Chapter 1 Environment and Theoretical Structure of Financial Accounting

QUESTIONS FOR REVIEW OF KEY TOPICS

Question 1-1

Financial accounting is concerned with providing relevant financial information about various kinds of organizations to different types of external users. The primary focus of financial accounting is on the financial information provided by profit-oriented companies to their present and potential investors and creditors.

Question 1-2

Resources are efficiently allocated if they are given to enterprises that will use them to provide goods and services desired by society and not to enterprises that will waste them. The capital markets are the mechanism that fosters this efficient allocation of resources.

Question 1-3

Two extremely important variables that must be considered in any investment decision are the expected rate of return and the uncertainty or risk of that expected return.

Question 1-4

In the long run, a company will be able to provide investors and creditors with a rate of return only if it can generate a profit. That is, it must be able to use the resources provided to it to generate cash receipts from selling a product or service that exceeds the cash disbursements necessary to provide that product or service.

Question 1-5

The primary objective of financial accounting is to provide investors and creditors with information that will help them make investment and credit decisions.

Question 1-6

Net operating cash flows are the difference between cash receipts and cash disbursements during a period of time from transactions related to providing goods and services to customers. Net operating cash flows may not be a good indicator of future cash flows because, by ignoring uncompleted transactions, they may not match the accomplishments and sacrifices of the period.

Answers to Questions (continued)

Question 1-7

Accounting standards provide both the broad and specific guidelines that a company should follow in measuring and reporting the information in their financial statements and related notes. It is important that all companies follow accounting standards so that investors can compare financial information across companies to make their resource allocation decisions.

Question 1-8

The standard-setting body responsible for determining IFRS is the International Accounting Standards Board. It is supported financially by the IFRS Foundation, whose Trustee members are responsible for selecting the IASB members, exercising general oversight of the IASB's activities, and ensuring adequate funding.

Question 1-9

Auditors are independent, professional accountants who examine financial statements to express an opinion. The opinion reflects the auditors' assessment of the statements' fairness, which is determined by the extent to which they are prepared in compliance with accounting standards. The auditor adds credibility to the financial statements, which increases the confidence of capital market participants relying on that information.

Question 1-10

On July 30, 2002, United States President Bush signed into law the Sarbanes-Oxley Act of 2002. The most dramatic change to federal securities laws since the 1930s, the Act radically redesigns federal regulation of public company corporate governance and reporting obligations. It also significantly tightens accountability standards for directors and officers, auditors, securities analysts and legal counsel. Student opinions as to the relative importance of the key provisions of the act will vary. Key provisions in the order of presentation in the text are:

- Creation of an Oversight Board
- Corporate executive accountability
- Non-audit services
- Retention of work papers
- Auditor rotation
- Conflicts of interest
- Hiring of auditor
- Internal control

Answers to Questions (continued)

Question 1-11

New accounting standards, or changes in standards, can have significant differential effects on companies, investors and creditors, and other interest groups by causing redistribution of wealth. There is also the possibility that standards could harm the economy as a whole by causing companies to change their behavior.

Question 1-12

The accounting standard setters undertakes a series of elaborate information gathering steps before issuing an accounting standards update to determine consensus as to the preferred method of accounting, as well as to anticipate adverse economic consequences.

Question 1-13

The purpose of the framework is to assist the IASB in reviewing existing standards, developing future standards, and promoting harmonization of standards, and to assist preparers and users of financial statements. The framework does not prescribe the accounting standards, but guides the IASB by providing an underlying foundation and basic reasoning on which to consider merits of alternatives.

Question 1-14

Relevance and faithful representation are the fundamental qualitative characteristics that make information decision-useful. Relevant information will possess predictive and/or confirmatory value. Faithful representation is the extent to which there is agreement between a measure or description and the phenomenon it purports to represent.

Question 1-15

The components of relevant information are predictive and/or confirmatory value, and materiality. The components of faithful representation are completeness, neutrality, and free from error.

Question 1-16

The benefit from providing accounting information is increased decision usefulness. If the information is relevant and possesses faithful representation, it will improve the decisions made by investors and creditors. However, there are costs to providing information that include costs to gather, process, and disseminate that information. There are also costs to users in interpreting the information as well as possible adverse economic consequences that could result from disclosing information. Information should not be provided unless the benefits exceed the costs.

