CHAPTER 2

CONCEPTUAL FRAMEWORK UNDERLYING FINANCIAL REPORTING

ASSIGNMENT CLASSIFICATION TABLE

Topic	Brief Exercise	Exercise	Problem	Writing assignments
Usefulness of the Conceptual Framework (CF) and main components of CF		5, 7		1
Qualitative Characteristics	1,2,3,9	1,5,6,7	2,3,4,5,7,8	3,5
Elements	4,5,6,7	2,7	2,3,5,8	3
Foundational Principles		2,3,4,5,6,7,8,9,10	1,2,3,5,7,8	
Accounting choices		1,8	2,6,7	
Standard setting trends		8,10		
Fair value	8,10,11	11		4

ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
E2-1	Qualitative characteristics.	Moderate	20-25
E2-2	Elements of financial statements.	Simple	15-20
E2-3	Foundational principles	Simple	15-20
E2-4	Foundational principles	Moderate	20-25
E2-5	Foundational principles	Moderate	25-30
E2-6	Tradeoffs in financial reporting	Moderate	15-20
E2-7	*Accounting principles–comprehensive*	Moderate	15-20
E2-8	Full Disclosure	Complex	25-30
E2-9	Going Concern	Simple	15-20
E2-10	Revenue recognition principle	Moderate	15-20
E2-11	Fair Value	Moderate	15-20
P2-1	Financial reporting issues	Simple	10-15
P2-2	Accounting Principles - comprehensive	Complex	30-35
P2-3	Accounting Principles - comprehensive	Complex	30-35
P2-4	Tradeoffs in financial reporting	Moderate	20-25
P2-5	Accounting Principles - comprehensive	Complex	30-35
P2-6	Financial engineering.	Moderate	15-20
P2-7	Issues in financial reporting	Moderate	15-20
P2-8	Qualitative characteristics.	Moderate	20-30

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 2-1

(a) Completeness
(b) Relevance
(c) Neutrality
(d) Representational faithfulness
(e) Predictive value
(f) Freedom from material error
(g) Feedback value
(h) Comparability
(i) Understandability
(j) Timeliness
(k) Verifiability

BRIEF EXERCISE 2-2

(a) Verifiability
(b) Comparability
(c) Timeliness
(d) Comparability (knowledge of this fact enables better comparison over time).
(e) Neutrality
(f) Completeness
(g) Freedom from material error

BRIEF EXERCISE 2-3

(a) Economic entity or control
(b) Full disclosure
(c) Matching
(d) Historical cost
(e) Periodicity and timeliness
(f) Going concern
(g) Revenue recognition
(h) Fair value

BRIEF EXERCISE 2-4

a) A corporate fleet of cars for senior management is an asset: the cars are tangible economic resources. The cars have been acquired through a past transaction. Additionally, the cars are present economic resources that produce cash inflows in conjunction with other economic resources – the cars are used by senior management to generate cash flows for the company. By virtue of its ownership, the company has control over the assets.

b) A franchise licence to operate a Tim Hortons store is an asset: the licence is an intangible economic resource. It can be sold or used to generate revenues (subject to contractual terms). The agreement grants exclusive ownership and access to the franchisee. Additionally, the contractual rights provide a present economic resource that is not contingent on a future event.

c) Customized manufacturing machinery that can only be used for one product line and for which there is a small and limited customer market is an asset: the machine is a tangible economic resource. The fact that it is of limited use or applicability will factor in its measurement or valuation – this does not affect its recognition as an asset. It is capable of providing future economic benefit through its use by the manufacturing company that owns it.

(d)The guarantee is a present resource that allows the subsidiary access to capital on a reduced cost basis and resulted from a past transaction or event. The benefit of having the parent company's unconditional promise to pay is reflected through a lower interest rate from the bank. However, assuming the guarantee came at no cost to the subsidiary, in this case, it is not recognized as an asset.

BRIEF EXERCISE 2-4 (Continued)

(e) If the spring water is freely available to all, it is not a specific asset to FreshWater Inc. Although the water has value, it does not have economic value for purposes of the accounting definition as FreshWater Inc. does not legally own or control the spring and cannot restrict others' access to it.

(f) If Mountain Ski makes the snow on their own slopes, it can be considered their asset – the value may be short-lived however and the associated costs would generally be expensed when incurred. The snow is controlled by Mountain Ski only to the extent it falls on their property (which they have control over). Snow that falls naturally onto the land owned by Mountain Ski would be valued at $0 since it literally fell from the sky at no cost.

BRIEF EXERCISE 2-5

There is no difference between the current or proposed standards with respect to whether each item would be considered an asset or not, however, the support in each case differs slightly.

a) A corporate fleet of cars for senior management: the cars are tangible economic resources. The cars can be sold or used. Additionally, the cars are present economic resources that produce cash inflows in conjunction with other economic resources – the cars are used by senior management to generate cash flows for the company. By virtue of its ownership, the company has a right of access to these assets that others do not have.

b) Franchise licence to operate a Tim Horton's store: the licence is an intangible economic resource. It can be sold or used (subject to contractual terms). The agreement grants exclusive ownership and access to the franchisee. Additionally, the contractual rights provide a present economic resource that is not contingent on a future event.

c) Customized manufacturing machinery that can only be used for one product line and for which there is a small and limited customer market: the machine is a tangible economic resource. It can be sold or used. The fact that it is of limited use or applicability will factor in its measurement or valuation – this does not affect its recognition as an asset.

(d)The guarantee is a present resource that allows the subsidiary access to capital on a reduced cost basis. The benefit of having the unconditional promise to pay is reflected through a lower interest rate from the bank. Assuming the guarantee came at no cost to the subsidiary, the guarantee is not recognized as an asset.

BRIEF EXERCISE 2-5 (Continued)

(e) If the spring water is freely available to all, it is not a recognized asset of FreshWater Inc. Although the water has value, it does not have economic value for purposes of the accounting definition. As FreshWater Inc. does not have an enforceable right to prevent others from using the spring, it is not an asset.

(f) If Mountain Ski makes the snow on their own slopes, it can be considered their asset – the value may be short-lived however and the associated costs would generally be expensed when incurred. The snow is controlled by Mountain Ski only to the extent it falls on their property (which they have control over). Snow that falls onto the land owned by Mountain Ski would be valued at $0. The snow is freely available to all and not considered to have economic value since it literally fell from the sky and has no cost.

(Note to Instructor – the proposed IFRS definitions are worded to ensure more consistent application. They are not necessarily meant to change the underlying substance of the asset definition).

BRIEF EXERCISE 2-6

(a) Environmental remediation after a chemical spill when a law has been broken: this is a duty or responsibility that the entity must correct and has no discretion to avoid. An entity must follow the laws/regulations of the legal jurisdiction in which it operates with no ability to avoid the cost. These laws result in a legal liability if the entity violates the law. It is enforceable by law or statute. Once the entity has responsibility for the spill, the law will be sufficiently specific for it to be clear that the entity must bear the costs for clean-up. The obligation exists at the balance sheet date, assuming the spill event occurred prior to the balance sheet date, making it a present responsibility.

(b) Environmental remediation after a chemical spill when no law has been broken: If there is no legal burden or requirement to bear the remediation costs, whether there is a liability will depend on whether the entity actually has responsibility for remediation. It must be determined whether there are other means by which remediation is enforceable on the entity, that is, whether there is little or no discretion for the entity to avoid the costs. In some jurisdictions, specific actions by the entity, such as a statement accepting responsibility and agreeing to clean-up costs, may be sufficient to be enforceable in a court of law. Alternatively, it may represent a constructive obligation if the entity has remediated in previous situations; constructive obligations are discussed in Chapter 6 and 13. Again, it is assumed that the spill took place prior to the balance sheet date so that if the entity is obligated, it is a present duty or responsibility.

