational faithfulness

15. A severe cold snap may affect this year's crop of Florida's citrus growers. The potentially adverse affect is disclosed in the financial statements of the citrus growers. This practice can be *best* described as an application of
    a. The derecognition of financial statement elements
    b. The full disclosure principle
    c. The going concern assumption
    d. The economic entity assumption

16. Representational faithfulness is an ingredient of the primary quality of

	Reliability	Relevance
a.	Yes	Yes
b.	No	Yes
c.	Yes	No
d.	No	No

17. Financial information does *not* demonstrate comparability when
    a. firms in the same industry use different accounting methods to account for the same type of transaction.
    b. a company changes its estimate of the residual value of a fixed asset.
    c. a company fails to adjust its financial statements for changes in the value of the measuring unit.
    d. none of these.

18. Financial information exhibits the characteristic of comparability when
    a. expenses are reported as charges against revenue in the period in which they are paid.
    b. accounting entities give accountable events the same accounting treatment from period to period.
    c. extraordinary gains and losses are not included on the income statement.
    d. accounting procedures are adopted which give a consistent rate of net income.

19. A principles based approach to financial reporting standards generally does *not* exhibit ` the following:
    a. Specific rules
    b. Flexibility
    c. General guidance
    d. Room for a large degree of professional judgement

20. Which of the following items below does *not* meet the definition of an asset?
    a. A building owned and used by a company
    b. Equipment that is owned and used by a company
    c. Publicly available water used by a farm to water its crops
    d. None of the above

21. The elements of financial statements include investments by owners. These are increases in an entity's net assets resulting from owners'
    a. transfers of assets to the entity.
    b. rendering services to the entity.
    c. satisfaction of liabilities of the entity.
    d. all of these.

22. In classifying the elements of financial statements, the primary distinction between revenues and gains is
    a. the materiality of the amounts involved.
    b. the likelihood that the transactions involved will recur in the future.
    c. the nature of the activities that gave rise to the transactions involved.
    d. the costs versus the benefits of the alternative methods of disclosing the transactions involved.

23. A decrease in net assets arising from peripheral or incidental transactions is called a(n)
    a. capital expenditure.
    b. cost.
    c. loss.
    d. expense.

24. Principles-based GAAP is sometimes criticized for being
    a. Too *in*flexible.
    b. Too flexible
    c. Too inconsistent
    d. None of these

25. 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

26. The economic entity assumption
    a. is inapplicable to unincorporated businesses.
    b. recognizes the legal aspects of business organizations.
    c. requires periodic income measurement.
    d. is applicable to all forms of business organizations.

27. Preparation of consolidated financial statements when a parent-subsidiary relationship exists is an example of the
    a. economic entity assumption.
    b. relevance characteristic.
    c. comparability characteristic.
    d. neutrality characteristic.

28. During the lifetime of an entity, accountants produce financial statements at arbitrary points in time in accordance with which basic accounting concept?
    a. Cost/benefit relationship
    b. Periodicity assumption
    c. Conservatism constraint
    d. Matching principle

29. What accounting concept justifies the usage of accruals and deferrals?
    a. Going concern assumption
    b. Materiality constraint
    c. Consistency characteristic
    d. Monetary unit assumption

30. 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. conservatism assumption.
    d. none of these.

31. Which of the following is an implication of the going concern assumption?
    a. The historical cost principle is credible.
    b. Amortization and amortization policies are justifiable and appropriate.
    c. The current-noncurrent classification of assets and liabilities is justifiable and significant.
    d. All of these.

32. Proponents of historical cost ordinarily maintain that in comparison with all other valuation alternatives for general purpose financial reporting, statements prepared using historical costs are more:
    a. reliable.
    b. relevant.
    c. indicative of the entity's purchasing power.
    d. conservative.

33. Valuing assets at their liquidation values rather than their cost is inconsistent with the
    a. periodicity assumption.
    b. matching principle.
    c. materiality constraint.
    d. historical cost principle.

