

## Chapter 0: Review (Not Required)

### 0.1 Purpose & Use of Financial Statements

#### 0.1.1 Users & Uses of Financial Statements

**Accounting:** An information system that identifies and records the economic events of an organization, and then communicates them to a number of interested users

Accounting and financial info must be transparent, relevant, and reliable in order to be useful for decision making. It must also be prepared according to high standards of ethical behaviour.

#### **Two types of users of accounting/financial information:**

1. **Internal Users** (e.g., managers)
2. **External Users** (e.g., investors, creditors, tax authorities, regulators, customers)

#### 0.1.2 Forms of Business Organization

1. **Proprietorship** (owned by one person, simple to set up, owner has control over the business, unlimited personal liability)
2. **Partnership** (owned by more than one person, access to more financial resources and human capital)
3. **Corporation** (separate legal entity, owned by shareholders, owners have limited liability, access to even more resources because sell shares)
  - a. **Public Corporation** (shares traded on public stock exchange, must use IFRS)
  - b. **Private Corporation** (shares are not traded on public stock exchange, can use either IFRS or ASPE)

#### 0.1.3 Types of Business Activity

1. **Financing Activities** (raising funds from external sources via borrowing or issuing shares or using funds to repay debt or repurchase shares)
2. **Investing Activities** (purchase or sale of long-lived assets, which a firm needs to operate)
3. **Operating Activities** (sale of goods or services in the normal course of business)

#### **Related Definitions:**

**Creditor:** Person or entity to whom the company owes money

A creditor has a legal right to be paid at an agreed-upon date, whereas a shareholder has no legal right to a firm's resources until all of its creditors are paid.

**Liability:** A debt or other obligation that represents a creditor's claim on the company's assets

**Short-term Liabilities** (e.g., bank indebtedness, short-term loans payable)

**Long-term Liabilities** (notes payable, mortgages payable, finance lease obligations, bonds payable)

**Share Capital:** Total amount paid into a company by shareholders for shares issued or sold

Corporations are not required to pay dividends.

**Long-Lived Assets** (long-term investments; PPE such as land, buildings, and vehicles; goodwill; and intangible assets such as patents, copyrights, and trademark)

**Revenues:** Increases in economic resources (usually increases in assets but sometimes decreases in liabilities) that result from a company's operating activities

**Expenses:** Costs of assets consumed or services used in the process of generating revenues

**Profit:** Revenues exceed expenses

### 0.1.4 Content & Purpose of Financial Statements

The financial statements provide information about a company's assets, liabilities, owners' equity, revenues, and expenses to interested users. They are prepared in the following order:

1. **Statement of Earnings (Income Statement):** Reports revenues and expenses to show level of performance during a period of time
  - Issuance of shares and distribution of dividends do not affect profit
2. **Statement of Changes in Equity:** Shows changes in total shareholders equity and changes in its components (share capital and retained earnings) during the period
  - Private companies prepare a statement of retained earnings, which only summarizes the change in retained earnings for the period
  - **Ending share capital** = beginning share capital + new shares issued - shares repurchased
  - **Ending retained earnings** = beginning retained earnings + profit (or - loss) - dividends
  - **Retained Earnings:** Cumulative profit that has been earned and not paid out as dividends
3. **Statement of Financial Position (Balance Sheet):** Reports assets and claims to those assets at a specific point in time
  - **Two types of claims:** claims of creditors (liabilities) and claims of shareholders
  - **Basic Accounting Equation:** ASSETS = LIABILITIES + SHAREHOLDERS' EQUITY
4. **Statement of Cash Flows:** Provides information about cash receipts and cash payments as well as financing, investing, and operating activities for a specific period of time

**Comparative Financial Statements:** Financial statements showing more than one period

## **0.2 A Further Look at Financial Statements**

### **0.2.1 The Classified Statement of Financial Position (Balance Sheet)**

**Classified Balance Sheet:** Groups assets, liabilities, and equities into standard classifications

Assets may be listed by liquidity and liabilities by payment date (or in reverse, or by another method).

#### **Common Asset Classifications:**

- 1. Current Assets:** Assets expected to be converted into cash, sold, or used, within one year of the financial statement date or operating cycle, whichever is longer
  - Cash, short-term investments, accounts receivable, inventory, supplies, prepaid expenses
- 2. Non-current Assets:** Assets not expected to be converted into cash, sold, or completely used up within one year of the financial statement date or operating cycle
  - Long-term investments in shares and debt securities of other corporations; PPE (e.g., land, buildings, equipment, furniture); intangible assets (items representing a privilege or right such as patents, copyrights, franchises, trademarks, trade names, licences) and goodwill (price of an acquired company less the FMV of its net identifiable assets; not amortized and reported separately); other assets (e.g., non-current receivables, deferred income tax assets, property held for sale)

#### **Common Liability Classifications:**

- 1. Current Liabilities:** Obligations that are to be settled within one year of the financial statement date or operating cycle, whichever is longer
  - Bank indebtedness, AP, accrued liabilities (e.g., salaries payable, interest payable, income tax payable), unearned revenue, notes payable, and current maturities of non-current debt
- 2. Non-current Liabilities:** Obligations that are expected to be paid beyond one year from the statement of financial position date
  - Notes payable (including bank loans payable, mortgages payable, and bonds payable), lease obligations, pension and benefit obligations, and deferred income tax liabilities

#### **Components of Shareholders' Equity:**

- 1. Share Capital:** Capital invested in or contributed to the company by its shareholders (e.g., common shares)
- 2. Retained Earnings:** Cumulative profit that has been retained for use in the company (i.e., not paid out in the form of dividends)
- 3. Shareholders' equity may contain other components (e.g., accumulated other comprehensive income)**

## 0.2.2 Using the Financial Statements

**Ratio Analysis:** Expressing the relationships between selected items of financial statement data to create more meaning for users

Ratios should be compared with benchmarks (e.g., prior years, competitors, industry averages) to be the most useful.

### Types of Balance Sheet Ratios:

1. **Liquidity:** Ability to pay obligations that are expected to become due within the next year
  - a. **Working Capital:** Difference between current assets and current liabilities
  - b. **Current Ratio:** Current assets divided by current liabilities
2. **Solvency:** Ability to survive over a long period of time, to pay interest as it becomes due, and to repay the face value of debt at maturity
  - a. **Debt-to-Total-Assets Ratio:** Percentage of assets financed by lenders and other creditors rather than by shareholders; Total liabilities divided by total assets

### Types of Income Statement Ratios:

1. **Profitability Ratios:** Operating success for a specific period of time
  - a. **Earnings per Share:** Profit available to common shareholders divided by the weighed average number of common shares
  - b. **Price-Earnings Ratio:** Market price per share divided by earnings per share

## 0.2.3 Conceptual Framework for Financial Reporting

**Conceptual Framework** for financial reporting guides decisions about what to present in financial statements, alternative ways of reporting economic events, and appropriate ways of communicating this information.

### 5 Sections of the Conceptual Framework:

1. **Objective of Financial Reporting:** To provide financial information that is useful for resource-allocation decisions
2. **Qualitative Characteristics of Useful Financial Information:**
  - a. **Fundamental Qualitative Characteristics:** Characteristics that must be present in accounting information in order for the information to be useful for decision-making
    - i. **Relevance:** Makes a difference in users' decisions
      - **Predictive Value:** Helps users predict future events
      - **Confirmatory or Feedback Value:** Helps users confirm or correct their previous predictions or expectations

- **Material:** Info whose misstatement or omission could influence users' decisions
- ii. **Faithful Representation:** Reflects the underlying economic reality of what really exists or happened, and is **complete, neutral** (not biased toward one stakeholder or another), and **free from material error**
- b. **Enhancing Qualitative Characteristics:** Characteristics that improve the usefulness of accounting information
  - i. **Comparability:** Enables users to identify and understand similarities and differences among financial statement items both between companies (intercompany) and across years for the same company (intracompany)
  - ii. **Verifiability:** Information that different knowledgeable and independent users would agree is faithfully represented
  - iii. **Timeliness:** Available to decision makers before it loses its ability to influence decisions
  - iv. **Understandability:** Classified, characterized, presented clearly and concisely, and understood by a reasonably informed user
- c. **Cost constraint:** The benefits of financial reporting information should justify the costs of providing and using it
- 3. **Underlying Assumption:** Going concern assumption (a company will continue in operation for the foreseeable future)
- 4. **Elements of Financial Statements:**
  - a. **Asset:** Resource controlled by the company as a result of past events and from which future economic benefits are expected to flow to the company
  - b. **Liability:** Present obligation of the company arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits
  - c. **Equity:** Residual interest in the company's assets after deducting all its liabilities
  - d. **Income:** Both revenue and gains; revenue arises in the course of the company's ordinary activities while gains may or may not
  - e. **Expenses:** Both losses and expenses; expenses arise from ordinary company activities while losses may or may not
- 5. **Measurement of the Elements of Financial Statements**
  - a. **Historical Cost Basis of Accounting:** Assets and liabilities should be recorded at their acquisition cost because the fair value of assets may not always be reliably determinable or faithfully representative.
  - b. **Fair Value Basis of Accounting:** Certain assets and liabilities should be recorded and reported at fair value, and only if they have fair values that are easily verifiable and neutral. For example, assets that are actively traded, such as certain investment securities, are measured under the fair value basis of accounting.