(c) Replanting trees under an existing contract: A liability exists once the transaction obligating the entity – cutting a tree – occurs (that is, it results from a past transaction or event). After that occurs, the entity has no ability to avoid the cost which will result in a future outflow of resources.

BRIEF EXERCISE 2-6 (Continued)

(d) Replanting trees based on a voluntary corporate policy: A constructive obligation exists even though the entity may not have a legal requirement to replant trees because its corporate policy has created the expectation that it will do so. See further discussion about constructive obligations in Chapter 6 and 13. It is a duty at the balance sheet date as it resulted from an event that occurred prior to the reporting date.

BRIEF EXERCISE 2-7

a) Environmental remediation after a chemical spill when a law has been broken: this is an economic burden or obligation as it will require an outflow of economic resources. An entity must follow the laws/regulations of the legal jurisdiction in which it operates. These laws result in a legal liability if the entity violates the law. The clean-up is a present obligation after the spill occurs since it is then enforceable by law or statute. The entity is clearly the obligor and the law will be sufficiently specific for it to be clear that the entity must bear the costs for clean-up.

b) Environmental re-mediation after a chemical spill when no law has been broken: If there is no legal burden or requirement to bear the remediation costs, whether there is a liability will depend on whether there are other means by which an obligation is enforceable on the entity. In some jurisdictions, specific actions by the entity, such as a statement accepting responsibility and agreeing to clean-up costs, may be sufficient to be enforceable in a court of law. Alternatively, it may represent a constructive obligation if the entity has remediated in previous situations; constructive obligations are discussed in Chapter 6 and 13.

c) Replanting trees under an existing contract: A liability exists since the entity has an economic burden, the entity is the obligor and the obligation is enforceable by law.

d) Replanting trees based on a voluntary corporate policy: A constructive obligation exists even though the entity may not have a legal requirement to replant trees because its corporate policy has created the expectation that it will do so. See further discussion about constructive obligations in Chapter 6 and 13.

(note to Instructor – the proposed definitions are worded to ensure more consistent application. They are not necessarily meant to change the underlying substance of the liability definition)

BRIEF EXERCISE 2-8

In general, the following should be noted:
In assessing whether an item is an asset, consideration is needed of these three essential characteristics:

1. **There is some future economic benefit to the entity.**
2. **The entity has control over that benefit.**
3. **The benefit results from a past transaction or event.**

Expenses are defined as decreases in assets through the ordinary revenue-producing activities of a company.

(a) **The land is a tangible economic resource owned by the company. The legal fees should be debited to the land account, as they are directly associated with acquiring the land (historical cost principle). These costs are associated with the land – they are not expenses associated with revenue producing activities and do not meet the definition of an expense.**

(b) **This is a tangible economic resource owned by the company. The driveway will last and have value for many years, and therefore it should be capitalized and depreciated.**

(c) **The contract provides a right for six months that is not contingent on future events. Only Alan and Cheng have the right to use the premises during the lease period (economic benefit). A prepaid asset will be established; the rent will be recognized as an expense over the 6-month period.**

BRIEF EXERCISE 2-8 (Continued)

(d) The building is a tangible economic resource being constructed by the company. Wages paid should be debited to the Building account during its construction, as they are part of the cost of that asset which will contribute to operations for many years (historical cost principle). They are also directly related to the construction of the building and required in order to get the asset ready for its intended use. These expenditures are not associated with the revenue producing activities of the enterprise and do not meet the definition of an expense in the current period.

(e) The patent represents an intangible economic resource; this resource provides a right that others do not have. The legal fees should be debited to the 'intangible asset' account since they are directly related to the patent that will contribute to future cash flows (historical cost). They are required in order to get the asset ready for its intended use.

(f) The delivery does not represent an economic resource; it represents an operating expense, as the benefits are used up as the service is provided. There are no future benefits. These costs are not associated with the flower inventory, and therefore they meet the definition of an expense.

(g) The flowers represent a tangible economic resource. The shipping costs are related to the flowers for sale and should be debited to the 'inventory' account as part of their historical cost. These costs are directly associated with the acquisition of the inventory – they are not expenses from revenue producing activities until the flowers are sold to customers.

BRIEF EXERCISE 2-9

(a) Equity – residual interest of owners
(b) Revenues – ordinary activities of company
(c) Assets
(d) Assets
(e) Expenses – ordinary activities of company
(f) Losses – peripheral or incidental activities
(g) Liabilities
(h) Equity – Distributions to owners

(i) Equity – Investments by owners

BRIEF EXERCISE 2-10

(a) Periodicity
(b) Monetary unit
(c) Full disclosure
(d) Control
(e) Revenue recognition
(f) Recognition
(g) Full disclosure
(h) Historical cost
(i) Fair value
(j) Going concern

BRIEF EXERCISE 2-11

The objective of financial reporting is to communicate information that is useful to investors, creditors, and other users in making their resource allocation decisions (including assessing management stewardship) about the economic resources and claims on them, as well as the financial performance. This objective represents the goals and purposes of financial accounting.

(a) Representational faithfulness - neutrality – Financial information should not favour one user or stakeholder over another. In addition, verifiability is a reasonable choice.

(b) Relevance – Financial information that makes a difference in the decision making of a user is being provided.

(c) Representational faithfulness – Accounting information should reflect the economic substance of business events or transactions. The lease, in substance, represents a financing arrangement through which Mohawk is purchasing the asset.

(d) Representational faithfulness - neutrality – Standards too must remain neutral and free from bias, regardless of the economic consequences.

*BRIEF EXERCISE 2-12

Investment 1—Level 3. Level 3 is the least reliable level since much judgement is needed based on the best information available. This often includes management judgements about how the markets would value the asset.

Investment 2—Level 1. Level 1 inputs provide the most reliable fair values because these inputs are based on quoted prices in an active market for the exact same item.

Investment 3—Level 2. Level 2 considers evaluating similar assets or liabilities in active markets or using observable inputs such as interest rates or exchange rates.

*BRIEF EXERCISE 2-13

Scenario 1: Cash flows are fairly certain

When the cash flows are fairly certain, the traditional approach works well. Under this approach, the stream of cash flows is discounted at a rate that reflects the riskiness of the cash flows. Therefore, the 6% rate would be used.

As such, the present value would be determined as follows:

PV of an annuity for 5 years at 6% = $421.24*

***using the PV factor of 4.21236 for an ordinary annuity at 6%**

Scenario 2: Cash flows are uncertain

When the projected cash flows are uncertain in timing or amount, the expected cash flow method works best. Under this approach, a risk-free rate is used to discount cash flows that have been adjusted for associated uncertainties. Additionally, this approach is more flexible when the cash flows vary over the term. As such, the present value would be determined as follows:

PV of [(25% X $75) + (75% X $100)] at 3% in five years

PV of $93.75 at 3% in five years = $80.87 **

**** using PV factor of .86261**

SOLUTIONS TO EXERCISES

EXERCISE 2-1 (20-25 minutes)

(a) Feedback value.

(b) It is generally the role of professional judgement to identify and balance tradeoffs between fundamental qualitative characteristics and enhancing qualitative characteristics. These include: between relevance and representational faithfulness; between relevance and verifiability; between relevance and comparability; between relevance and timeliness; between relevance and understandability. Note that the fundamental qualitative characteristics have precedence over the enhancing characteristics.
Constraint: Cost/Benefit
Note – other examples are also acceptable

(c) Neutrality.