34. The current mixed valuation model primarily ties the basis of valuation to
    a. the level of uncertainty.
    b. measurement reliability.
    c. the age of the asset.
    d. management intent with respect to the asset.

35. Revenue is generally recognized when performance is achieved and it is measurable and collectible. This statement describes the
    a. consistency characteristic.
    b. matching principle.
    c. revenue recognition principle.
    d. relevance characteristic.

36. Generally, revenue from sales should be recognized at a point when
    a. management decides it is appropriate to do so.
    b. the product is available for sale to the ultimate consumer.
    c. the entire amount receivable has been collected from the customer and there remains no further warranty liability.
    d. none of these.

37. Revenue generally should be recognized
    a. at the end of production.
    b. at the time of cash collection.
    c. when performance is achieved.
    d. when performance is achieved and the amount earned is measurable and collectible.

38. Which of the following is *not* a time when revenue may be recognized?
    a. At time of sale
    b. At receipt of cash
    c. During production
    d. All of these are possible times of revenue recognition.

39. Under the currently proposed definition of an asset, what is the most important aspect to consider when deciding whether the item should be recognized as an asset?
    a. The item represents a present economic resource to which the entity has a right
    b. The item is shown on the balance sheet
    c. The transaction underlying the resource has occurred
    d. The item is measurable

40. One of the principles of the conceptual framework is the matching principle. Which of the following is *not* a good example of that principle?
    a. A machine that produces certain goods is amortized over its useful life. The resulting amortization expense is matched with the proceeds from the sale of those goods.
    b. The entire two-year insurance premium is expensed in the first year.
    c. The write-off an uncollectible receivable in the year that the sale was made.
    d. The recognition of revenue for which associated expenses can not yet be determined is delayed until such determination can be made.

41. The allowance for doubtful accounts, which appears as a deduction from accounts receivable on a balance sheet and which is based on an estimate of bad debts, is an application of the
    a. consistency characteristic.
    b. matching principle.
    c. materiality constraint.
    d. revenue recognition principle.

42. The accounting principle of matching 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. establishing an Appropriation for Contingencies account.

43. Which of the following serves as the justification for the periodic recording of amortization expense?
    a. Association of efforts (expense) with accomplishments (revenue)
    b. Systematic and rational allocation of cost over the periods benefited
    c. Immediate recognition of an expense
    d. Minimization of income tax liability

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

45. 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 and disclose the measurement uncertainty in the notes to the financial statements.
    d. record the maximum amount in the financial statements.

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

47. The operations of a resource company's oil sands operations results in environmental damage. While the extent of the damage can not yet be determined, 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

48. Charging off the cost of a wastebasket with an estimated useful life of 10 years as an expense of the period when purchased is an example of the application of the
 a. consistency characteristic.
 b. matching principle.
 c. materiality constraint.
 d. historical cost principle.

49. Which of the following statements about materiality is *not* correct?
 a. An item must make a difference or it need not be disclosed.
 b. Materiality is a matter of relative size or importance.
 c. An item is material if its inclusion or omission would influence or change the judgement of a reasonable person.
 d. All of these are correct statements about materiality.

50. Fraudulent financial reporting is a business reality. While it cannot be eliminated, the risk of fraudulent reporting can be decreased. Which of the following considerations is *least* likely to lessen that risk?
 a. An independent audit committee
 b. An internal audit function
 c. An increased focus on tying bonuses to short-term company performance
 d. Vigilant management

51. Information that is representationally faithful is
 a. Complete
 b. Neutral
 c. Free from material error or bias
 d. All of these

52. Which of the following *best* describes the importance of qualitative characteristics as part of the conceptual framework of financial reporting?
 a. Relevance and representational faithfulness must always be present.
 b. Representational faithfulness may be traded off.
 c. Timeliness is a fundamental qualitative characteristic.
 d. All of these