Objective of Financial Reporting		
Qualitative Characteristics of Useful Financial Information		
Fundamental Qualitative Characteristics	Enhancing Qualitative Characteristics	Constraint
<ol style="list-style-type: none"> <li>1. Relevance                             <ul style="list-style-type: none"> <li>• Predictive value</li> <li>• Confirmatory value</li> <li>• Material</li> </ul> </li> <li>2. Faithful representation                             <ul style="list-style-type: none"> <li>• Complete</li> <li>• Neutral</li> <li>• Free from material error</li> </ul> </li> </ol>	<ol style="list-style-type: none"> <li>1. Comparability</li> <li>2. Verifiability</li> <li>3. Timeliness</li> <li>4. Understandability</li> </ol>	<ol style="list-style-type: none"> <li>1. Cost</li> </ol>

Underlying Assumption—Going Concern	
Elements	Measurement of the Elements
<ol style="list-style-type: none"> <li>1. Assets</li> <li>2. Liabilities</li> <li>3. Equity</li> <li>4. Revenue</li> <li>5. Expenses</li> </ol>	<ol style="list-style-type: none"> <li>1. Historical cost</li> <li>2. Fair value</li> </ol>

### 0.3 The Accounting Information System

#### 0.3.1 Accounting Transactions

**Accounting Information System:** System of collecting and processing transaction data and communicating financial information to decision makers

**Accounting Transaction:** Occurs when assets, liabilities, or shareholders' equity items change as a result of some economic event

**Accounting Equation:** ASSETS = LIABILITIES + SHAREHOLDERS' EQUITY

The accounting equation must be in balance after each transaction.

#### 0.3.2 The Account

**Account:** An individual accounting record of increases and decreases in a specific asset, liability, or shareholders' equity item

**T-Account:** Simplest form of an account that has a title, a left side (debit side), and a right side (credit side)

**Debit:** To enter an amount on the left side of an account

**Credit:** To enter an amount on the right side of an account

Total debits must equal total credits. This is the basis of the **double-entry accounting system** and it keeps the accounting equation in balance.

**Normal Balance:** The side which increases the account

	<b>Debit</b>	<b>Credit</b>
Assets	+	-
Dividends	+	-
Expenses	+	-
Liabilities	-	+
Shareholders' Equity (share capital and RE)	-	+
Revenues	-	+

\* RE consists of revenues, expenses, and dividends (R increases RE; E and D decrease RE)

**9 Steps in the Accounting Cycle:**

1. Analyze business transactions
2. Journalize transactions
3. Post to general ledger accounts
4. Prepare a trial balance
5. Journalize and post adjusting entries (prepayments/accruals)
6. Prepare adjusted trial balance
7. Prepare financial statements (income statement, statement of changes in equity, balance sheet, statement of cash flows)
8. Journalize and post closing entries
9. Prepare a post-closing trial balance

**0.3.3 Recording Process**

**Journalizing:** Process of entering transaction data in the general journal (chronological order)

**Journal Entry Components:**

1. Date of transaction
2. Accounts and amounts debited and credited
3. Explanation of the transaction

		DEBIT	CREDIT
May 12	Supplies	500	
	Cash		500
	(Purchased supplies for cash)		

### 0.3.4 Posting Transactions

**General Ledger:** Paper or electronic file that contains all the asset, liability, shareholders' equity, revenue, and expense accounts maintained by the company, and all the information about the changes in each account

**Chart of Accounts:** Framework for the accounting database; it lists the accounts and account numbers that identify where the accounts are in the general ledger

**Posting:** Process of transferring general journal entries to general ledger accounts

### 0.3.5 Trial Balance

**Trial Balance:** List of general ledger accounts and their balances at a specific time

The primary purpose of a trial balance is to prove the mathematical equality of debits and credits in the general ledger. It helps uncover errors from journalizing and posting.

Even if a trial balance has total debits equal to total credits, mistakes may still be present.

- Omissions of journal entries
- Multiple postings of journal entries
- Postings of incorrect amounts on both sides
- Postings to incorrect accounts on the same side

## 0.4 Accrual Accounting Concepts

### 0.4.1 Timing Issues

Accounting assumes that the economic life of a business can be divided into artificial time periods. Thus, financial statements can be prepared on a periodic basis. An accounting time period may be a month, a quarter, or a year. Some business transactions affect more than one accounting period.

**Revenue is recognized** in the accounting period when all 3 following criteria are met:

1. Sales or performance effort is substantially complete
2. Amount of revenue is determinable
3. Collection of revenue is reasonable assured

**Expenses are recognized** when, due to an ordinary activity, there is a decrease in future economic benefits related to a decrease in an asset or an increase in a liability and the change can be measured reliably. Expense recognition normally coincides with revenue recognition; however, some expenses are recorded in the period they are incurred due to uncertainty about whether they will eventually contribute to revenue (e.g., research expenditures).

**Accrual Basis Accounting:** Transactions affecting a company's financial statements are recorded in the periods in which the events occur, rather than in the periods in which the company actually receives or pays cash.

**Cash Basis Accounting:** Revenue is recorded only when cash is received, and an expense is recorded only when cash is paid. Financial statements prepared under cash basis accounting are often misleading because revenues will not necessarily be recognized when earned, and expenses will not necessarily be recognized when there is a decrease in future economic benefits related to a decrease in an asset or an increase in a liability.

**0.4.2 The Basics of Adjusting Entries**

**Adjusting Entries:** Journal entries recorded at the end of each accounting period (prior to preparing financial statements) to account for incorrect balances (e.g., unrecorded events, expired costs)

**Two Types of Adjusting Entries:**

1. **Prepayments:** Prepaid expenses and unearned revenues (cash paid/received but g/s not yet consumed/provided)
2. **Accruals:** Accrued expenses and accrued revenues (expenses/revenues incurred/earned but cash not yet paid/received)

**Note:**

- Adjusting entries usually affect one income statement and one balance sheet account
- Adjusting entries will never affect the cash account

**Prepayments:**

**Prepaid Expenses:** Costs paid for in cash before they are used; initially recorded as assets and expire through the passage of time or through use; usually results in a debit to an expense account and a credit to an asset account

Supplies Expense	600	
Supplies		600
(To record supplies used)		

**Supplies:** \$800 of supplies are purchased at the beginning of the period. At the end of the period, \$200 of supplies remain. Thus, \$600 of supplies were used.

Rent Expense	400	
Prepaid Rent		400
(To record expired rent)		

**Rent:** Six months' rent of \$2,400 is paid in advanced. At the end of one month, \$400 of rent has been used up.

Depreciation Expense	300	
Accumulated Depreciation—Vehicle		300
(To record monthly depreciation)		

**Depreciation:** Prepayment adjusting entry (purchases of long-lived assets are essentially a long-term prepayment for services)

A vehicle costs \$18,000 and has an estimate useful life of 5 years. The entry to record one month of depreciation is:

**Depreciation:** Process of allocating the acquisition cost of a long-lived or non-current asset to expense over its useful life, in a rational and systematic manner (an allocation concept, not a valuation concept)

**Straight-Line Depreciation:** Asset cost divided by useful life

**Accumulated Depreciation:** A contra asset account that allows the financial statement user to see the original cost of the asset as well as the portion of the asset cost that has been depreciated to date

Vehicle	\$18,000	<b>Carrying Amount (Book Value):</b> Asset cost less accumulated depreciation
Less: Accumulated depreciation—Vehicle	300	
Carrying amount	17,700	<b>Unearned Revenues:</b> Cash is received before revenue is earned (e.g., magazine subscription or rent revenue)
Unearned Rent Revenue	1,000	
Rent Revenue	1,000	\$6,000 is received as payment for 6-months' rent in advanced. After one month, \$1,000 of rent has been provided to the customer.
(To record revenue earned)		

**0.4.3 Accruals**

**Accrued Revenues:** Revenues earned but not yet received in cash or recorded at the financial statement date (e.g., interest revenue, rent revenue, service revenue); debit a receivable and credit a revenue

Interest Receivable	300	\$300 was earned in interest revenue but has not yet been collected.
Interest Revenue	300	
(To record interest revenue)		

**Accrued Expenses:** Expenses incurred but not yet paid or recorded at the financial statement date (e.g., interest expense, rent expense, tax expense, salaries expense); debit to expense and credit to liability

Interest Expense	120	On November 1, \$12,000 is borrowed at 6% for 6 months. On December 31 (year-end) an adjusting journal entry is needed for the interest owed but not yet paid.
Interest Payable	120	
(To record accrued interest)		

In summary, the **accrual basis of accounting** requires that transactions affecting a company's financial statements are recorded in the periods in which the events occur, rather than when the company actually receives or pays cash. This gives rise to the need for adjusting entries, which record any events that occurred in the period that are not yet recorded as at the financial statement date. Adjusting entries bring the accounts up to date as at the financial statement date, and allow for preparation of financial statements in accordance with the accrual basis of accounting.