Answers to Questions (continued)

Question 1-17

Information is material if it is deemed to have an effect on a decision made by a user. The threshold for materiality will depend principally on the relative dollar amount of the transaction being considered. One consequence of materiality is that accounting standards need not be followed in measuring and reporting a transaction if that transaction is not material. The threshold for materiality has been left to subjective judgment.

Question 1-18

1. "An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity."
2. "A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits."
3. "Equity is the residual interest in the assets of the entity after deducting its liabilities."
4. "Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants." Income includes revenues (income that "arises in the course of the ordinary activities of an entity") and gains ("other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity").
5. "Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants."

Question 1-19

The basic assumptions underlying the measurement and reporting of financial statement information are the going concern assumption, the economic entity assumption, the periodicity assumption, and the monetary unit assumption.

Question 1-20

The going concern assumption means that, in the absence of information to the contrary, it is anticipated that a business entity will continue to operate indefinitely. This assumption is important to many broad and specific accounting principles such as the historical cost principle.

Question 1-21

The periodicity assumption relates to needs of external users to receive timely financial information. This assumption requires that the economic life of a company be divided into artificial periods for financial reporting. Companies usually report to external users at least once a year.

Question 1-22

The commonly used measurement attributes are historical cost, net realizable value, present value, and fair value.

Answers to Questions (continued)

Question 1-23

Two important reasons to base valuation on historical cost are (1) historical cost provides important cash flow information since it represents the cash or cash equivalent paid for an asset or received in exchange for the assumption of a liability, and (2) historical cost valuation is the result of an exchange transaction between two independent parties and the agreed upon exchange value is, therefore, objective and possesses a high degree of verifiability.

Question 1-24

IFRS requires the following criteria to be satisfied before revenue can be recognized:

(a) The amount of revenue, associated costs, and stage of completion (for sales of services) can be measured reliably,

(b) It is probable that economic benefits will flow to the seller, and

(c) The seller has transferred to the buyer the risks and rewards of ownership (for sales of goods).

Question 1-25

The four different approaches to implementing the matching principle are:

1. Recognizing an expense based on an exact cause-and-effect relationship between a revenue and expense event. Cost of goods sold is an example of an expense recognized by this approach.
2. Recognizing an expense by identifying the expense with the revenues recognized in a specific time period. Office salaries are an example of an expense recognized by this approach.
3. Recognizing an expense by a systematic and rational allocation to specific time periods. Depreciation is an example of an expense recognized by this approach.
4. Recognizing expenses in the period incurred, without regard to related revenues. Advertising is an example of an expense recognized by this approach.

Question 1-26

In addition to the financial statement elements arrayed in the basic financial statements, information is disclosed by means of parenthetical or modifying comments, notes, and supplemental financial statements.

Question 1-27

IFRS prioritizes the inputs companies should use when determining fair value. The highest and most desirable inputs, Level 1, are quoted market prices in active markets for identical assets or liabilities. Level 2 inputs are other than quoted prices that are observable including quoted prices for similar assets or liabilities in active or inactive markets and inputs that are derived principally from observable related market data. Level 3 inputs, the least desirable, are inputs that reflect the entity’s own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

Answers to Questions (continued)

Question 1-28

Under the revenue/expense approach, we emphasize the principles for recognizing revenues and expenses, with some assets and liabilities recognized as necessary to make the statement of financial position reconcile with the income statement. Much of our accounting for revenues and expenses follows this revenue/expense approach. Key to the revenue/expense approach are the revenue recognition criteria and the matching principle. Under the asset/liability approach, on the other hand, we first recognize and measure the assets and liabilities that exist at the financial year end and, secondly, recognize and measure the revenues, expenses, gains and losses needed to account for the changes in these assets and liabilities from the previous measurement date. Recent standards involving accounting for revenue, investments, and income taxes follow this asset/liability approach.

