

Chapter 01 - Conceptual and Case Analysis Frameworks for Financial Reporting

**Chapter 01**

**Conceptual and Case Analysis Frameworks for Financial Reporting**

**Multiple Choice Questions**

1. Which of the following would NOT be a reason to obtain a greater understanding of accounting practices in other nations?

- A. Financial results are disclosed in different currencies.
- B. One needs to be aware of differing disclosure requirements from nation to nation, as this impacts the preparation of financial statements.
- C. Income-smoothing may have affected a foreign subsidiary's results; such smoothing practices are not permitted in North America.
- D. Departures from the historical cost principle may be possible in other nations.

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: Easy*

*Learning Objective: 01-01 Describe and apply the conceptual framework for financial reporting.*

*Topic: 01-01 The Conceptual Framework for Financial Reporting*

2. Which of the following would be most affected by financial statements being prepared under different accounting principles?

- A. Reduced comparability.
- B. Reduced reliability.
- C. Increased complexity.
- D. Inaccurate asset valuations.

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: Easy*

*Learning Objective: 01-01 Describe and apply the conceptual framework for financial reporting.*

*Topic: 01-01 The Conceptual Framework for Financial Reporting*

3. The *CPA Canada Handbook - Accounting* is the handbook of Canadian accounting standards. Why do companies in Canada ensure that their financial reporting is consistent with Canadian GAAP?
- A. Their bank requires them to do so.
  - B. Their auditors require them to do so.
  - C. Reporting under the *CPA Canada Handbook - Accounting* is required by public companies' boards of directors.
  - D.** Compliance with the *CPA Canada Handbook - Accounting* pronouncements is usually required by many legal statutes.

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: Easy*

*Learning Objective: 01-01 Describe and apply the conceptual framework for financial reporting.*

*Topic: 01-01 The Conceptual Framework for Financial Reporting*

4. Which decision has Canada made with respect to financial reporting for private enterprises?
- A. To adopt the IFRS standards for small and medium-sized enterprises.
  - B. To retain the current standards.
  - C. To look to US GAAP for standards.
  - D.** To develop and maintain its own standards for private enterprises.

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: Easy*

*Learning Objective: 01-02 Describe how accounting standards in Canada are tailored to different types of organizations.*

*Topic: 01-05 GAAP for Private Enterprises*

5. Starting in 2011, what is the definition of a private enterprise (PE) under Canadian GAAP?

- A. A corporation that has no public shareholders.
- B. A corporation that has less than 500 shareholders and is not listed on a stock exchange.
- C. A corporation which is not profit oriented.
- D.** A profit oriented enterprise that has none of its issued and outstanding financial instruments traded in a public market and does not hold assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses.

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: Easy*

*Learning Objective: 01-02 Describe how accounting standards in Canada are tailored to different types of organizations.*

*Topic: 01-05 GAAP for Private Enterprises*

6. Which enterprises must report under IFRS in Canada?

- A. All corporations, government agencies and private companies.
- B. Public companies and private companies whose shareholders' equity is in excess of \$500,000,000 at any particular year end.
- C. Public companies, private companies and not-for-profit organizations.
- D.** Publicly accountable enterprises.

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: Easy*

*Learning Objective: 01-02 Describe how accounting standards in Canada are tailored to different types of organizations.*

*Topic: 01-04 GAAP for Publicly Accountable Enterprises*

7. What approach did Canada first decide to take with respect to convergence with IFRS?

- A.** Harmonization of *CPA Canada Handbook* with IFRS.
- B. Substituting IFRS for Canadian GAAP when approved by the IASB.
- C. Adopting some but not necessarily all IFRSs by reviewing them on a case by case basis.
- D. Reviewing them with all publically accountable entities to see which ones would be acceptable.