**The Adjusted Trial Balance and Financial Statements:**

**Adjusted Trial Balance:** Prepared to prove the equality of total debit balances and total credit balances in the general ledger, *after* all adjusting entries have been journalized and posted

Once the account balances are brought up to date via the adjusted trial balance, the **financial statements** can be prepared.

### 0.4.4 Closing the Books

**Temporary Accounts:** Accounts that relate to a particular accounting period (e.g., revenues, expenses, and dividends)

**Permanent Accounts:** Accounts with balances that carry forward to future accounting periods (e.g., assets, liabilities, and shareholders' equity)

At the end of the accounting period, temporary accounts are closed/zeroed out and are transferred to the permanent shareholders' equity account.

Closing entries transfer revenues and expenses to another temporary account (Income Summary) and then transfer the resulting profit or loss in Income Summary to Retained Earnings.

#### 2 Purposes of Closing Entries:

1. Update the retained earnings account
2. Eliminate the balance in each temporary account for the next accounting period

**Post-Closing Trial Balance:** Prepared to prove the equality of total debit balances and total credit balances in the general ledger, after all closing entries have been journalized and posted; only permanent accounts should appear on this trial balance

Key Differences	International Financial Reporting Standards (IFRS)	Accounting Standards for Private Enterprises (ASPE)
Accounting standards	Publicly traded corporations must use IFRS; private corporations can choose to use IFRS or ASPE.	Private corporations can choose to use IFRS or ASPE. Once the choice is made, it must be applied consistently.
Terminology	The balance sheet is more commonly known as the statement of financial position and net income as profit under IFRS.	The statement of financial position is more commonly known as the balance sheet and profit as net income under ASPE.
Statement of changes in equity vs. statement of retained earnings	A statement of changes in equity must be presented that shows the changes in all components of shareholders' equity (e.g., share capital and retained earnings).	A statement of retained earnings is presented that shows the change in only one component—retained earnings—of shareholders' equity.

<b>Key Differences</b>	<b>International Financial Reporting Standards (IFRS)</b>	<b>Accounting Standards for Private Enterprises (ASPE)</b>
Terminology	The term <i>depreciation</i> refers to the allocation of the cost of depreciable tangible assets over their useful lives. The term <i>amortization</i> refers to the allocation of the cost of certain kinds of intangible assets over their useful lives.	The term <i>amortization</i> is used for the allocation of the cost of both depreciable tangible assets and certain kinds of intangible assets over their useful lives.
Earnings per share	Required to present in financial statements	Not required to present in financial statements
Conceptual framework for financial reporting	Still under development	Same general framework currently under development by international and U.S. standard setters anticipated to be applied to private enterprises when complete

<b>Key Differences</b>	<b>International Financial Reporting Standards (IFRS)</b>	<b>Accounting Standards for Private Enterprises (ASPE)</b>
Frequency of adjusting entries	Public companies must release quarterly financial statements so adjusting entries have to be made at least quarterly, although many will record adjusting entries every month.	Private companies usually release financial statements to their banker, and shareholder(s), along with certain financial information to the Canada Revenue Agency on an annual basis so adjusting entries may be done at year end, although many will record adjusting entries more frequently.
Terminology	The term <i>depreciation</i> refers to the allocation of the cost of depreciable tangible assets over their useful lives. The term <i>amortization</i> refers to the allocation of the cost of certain kinds of intangible assets over their useful lives.	The term <i>amortization</i> is used for the allocation of the cost of both depreciable tangible assets and certain kinds of intangible assets over their useful lives.

## Chapter 1: Canadian Reporting Environment

### Learning objectives:

1. Understand the role of financial accounting in the capital allocation process.
2. Understand the relationship between financial reporting and information asymmetry.
3. Understand the relationship between legislation, accounting scandals, financial engineering, and ethics.
4. Understand standard setting in Canada
5. Distinguish between rules vs. principles based GAAP.

### Readings: CH 1

### ENRON Case Discussion: CA1-1, CA1-3

THE CANADIAN FINANCIAL REPORTING ENVIRONMENT			
Financial Statements and Financial Reporting	Standard Setting	Generally Accepted Accounting Principles	Challenges and Opportunities for the Accounting Profession
<ul style="list-style-type: none"> <li>▪ Accounting and capital allocation</li> <li>▪ Stakeholders</li> <li>▪ Objective of financial reporting</li> <li>▪ Information asymmetry</li> </ul>	<ul style="list-style-type: none"> <li>▪ Need for standards</li> <li>▪ Parties involved in standard setting</li> </ul>	<ul style="list-style-type: none"> <li>▪ GAAP hierarchy</li> <li>▪ Professional judgement</li> </ul>	<ul style="list-style-type: none"> <li>▪ Oversight in the capital marketplace</li> <li>▪ Centrality of ethics</li> <li>▪ Standard setting in a political environment</li> <li>▪ Principles versus rules</li> <li>▪ Impact of technology</li> <li>▪ Integrated reporting</li> <li>▪ Conclusion</li> </ul>

## Chapter 1 Learning Objectives

### Explain how accounting makes it possible to use scarce resources more efficiently.

Accounting provides reliable, relevant, and timely information to managers, investors, and creditors so that resources are allocated to the most efficient enterprises. Accounting also provides measurements of efficiency (profitability) and financial soundness.

### Explain the meaning of “stakeholder” and identify key stakeholders in financial reporting, explaining what is at stake for each one.

Investors, creditors, management, securities commissions, stock exchanges, analysts, credit rating agencies, auditors, and standard setters are some of the major stakeholders. Illustration [1-4](#) explains what is at stake for each one.

### Identify the objective of financial reporting.

The objective of financial reporting is to communicate information that is useful to key decision-makers such as investors and creditors in making resource allocation decisions (including assessing management stewardship) about the resources and claims to resources of an entity and how these are changing.

### Explain how information asymmetry and bias interfere with the objective of financial reporting.

Ideally, all stakeholders should have access to the same information in order to ensure that good decisions are made in the capital marketplace. This is known as information symmetry. However, this is not the case—there is often information asymmetry. Of necessity, management has access to more information so that it can run the company. It must also make sure that it does not give away information that might harm the company, such as in a lawsuit where disclosure might cause the company to lose. Aside from this, information asymmetry exists because of management bias whereby management acts in its own self-interest, such as wanting to maximize management bonuses. This is known as moral hazard in accounting theory. Information asymmetry causes markets to be less efficient. It may cause stock prices to be discounted or costs of capital to increase. In addition, it might restrict good companies from raising capital in the particular market where relevant information is not available (referred to as adverse selection in accounting theory). The efficient markets hypothesis is felt to exist only in a semi-strong form, meaning that only publicly available information is assimilated into stock prices.

**Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.**

The accounting profession has tried to develop a set of standards that is generally accepted and universally practised. This is known as GAAP (generally accepted accounting principles). Without this set of standards, each enterprise would have to develop its own standards, and readers of financial statements would have to become familiar with every company's particular accounting and reporting practices. As a result, it would be almost impossible to prepare statements that could be compared. In addition, accounting standards help deal with the information asymmetry problem.

The Canadian Accounting Standards Board (AcSB) is the main standard-setting body in Canada for private companies, pension plans, and not-for-profit entities. Its mandate comes from the Canada Business Corporations Act and Regulations as well as provincial acts of incorporation. For public companies, GAAP is International Financial Reporting Standards (IFRS) as established by the International Accounting Standards Board (IASB). Public companies are required to follow GAAP in order to access capital markets, which are monitored by provincial securities commissions. The U.S. Financial Accounting Standards Board (FASB) is also important because it influences IFRS standard setting. Private companies may choose to follow IFRS. Public companies that list on U.S. stock exchanges may choose to follow U.S. GAAP.

**Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP.**

Generally accepted accounting principles are either principles that have substantial authoritative support, such as the *CPA Canada Handbook*, or those arrived at through the use of professional judgement and the conceptual framework.

Professional judgement plays an important role in Accounting Standards for Private Enterprises (ASPE) and IFRS since much of GAAP is based on general principles, which need to be interpreted.

**Discuss some of the challenges and opportunities for accounting.**

Some of the challenges facing accounting are oversight in the capital markets, centrality of ethics, standard setting in a political environment, principles- versus rules-based standard setting, the impact of technology, and integrated reporting. All of these require the accounting profession to continue to strive for excellence and to understand how accounting adds value in the capital marketplace.

## Chapter 1 Glossary

<b>Accounting Standards Board (AcSB):</b>	The group primarily responsible for setting GAAP in Canada, which publishes the <i>CPA Canada Handbook</i> and other authoritative documents.
<b>Accounting Standards for Private Enterprises (ASPE)</b>	The financial reporting standards applicable to private entities in Canada. Private entities may also use IFRS.
<b>Accounting Standards Oversight Council (AcSOC)</b>	The group that provides oversight to AcSB activities such as setting the agenda, reporting to the public, and raising funds for standard setting.
<b>Adverse Selection</b>	A result of information asymmetry whereby the capital marketplace may attract the wrong types of companies (that is, those that have the most to gain from having information that others do not).
<b>Aggressive Accounting</b>	A bias that exists in financial reporting that focuses more on the positive information about a company and its financial position and operations; for example, a company may overstate net income or net assets.
<b>Bright-Line Test</b>	Quantitative thresholds in financial reporting standards that act as a benchmark to dictate how something is to be accounted for.
<b>Canadian Institute of Chartered Accountants (CICA)</b>	The predecessor organization of Chartered Professional Accountants Canada (CPA Canada).
<b>Canadian Public Accountability Board (CPAB)</b>	The regulatory oversight body that ensures that certain standards are met regarding quality controls and independence.
<b>Capital Allocation</b>	The process by which accounting enables investors and creditors to assess the relative returns and risks associated with investment opportunities and thereby channel resources more effectively.
<b>Chartered Professional Accountants Canada (CPA Canada)</b>	The main professional accounting body for chartered accountants that also has primary responsibility for setting GAAP in Canada through the Accounting Standards Board.
<b>Conservative Accounting</b>	A bias that exists in financial reporting that ensures that, where uncertainty exists and judgement is needed, net income and/or net assets are understated rather than being overstated.
<b>CPA Canada Handbook</b>	A set of principles and guidelines for accounting and assurance.
<b>Decision Usefulness Approach</b>	Approach to financial reporting whereby the amount and types of information to be disclosed and the format in which information should be presented involves determining which alternative provides the most useful information for decision-making purposes.
<b>Due Process</b>	A method used in standard setting in order to ensure that standard-setting bodies operate in full view of the public by giving those who are interested ample opportunity to make their views known.
<b>Efficient Markets Hypothesis</b>	A theory that states that, if information is available, it will be incorporated into decisions made by market participants.

<b>Entity Perspective</b>	The viewpoint that companies are viewed as separate and distinct from their owners and therefore financial reporting should focus on the needs of the main users and not just the owners.
<b>Ethical Dilemmas</b>	Problems where there are no set guidelines to follow in order to resolve a situation. These are the grey areas where one has to ask "Is it right or wrong?"
<b>Financial Accounting</b>	The process that culminates in the preparation of financial reports for the company as a whole for use by both internal and external parties. Also known as <i>Financial reporting</i> .
<b>Financial Accounting Standards Board (FASB)</b>	The major standard-setting body in the United States.
<b>Financial Reporting</b>	The process that culminates in the preparation of financial reports for the company as a whole for use by both internal and external parties. Also known as <i>Financial accounting</i> .
<b>Financial Statements</b>	The principal means through which financial information is communicated to those outside a company. They provide a company's history, quantified in money terms.
<b>GAAP Hierarchy</b>	Guidance that notes that primary sources of GAAP should be used first, followed by other relevant and reliable sources, including the conceptual framework and professional judgement.
<b>Generally Accepted Accounting Principles (GAAP)</b>	The common set of standards and procedures used to prepare financial statements with the expectation that the majority of users' needs will be met.
<b>General-Purpose Financial Statements</b>	Basic GAAP financial statements that provide information that meets the needs of external users (normally investors and creditors).
<b>IFRS Advisory Council</b>	A group that provides strategic advice to the IASB.
<b>IFRS Foundation</b>	A group that raises finances and provides strategic direction and oversight to the IASB.
<b>Information Asymmetry</b>	The state that exists when one party (such as management) has access to more information than the other party (for example, investors).
<b>Information Symmetry</b>	The state that exists when both parties have access to the same information.
<b>Institutional Investors</b>	Large corporations or corporate investors such as pension funds or mutual funds.
<b>International Accounting Standards Board (IASB)</b>	The group responsible for setting IFRS with the goal of increasing the transparency of financial reporting by achieving a single, global method of accounting.
<b>International Financial Reporting Interpretation Committee (IFRIC)</b>	A committee that studies and provides recommendations on issues not covered by the IASB.
<b>International Financial Reporting Standards (IFRS)</b>	The internationally recognized common set of financial reporting standards and procedures.

<b>International Integrated Reporting Committee (IIRC)</b>	A group that looks at a broader view of financial reporting that includes management information, governance and compensation, and sustainability reporting.
<b>Management Bias</b>	The presentation by management of information about their company in its best light in order to make their company look as successful as possible
<b>Managerial Accounting</b>	The process of identifying, measuring, analyzing, and communicating financial information to internal decision-makers.
<b>Moral Hazard</b>	The risk that certain parties who have additional information not accessible to others will act in their own self-interest.
<b>Objective of Financial Reporting</b>	The goal “to communicate information that is useful to investors, members, contributors, creditors, and other users in making their resource allocation decisions and/or assessing management stewardship,” as laid out in the <i>CPA Canada Handbook</i> .
<b>Ontario Securities Commission (OSC)</b>	A group that regulates companies listed on the Toronto Stock Exchange (TSX) by reviewing and monitoring their financial statements with a view to assessing whether the statements present fairly the financial position and results of operations.
<b>Professional Judgement</b>	The process by which professional accountants with significant education and experience apply the <i>CPA Canada Handbook's</i> “general principles” appropriately as they see fit, which is important in Canada because IFRS and ASPE are based primarily on general principles rather than specific rules.
<b>Proprietary Perspective</b>	The viewpoint that financial reporting should focus on the needs of the owners of the company.
<b>Provincial Securities Commissions</b>	The groups that oversee and monitor the provincial capital marketplaces. They ensure that the participants in the capital markets adhere to securities legislation, and thus that the marketplace is fair.
<b>Public Company Accounting Oversight Board (PCAOB)</b>	The regulatory oversight body in the United States that ensures that certain standards are met regarding quality controls and independence.
<b>Securities and Exchange Commission (SEC)</b>	The U.S. counterpart of the Ontario Securities Commission, which regulates the U.S. capital markets and supports the FASB by indicating that financial statements conforming with FASB standards will be presumed to have substantial authoritative support.
<b>Stakeholders</b>	Parties who rely on and use financial statements and other financial documents to make decisions.
<b>Stewardship</b>	Management's responsibility to manage assets with care and trust, which is described as its fiduciary relationship.
<b>Toronto Stock Exchange</b>	Largest stock exchange in Canada

## **1.1 Financial Statements and Financial Reporting**

The accounting environment has been shaped by business failures (e.g., WorldCom Inc., Enron, Arthur Andersen), capital market failure (e.g., subprime lending crisis, bank failures), near bankruptcies of several countries, globalization of capital and other markets, globalization of financial reporting standards, technology, access to more information.

### **Accounting is:**

1. The identification, measurement, and communication of financial information
2. About economic entities
3. To interested persons

**Financial Accounting:** Process that culminates in the preparation of financial reports that cover all of the company's business activities and that are used by both internal and external parties

**Managerial Accounting:** Process of identifying, measuring, analyzing, and communicating financial information to internal decision-makers

**Financial Statements:** Principal way of communicating financial information to those who are outside an enterprise; a firm's history, quantified in terms of money

1. Statement of Income (Income Statement)
2. Statement of Changes in Equity (Statement of Retained Earnings)
3. Statement of Financial Position (Balance Sheet)
4. Statement of Cash Flows

**Note Disclosures:** Information that cannot be expressed in financial statements (e.g., president's letter, supplementary schedules, prospectus, reports filed with government agencies, news releases, management forecasts, and descriptions of an enterprise's social or environmental impact) that is required by an authority, regulatory rule, or customer, or is disclosed voluntarily

### **1.1.1 Accounting and Capital Allocation**

Accounting has the responsibility of **measuring company performance** (e.g., assets, income, risks and returns) accurately and fairly on a timely basis.

