

Chapter 2 Solutions:

Questions:

1. A
2. D

Exercise 1:

- A. Timeliness. Because this is only an enhancing qualitative characteristic, the information may still be considered useful although it is lacking the timeliness characteristic.
- B. Faithful representation and verifiability. Because the information is lacking faithful representation, one of the two fundamental qualitative characteristics, it would not be considered useful.
- C. Faithful representation and comparability. Because the information is lacking faithful representation, one of the two fundamental qualitative characteristics, it would not be considered useful.
- D. Relevance. Because the information is lacking relevance, one of the two fundamental qualitative characteristics, it would not be considered useful.

Exercise 2:

- A. This information is most likely irrelevant, because the brand of machinery is not likely to influence the decision of users of the financial statements. The information does not have confirmatory or predictive value.
- B. This information is relevant and contains both confirmatory and predictive value.
- C. This information is relevant, because it can be used by investors to make forecasts for future operations.
- D. This information is most likely irrelevant, because the average salary of employees is not likely to influence the decision of users of the financial statements. The overall cost of wages would be relevant and is reported in the income statement in various accounts.

Exercise 3:

- A. Payment of dividends does not result in an expense because contributions from or distributions to equity participants never result in income or expenses.
- B. The incurrence of a tax liability results in an expense because the increase in liabilities causes a decrease in equity.
- C. The purchase of a new delivery truck is not an expense. It is just the exchange of one asset (the truck) for another (cash). This does not result in a change in equity.
- D. Sale of inventory results in both income and an expense. The cash received increases cash and equity resulting in income for the amount of the sale. Inventory and equity decrease by the amount of the inventory's value, resulting in an expense.

Exercise 4:

- A. Inventory entity has an asset as defined by the conceptual framework. The receivable represents an exclusive right to collect, is present and is expected to produce a future cash flow which qualifies it as an economic resource.

- B. The patent qualifies as an asset as defined by the conceptual framework, as a present, exclusive right to collect an economic resource expected to produce future cash flows.
- C. The promise to ship inventory represents a present economic obligation for which the entity is the obligor and is therefore best classified as a liability.
- D. Dividends are recognized on the declaration date. On this date, the journal entry debiting retained earnings and crediting dividend payable is recorded. No entry is recorded on the date that the board discusses and approves the dividend. No entry is recorded on the date of record.

Case:

The following are key concepts discussed in the *Conceptual Framework* that the student may use to defend the position that the buildings should not be classified as held-for-sale:

- The buildings are not likely to be sold. If Troubled Entity were to classify the buildings as held-for-sale, the information provided to users of the financial statements would not be faithfully represented because the classification in this scenario is not a neutral depiction.
- The classification would also diminish the confirmatory and predictive value of depreciation expense related to the buildings.
- The enhancing qualitative characteristic of understandability is absent in the decision to classify the buildings as held-for-sale.
- Because a knowledgeable and independent observer would likely conclude that it is not probable that the buildings will be sold based on the information provided in the case, the enhancing qualitative characteristic of verifiability is compromised in the decision to classify the buildings as held-for-sale.
- The general purpose of financial reporting as stated in the *Conceptual Framework* specifically includes lenders and other creditors as users of the financial statements. Much of the *Framework* was written with consideration as to the needs of these users. Classifying the buildings as held-for-sale would not be providing lenders and other creditors with useful information regarding Troubled Entity.

Writing Assignment:

Asset definition under:

- **GAAP:** probable future economic benefit obtained or controlled by a particular entity as a result of past transactions or events.
- **IFRS:** a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
- **Conceptual Framework project:** a present economic resource to which the entity has a right or other access that others do not have.

Liability definition under:

- **GAAP:** probable future sacrifice of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.
- **IFRS:** a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits
- **Conceptual Framework project:** a present economic obligation for which the entity is the obligor.

Definition differences between U.S. GAAP/IFRS and the Conceptual Framework project include:

- The conceptual framework project excludes the terms probable and expected
- GAAP/IFRS focus more on future inflow/outflow of economic obligation/benefit while the Conceptual Framework project focuses more on the existence of present obligations/benefits

- GAAP/IFRS focus on the asset/liability existing due to past events while the conceptual framework makes no mention of past events

The differences between IFRS/GAAP and the Conceptual Framework Project are quite significant.

The new standards would give standard setters better guidance in writing standards due to the extended definitions that will be included with the main definition. The words present, economic obligation, and obligor will be defined to allow for correct interpretation.