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: Easy*

*Learning Objective: 01-02 Describe how accounting standards in Canada are tailored to different types of organizations.*

*Topic: 01-04 GAAP for Publicly Accountable Enterprises*

8. What choice(s) do private enterprises have in their financial reporting in Canada?
- A. They have no choice at all; they will need to report under IFRS.
  - B. They may elect to continue with differential reporting.
  - C. They may adopt accounting principles that are appropriate to the circumstances.
  - D.** They may elect to report under either IFRS or ASPE but once adopted, must use all the standards.

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: Easy*

*Learning Objective: 01-02 Describe how accounting standards in Canada are tailored to different types of organizations.*

*Topic: 01-05 GAAP for Private Enterprises*

9. For which of the following types of organizations does the *CPA Canada Handbook* not provide specific accounting standards?
- A. Publicly accountable enterprises.
  - B. Private enterprises.
  - C. Not-for-profit organizations.
  - D.** Proprietorships.

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: Easy*

*Learning Objective: 01-02 Describe how accounting standards in Canada are tailored to different types of organizations.*

*Learning Objective: 01-03 Identify some of the differences between IFRS and ASPE.*

*Topic: 01-04 GAAP for Publicly Accountable Enterprises*

*Topic: 01-05 GAAP for Private Enterprises*

*Topic: 01-06 GAAP for Not-for-Profit Organizations*

*Topic: 01-07 GAAP for Government and Other Government Organizations*

10. Which of the following is NOT a reason why a Canadian private company would elect to report under IFRS?
- A. The company is planning to go public in the near future.
  - B. The company seeks comparability with public companies of a similar size.
  - C.** It is likely to be less expensive than reporting under ASPE.
  - D. The company is a subsidiary of a Canadian public company.

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: Easy*

*Learning Objective: 01-02 Describe how accounting standards in Canada are tailored to different types of organizations.*

*Topic: 01-05 GAAP for Private Enterprises*

11. The current ratio measures:

- A.** liquidity.
- B. solvency.
- C. profitability of assets.
- D. profitability of owners' investment.

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Blooms: Understand*

*Difficulty: Easy*

*Learning Objective: 01-04 Analyze and interpret financial statements to assess the impact of different accounting methods on key financial statements ratios.*

*Topic: 01-08 Analysis and Interpretation of Financial Statements*

12. The formula for the current ratio is:

- A. current assets - current liabilities
- B.** current assets/current liabilities
- C. total debt/shareholders' equity
- D. net income/shareholders' equity

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: Easy*

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13. The debt-to-equity ratio measures:

- A. liquidity.
- B.** solvency.
- C. profitability of assets.
- D. profitability of owners' investment.

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Blooms: Understand*

*Difficulty: Easy*

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### Short Answer Questions

14. One of the underlying assumptions of the Historical Cost Principle is that a stable unit of measure (currency) should be used for Financial Reporting. Is this always the case?

The Historical Cost Principle is not very useful when inflation rates are high. As a result of the eroding purchase power associated with periods of high inflation, many countries have had to experiment with price-level adjustments. These adjustments often include asset revaluations to reflect their current values.

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Blooms: Understand*

*Difficulty: Easy*

*Learning Objective: 01-01 Describe and apply the conceptual framework for financial reporting.*

*Topic: 01-01 The Conceptual Framework for Financial Reporting*

*Topic: 01-02 Professional Judgment*

15. X Inc. and Y Inc. are virtually identical companies with identical cost structures and very similar business practices operating in the same lines of business. X Inc. is a public company based in Canada and follows IFRS while Y Inc. is a private enterprise based in Canada and follows ASPE. The following were the condensed income statements for both companies for the last year before both adopted IFRS.

	<b>X Inc.</b>	<b>Y Inc.</b>
Sales:	\$1,000,000	\$2,000,000
Less:		
Cost of Goods Sold	\$500,000	\$1,600,000
Gross Margin	\$500,000	\$400,000
Administrative Expenses	\$200,000	\$300,000
Net Income:	\$300,000	\$100,000

**Required:**

Given the information provided, what are some possible causes for the differing results of these companies?