Reliable and relevant accounting information enables individuals to make informed **resource allocation decisions (comparing, assessing relative risks and returns)**, thereby improving the efficiency of capital markets, economic growth, and the standard of living.

The accounting system does not always work, though, because humans behave unpredictably and often act in their own self-interest rather than in the best interest of the capital market place (e.g., 2007 subprime mortgage crisis).

In Canada, the primary exchange mechanisms for allocating resources are **debt and equity markets** (both public exchanges and private sources), as well as **financial institutions** such as banks.

### 1.1.2 Stakeholders

**Stakeholders:** Parties who have something at risk in the financial reporting environment, such as their salary, job, investment, or reputation (i.e., traditional users of financial informations such as investors and creditors)

More broadly, stakeholders include anyone who prepares, relies on, reviews, audits, or monitors financial information (e.g., financial analysts and regulators).

- Investors, creditors, analysts, managers, employees, customers, suppliers, industry groups, unions, government departments and ministers, the public in general (such as consumer groups), regulatory agencies, other companies, and standard setters, as well as auditors, lawyers, and others

#### Functions of Various Stakeholders (and what is at stake):

- **Management** prepares the financial statements (job, bonus, reputation, salary increase, access to capital markets by company)
- **Auditors** audit the financial statements to ensure economic transactions are accounted for properly and that sound accounting choices were made (reputation and profits as firms are their clients)
- **Investors and creditors** rely on financial statements to make decisions (investment or loan)
- **Standard setters** set GAAP (reputation)
- **Securities commissions and stock exchanges** monitor the financial statements to ensure full and plain disclosure of material information (reputation, effective and efficient capital market place)
- **Credit rating agencies and analysts** monitor and analyze financial statements to find changing financial condition (reputation, profits)

### 1.1.3 Objective of Financial Reporting

**Decision-usefulness Approach:** Providing financial information that is useful to present and potential equity investors, lenders, and other creditors in making decisions in their capacity as capital providers

**Entity Perspective:** Companies are viewed as separate and distinct from their owners

**Proprietary Perspective:** Financial reporting should be focused only on the needs of shareholders (inappropriate perspective)

#### Investors are interested in assessing:

1. The company's ability to generate net cash inflows
2. Management's ability to protect and enhance the capital providers' investments

#### Financial reporting should help investors and creditors assess and understand:

1. The amounts, timing, and uncertainty of prospective cash inflows from dividends or interest
2. Proceeds from the sale, redemption, or maturity of securities or loans
3. The firm's economic resources, the claims to those resources, and the changes in them

Providing information that is useful to users is challenging since they have **different needs and levels of knowledge**

### 1.1.4 Information Asymmetry

**Information Symmetry:** All stakeholders have equal access to all relevant information, facilitating the efficient and effective flow of capital

**Information Asymmetry Exists:**

1. Management does not wish to disclose information that will hurt the firm's competitive advantage or position
2. Capital markets may not be fully efficient (e.g., insider info not reflected in stock price)
3. Self-interested human behaviour (e.g., management only presents positive information to ensure access to capital markets or maximize their own personal bonuses)

**Efficient Markets Hypothesis:** Market prices reflect all publicly available info about a firm

- Some argue that info asymmetry results in an inefficient capital market (e.g., investors discount share prices, require higher ROIs, or choose not to invest) and, in the extreme, interfere with a firm's ability to access capital and/or minimize the cost of capital

**Adverse Selection:** Information asymmetry means that the capital market may attract poor-quality companies (buyers are unable to accurately assess them) and repel high-quality companies (believe their share prices might be unfairly discounted)

**Moral Hazard:** Shirking responsibilities because you believe no one is watching

**Management Bias:** Managers may decide to downplay the negative and focus on the positive

**Aggressive Accounting:** Accounting practices that are designed to overstate a company's financial performance, either by delaying or covering up losses, artificially inflating its value by overstating earnings, or carefully selected note disclosures that emphasize only positive events

**Conservative Accounting:** Accounting practices that are more likely to understate performance, and thus the firm's value

MOTIVATION TO BIAS INFO	EXPLANATION
Evaluation of management performance	Financial statements provide evidence to investors about how management has discharged its <b>stewardship</b> function. Stewardship refers to how well management has looked after the money invested in the company. Ideally they at least maintained the capital and hopefully increased it.
Compensation structures	Management remuneration may be based on financial statements directly (for example, bonus based on net income) or indirectly (stock options based on the value of the shares that may be affected by reported net income).
Access to capital markets and meeting financial analyst expectations	There is a strong desire to meet financial analysts' expectations because this may affect a company's cost of capital or access to capital markets. <sup>13</sup> In addition, there may be a concern that share prices and therefore management compensation may drop.
Contractual obligations	Many lending agreements and contracts require that certain financial benchmarks be met, and these often relate to financial stability or liquidity. For instance, a debt covenant (a term in a loan agreement) may state that the company must maintain certain minimum financial ratios or the loan may be called (demanded to be repaid).

## **1.2 Standard Setting**

### **1.2.1 Need for Standards**

Standards help reduce information asymmetry by requiring that transactions and events be recognized, measured, presented, and disclosed in a specific way.

Standards help facilitate comparisons of financial statements.

**Generally Accepted Accounting Principles (GAAP):** Common set of standards and procedures that are recognized by the financial community to be the most useful

### **1.2.2 Parties Involved in Standard Setting**

<b>Standard-Setting Body</b>	<b>GAAP Development</b>	<b>How GAAP Applies to Canadian Entities</b>
Canadian Accounting Standards Board (AcSB)	GAAP for Canadian private companies ( <b>ASPE</b> ), pension plans, and not-for-profit entities	ASPE is effective for periods beginning on or after January 1, 2011. Not-for-profit entities in the public sector may have to follow public sector GAAP, which is the responsibility of the Public Sector Accounting Board (PSAB).
International Accounting Standards Board (IASB)	GAAP for public companies, ( <b>IFRS</b> )	IFRS is effective for periods beginning on or after January 1, 2011. Private companies and not-for-profit entities may choose to use IFRS.
Financial Accounting Standards Board (FASB)	GAAP for U.S. entities (referred to as U.S. GAAP)	Canadian public companies may choose to follow U.S. GAAP (see text directly below under Securities commissions).
Securities Commissions	Not responsible for GAAP but often require additional disclosures for public companies	The Ontario Securities Commission requires that public companies follow IFRS or U.S. GAAP (where public companies list on U.S. stock exchanges or markets and choose to follow U.S. GAAP instead of IFRS) for periods beginning on or after January 1, 2011.

### **1.3 Generally Accepted Accounting Principles**

#### **GAAP includes:**

- Specific rules, practices, and procedures
- Broad principles and conventions and underlying concepts

#### **1.3.1 GAAP Hierarchy**

**GAAP Hierarchy:** Which sources of GAAP should be consulted first

**ASPE GAAP (identified in CPA Canada Handbook, Part II, section 1100):**

##### **1. Primary Sources**

- a. CPA Canada Handbook (sections 1400 to 3870)
- b. Accounting guidelines, including appendices

##### **2. Other Sources**

- a. Background information and basis for conclusion documents issued by the AcSB
- b. Pronouncements by accounting standard-setting bodies in other jurisdictions
- c. Approved drafts of primary sources of GAAP
- d. Research studies
- e. Accounting textbooks, journals, studies, and articles
- f. Other sources, including industry practice

Primary sources should be looked at first. Then, accounting policies consistent with the primary sources and the conceptual framework should be looked at.

#### **IFRS GAAP**

1. IFRS
2. International Accounting Standards (IAS)
3. Interpretations (IFRIC)

**OTHER:** Pronouncements of other standard setting bodies, other accounting literature, accepted industry practices

#### **1.3.2 Professional Judgement**

Professional judgment plays an especially important role in ASPE and IFRS.

There cannot be a rule for every situation, thus ASPE and IFRS are based on general principles.