(d) Not acceptable – in many cases, this goes against representational faithfulness. We should consider the substance of a transaction as well as its legal form.

(e) Neutrality.

(f) Understandability.

(g) Timeliness.

(h) Relevance.

(i) Comparability.

(j) Verifiability.

(k) Freedom from material error or completeness.

EXERCISE 2-2 (15-20 minutes)

(a)

1. **Gains, Losses.**
2. **Liabilities. – would be a liability under both current and proposed definitions**
3. **Equity (increase).**
4. **Equity (decrease).**
5. **Assets. – would be assets under both current and proposed definitions**
6. **Expenses.**
7. **Revenues (inflows of net assets) or expenses (outflows of net assets).**
8. **Equity.**
9. **Revenues, if it is the sale of a product sold in the normal course of business; otherwise it would be a gain.**
10. **Equity (decrease).**

(b)

1. **Asset – the contract represents a future economic benefit to which the entity is entitled and has control over. However, the amount of the benefit is uncertain: the fact that future recordings are necessary will factor into the valuation or measurement of the asset, and so it may not be recorded at any amount. Under the proposed definition, the contract is a present economic resource to which the entity has a right that is legally enforceable. As such, it would still meet the definition of as asset. Measurement uncertainty would be taken into account upon measurement (which may be zero when signed as noted above).**
2. **Asset – consignment inventory belongs to ReadyMart until it is sold to the final customer. It represents a benefit as it can be sold. The company still controls/has access (through legal title) even though physical possession is with the local retailer. This is the case under either the current or proposed definitions of an asset.**

EXERCISE 2-2 (15-20 minutes) (Continued)

3. **Liability – this contract represents an obligation that will result in the future outflow of resources, subject to the sale of the recordings. However, the transaction that obligates the company – sale of recordings – has to occur. At that point, a liability would exist. Under the proposed definition, the contract represents an unconditional requirement and an obligation that is presently enforceable, and so would meet the definition of a liability in either case. Under the proposed definition, the uncertainty would be taken into account on measurement.**

EXERCISE 2-3 (15-20 minutes)

(a) 4. Matching
(b) 8. Historical cost
(c) 10. Full disclosure
(d) 7. Going concern
(e) 2. Control
(f) 1. Economic entity
(g) 5. Periodicity
(h) 9. Fair value
(i) 3. Revenue recognition and realization
(j) 6. Monetary unit

EXERCISE 2-4 (20-25 minutes)

1. **Monetary unit**
2. **Full disclosure**
3. **Historical cost and matching**
4. **Going concern**
5. **Fair value**
6. **Historical cost**
7. **Full disclosure**
8. **Revenue recognition and realization**
9. **Full disclosure**
10. **Full disclosure**
11. **Economic entity**
12. **Periodicity**
13. **Matching/fair value**
14. **Historical cost**
15. **Matching**

EXERCISE 2-5 (25-30 minutes)

(a) A conceptual framework is useful for standard setters since having an established body of concepts and objectives helps them to develop additional useful and consistent standards. This results in a coherent set of standards and rules that are built upon the same foundation. An understanding of the underlying concepts helps the preparer and the auditor ensure consistent and meaningful application of the principles. Such a framework also increases the financial statement user's understanding of, and provides confidence in, financial reporting. It also enhances comparability of different companies' financial statements.

(b) Foundational principle or characteristic violated:

1. **Periodicity; relevance (predictive and feedback value); timeliness**
2. **Historical cost; verifiability; relevance**
3. **Historical cost or matching; comparability; representational faithfulness; relevance**
4. **Revenue recognition and realization; representational faithfulness**
5. **Full disclosure; representational faithfulness; relevance**
6. **Economic entity; free from material error, representational faithfulness**
7. **Control; comparability; representational faithfulness**
8. **Matching; free from error; relevance**
9. **Full disclosure and representational faithfulness (neutrality)**

(Note that other principles/characteristics may also be discussed. There is rarely a single right and wrong answer to these types of questions.)

EXERCISE 2-6 (15-20 minutes)

1. **While both of the fundamental qualities (relevant and representational faithfulness) should be present for financial information to be decision-useful, tradeoffs are often necessary. As an example, in an attempt to provide more relevant information, some additional time may be needed to compile the data (i.e. affecting timeliness), or perhaps some additional estimates or assumptions must be made (i.e. affecting verifiability). Providing complete and full information may impact understandability of the information.**
    a. **Additionally, there is a constraint in financial reporting: Cost/Benefit – information is not cost-free. The costs of providing the financial information should not outweigh the benefits of the financial information to its users.**
    b. **Further, materiality must be considered when assessing the relevance of information – information must have the potential to make a difference in the decisions being made, otherwise it is irrelevant.**
    c. **The goal is to provide a balance between the required level of detail but also make it condensed enough so that it is understandable at a reasonable cost. More is not always better.**
2. **Professional judgement must be exercised to ensure that the end product assists users in their decision making.**

EXERCISE 2-7 (15-20 minutes)

1. Definition of element – asset
Foundational principles – historical cost and matching

Maintenance and repairs expense	**2,000**	
Accounts payable		**2,000**

2. Qualitative characteristic – representational faithfulness
Definition of element – revenue
Foundational principles – revenue recognition

Cash	**18,000**	
Unearned revenue		**18,000**

3. Definition of element – asset
Qualitative characteristic – representation faithfulness
Inventory held on consignment is not an economic resource of Bounce; it is an economic resource to Rubber and Rubber has the right to this inventory. NO journal entry should be made by Bounce until the sale of the inventory to a third party.

4. Definition of element – expense
Foundational principles - matching
Qualitative characteristic – representational faithfulness

Prepaid insurance	**4,000**	
Cash		**4,000**

For item 4, a principle is not necessarily violated if the company is using the alternative method of recording prepayments and the appropriate adjusting entry is created as part of the year-end process.

EXERCISE 2-8 (20-25 minutes)

(a)

The financial statements are a formalized, structured way of communicating financial information. The full disclosure principle requires that information that is required for fair presentation that is relevant to decisions should be included in the financial statements, including the related notes. The notes are not only helpful to understanding the enterprise's performance and position—they are a required component of the financial statements. The full-disclosure principle recognizes that the nature and amount of information included in financial reports reflects a series of judgmental tradeoffs. These trade-offs aim for information that is:

- **detailed enough to disclose matters that make a difference to users, but**
- **condensed enough to make the information understandable, and also appropriate in terms of the costs of preparing and using it.**

More information is not always better. Too much information may result in a situation where the user is unable to digest or process the information.