BRIEF EXERCISES

Brief Exercise 1-1

Revenues ($340,000 + 60,000)	$400,000
Expenses:	
Rent ($40,000 ÷ 2)	(20,000)
Salaries	(120,000)
Utilities ($50,000 + 2,000)	(52,000)
Net income	**$208,000**

Brief Exercise 1-2

(1) Liabilities
(2) Assets
(3) Income
(4) Expenses

Brief Exercise 1-3

1. The periodicity assumption
2. The economic entity assumption
3. Revenue recognition criteria
4. The matching principle

Brief Exercise 1-4

1. The matching principle
2. The historical cost (original transaction value) principle
3. The economic entity assumption

Brief Exercise 1-5

1. Disagree — The full disclosure principle
2. Agree — The periodicity assumption
3. Disagree — The matching principle
4. Agree — Revenue recognition criteria

Brief Exercise 1-6

1. The IFRS Foundation Trustees
2. The International Accounting Standards Board (IASB)
3. The International Organization of Securities Commissions (IOSCO)
4. The IFRS Advisory Council
5. The IFRS Interpretations Committee

EXERCISES

Exercise 1-1

Requirement 1

Pete, Pete, and Roy Operating Cash Flow	Year 1	Year 2
Cash collected	$160,000	$190,000
Cash disbursements:		
Salaries	(90,000)	(100,000)
Utilities	(30,000)	(40,000)
Purchase of insurance policy	(60,000)	- 0 -
Net operating cash flow	$(20,000)	$ 50,000

Requirement 2

Pete, Pete, and Roy Income Statements	Year 1	Year 2
Revenues	$170,000	$220,000
Expenses:		
Salaries	(90,000)	(100,000)
Utilities	(35,000)	(35,000)
Insurance	(20,000)	(20,000)
Net Income	$ 25,000	$ 65,000

Requirement 3

Year 1:	Amount billed to customers	$170,000
	Less: Cash collected	(160,000)
	Ending accounts receivable	$ 10,000
Year 2:	Beginning accounts receivable	$ 10,000
	Plus: Amounts billed to customers	220,000
		$230,000
	Less: Cash collected	(190,000)
	Ending accounts receivable	$ 40,000

Exercise 1-2

Requirement 1

	Year 2	Year 3
Revenues	$350,000	$450,000
Expenses:		
Rent ($80,000 ÷ 2)	(40,000)	(40,000)
Salaries	(140,000)	(160,000)
Travel and entertainment	(30,000)	(40,000)
Advertising	(25,000)	(20,000)*
Net Income	$115,000	$190,000

Requirement 2

Amount owed at the end of year one	$ 5,000
Advertising costs incurred in year two	25,000
	30,000
Amount paid in year two	(15,000)
Liability at the end of year two	15,000
Less cash paid in year three	(35,000)
Advertising expense in year three	**$20,000***

Exercise 1-3

1. Liability
2. Distribution to owners – decrease in equity
3. Income
4. Assets, liabilities, and equity
5. Revenue
6. Gain
7. Loss
8. Equity
9. Asset
10. Net income
11. Investment by owner – increase in equity
12. Expense

Exercise 1-4

Answer		List A	List B
o	1.	Predictive value	a. Decreases in equity resulting from transfers to owners.
h	2.	Relevance	b. Requires consideration of the costs and value of information.
g	3.	Timeliness	c. Important for making interfirm comparisons.
a	4.	Distribution to owners	d. Applying the same accounting practices over time.
j	5.	Confirmatory value	e. Users understand the information in the context of the decision being made.
e	6.	Understandability	f. Agreement between a measure and the phenomenon it purports to represent.
n	7.	Gain	g. Information is available prior to the decision.
f	8.	Faithful representation	h. Pertinent to the decision at hand.
k	9.	Expenses	i. Implies consensus among different measurers.
p	10.	Materiality	j. Information confirms expectations.
c	11.	Comparability	k. Decreases in equity from depletion of assets.
m	12.	Neutrality	l. The process of admitting information into financial statements.
l	13.	Recognition	m. The absence of bias.
d	14.	Consistency	n. Results if an asset is sold for more than its book value.
b	15.	Cost effectiveness	o. Information is useful in predicting the future.
i	16.	Verifiability	p. Concerns the relative size of an item and its effect on decisions.