Accountants either:

- Apply specific standards that are based the conceptual framework
- Use the conceptual framework and professional judgement to reason through to an answer where no specific standard exists

## **1.4 Challenges and Opportunities for the Accounting Profession**

### **1.4.1 Oversight in the Capital Market**

- Accounting scandals at companies such as Enron, Cendant, Sunbeam, Rite-Aid, and Livent have prompted governments to increase regulation in the capital marketplace
- Sarbanes-Oxley Act (SOX) enacted in US in 2002 to fight fraud and poor business practices

### **1.4.2 Centrality of Ethics**

- Management bias are the starting point of many ethical dilemmas
- Internally-prompted management bias (e.g., desire to maximize bonuses)
- Externally-prompted management bias (e.g., desire to meet security analyst's expectations)
- Management biases lead to a focus on short-term results over long-term results
- This places accounts in an environment of conflict of pressure, playing the conscience of the capital marketplace
- The process of ethical sensitivity and choosing among alternatives is further complicated by time pressures, job pressures, client pressures, personal pressures, and peer pressures

### **1.4.3 Standard Setting in Political Environments**

- Stakeholders have a powerful influence in standard setting
- The IASB has committed to 4 principles to ensure that the nature and amount of funding for standard setting does not result in politicization of the process
- The IASB believes that funding should be broad-based, compelling, open-ended, and country-specific to avoid politicization

### **1.4.4 Principles versus Rules**

- Canada and US GAAP use rules-based approach
  - Greater body of knowledge to learn
  - Tendency to interpret the rules literally
  - Tendency to follow unethical actions if there is no rule for them
  - Tendency to assume that compliance in the narrow sense is in accordance with GAAP
  - Does not always emphasize the importance of communicating the best information for users
- IFRS and ASPE use a principles-based approach
  - Smaller body of knowledge to learn
  - Professional judgement is fundamental
  - Minimization of bright-line tests (numeric benchmarks for determining accounting treatments)

Standard setters must ensure the body of knowledge:

1. Rests on a cohesive set of principles and a conceptual framework that are consistently applied
2. Is sufficiently flexible to be of use in many differing business situations and industries
3. Is sufficiently detailed to provide good guidance but not so big as to be unwieldy

### **1.4.5 Impact of Technology**

- Can provide significant amount of timely information to a wide variety of users at a low cost
- Issues of information asymmetry, accessibility, quality, and reliability

## Chapter 2: Conceptual Framework

### Learning objectives:

1. Understand the objectives of financial reporting in relation to various stakeholders, their needs and potential conflicts/biases.
2. Understand qualitative characteristics of accounting information and elements.
3. Understand what Recognition, Measurement, and Presentation mean in financial reporting
4. Learn the case approach based on the conceptual framework.

### Readings:

- Kieso Chapter 2
- Case discussion: CA2-2
- Review Questions: E2-3, E2-4, E2-8, P2-5, P2-8

CONCEPTUAL FRAMEWORK UNDERLYING FINANCIAL REPORTING				
Conceptual Framework	Objective of Financial Reporting	Foundational Principles	Financial Reporting Issues	IFRS/ASPE Comparison
<ul style="list-style-type: none"> <li>▪ Rationale for conceptual framework</li> <li>▪ Development of the conceptual framework</li> <li>▪ Information asymmetry revisited</li> </ul>	<ul style="list-style-type: none"> <li>▪ Qualitative characteristics of useful information</li> <li>▪ Elements of financial statements</li> </ul>	<ul style="list-style-type: none"> <li>▪ Recognition/derecognition</li> <li>▪ Measurement</li> <li>▪ Presentation and disclosure</li> </ul>	<ul style="list-style-type: none"> <li>▪ Principles-based approach</li> <li>▪ Financial engineering</li> <li>▪ Fraudulent financial reporting</li> </ul>	<ul style="list-style-type: none"> <li>▪ Looking ahead</li> </ul>

**1. Indicate the usefulness and describe the main components of a conceptual framework for financial reporting.**

A conceptual framework is needed to (1) create standards that build on an established body of concepts and objectives, (2) provide a framework for solving new and emerging practical problems, (3) increase financial statement users' understanding of and confidence in financial reporting, and (4) enhance comparability among different companies' financial statements. The first level of the framework deals with the objective of financial reporting. The second level includes the qualitative characteristics of useful information and elements of financial statements. The third level includes foundational principles and conventions.

**2. Identify the qualitative characteristics of accounting information.**

The overriding criterion by which accounting choices can be judged is decision usefulness; that is, the goal is to provide the information that is the most useful for decision-making. Fundamental characteristics include relevance and faithful representation. These two characteristics must be present. Enhancing characteristics include comparability, verifiability, timeliness, and understandability. There may be trade-offs.

**3. Define the basic elements of financial statements.** The basic elements of financial statements are (1) assets, (2) liabilities, (3) equity, (4) revenues, (5) expenses, (6) gains, and (7) losses.

**4. Describe the foundational principles of accounting.** (1) Economic entity: the assumption that the activity of a business enterprise can be kept separate and distinct from its owners and any other business unit. (2) Control: the entity has the power to make decisions and reap the benefits or be exposed to the losses (which are variable). (3) Revenue recognition: revenue is generally recognized when it is (a) earned, (b) measurable, and (c) collectible (realizable). (4) Matching: the assumption assists in the measurement of income by ensuring that costs (relating to long-lived assets) incurred in earning revenues are booked in the same period as the revenues earned. (5) Periodicity: the assumption that an enterprise's economic activities can be divided into artificial time periods to facilitate timely reporting. (6) Monetary unit: the assumption

that money is the common denominator by which economic activity is conducted, and that the monetary unit gives an appropriate basis for measurement and analysis. (7) Going concern: the assumption that the business enterprise will have a long life. (8) Historical cost principle: existing GAAP requires that many assets and liabilities be accounted for and reported based on their acquisition price. (9) Fair value principle: assets and liabilities are valued at fair value—that is, an exit price—and viewed from a market participant perspective. (10) Full disclosure principle: accountants follow the general practice of providing information that is important enough to influence an informed user's judgement and decisions.

**5.Explain the factors that contribute to choice and/or bias in financial reporting decisions.** Choice is the result of many things, including principles-based standards, measurement uncertainty, and increasingly complex business transactions. The conceptual framework is the foundation that GAAP is built on. If there is no primary source of GAAP for a specific decision, then professional judgement must be used, making sure that the accounting policies chosen are consistent with the primary sources of GAAP and the conceptual framework. Financial engineering is the process of legally structuring a business arrangement or transaction so that it meets the company's financial reporting objective. This can be a dangerous practice since it often results in biased information.

Fraudulent financial reporting often results from pressures on individuals or the company. These pressures may come from various sources, including worsening company, industry, or economic conditions; unrealistic internal budgets; and financial statement focal points related to contractual, regulatory, or capital market expectations. Weak internal controls and governance also contribute to fraudulent financial reporting.

**6.Discuss current trends in standard setting for the conceptual framework.** The IASB was in the stages of issuing a new conceptual framework, which was expected to be issued in final form in 2016. It was also working on projects relating to disclosure and materiality.

<b>Assets</b>	Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
<b>Basic Elements</b>	Financial reporting terms that constitute the language of accounting and business, such as “assets,” “liabilities,” and “equity.”
<b>Comparability</b>	What occurs when information that has been measured and reported in a similar manner for different companies is considered comparable.
<b>Completeness</b>	The quality of accounting information that makes it reliable by including all information necessary to provide an accurate portrayal of events and transactions.
<b>Comprehensive Income</b>	A measure of income under IFRS that includes net income plus other comprehensive income.
<b>Conceptual Framework</b>	A coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements.
<b>Conservatism</b>	A constraint of financial reporting stipulating that, in doubtful situations, the solution that will least likely overstate assets and income should be chosen.
<b>Consistency</b>	What occurs when a company applies the same accounting treatment to similar events from period to period.
<b>Constructive Obligations</b>	A type of performance obligation not stated in a contract that is created through a past practice or by signalling something to potential customers, such as a “100% satisfaction guaranteed” policy.
<b>Control</b>	Under ASPE, the continuing power to determine the strategic operating, financing, and investing policies of another entity without the co-operation of others. Under IFRS, the power to direct the activities of another entity to generate returns, either positive or negative, for the investor.
<b>Cost-Benefit Relationship</b>	A constraint of financial reporting that the costs of obtaining and providing information should not be higher than the benefits that are gained by providing it.
<b>Decision Usefulness</b>	Approach to financial reporting whereby the amount and types of information to be disclosed and the format in which information should be presented involves determining which alternative provides the most useful information for decision-making purposes.
<b>De-recognition</b>	The process of removing an item from a company's statement of financial position or income statement.
<b>Economic Entity Assumption</b>	An assumption that a company's business activity can be kept separate and distinct from its owners and any other business units. Economic activity can therefore be identified with a particular degree of accountability.
<b>Economic Substance</b>	The underlying economic reality reported on a representationally faithful document.
<b>Elements of Financial Statements</b>	Basic items that are presented in the financial statements.