Information about a company's financial position, income, cash flows, and investments can be found in one of three places:

1. **in the main body of financial statements**
2. **in the notes to the financial statements**
3. **as supplementary information, including the Management Discussion and Analysis (MD&A)**

EXERCISE 2-8 (Continued)

Some important points to remember:

1. **Disclosure is not a substitute for proper accounting.**
2. **The notes to financial statements generally amplify or explain the items presented in the main body of the statements.**
3. **Information in the notes does not have to be quantifiable, nor does it need to qualify as an element. Notes can be partially or totally narrative. Examples of notes are:**

    - **descriptions of the accounting policies and methods used in measuring the elements reported in the statements**
    - **explanations of uncertainties and contingencies**
    - **statistics and details that are too voluminous to include in the statements**

4. **Supplementary information may include details or amounts that present a different perspective from what appears in the financial statements. They may include quantifiable information that is high in relevance but low in reliability, or information that is helpful but not essential.**

(b)

1. **It is well established in accounting that revenues and expenses, including the cost of goods sold (or raw materials/consumables used), must be disclosed in the income statement. Disclosure of specific items such as interest expense and depreciation expense is mandatory under GAAP. Showing additional details also meets the objectives of financial statements for relevance: the classifications on the income statement help in providing predictive and feedback information. It also separates major categories of elements such as revenues from gains, and expenses from losses.**

EXERCISE 2-8 (Continued)

2. **The proper accounting for this situation is to report the full cost of the equipment as an asset and the note payable as a liability on the balance sheet. Offsetting is permitted in only limited situations where certain assets are contractually committed to pay off specific liabilities. Not showing the items separately would mean that certain elements of the financial statements would be missing and some key ratios would be affected. This also violates the cost principle since the equipment would not be shown at its acquisition cost.**

3. **One might argue that this event need not be disclosed in the financial statements since the amount of money involved is relatively small (i.e. not material) in relation to the net income of the business and should not affect the fairness of the presentation of the financial statements. Having said that, investors and other users might find this information material regardless of the size and the loss should therefore be reported, even if not separately identified as a line item on the statement.**

4. **According to GAAP, the basis upon which inventory amounts are stated (lower of cost and net realizable value) and the method used in determining cost (FIFO, average cost, etc.) should also be reported. The disclosure requirement related to the method used in determining cost should be emphasized, indicating that where possible alternatives exist in financial reporting, disclosure in some format is required. Assuming the categories of inventory are material, disclosure of the amounts of raw materials, goods in process and finished goods would also be reported, likely in a note cross referenced to the balance sheet.**

EXERCISE 2-8 (Continued)

5. A change in depreciation method is considered to be a change in estimate of the pattern in which the entity receives benefits from the asset. Therefore, it is accounted for prospectively; i.e., in the current and future periods only. Estimates are a fundamental part of accounting and to constantly go back and restate previous statements every time management changes its estimates would actually work against the idea of comparability. However, if the change in estimate has a significant effect on current or future periods, the change in estimate should be disclosed. This is consistent with the full disclosure principle.

EXERCISE 2-9 (15-20 minutes)

(a) The going concern assumption implies that a business entity will continue its operations for the foreseeable future and will be allowed to realize or utilize its assets and discharge its obligations in the normal course of business. This assumption affects the accounting measurement base for financial statement preparation and the allocation of costs and revenues among accounting periods. It is the basis of accrual accounting.

(b) If the assumption is not applicable, the historical cost principle loses its usefulness. Under this scenario, asset and liability values are better stated at net realizable values; additionally, the current versus non-current classification of assets and liabilities loses its significance. Depreciation policies are irrelevant since there is no longer a concern with allocating costs to future revenues.

1. **Net realizable value**
2. **Would not be disclosed. Liabilities would be valued at the amount required to be settled immediately and all would be presented as currently payable.**
3. **Would not be recognized. Depreciation would be inappropriate if the going concern assumption no longer applies. Assets would be valued at net realizable value.**
4. **Net realizable value.**
5. **Net realizable value (i.e. redeemable value).**

EXERCISE 2-10 (15-20 minutes)

(a) Under the revenue recognition principle, revenue is recorded when:

- **Risks and rewards have passed**
- **Revenue is measurable; and,**
- **Collectability is assured**

This model is further discussed in Chapter 6.

(b) Using the revenue recognition principle discussed in this chapter, revenue would be recorded as follows:

1. **Since the sales effort (i.e. passing of risks and rewards) is not complete until the flight actually occurs, revenue should not be recognized until December.**

2. **If collection can be reasonably assured and an estimate of uncollectible amounts can be made, then revenue can be recognized at the point of sale when the risks and rewards transfer to the purchaser. If an estimate for uncollectible amounts cannot be made, accounting reverts to a cash basis, and the sale is not recorded until payment is received (further discussed in chapter 6).**

3. **Revenue should be recognized on a per game basis over the season from April to October.**

4. **Revenue should be recorded at the time the sweater is shipped to the customer and charged to her credit card. Companies selling using on-line catalogues usually estimate an allowance (and a charge against sales) for expected returns, all based on prior experience or industry norms. The company would also use their past experience in estimating bad debt expense and an allowance for doubtful accounts. The usual treatment, therefore, is to recognize revenue when the goods are shipped, and to estimate any future charges that may arise in connection with that revenue.**

*EXERCISE 2-11 (15-20 minutes)

(a) At a minimum, an entity must determine

- **the particular asset being measured (its condition, specific nature, location, etc.)**
- **whether the assets will be valued by the market as a group or on a stand-alone basis – the highest and best use that is legally, physically, and financially possible will be used**
- **availability of data, valuation technique to use, use of observable inputs**

(b)There are three levels in the fair value hierarchy

Level 1	**level 1 inputs provide the most reliable fair values because these inputs are based on quoted prices in an active market for the exact same item**
Level 2	**level 2 is the next most reliable and considers evaluating similar assets or liabilities in active markets or using observable inputs such as interest rates or exchange rates.**
Level 3	**level 3 is the least reliable level since much judgement is needed based on the best information available. This often includes management judgements about how the markets would value the asset.**

*EXERCISE 2-11 (15-20 minutes) (Continued)

(c)

Land – standalone	**Level 1- Markets for land and real estate in general may not be very liquid nor necessarily transparent. Also there would be little if any evidence regarding sales of an identical piece of land. Therefore it is likely that no level 1 inputs are available.** **Level 2 – quoted market prices for similar properties in the area could be obtained. It would depend on whether or not the real estate market was experiencing sufficient volume. Sufficient volume to form a "normal market" would result in better information.** **Level 3 – management assumptions about how the market would value the land. In all likelihood, the company would have to rely on level 3 inputs to value the land, given the uniqueness of real estate in general.**

*EXERCISE 2-11 (15-20 minutes) (Continued)

Building – standalone	**Level 1- quoted market prices do not likely exist for the building. The market may publish statistics such as price per square footage however, these would likely be an aggregation of all buildings in the area and as such would not necessarily reflect market prices for this particular building. It is unlikely that level 1 inputs would exist for the building.** **Level 2 – see above comments. The prices per square foot may qualify as level 2 inputs (e.g. similar assets) as long as the market was active (sufficient transactions).** **Level 3 – management assumptions about cash flows that could be generated from the use of the building/discount rates.**
Equipment – standalone	**Level 1 – perhaps a market price exists for used equipment although if the equipment were older, it may be difficult to obtain the price for identical equipment.** **Level 2 – perhaps a market price exists for similar used equipment. Markets for used equipment often exist.** **Level 3 – management assumptions about cash flows that could be generated from the use of the equipment/discount rates.**
Overall manufacturing plant (i.e. value in use)	**Level 1 – unlikely to be an active market for the exact facility given its uniqueness.** **Level 2 – perhaps a market multiple or price/earnings ratio exists for similar lines of business.** **Level 3 – management assumptions about cash flows that could be generated from the use of the facility as a whole/discount rates.**

EXERCISE 2-12 (15 – 20 minutes)

(a) Hoda must consider the following three items:

- **The amount of cash flows that are expected from the investment. Dividends have been received in the past, but management would have to consider if those dividends are expected to continue and in what amount.**
- **The timing of the cash flows. Since cash flows will need to be discounted to a present value, it is relevant to consider when the cash is expected to be received.**
- **The risk involved in the cash flows. Hoda will need to consider the discount rate to be used in calculating the present value and whether that discount rate needs to be a risk-adjusted rate, or if the cash flows will be adjusted for risk of uncertainty**

Hoda will also need to consider how long the shares are intended to be held for, and what their purpose is for this investment – is it just to collect dividends, or do they intend to derive some other economic benefit from this company if they have some ability to exert some influence with their 25% ownership.