Exercise 1-5

1. Materiality
2. Neutrality
3. Consistency
4. Timeliness
5. Predictive value and/or confirmatory value
6. Faithful representation
7. Comparability
8. Cost effectiveness

Exercise 1-6

	List A	List B
d	1. Matching principle	a. The enterprise is separate from its owners and other entities.
g	2. Periodicity	b. A common denominator is the dollar.
e	3. Historical cost principle	c. The entity will continue indefinitely.
i	4. Materiality	d. Record expenses in the period the related revenue is recognized.
h	5. Revenue recognition	e. The original transaction value upon acquisition.
c	6. Going concern assumption	f. All information that could affect decisions should be reported.
b	7. Monetary unit assumption	g. The life of an enterprise can be divided into artificial time periods.
a	8. Economic entity assumption	h. Criteria usually satisfied at point of sale.
f	9. Full-disclosure principle	i. Concerns the relative size of an item and its effect on decisions.

Exercise 1-7

1. The economic entity assumption
2. The periodicity assumption
3. The matching principle (also the going concern assumption)
4. The historical cost (original transaction value) principle
5. Revenue recognition criteria
6. The going concern assumption
7. Materiality

Exercise 1-8

1. The historical cost (original transaction value) principle
2. The periodicity assumption
3. Revenue recognition criteria
4. The economic entity assumption
5. The matching principle; materiality
6. The full disclosure principle

Exercise 1-9

1. Disagree — Monetary unit assumption
2. Disagree — Full disclosure principle
3. Agree — The matching principle
4. Disagree — Historical cost (original transaction value) principle
5. Agree — Revenue recognition criteria
6. Agree — Materiality
7. Disagree — Periodicity assumption

Exercise 1-10

1. Disagree /Agree (depending on the model used to value the land)
   —Under IFRS, the company has to decide whether to choose the cost model or the revaluation model to value property, plant, and equipment.
   Disagree for Cost Model: If the company had chosen the cost model to value its land, there will be a violation of the historical cost (original transaction value) principle.
   Agree for Revaluation Model: If the company had chosen the revaluation model to value the land, the land can be reported at market value subsequently, and there will not be any violation of accounting policies or principles.
2. Disagree — This is a violation of the economic entity assumption.
3. Disagree — This is a violation of the revenue recognition criteria.
4. Agree — The company is conforming to the matching principle.
5. Agree — The company is conforming to the full disclosure principle.
6. Disagree — This is a violation of the periodicity assumption.

Exercise 1-11

Statement		Assumption, Principle, Constraint
1.	f.	Revenue recognition
2.	h.	Full-disclosure principle
3.	g.	Matching principle
4.	e.	Historical cost principle
5.	c.	Periodicity assumption
6.	a.	Economic entity assumption
7.	i.	Cost effectiveness
8.	j.	Materiality
9.	b.	Going concern assumption
10.	d.	Monetary unit assumption

Exercise 1-12

1. b
2. c
3. d
4. b
5. b

CASES

Research Case 1-1

Requirement 1

In many countries, such as Canada, New Zealand, and the Philippines, accounting standards are set by a private-sector professional accounting body. In a few countries, such as Japan, the United Kingdom, and the United States, the private-sector standard setting body is independent of the government and of the accounting profession. In many other countries, such as Australia, France, India, and Singapore, the standard-setting organization is a governmental body.

Requirement 2

The accounting standards in different countries are not the same because of differences in legal systems, inflation rate, degrees of sophistication and use of capital markets, use of financial reports by tax or government authorities, and political and economic ties with other countries.

These differences can cause problems for multinational corporations who may find it difficult to comply with a few different sets of accounting standards. These differences also cause problems for investors who are comparing companies whose financial statements are prepared using different standards.

It is therefore necessary to form an organization to develop a single set of high-quality, understandable, and enforceable global and harmonized accounting standards that help participants in worldwide capital markets and other users to make economic decisions.

Requirement 3

The IASB does not have the authority to enforce the use of IFRS in different jurisdictions. It has to depend on each jurisdiction's regulatory authority to enforce the application of IFRS in that jurisdiction.

Research Case 1-2

Requirement 1

The IASB is supported financially by the IFRS Foundation, whose Trustee members are responsible for selecting the IASB members and members of the IFRS Advisory Council and the IFRS Interpretations Committee, exercising general oversight of the IASB's activities, and ensuring adequate funding. The Trustees are in turn appointed and monitored by the Monitoring Board, which consists of public capital market authorities.