There could be many possible explanations for these differing results. Y Inc.'s net income is \$100,000, compared to X Inc.'s \$300,000. Conversely, Y Inc.'s sales are twice those of X Inc. What is particularly noteworthy is Y Inc.'s 20% gross margin compared to X Inc.'s 50% gross margin. This could be due to the accelerated depreciation on Y Inc.'s property, plant and equipment or provisions made for future maintenance costs.

Smoothing practices may have been applied to reduce Y Inc.'s income, and of course, its tax liability. Y Inc.'s income may have been further reduced by higher estimates (for example: bad debt expense, warranty costs and so forth) which are not necessarily be indicative of economic conditions.

Note: Once again, the above analysis is not necessarily exhaustive. Students may be able to identify other valid differences.

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Blooms: Understand*

*Difficulty: Medium*

*Learning Objective: 01-02 Describe how accounting standards in Canada are tailored to different types of organizations.*

*Learning Objective: 01-03 Identify some of the differences between IFRS and ASPE.*

*Topic: 01-03 Accounting Standards in Canada*

*Topic: 01-04 GAAP for Publicly Accountable Enterprises*

*Topic: 01-05 GAAP for Private Enterprises*

16. Briefly discuss the external users need for high quality financial information.

External users require high quality financial information to enable them to assess the likelihood of making a reasonable return with an acceptable level of risk. It is important that the quality of the financial statements provide useful and reliable information to assess the prospects of future cash flows or future earnings.

The users want the information to faithfully represent what has happened during the past period. Distorting the real situation by using accounting methods that do not match the actual situation or managing earnings to recognize revenue earlier or delay reporting expenses to a later period are not a faithful representation of the actual situation. The result is the external users are not able to make appropriate decisions as to whether to increase, decrease, or maintain their level of participation with the reporting entity in their capacity as investor, creditor, supplier, and/or customer.

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*Blooms: Remember*

*Blooms: Understand*

*Difficulty: Easy*

*Learning Objective: 01-04 Analyze and interpret financial statements to assess the impact of different accounting methods on key financial statements ratios.*

*Topic: 01-08 Analysis and Interpretation of Financial Statements*

17. What disclosure requirements must be met when a Canadian company adopts IFRS for the first time?

1. The company must reconcile its equity reported under the previous GAAP to its equity in accordance with IFRS for both the date of transition to IFRS and the end of the latest period reported under the previous GAAP.
2. The company must reconcile its total comprehensive income in accordance with IFRS to that reported in the latest statements prepared under the previous GAAP.
3. The company must provide sufficient detail to enable users to understand the material adjustments to the statement of financial position, the statement of comprehensive income and the statement of cash flows.

*Accessibility: Keyboard Navigation*

*Blooms: Remember*

*Difficulty: Medium*

*Learning Objective: 01-02 Describe how accounting standards in Canada are tailored to different types of organizations.*

*Topic: 01-03 Accounting Standards in Canada*

*Topic: 01-04 GAAP for Publicly Accountable Enterprises*



Chapter 01 - Conceptual and Case Analysis Frameworks for Financial Reporting

18. Provide the procedures used to analyze a company's financial statements to determine its future prospects.

Procedures to analyze a company's financial statements:

Perform common-size analysis and interpret the results.

Review the accounting policies and estimates used by the company to ensure that they are appropriate.

Adjust the financial statements, as necessary, to use appropriate accounting policies and estimates.

Calculate the ratios for one or more periods.

Compare the ratios to relevant benchmarks.

Interpret the results of the analysis to determine whether they are better, worse, or the same as the benchmark.

Decide whether to increase, decrease, or maintain the level of participation with the reporting entity.

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*Blooms: Remember*

*Difficulty: Easy*

*Learning Objective: 01-04 Analyze and interpret financial statements to assess the impact of different accounting methods on key financial statements ratios.*

*Topic: 01-08 Analysis and Interpretation of Financial Statements*