(b) Under the traditional approach, cash flows are discounted using the credit adjusted rate:

Annual cash expected = 80,000 x PV factor of annuity, 5 years, 6%

= 80,000 x 4.21236 = 336,989

Plus the sale proceeds expected at the end of year 5:

1,000,000 x PV factor of lump sum, 5 years, 6%

= 1,000,000 x .74726 = 747,260

The fair value is the sum of the two amounts:

= 336,989 + 747,260 = $1,084,249

EXERCISE 2-12 (15 – 20 minutes) (Continued)

(c) Under the expected cash flow approach, cash flows are adjusted for risk and are discounted at the risk free rate, since the cash flows already incorporate risk expected.

In this case, there is an 80% chance dividends of $80,000 will be received and a 20% chance they will be $50,000.

The probability weighted annual cash flow is:

80,000 x 80% = 64,000

50,000 x 20% = 10,000

74,000

Discounting the cash flows:

Annual cash flow = 74,000 x PV factor of annuity, 5 years, 4%

= 74,000 x 4.45182 = 329,435

Plus the sale proceeds expected at the end of year 5:

1,000,000 x PV factor of lump sum, 5 years, 4%

= 1,000,000 x .82193 = 821,930

The fair value is the sum of the two amounts:

= 329,435 + 821,930 = $1,151,365

(d) The expected cash flow approach is best since the cash flows are uncertain.

TIME AND PURPOSE OF PROBLEMS

Problem 2-1 (Time 10-15 minutes)

Purpose—the student is asked to describe the fundamental issues in financial reporting.

Problem 2-2 (Time 30-35 minutes)

Purpose—to provide the student with an opportunity to review again the basic principles, assumptions and constraints illustrated in the chapter. The student is asked to consider user needs and possible IFRS options.

Problem 2-3 (Time 30-35 minutes)

Purpose—to provide the student with the opportunity to examine a series of transactions that are biased towards understating net income. The student must recalculate the effect on NIBT after proposing adjustment.

Problem 2-4 (Time 20-25 minutes)

Purpose— to provide the student with an opportunity to describe various characteristics of useful accounting information and to identify possible trade-offs among these characteristics and to provide examples of trade-offs.

Problem 2-5 (Time 30-35 minutes)

Purpose— to provide the student with an opportunity to review again the basic principles, assumptions and constraints illustrated in the chapter. The student is asked to agree or disagree with each of these situations.

Problem 2-6 (Time 15-20 minutes)

Purpose— to provide the student with the opportunity to examine a series of transactions that involve financial engineering and to determine where on the continuum of choices in accounting decision-making the transactions fall.

Problem 2-7 (Time 15-20 minutes)

Purpose—to provide the student with the opportunity to discuss considerations and tradeoffs in financial reporting.

Problem 2-8 (Time 20-30 minutes)

Purpose— to provide the student with the opportunity to discuss the relevance and reliability of financial statement information. This case provides a good writing exercise for students, as the instructions require the answer to be presented in the form of a business letter.

SOLUTIONS TO PROBLEMS

PROBLEM 2-1

Recognition/ derecognition: deals with the act of including something in the company's financial statements. Accounting standards provide criteria or guidance as to whether an item should be recognized, how it should be recognized, and when it should be recognized. Standards also cover when items are derecognized, or removed from the financial statements.

The broad principles associated with recognition/derecognition are economic entity, control, revenue recognition/realization, and matching.

Measurement: business transactions must be converted to dollar values in order to be recorded in the financial ledgers. Accounting standards provide criteria or guidance on the method(s) to be used for measurement and how to apply these method(s).

The broad principles associated with measurement are periodicity, monetary unit, going concern, historical cost, and fair value.

Presentation: various classifications are available for portraying accounting balances in the financial statements – short term v. long term; current v. noncurrent; operating v. nonoperating, debt v. equity, etc.

Disclosure: accounting information may be provided on the face of the financial statements, in parentheses, or in notes.

The broad principle associating presentation and disclosure is full disclosure.

PROBLEM 2-2

(a) It should be noted that the users are sensitive to Fuster's debt, equity, and asset amounts since they are used to calculate debt covenant requirements. If these amounts are not appropriately recognized, measured, presented, and disclosed, the users could make incorrect decisions.

Additionally, since the management bonus is partially dependent on the revenues for the year, this figure is also sensitive for the internal users.

(b) Appropriate accounting for each transaction:

Transaction 1.
Depreciation is an allocation of cost, not an attempt to value assets. As a consequence, even if the value of the building is increasing, the remaining costs related to this building should be matched with revenues on the income statement. A change in the residual value is a change in accounting estimate, requiring the determination of a revised depreciation rate. As such, making no entry violates the matching principle.

This error will affect the equity and assets used in the covenants. By failing to record depreciation expense in the year, net income and ending shareholders' equity are both overstated as is the return on assets ratio. This error likely does not affect the management bonus that is based partially on revenues reported, unless the other part is based on net income, for example.

Transaction 2.
This transaction should not be recorded at this time, as no business or economic transaction has occurred. This entry violates the representational faithfulness quality and also does not satisfy the requirements of the 'recognition' principle: the definition of an 'element' (i.e. asset or liability) and the probability criteria have not been fulfilled. Historical cost principle is also violated.

An asset will be recognized only when the item is actually purchased or the equipment is upgraded. Additionally, no liability exists; there is no obligation for Fusters to install the pollution control equipment until the legislation is actually passed in the future. The company is currently in compliance with environmental laws and feels that they are acting in a responsible manner regarding dealing with pollution.

PROBLEM 2-2 (Continued)

This error affects both the asset and liability numbers in the debt covenants. No effect on the management bonus of this error, depending what the other part of the bonus is based on.

Transaction 3.
The disposal and associated gain should be recognized when they occur. Deferral of the gain is not permitted, as it has been both realized and earned. The future purchase is a separate transaction and must be accounted for separately from the disposal. Netting and offsetting the transactions is not permitted.

This error will affect the equity (gain not recorded in net income affecting retained earnings) in the covenant calculation as well as the return on assets, as the net income is likely the numerator for that ratio. This 'gain' (i.e. peripheral activities) likely does not affect the bonus which is based on 'revenues' from ordinary operating activities

Transaction 4.
Based on the information provided, the sale should be recorded in 2014 instead of 2013. In this situation the shipping terms are irrelevant (whether the terms are FOB shipping point or FOB destination) since the transaction occurred in 2014.

This error affects equity and assets (accounts receivable) in the debt covenant calculations. This error also affects revenue, thus impacting the management bonus.

(c) Option exists for Transaction (1)

As indicated above, instead of making no depreciation entry in the year, the company must recognize depreciation expense. However, with an increase in the residual value, the annual depreciation expense can be reduced below the $45,000 amount under the past estimates.

As discussed later in the text (see Chapter 10) there is an additional option under IFRS for property, plant, and equipment. The revaluation method may be used and the revaluation gain will be recorded in other comprehensive income in equity. However, the need for a depreciation entry remains unchanged under IFRS.

This option would permit Fusters to account for the fair value changes in its property, plant and equipment; thereby providing more relevant decision-useful information to its users without violating the accounting principles.