The IFRS Advisory Council advises the IASB on matters concerning its agenda, projects, and work priorities. The IFRS Interpretations Committee provides interpretations for the application of existing IFRS and resolves specific accounting issues that are not specifically addressed by the IFRS, within the framework of existing IFRS. Regulatory oversight of the IASB is provided by the International Organization of Securities Commissions (IOSCO), which consists of representatives from securities markets regulators.

Requirement 2

The IASB issues the following types of standards:

1. International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS).
2. Conceptual Framework for Financial Reporting
3. International Financial Reporting Standards Interpretations (IFRICs and SICs)

Requirement 3

Before issuing a new or revised standard, the IASB undertakes a series of elaborate information-gathering steps which include public hearings, deliberations, and requests for written comments from interested parties. The following are the six steps that the IASB undertakes before issuing a new or revised standard:

1. Setting the agenda. The Board decides whether to add a project to its agenda.
2. Planning the project. The Board forms a project team, and comes up with a project plan.
3. Developing and publishing the discussion paper.
4. Developing and publishing the exposure draft.
5. Developing and publishing the standard.
6. After the standard is issued. The Board holds meetings with interested parties to discuss implementation issues.

Research Case 1-3

Requirement 1

The IASB is committed to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements. In addition, the IASB co-operates with national accounting standard-setters to achieve convergence in accounting standards around the world.

Requirement 2

The answers to this question will vary depending on the date the research is conducted. The IASB has 15 full-time Board members. Below is a list of the Board members as of July 2012:

•Hans Hoogervorst (chairman)
•Ian Mackintosh (vice-chairman)
•Stephen Cooper
•Philippe Danjou
•Jan Engström
•Patrick Finnegan
•Amaro Luiz de Oliveira Gomes
•Prabhakar Kalavacherla (‘PK’)
•Patricia McConnell
•Takatsugu Ochi
•Paul Pacter
•Darrel Scott
•John Smith
•Chungwoo Suh
•Zhang Wei-Guo

Many of the Board members had previously worked as public accountants, financial analysts, government authorities, standard setters and regulatory authorities in their own countries, corporate executives in multinational corporations, and accounting academics.

Requirement 3

London, United Kingdom.

Research Case 1-4

Requirement 1

The mission of the Financial Accounting Standards Board is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information.

Requirement 2

The FASB has seven full-time board members.

Requirement 3

The answer to this question will vary depending on the date the research is conducted. In 2012, the chairman of the FASB is Leslie F. Seidman. Her term expires on June 30, 2013.

Research Case 1-5

Requirement 2

In 1978, China's enterprise reform program was initiated. Prior to 1978, all business enterprises were state owned and run. Now, China's companies exhibit a considerable range of ownership structures. For example, the Contract Responsibility System was introduced to provide financial incentives to both workers and managers of state-owned enterprises. In addition, many state-owned enterprises were converted into companies with limited liabilities similar to corporations in the United States.

Requirement 3

The author feels that the accounting environment in China differs considerably from what is typically presumed by IFRS. In particular, the lack of independent/professional auditing in China implies that the proposed detailed IFRS-based standards may be counterproductive in China.

Communication Case 1-6

In the long run, a company will be able to provide investors with a return only if it can generate a profit. That is, it must be able to use the resources provided by investors and creditors to generate cash receipts from selling a product or service that exceed the cash disbursements necessary to provide that product or service. If this excess cash can be generated, the marketplace is implicitly saying that society's resources have been efficiently allocated. The marketplace is assigning a value to the product or service that exceeds the value assigned to the resources used to produce that product or service. Pollution costs to society should be borne by the company/individual causing the costs to be incurred. If they are, and the pollution-causing company can still generate a profit, then society's resources are still being allocated efficiently. From this perspective, it appears that information on pollution costs is *relevant* information to financial statement users.

However, even though this information might be relevant, it would not possess *faithful representation*. For example, how could we objectively measure the costs to society of dumping hazardous waste into a river? Fish and other river-life will die, drinking water will contain more pollutants, and the river will be a less desirable place for recreation. Some of these costs can be quantified (estimated), but others can't.

It is important that each student actively participate in the process of arriving at a solution. Domination by one or two individuals should be discouraged. Students should be encouraged to contribute to the group discussion by (a) offering information on relevant issues, and (b) clarifying or modifying ideas already expressed, or (c) suggesting alternative direction.