53. Schmidt Ltd. aims to improve the qualitative characteristics of its financial statements. Your assistant has presented you with options shown below. Which of those options would *most* likely improve the *comparability* of your company's financial statements?
    a. The restatement of its financial statements from Canadian GAAP to US GAAP for its American investors
    b. The preparation of monthly financial statements
    c. The introduction of a policy that specifies how Schmidt's capital assets should be amortized
    d. The use of foreign-trained accountants

54. 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. To increase the frequency of issue from annually to quarterly
    b. To increase the number of disclosures
    c. To increase the amortization period for capital assets from 5 to years.
    d. To change the timing of when revenues are recognized

55. Gains and losses are based on whether they are related to an entity’s major ongoing or central operations. These gains or losses may be related to

	Peripheral Activities	Use by Others of Resources
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

Multiple Choice Answers—Conceptual

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
1.	c	9.	a	17.	d	25.	b	33.	d	41.	b	49.	d
2.	d	10.	c	18.	b	26.	d	34.	d	42.	b	50.	c
3.	d	11.	d	19.	a	27.	a	35.	c	43.	b	51.	d
4.	c	12.	a	20.	c	28.	b	36.	d	44.	c	52.	a
5.	a	13.	c	21.	d	29.	a	37.	d	45.	b	53.	a
6.	c	14.	c	22.	c	30.	d	38.	d	46.	c	54.	a
7.	b	15.	b	23.	c	31.	d	39.	a	47.	b	55.	a
8.	b	16.	c	24.	b	32.	a	40.	a	48.	c		

Solutions to those Multiple Choice questions for which the answer is “none of these.”

17. a company changes its inventory method every few years in order to maximize reported income (other answers are possible).
20. comparability.
30. going concern assumption.
36. an exchange has taken place and the earnings process is virtually complete.

EXERCISES

Ex. 2-56 – Foundational principles.

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

Solution 2-56

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

Recognition focuses on whether something should be included in a company's financial statements. It includes the principles of economic entity, control, revenue recognition and matching. Measurement relates to the "conversion" of information into numbers. It includes the principles of periodicity, monetary unit, going concern, historical cost and fair value. Presentation relates to the way of how (and how much) information is conveyed to the user. It includes the general practice of providing information that is important enough to influence an informed user's judgement and decisions.

Ex. 2-57- Fair Value Measurement

The ongoing trend toward using fair value has both critics and advocates. State and briefly explain arguments in favour and against the use of fair value.

Solution 2-57

Arguments in favour:

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

Arguments against:

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

Ex. 2-58- Accounting principles - identification

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

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

Solution 2-58

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

Ex. 2-59—Accounting concepts—identification.

Presented below are a number of accounting procedures and practices in McEvoy Inc. For each of these items, list the assumption, principle, information characteristic, or modifying convention that is violated.

1. Because the company's income is low this year, a switch from accelerated amortization to straight-line amortization is made for the period.
2. The president of McEvoy Inc. believes it is foolish to report financial information on a yearly basis. Instead, the president believes that financial information should be disclosed only when significant new information is available related to the company's operations.
3. McEvoy Inc. decides to establish a large loss and related liability this year because of the possibility that it may lose a pending patent infringement lawsuit. The possibility of loss is considered remote by its attorneys.
4. An officer of McEvoy Inc. purchased a new home computer for personal use with company money, charging miscellaneous expense.
5. The company receives a payment that does *not* relate to its ordinary revenue-generating activities and records it as revenue.

Solution 2-59

1. Neutrality.
2. Periodicity.
3. Matching (also, conservatism).
4. Economic entity.
5. Financial Statement Elements

Ex. 2-60—Accounting concepts—matching.