<b>Equitable Obligations</b>	Commitments that arise from moral or ethical considerations.
<b>Equity</b>	The residual interest in the assets of a company that remains after deducting its liabilities.
<b>Exit Price</b>	A measure of fair value that represents the amount that a company would receive on selling an asset or transferring a liability.
<b>Expenses</b>	Decreases in economic resources, either by outflows or reductions of assets or incurrence of liabilities resulting from a company's ordinary revenue-generating activities.
<b>Fair Value Option</b>	The option given to companies allowing them to use fair value for most financial instruments. Under IFRS, certain conditions must be met.
<b>Fair Value Principle</b>	The GAAP principle that provides guidance regarding how to measure financial statement elements using best estimates of market values.
<b>Feedback/Confirmatory Value</b>	The notion that relevant information helps users confirm or correct prior expectations.
<b>Financial Engineering</b>	A process whereby a business arrangement or transaction is structured legally such that it meets the company's financial reporting objective (for example, to maximize earnings, minimize a debt-to-equity ratio, or other).
<b>First Principles</b>	Foundational principles from which decisions stem, making decisions theoretically consistent if they stem from the same foundational reasoning.
<b>Freedom from Material Error</b>	A measure of the reliability of reported information, assuring that the relevant information is accurate and unaffected by the opinions of stakeholders.
<b>Full Disclosure Principle</b>	Financial reporting of any information significant enough to influence the judgement of an informed reader.
<b>Gains</b>	Increases in equity (net assets) from a company's peripheral or incidental transactions and from all other transactions and other events and circumstances affecting the company during a period, except those that result from revenues or investments by owners.
<b>General-Purpose Financial Statements</b>	Basic GAAP financial statements that provide information that meets the needs of external users (normally investors and creditors).
<b>Going Concern Assumption</b>	The assumption of most accounting methods that the company will have a long life.
<b>Historical Cost Principle</b>	An accounting principle that provides guidance on how to measure transactions and balances on the basis of acquisition price.
<b>Information Overload</b>	The phenomenon that too much information may result in a situation where the user is unable to digest or process the information.

<b>Laid-Down Costs</b>	Any cost incurred to get the asset in place and ready for use (whether it is for sale or to generate income through use). Also known as “out-of-pocket costs.”
<b>Liabilities</b>	“Obligations of an enterprise arising from past transactions or events, the settlement of which may result in the transfer of assets, provisions of services or other yielding of economic benefits in the future,” as described in the <i>CPA Canada Handbook</i> .
<b>Losses</b>	Decreases in equity (net assets) from a company's peripheral or incidental transactions and from all other transactions and other events and circumstances affecting the company during a period, except those that result from expenses or distributions to owners.
<b>Management Best Estimate</b>	Assumptions made by management in light of their knowledge and familiarity with the company, the industry, and the economy.
<b>Matching</b>	The accounting principle that dictates that efforts (expenses) be matched with accomplishments (revenues) whenever reasonable and practicable.
<b>Materiality</b>	The constraint that relates to an item's impact on a company's overall financial operations. An item is material if its inclusion or omission would influence or change the judgement of a reasonable person.
<b>Measurement Uncertainty</b>	What occurs when there is a variance between the recognized amount and another reasonably possible amount.
<b>Monetary Unit Assumption</b>	The assumption that money is the common denominator of economic activity and provides an appropriate basis for accounting measurement and analysis.
<b>Neutrality</b>	The quality of accounting information that makes it reliable by being reasonably free of error and bias.
<b>Nonmonetary/ Barter Transactions</b>	Transactions where few or no monetary assets are received as consideration when goods or services are purchased or sold. Also known as <i>Barter transactions</i> .
<b>Nonmonetary, Non-Reciprocal Transactions</b>	A type of transaction where there is no exchange (such as a donation), making it difficult to determine cost or fair value.
<b>Notes to Financial Statements</b>	Information that is linked to the financial statements that generally amplifies or explains the items presented in the main body of the statements in order to complete the picture of a company's performance and position.
<b>Objective of Financial Reporting</b>	The goal “to communicate information that is useful to investors, members, contributors, creditors, and other users in making their resource allocation decisions and/or assessing management stewardship,” as laid out in the <i>CPA Canada Handbook</i> .
<b>Other Comprehensive Income</b>	Items of revenues, expenses, gains, and losses that are required by IFRS to be included in comprehensive income, but excluded from net income.
<b>Performance Obligation</b>	An obligation that arises when a company promises to deliver something or provide a service in the future.

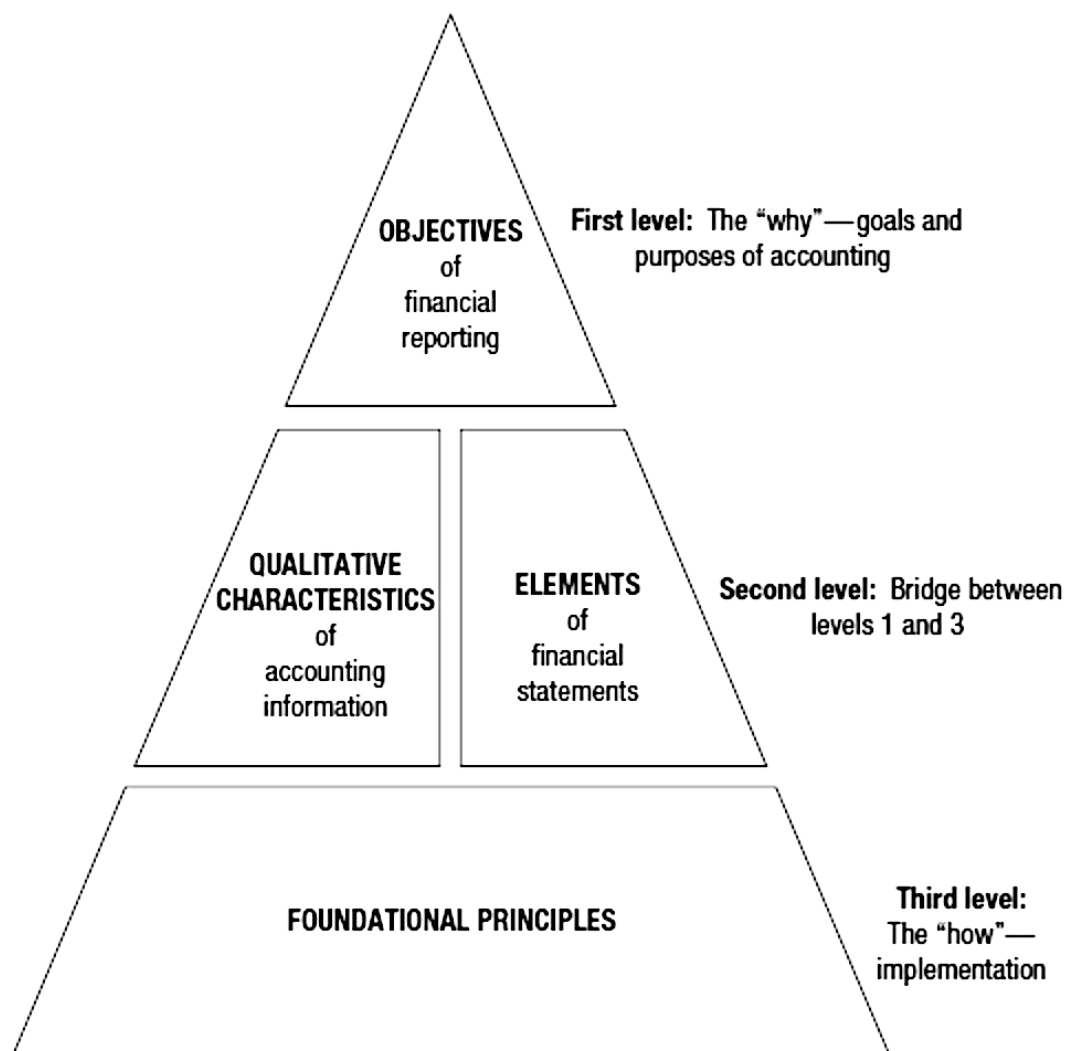
<b>Periodicity Assumption</b>	The accounting assumption that implies that a company's economic activities can be divided into artificial time periods.
<b>Predictive Value</b>	A characteristic of accounting information that helps users make predictions about the ultimate outcome of past, present, and future events.
<b>Qualitative Characteristics</b>	The characteristics defined by the conceptual framework that distinguish more useful information from less useful information for decision-making purposes.
<b>Realizable (revenue)</b>	Revenue from assets received or sold that can be readily converted into cash or claims to cash.
<b>Realized (revenue)</b>	Revenue from products (goods or services), merchandise, or other assets that are exchanged for cash.
<b>Reciprocal Exchange</b>	A two-way exchange.
<b>Recognition</b>	The process of recording a transaction in a company's statement of financial position or income statement.
<b>Related Party Transactions</b>	A transaction in which one of the transacting parties has the ability to significantly influence the policies of the other, or in which a nontransacting party has the ability to influence the policies of the two transacting parties.
<b>Relevance</b>	A qualitative characteristic of accounting information that indicates that it must make a difference in a decision.
<b>Representational Faithfulness</b>	A qualitative characteristic of accounting information that represents economic reality. It must be transparent, complete, neutral, and free from material error and bias.
<b>Revenue Recognition Principle</b>	The accounting principle that sets guidelines as to when revenue should be reported.
<b>Revenues</b>	Increases in economic resources, either by inflows or other enhancements of a company's assets or settlement of its liabilities resulting from its ordinary activities.
<b>Supplementary Information</b>	Information that may include details or amounts that presents a different perspective from that adopted in the financial statements.
<b>Timeliness</b>	A characteristic of relevance that states that information must be available for decision-makers before it loses its capacity to influence their decisions.
<b>Transparency</b>	A goal of financial reporting such that the information provided reflects the underlying transactions and events and their effects on a company. Is one of the characteristics of representational faithfulness.
<b>Understandability</b>	The quality of information that permits reasonably informed users to perceive its significance.
<b>Verifiability</b>	The quality of information that demonstrates that independent measurers, using the same measurement methods, obtain similar results.