Communication Case 1-7

Suggested Grading Concepts and Grading Scheme:

Content (70%)

______ 30 Briefly outlines the standard setting process.
- _____ Role of IASB.
- _____ The process.

______ 20 Explains the meaning of economic consequences.

______ 20 Discusses the need to balance accounting considerations and economic consequences.

______ 70 points

Writing (30%)

______ 6 Terminology and tone appropriate to the audience of a business journal.

______ 12 Organization permits ease of understanding.
- _____ Introduction that states purpose.
- _____ Paragraphs that separate main points.

______ 12 English
- _____ Sentences grammatically clear and well organized, concise.
- _____ Word selection.
- _____ Spelling.
- _____ Grammar and punctuation.

______ 30 points

Ethics Case 1-8

Discussion should include these elements.

Auditors' Role in Examining Financial Statements:

The function of the auditor is to assure the fairness of financial statements and their compliance with accounting standards, not the verification of account correctness. As some items in financial statements are the result of estimates, auditors are unable to provide an opinion as to the exactness of an entity's financial position. Auditing Standards suggest that "present fairly" or “present a true and fair view” correlates to presenting financial information that is believable, reliable, and not misleading to users of the financial statements.

An auditor must provide an independent opinion on an entity's financial statements even though the entity pays the audit fee and the audit company performs other services such as the preparation of tax returns. In the United States, the Sarbanes-Oxley Act significantly restricts the additional services that an auditor can perform for an audit client. In many other countries, there are also legal regulations that restrict the additional services that an auditor can perform for an audit client.

Who is affected?

Auditors
Company management
Company employees and labor unions
Current and future shareholders
Creditors
Financial analysts
Government entities
Society in general

Ethical Values:

Ethical values pertaining to auditor responsibility include honesty, integrity, and service to the public, lack of bias, independence in attitude as well as appearance, and quality of work in conducting the audit. Many countries in the world have specific rules of conduct that demand these qualities of public auditors.

Ethics Case 1-8 (concluded)

Ethical issues or challenges:

1. Pressure from management to bias the audit opinion by threatening to withhold audit fee payment, to hire another audit firm, or to assign tax preparation work to another audit firm.
2. Pressure from management to bias the audit opinion by providing an expensive gift or an outright bribe to the auditor. Auditors should refuse all but nominal gifts from their clients.
3. Pressure to bias the audit opinion in favor of the client because the auditor, or family member, has a financial interest in the client beyond the audit fee. The interest could be in the form of an investment or a loan to or from the client.
4. Pressure to bias the audit opinion in favor of the client because the auditor, or family member, has current or future employment or is in a position of influence with the client.
5. An unfavorable opinion may provoke a lawsuit by investors and other injured parties against both the company and the auditors. Fear of litigation may prompt the auditors to give a favorable or clean opinion, when misleading information exists in the financial statements.

Judgment Case 1-9

The two primary qualitative characteristics of accounting information are relevance and faithful representation. However, these qualities can often conflict, requiring a trade-off between various degrees of relevance and faithful representation. A forecast of a financial variable may possess a high degree of relevance to investors and creditors. However, a forecast necessarily contains subjectivity in the estimation of future events. Since a forecast of the future is involved, information could be more easily biased and may contain material errors. Therefore, accounting standards do not require companies to provide forecasts of any financial variables.

Judgment Case 1-10

Requirement 1

Mary will be able to compare the financial statements due to the existence of accounting standards that provide both the broad and specific guidelines that companies should follow when measuring and reporting the information in their financial statements and related notes.

Requirement 2

Auditors examine financial statements to express an opinion on their compliance with accounting standards.

Judgment Case 1-11

Requirement 1

The desired benefit is that the new standard will provide a better set of information to external users. This will then increase the efficiency of the resource allocation process. The IASB will be better able to achieve an appropriate combination of relevance and faithful representation.

Requirement 2

The costs could include increased information-gathering, processing and dissemination costs to the companies affected, increased interpreting costs to users, and adverse economic consequences to the companies, their investors, creditors, employees, other interest groups as well as to society as a whole.