PROBLEM 2-3

1. This entry is fine as long as the land is determined to be impaired or is designated as held for sale by the company. Losses are generally recognized when they are likely or probable and measurable. As prices are depressed, the company should review for impairment (further discussed in Chapter 11) and/or make a decision as to whether the land is held for sale (further discussed in chapter 4). If impaired, the land would be reduced to its recoverable amount (higher of value in use and fair value less cost to sell). If designated as held for sale, the land would be written down to fair value less cost to sell.
   This entry, by reducing net income, would lower the divorce settlement available to the president's wife so care should be taken regarding the above analysis to ensure that it is properly supported.

2. The historical cost principle indicates that assets and liabilities are accounted for on the basis of cost. If we were to select sales value, for example, we would have an extremely difficult time establishing a sales value for a given item without selling it. It should further be noted that the revenue recognition principle provides the answer to when revenue should be recognized. Revenue should be recognized when the risks and rewards have passed. In this situation, an earnings process has definitely not taken place.
   This error, by inflating net income, would have increased the divorce settlement available to the president's wife.

3. General recognition criteria state that an item should be recognized when it: meets the definition of an element; it is probable; and it is measurable. In this case, the lawyers have given an opinion that the loss is not probable. Further, the definition of a liability has not been met as there is not a current obligation requiring future settlement. The payment is contingent upon a future event. It is not clear that the company is at fault and at the present time, they have broken no laws or created any expectations that they will settle. This event would not require recognition based on these general criteria.

   Further, neutrality is likely being violated by this overly conservative accounting. It might seem that the loss has been recorded to reduce net income to impact the divorce settlement.

PROBLEM 2-3 (Continued)

This error, by reducing net income, would lower the divorce settlement available to the president's wife.

4. Accountants (and GAAP) do not recognize price-level adjustments in the accounts (unless the company is in a hyperinflationary economy and constrained by IFRS). Hence, it is misleading to deviate from the assumption that the value of the measuring unit does not change. It should also be noted that depreciation is not so much a matter of valuation as it is a means of cost allocation. Assets are not depreciated on the basis of a decline in their fair market value, but are depreciated on the basis of systematic charges of costs against revenues as the asset benefits are used up. This error, by reducing net income, would incorrectly lower the divorce settlement available to the president's wife.

5. Most accounting methods are based on the assumption that the business enterprise will have a long life. Acceptance of this assumption provides credibility to the historical cost principle, which would be of limited usefulness if liquidation were assumed. Only if we assume some permanence to the enterprise is the use of depreciation policies justifiable and appropriate. Therefore, it is incorrect to change to a liquidation value as Lucky Bamboo, Inc. has done in this situation. It should be noted that only where liquidation appears imminent is the going concern assumption inapplicable. In addition, the acquisition of the goodwill was a current period transaction, so it is doubtful the goodwill would be considered impaired after so little time. It is unlikely that any entry should be made in this situation.

   Also note that when goodwill is tested for impairment and needs to be written down, the debit is made to a loss account – not directly to retained earnings as indicated in the journal entry provided (further discussed in Chapter 12).

6. The answer to this situation is the same as 2.

PROBLEM 2-4

(a) (Note to instructor: There are a multitude of answers possible here. The suggestions below are intended to serve as examples only.)

1. Forecasts of future operating results and projections of future cash flows may be highly relevant to some decision makers. However, they would not be as verifiable as historical cost information about past transactions. Additionally, such information would require estimates and assumptions that would increases the subjectivity of the information.

2. Proposed new accounting methods may be more relevant to many decision makers than existing methods. However, if adopted, they would make trend comparisons of an enterprise's results over time difficult or impossible.

3. Providing estimates of future cash flows would be useful for decision making, but they involve significant data which may be time-consuming to obtain and may be somewhat subjective.

4. Occasionally, relevant information is exceedingly complex. Judgement is required in determining the optimum trade-off between relevance and understandability. Information about the impact of general and specific price changes may be highly relevant but not understandable by all users.

(b) Financial information must be relevant and representationally faithful. Often the other enhancing characteristics of useful information may have to be sacrificed. Although trade-offs result in the sacrifice of some desirable quality of information, the overall result should be information that is more useful for decision-making. What the proper trade-off is will depend on the facts and circumstances - ultimately, this will come down to the users' needs.

The accounting profession is continually striving to produce financial information that meets all of the qualitative characteristics of useful information.

PROBLEM 2-5

1. Agree. This is a change in how Sheridan does business. The revenue recognition principle requires that the risks and rewards of ownership be transferred to the purchaser in order for the sale to be recognized. While the shipping terms have been changed, further investigation should be undertaken to ensure that customer business practices are aligned with this changed policy. For example, if the company will continue to replace items lost or damaged in transit, the risks have not passed, irrespective of the change in shipping terms, and the timing of revenue recognition should not change. (further discussed in Chapter 6).

2. Agree. Depreciation is a means of cost allocation on a systematic charge against revenues. As it is based on best estimates, the useful life, and resulting depreciation expense, should be revised when economic or business events dictate that an asset will remain useful for a longer period. While comparability is impaired, changes in estimates are accounted for prospectively. Restatement would not provide decision useful information, since depreciation of the prior periods was determined with the best estimates available at the time. All estimates and judgements used to prepare the financial information should be free from bias, error or omission. The change is acceptable as long as it is supported by evidence that the equipment is lasting longer and is not a change simply to reduce annual depreciation expense.

3. Agree. The full disclosure principle recognizes that reasonable condensation and summarization of the details of a corporation's operations and financial position are essential to readability and comprehension. Thus, in determining full disclosure the accountant makes decisions on the basis of whether omission will cause a misleading inference by the reader of the financial statements. Only the total amount of cash is generally presented on a balance sheet, unless some special circumstance is involved such as a possible restriction on the use of the cash. In most cases, however, the company's presentation would be considered appropriate and in accordance with the full disclosure principle. Showing the additional detail on the balance sheet would not be relevant to the reader.

PROBLEM 2-5 (Continued)

4. Disagree. The historical cost principle indicates that assets and liabilities are accounted for on the basis of cost. If we were to select sales value, for example, we would have an extremely difficult time in attempting to establish an appraisal value for the given item without selling it (i.e. verifiability violated). It should further be noted that the revenue recognition principle provides guidance as to when revenue should be recognized. In this case, the revenue was not earned because the transfer of risks and rewards (i.e. "sale of the land") had not occurred. In addition the development costs of subdividing the land should be included in inventory cost of the lots and appear on the balance sheet, and not as expenses of the period. These costs are associated with the land (economic resource) – not an expense associated with the revenue producing activities for the year.

   NOTE: IFRS allows investment property to be measured at fair value. Land to be developed and sold does not qualify as investment property, so this standard does not apply (IFRS 40.08 and .09). The company could use the revaluation model as an accounting policy choice under IAS 16. (This will be covered in Chapter10).

5. From the facts it is difficult to determine whether to agree or disagree with the president. Comparability requires that accounting entities give accountable events the same accounting treatment from period to period for a given business enterprise. The choice of accounting policy should not be made based on the impact on net income but rather on the method that provides the most relevant information (i.e. neutrality and free from bias could be violated). It might be useful for users if Sheridan reports on a moving average basis as it would make the statements more comparable across other companies in the same industry

6. Disagree. While there is an economic burden as a result of the new legislation, this is not a present obligation since the new law cannot be enforced until 2019. A liability does not exist in fiscal 2014.

7. Disagree. The voluntary recall establishes an unconditional economic burden for Sheridan. This is a present obligation that is legally enforceable based on Sheridan's recall announcement. A liability should be provided at the time the recall is made.