Listed below are several information characteristics and accounting principles and assumptions. Match the letter of each with the appropriate phrase that states its application. (Items *a* through *k* 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 characteristic
j. Reliability characteristic
k. Comparability characteristic

____ 1. Stable-dollar assumption (do not use historical cost principle).
____ 2. Earning process completed and realized or realizable.
____ 3. Presentation of error-free information with representational faithfulness.
____ 4. Yearly financial reports.
____ 5. Accruals and deferrals in adjusting and closing process. (Do not use going concern.)
____ 6. Useful standard measuring unit for business transactions.
____ 7. Notes as part of necessary information to a fair presentation.
____ 8. Affairs of the business distinguished from those of its owners.
____ 9. Business enterprise assumed to have a long life.
____10. Valuing assets at amounts originally paid for them.
____11. Application of the same accounting principles as in the preceding year.
____12. Summarizing significant accounting policies.
____13. Presentation of timely information with predictive and feedback value.

Solution 2-60

1. c	4. d	7. h	10. e	13. i
2. f	5. g	8. a	11. k	
3. j	6. c	9. b	12. h	

Ex. 2-61-Accounting concepts-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 qualities that make accounting information useful for decision-making.

2. Enhancing qualitative characteristics include __________________________ and ____________________.

3. Liabilities have two essential characteristics. 1. They represent an __________________ and 2. the entity has a _______________________.

4. While consolidated financial statements are prepared from the perspective of the _____________, taxes are paid from the perspective of the _______________.

5. Collectability is one of the three conditions of the revenue recognition principle. Assuming the other two conditions are met, revenue should only be recognized if collectability is ______________________.

6. The __________________ stipulates that anything that is relevant to decisions should be included in the financial statements.

7. A company's Management Discussion and Analysis (MD&A) is an example of ____________________________.

8. A ____________- based approach as used in Canadian GAAP and IFRS is sometimes criticized for being too ________.

9. Under the _____________ principle, ___________ incurred during a particular period are matched with ___________ earned during that same period.

10. The ___________________ is based on the assumption that a business enterprise will continue to operate for the foreseeable future.

11. One of the assumptions of the ____________________ is the 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.

14. Good financial reporting should be based on ____________ and _______________analysis.

Solution 2-61

1. Coherent, relevance, representational faithfulness
2. Comparability, verifiability, timeliness, understandability
3. Economic burden or obligation, present enforceable obligation
4. Economic entity, legal entity
5. Reasonably assured
6. Full disclosure principle
7. Supplementary information
8. Principles, Flexible
9. Matching, expenses, revenues
10. Going concern assumption
11. Historical cost principle
12. Fair value
13. Fair value
14. Well-reasoned, supported

Ex. 2-62—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 ideas in (a) revenue recognition and (b) expense recognition.

Solution 2-62

(a) The ideas in revenue recognition include the following:

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

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

Solution 2-62 (Continued)

(b) The ideas in expense recognition include "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 is that expenses are matched with revenues. Expenses are matched three ways:

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

Ex. 2-63-Conceptual framework
Financial accounting and reporting is based on a conceptual framework. Discuss the purpose and usefulness of that framework.

Solution 2-63
To be useful, standard setting should be built on an established body of concepts and objectives. Having a soundly developed conceptual framework as their starting point, standard setters are then able to issue additional and consistent standards over time.

In the meantime, until additional standards have been issued, accountants can use the framework to solve new and emerging practical problems.

Ex. 2-64—Principles vs. rules based GAAP.

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

Solution 2-64

Advantages of a principles based approach:

a) decisions are based on the conceptual framework – so they should be consistent

b) flexibility – allows for making decisions about new or unusual transactions based on principles

c) allows accountants to use their professional expertise – professional judgement

Disadvantages of a principles based approach:

a) flexibility may result in reduced comparability between different firms

b) flexibility may be abused and bias may creep into decisions

Ex. 2-65—Financial Engineering.

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

Solution 2-65

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

Ex. 2-66 – Fraudulent financial reporting.

Identify several factors that contribute to fraudulent financial reporting.

Solution 2-66

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.