Requirement 3

The standards setting board undertakes a series of elaborate information gathering steps before issuing a new or revised accounting standard. These steps include open hearings, deliberations, and requests for written comments. These steps provide information to the board as to the possible benefits and costs of the new or revised standard.

Judgment Case 1-12

Requirement 1

IFRS requires the following criteria to be satisfied before revenue can be recognized:

(a) The amount of revenue, associated costs, and stage of completion (for sales of services) can be measured reliably,

(b) It is probable that economic benefits will flow to the seller, and

(c) The seller has transferred to the buyer the risks and rewards of ownership (for sales of goods).

Requirement 2

Disagree. Although at the beginning of the period, the first two criteria are satisfied (revenue and associated costs can be measure reliably and it is probable that economic benefits will flow to the seller), the seller has not provided the rental services to the buyer. Revenue should be recognized over the rental period, not at the beginning of the period.

Analysis Case 1-13

Requirement 1

The term *matched with revenues* means that an attempt is made to recognize expenses in the same period as the related revenues. Implicit in this definition is a cause-and-effect relationship between revenue and expense. However, difficulties arise in trying to identify cause-and-effect relationships. Many expenses are not directly incurred because of a revenue event.

Requirement 2

The four different approaches to implementing the matching principle are:

1. Recognizing an expense based on an exact cause-and-effect relationship between a revenue and expense event. Cost of goods sold is an example of an expense recognized by this approach.
2. Recognizing an expense by identifying the expense with the revenues recognized in a specific time period. Office salaries are an example of an expense recognized by this approach.
3. Recognizing an expense by a systematic and rational allocation to specific time periods. Depreciation is an example of an expense recognized by this approach.
4. Recognizing expenses in the period incurred, without regard to related revenues. Advertising is an example of an expense recognized by this approach.

Requirement 3

a.	The cost of producing a product	-	1.
b.	The cost of advertising	-	4.
c.	The cost of monthly rent on the office building	-	2.
d.	The salary of an office employee	-	2.
e.	Depreciation on an office building	-	3.

Judgment Case 1-14

Requirement 1

The key factor is whether or not the expenditure creates a benefit beyond the current period. If it does, then the expenditure should be capitalized and expensed in future periods when the benefits from that asset are realized. For example, if the expenditure is for the purchase of a machine that will be used for five years to produce products, the expenditure creates future benefits and should be capitalized.

On the other hand, if the expenditure is for this month's rent, no benefits beyond the current period are created and the expenditure should be expensed now.

Requirement 2

The key accounting principle related to this decision is the matching principle, which states that expenses are recognized in the same period as the related revenues.

Requirement 3

Yes, the materiality constraint. If an expenditure creates a benefit beyond the current period but the amount is below the materiality threshold, companies often expense rather than capitalize.

Real World Case 1-15

Requirement 1

The company's financial year ends on October 31, 2011.

Requirement 2

a.	**Total net revenues**	=	$127,245 million
b.	**Total operating expenses**	=	$117,568 million
c.	**Net income (earnings)**	=	$ 7,074 million
d.	**Total assets**	=	$129,517 million
e.	**Total shareholders' equity**	=	$ 39,004 million

Requirement 3

The statement of financial position reports 1,991 million shares issued as of October 31, 2011.

Requirement 4

The presentation of more than one year facilitates the ability of investors and creditors to compare the profitability of the company over time. This, in turn, provides important information for predicting future results.

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Requirement 1

a.	**Total revenues**	=	$ 14,524.8 million
b.	**Income from operations**	=	$ 1,271.3 million
c.	**Net income**	=	$ 1,148.8 million
d.	**Total current assets**	=	$ 9,779.2 million
e.	**Total shareholders' equity**	=	$ 14,502.8 million

Requirement 2

The company's basic earnings per share for 2011 was 91.4 cents.

Requirement 3

Note 2 contains a summary of the significant accounting policies that the company applied to prepare its financial statements.

It is important for users to know the accounting policies used by the company because such policies will affect the measurement amounts of many of the items recorded in the financial statements. In addition, when users are comparing the financial statements of Singapore Airlines over time or with those of other airlines or other companies, it is important for them to know the accounting policies applied. This is because differences in the financial statements could be due to the use of different accounting policies by the companies, or the use of different policies in the various financial periods compared.