## 2.1 Conceptual Framework

**Conceptual Framework:** Coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements.

### 2.1.1 Rationale for Conceptual Framework

- Standards should be built on an established body of concepts and objectives in order to be **useful and consistent**
- Produces a **coherent** set of standards and rules
- Should improve **understandability**, **comparability**, and **confidence** in financial reporting
- Enables accountants to use **good judgement** and solve **new emerging issues** more quickly
- Helps **reduce information asymmetry** issues such as adverse selection and moral hazard



## 2.2 Objective of Financial Reporting

**Objective of Financial Reporting:** To communicate information that is useful to investors, members, contributors, creditors, and other users in making their resource allocation decisions and/or assessing management stewardship

**General-Purpose Financial Statements:** Basic GAAP financial statements that provide information that meets the needs of external users (normally investors and creditors)

### 2.2.1 Qualitative Characteristics of Useful Information

**Decision-Usefulness:** Approach to financial reporting whereby the amount and types of information to be disclosed and the format in which information should be presented involves determining which alternative provides the most useful information for decision-making purposes

FUNDAMENTAL QUALITATIVE CHARACTERISTICS	
<b>Relevance</b>	<p>Must make a difference in a decision</p> <p><b>Predictive Value:</b> Helps make predictions about the outcomes of events</p> <p><b>Feedback (Confirmatory) Value:</b> Helps confirm or correct previous expectations</p> <p><b>Materiality:</b> How important/relevant information is (tip: compare amount to sensitive FS numbers and consider qualitative factors such as legality and compliance)</p>
<b>Representational Faithfulness</b>	<p>Reflects economic reality (transparent, complete, neutral, and free from material error and bias)</p> <p><b>Completeness:</b> Includes all pertinent information</p> <p><b>Neutrality:</b> Information is not selected in favour of one set of interested parties over another</p> <p><b>Management Best Estimate:</b> Assumptions that are unbiased and involve diligent effort to produce the best-quality information</p> <p><b>Free From Material Error:</b> Information is reliable</p>
ENHANCING QUALITATIVE CHARACTERISTICS	
<b>Comparability</b>	Information that has been measured and reported in a similar manner for different companies is considered comparable
<b>Verifiability</b>	Independent measurers, using the same measurement methods, obtain similar results
<b>Timeliness</b>	Available for decision-makers before it loses its capacity to influence their decisions
<b>Understandability</b>	Reasonably informed users can perceive its significance

**Tradeoffs:** 1) among enhancing qualitative characteristics, 2) between cost and benefit of info

## 2.2.2 Elements of Financial Statements

<b>ASSETS</b>	<p><b>Assets</b> have three essential characteristics:</p> <ol style="list-style-type: none"> <li>1. There is some economic benefit to the entity.</li> <li>2. The entity has control over that benefit.</li> <li>3. The benefits result from a past transaction or event.<sup>12</sup></li> </ol> <p>Includes contractual and other rights</p>
<b>LIABILITIES</b>	<p><b>Liabilities</b> have three essential characteristics:</p> <ol style="list-style-type: none"> <li>1. They represent a present duty or responsibility.</li> <li>2. The duty or responsibility obligates the entity, leaving it little or no discretion to avoid it.</li> <li>3. The transaction or event results from a past transaction or event.<sup>13</sup></li> </ol> <p>Arise from contractual obligations, statutory requirements, constructive obligations, and equitable obligations</p> <p><b>Constructive Obligations:</b> Arise through past or present practices that signal that the firm acknowledges a potential economic burden (e.g., statement to “stand behind its products” creates an expectation the firm will replace a defective product)</p> <p><b>Equitable Obligations:</b> Arise due to ethical or moral considerations (e.g., moral obligation to retrain an employee who is being downsized)</p>
<b>EQUITY</b>	<ul style="list-style-type: none"> <li>- Residual interest in an entity that remains after deducting its liabilities from its assets (i.e., net worth)</li> <li>- Normally consists of common or ordinary shares, preferred shares, retained earnings, and, under IFRS, accumulated other comprehensive income</li> </ul>
<b>REVENUES</b>	<ul style="list-style-type: none"> <li>- Increases in economic resources, either by inflows or other enhancements of an entity’s assets or by settlement of its liabilities, which result from it’s ordinary activities</li> </ul>
<b>EXPENSES</b>	<ul style="list-style-type: none"> <li>- Decreases in economic resources, either by outflows or reductions of assets or by the insurance of liabilities that result from its ordinary revenue-generating activities</li> </ul>
<b>GAINS/LOSSES</b>	<p><b>Gains:</b> Increases in equity from an entity’s peripheral or incidental transactions and from all other transactions and other events and circumstances affecting the entity during a period, except those that result from revenues or investments by owners</p> <p><b>Losses:</b> Decreases in equity from an entity’s peripheral or incidental transactions and from all other transactions and other events and circumstances affecting the entity during a period, except those that result from expenses or distributions to owners</p>

The financial statements include the following items:

1. Income statement and/or statement of comprehensive income (IFRS only)
2. Statement of financial position
3. Statement of retained earnings (ASPE only) or changes in shareholders' equity (IFRS only)
4. Statement of cash flows

**Comprehensive Income:** A measure of income under IFRS that includes net income plus other comprehensive income

**Other Comprehensive Income:** Items of revenues, expenses, gains, and losses that are required by IFRS to be included in comprehensive income, but excluded from net income (i.e., changes in equity other than owners' investments and distributions)

**Other comprehensive income examples:**

- Unrealized holding gains and losses on certain securities (e.g., Fair Value - OCI investments)
- Changes in the revaluation surplus when using the revaluation method to account for capital assets
- Certain gains and losses related to the translation of foreign operations, and cash flow hedges
- Certain gains and losses related to remeasurement of defined benefit plans and liabilities measured at fair value

## 2.3 Foundational Principles

**Foundational Principles:** Principles, assumptions, and conventions that help to explain which, when, and how financial elements and events should be recognized, measured, and presented/disclosed

Recognition/Derecognition	Measurement	Presentation and Disclosure
1. Economic entity assumption	5. Periodicity assumption	10. Full disclosure principle
2. Control	6. Monetary unit assumption	
3. Revenue recognition and realization principles	7. Going concern assumption	
4. Matching principle	8. Historical cost principle	
	9. Fair value principle	

### 2.3.1 Recognition/Derecognition

**Recognition:** Recording a transaction on the entity's SFP or IS

Historically, elements of financial statements have been recognized when they:

- meet the definition of an element (for example, a liability),
- are probable, and
- are reliably measurable.

**Definition of "probable":**

- IFRS: More likely than not (greater than 50% chance)
- ASPE: Likely (high chance of occurring)

**Derecognition:** Removing a transaction from the entity's SFP or IS