PROBLEM 2-6

1. This transaction may be a bona fide business transaction but it is structured to minimize the impact on debt covenants. By modifying the payment terms (and with the creditor's agreement), the company president will move the payable into long-term debt and improve the company's current ratio. Care should be taken to ensure all legal documentation is in place on a timely manner so that the financial statements reflect the true nature of the transaction.

2. This may be an aggressive interpretation of GAAP. Capital assets should be tested regularly for impairment and written down when their cost will not be recovered. The timing of the write-down to coincide with lower levels of net income indicates that the controller may be trying to show improved financial results in future years. The controller is taking advantage of current poor financial results to write down the capital assets, thereby improving future years' results when those write-downs would have otherwise been recorded.

3. This is an example of a bona fide business transaction with no bias. Companies should select the inventory cost assumption that best approximates the cost flow. As well, under GAAP, this change in accounting policy would be accounted for retrospectively – hence full disclosure would sufficiently inform the users.

4. Under IFRS, companies must capitalize interest on self-constructed assets; under ASPE, companies have an accounting policy choice. Since the policy is applied to only one property, this indicates that the policy may have been set with key financial ratios in mind. As such, this would mean that the sole purpose is to make the financial statements look better, which is not an acceptable approach to selecting policies.

5. This is an example of a business transaction entered into for the sole purpose of making the financial statements show revenue on merchandise where it is unlikely that the risks and rewards of ownership have, in fact, passed to the other party. What would happen if the business owner's ultimate customer decided not to proceed with the purchase? Would the business owner have an agreement with the business associate that it would repurchase the goods? Who is insuring the goods? What is the nature of the "holding company"? Care should be taken to investigate whether all the revenue recognition criteria have actually been met.

PROBLEM 2-6 (Continued)

6. This represents an error in the application of GAAP. Under the economic entity and control principles, Maher Company does not have control over the investee and as such its assets and liabilities are not part of Maher's economic resources and obligations and would not be consolidated.

PROBLEM 2-7

1. Costs likely exceed the benefits. Information about competitors might be useful for benchmarking the company's results but if management does not have expertise in providing the information, it could lack neutrality and verifiability. In addition, it is likely very costly for management to gather sufficiently reliable information of this nature.

2. Costs likely exceed the benefits. While users of financial statements might benefit from receiving internal information, such as company plans and budgets, competitors might also be able to use this information to gain a competitive advantage relative to the disclosing company. Note, however, that this information would be useful to users.

3. Costs likely exceed the benefits. In order to produce forecasted financial statements, management would have to make numerous assumptions and estimates, which would be costly in terms of time and data collection. Because of the subjectivity involved, the forecasted statements would lack neutrality and verifiability, thereby detracting from any potential benefits. In addition, while management's forecasts of future profitability or balance sheet amounts could be of benefit, companies could be subject to shareholder lawsuits if the amounts in the forecasted statements are not realized.

4. Costs likely exceed the benefits. It would be excessively costly for companies to gather and report information that is not used in managing the business.

5. Benefits likely exceed costs. Flexible reporting allows companies to "fine-tune" their financial reporting to meet the information needs of its varied users. In this way, they can avoid the cost of providing information that is not demanded by its users.

PROBLEM 2-8

Dear Uncle Warren,

I received the information on Jingle Corp. and appreciate your interest in sharing this venture with me. However, I think that basing an investment decision on these financial statements would be unwise because they are neither relevant nor representationally faithful.

One of the most important characteristics of accounting information is that it is relevant, i.e., it will make a difference in the users' decision. One element of relevance is predictive value and Jingle's accounting information proves irrelevant in this regard. Shown without reference to other years' profitability, it cannot help me predict future profitability because I cannot see any trends developing. Closely related to predictive value is feedback value. These financial statements do not provide feedback on any strategies, which the company may have used to increase profits.

These financial statements are also not representationally faithful. The accounting information must reflect the underlying substance of the events and transactions. As a financial statement user, I should be able to see what lies beneath the numbers and feel comfortable that it is complete, neutral and free from bias or error.

Another quality of decision-useful financial information is that it should be timely. Because Jingle's financial statements are a year old, they have lost their ability to influence my decision: a lot could have changed in that one year. The information must be verifiable by several independent parties. Because no independent auditor has verified these amounts, there is no way of knowing whether or not they are represented faithfully. For instance, I would like to believe that this company earned $2,424,240, and that it had a very favourable debt-to-equity ratio. However, unaudited financial statements do not give me any reasonable assurance about these claims. Financial statements prepared by the company should be of sufficient quality and clarity so that I can understand the item's significance.

Finally, the statements are missing additional information that is normally available through note disclosures. Without these note disclosures, I cannot assess if the accounting policies followed are in accordance with GAAP, or their impact on the information presented.

Finally, the fact that Mrs. Jingle herself prepared these statements indicates a lack of neutrality. Because she is not a disinterested third party, I cannot be sure that she did not prepare the financial statements in favour of her husband's business.

PROBLEM 2-8 (Continued)

Under the circumstances, I do not wish to invest in the Jingle bonds and would caution you against doing so. Before you make a decision in this matter, please call me.

Sincerely,

Your Nephew

CASES

See the Case Primer on the Student Website as well as the summary case primer in the front of the text. Note that the first few chapters of the text lay the foundation for financial reporting decision-making. Therefore the cases in the first few chapters (1-5) are shorter with less depth. As such, they may not cover all aspects of a full-blown case analysis. The solutions to these cases are based on the conceptual framework and not a specific GAAP such as ASPE or IFRS.

CA 2-1 BRE-X

Overview

Given that the company was in the mining industry and had recently suggested that it had discovered a large gold deposit in Indonesia, much of the value of the shares would be attributable to the potential value of the unmined gold. The main asset on the balance sheet would have related to the property. Many investors relied on the existence of potential gold and subsequently lost a lot of money.

Management may have had a bias to delay making the negative findings public in hopes that the samples were not representative of the extent of the rest of the gold deposits.

GAAP standards were a constraint given that the company was a public company with shares traded on the Toronto and Montreal exchanges in Canada and on the NASDAQ in the U.S.

Analysis and Recommendations

The issue is one of asset impairment (measurement). The company did not write the assets down nor disclose the problem in the notes to the financial statements.

NB: The case uses the conceptual framework only to analyze the issues (as opposed to any particular specific GAAP body of knowledge such as IFRS).

CA 2-1 (Continued)

Write assets down/disclose	Do nothing
- The main asset on the balance sheet would be for the property. Therefore this was a **material** issue. - Note that the full value of the gold would not be capitalized on the balance sheet – only the costs to develop the mines. Nonetheless, even the **future benefit** of those values would be in question if there was very little or no gold. - Management knew or should have known that the gold discovery was driving the share value and therefore, this information was **decision relevant.** - The salting of the sample was a fraud – a deliberate intent to mislead. The information was therefore **biased.** - The **full disclosure** principle would dictate at least disclosing the problem as soon as it was discovered. - Other.	- Perhaps management felt that it was too early in the game to disclose the bad news i.e. they might have delayed disclosing the information in hopes of doing more exploration to substantiate the fact that gold did exist. There was significant **uncertainty** regarding whether there was a problem or not. - Given **measurement uncertainty**, it would have been difficult to measure the potential loss. - Sending a message without trying to explain the outcome might have panicked investors. - Other.

In conclusion, it is difficult to justify not at least disclosing the information since it was clearly a decision relevant to the investors.

CA 2-2 BENNETT ENVIRONMENTAL

Overview

The company is in the business of treating/neutralizing contaminated material. As such, it is at risk for potential claims against the company for environmental damage – either resulting from the treatment process or because the cleanup site was not properly cleaned. Because the company transports the contaminated material, there is a risk of spillage.

Investors will be interested in how the company is managing these risks and will be looking for any hints of potential related losses. The current loss of $9.3 million and the accumulated deficit point to possible financial difficulties.

The company is a public company (shares traded on the TSX) and therefore IFRS is a constraint (not given in the case, however, students should be able to look this up).

NB - Students may use the conceptual framework for the analysis.

Analysis and Recommendations

Issue: How to treat the transportations costs

Expense	Capitalize
- These costs do not add any value to the asset and should therefore be expensed. - When the amount is reimbursed, ensure that it is credited to the expense line. - Other.	- These costs are part of the costs to get the “raw materials” in place and ready for processing. - They therefore make up part of the cost of the asset. Since they are reimbursable, they represent a future benefit through future cash flows. - Because of the unique business model, it makes sense to capitalize these costs. - Other.

Since the costs are reimbursable they should be capitalized as a type of inventory. This is very similar to purchasing goods for a customer where the sale will occur in a future period. In both cases, the future benefits are the expected future cash receipts as the service/product sale is completed. If service revenue is recognized (accrued) instead as the service is performed, then the costs incurred for transportation should be expensed to match them with the associated revenue.

CA 2-2 (CONTINUED)

Issue: Lawsuit

Recognize a liability/disclose	Do not recognize/disclose
- The entity should recognize a liability for the lawsuit if the company's lawyers feel that a liability exists. All information would have to be taken into account including whether they did indeed commit fraud, and if so, the potential settlement. - The company would assess whether a settlement is probable and measurable. - Relevant information – most users would likely want to know if fraud had been committed. - Other.	- Disclosure/recognition might prejudice the case. - At year-end, too much measurement uncertainty – thus information not meaningful (would not add value since so much uncertainty). - Since the proceedings have been halted, this adds additional uncertainty. - Other.

CA 2-3 TIMBER COMPANY

Overview

Since this is a public company, IFRS would be a constraint. As noted above, the analysis may be prepared using the conceptual framework (only) without reference to specific IFRS.

The nature of the industry is such that the main asset is the property including the trees which are still growing. Much of this value will be unrecognized since the asset recognized on the books would include the price to purchase the land (if owned) plus perhaps any costs directly related to getting the trees ready for sale (growing costs and labour). This issue is one of measurement or valuation of the assets. Thus the main asset on the balance sheet may be understated – even though there may be a bias for management to reflect the true value.

Management may be looking to make the statements look better to compensate for this.

CA 2-3 (Continued)

Analysis and Recommendation

Value the property at laid down cost	Value the property at fair value
- The **historical cost principle** supports valuing the property at the **laid down cost** (i.e. the acquisition cost) plus any costs incurred to **get the asset ready for the intended use.** - The trees will grow and therefore increase in value each year. They are similar to **self-constructed assets** and thus any costs incurred in "producing" the trees would be capitalized. This might include **direct material** (such as fertilizers) and **direct labour** (the labour costs to facilitate growth) and a **reasonable allocation of overhead** – all **similar to inventory**. - Costs such as pesticides etc. might be seen as **maintenance** costs rather than part of the cost of the asset since they must be incurred as part of the ongoing daily operations to maintain the value of the assets (rather than increasing the value). - The **historical cost principle** precludes measurement at selling price due to the **measurement uncertainty** associated with that value. - Lumber is a commodity and the price is affected by supply and demand. Wood may easily be damaged by infestations (and thus become worthless). Thus there is significant **measurement uncertainty** surrounding valuing the asset at other than historical cost.	- The main argument for fair value accounting rests with providing **relevant** information. - Without this information, the investor is left guessing at the value. Thus the financial statements do not provide **useful information**. - It is easier for management to assess the value since they have more information about the company (than the investor who is really an outsider to the company and has little additional details about the company other than what they are given by the company). - Companies know how many hectares of trees they have and also must be able to convert this to lumber yield based on history. Lumber costs are available. Thus the **value is measurable** if only within a range. - Other.

CA 2-3 (Continued)

- A **reciprocal exchange with an outside party** will not occur until the trees are sold. At this point, the measurement uncertainty is resolved. - Other.	

In conclusion, given the measurement uncertainty, the trees should be reported at cost. In order to provide more meaningful information, the company may always provide detailed additional note disclosures.

[On the other hand, students should note that IAS 41 deals with biological assets and requires fair value accounting where the activity is managed by the entity and fair values can be reliably measured. This is often the case in such an established industry. In general, the measurement uncertainty issue is resolved by increased disclosure requirements about how fair value measures are determined.]

TIME AND PURPOSE OF WRITING ASSIGNMENTS

WA 2-1 (Time 20-25 minutes)

Purpose—to provide the student with the opportunity to comment on the purpose of the conceptual framework.

WA 2-2 (Time 25-35 minutes)

Purpose—to provide the student with some familiarity with the concepts of faithful representation, reliability, substance over form and conservatism and neutrality. The students are also asked to address what should be disclosed when there is a true and fair view override of an accounting standard as allowed under IAS 1.

WA 2-3 (Time 20-25 minutes)

Purpose—to provide the student with an opportunity to assess different points to report costs as expenses. Direct cause and effect, indirect cause and effect, and rational and systematic approaches are developed. Specifically, the students are to address also the issues of matching and the definition of an asset.

WA 2-4 (Time 15-20 minutes)

Purpose—to provide the student with the opportunity to use the fair value hierarchy. Five different situations are given where fair values have been used and the student is asked to assess what level and method has been used, and what disclosures should be provided by the reporting entity to assist the user.

WA 2-5 (Time 10-15 minutes)

Purpose—to provide the student with the opportunity to apply the definition of a liability to different situations and to determine if a liability exists.

SOLUTIONS TO WRITING ASSIGNMENTS

WA 2-1

A conceptual framework is like a constitution. Its objective is to provide 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."

A conceptual framework is necessary so that standard setting is useful, i.e., standard setting should build on and relate to an established body of concepts and objectives. A well-developed conceptual framework should enable the AcSB and IASB to issue more useful and consistent standards in the future.

Specific benefits that may arise are:

1. A coherent set of standards and rules should result.
2. New and emerging practical problems should be more quickly solvable by reference to an existing framework.
3. It should increase financial statement users' understanding of and confidence in financial reporting.
4. It should enhance comparability among companies' financial statements.
5. It should help determine the bounds for judgement in preparing financial statements.
6. It should provide guidance to the body responsible for establishing accounting standards.

Having a separate conceptual framework for ASPE and for IFRS better addresses the factors that are most relevant to the companies applying the different standards. Since the reporting needs differ greatly between public companies and private companies, it is appropriate that a different conceptual framework be used to structure the reporting standards for each.

WA 2-2

(a) “Faithful representation” means the financial statements reflect the economic substance of transactions that have occurred. In doing so, the statements must be complete, neutral and free of error. The Board found that the word “reliability” had different meanings with users. Some used the term to mean *verifiability* or *free from error*. Some used it to mean “faithful presentation combined with neutrality”. Others used the term to mean *precision*. In addition, the Board had found historically that when new standards were proposed, the criticisms received always referred to reliability. In some cases, critics stated that the new proposal would not result in reliable financial statements. And in other cases, for exactly the same proposals, other comments supported the proposals because it was felt that they did result in reliable information. However, never did any groups define what was meant by reliable. Therefore, the Board determined that they had to come up with a different term to better convey this. So the term itself was changed to be “faithful representation.”

(b) “Substance over form” is part of the definition of representing transactions based on their economic substance. The discussion centres on “legal” form versus the nature or substance of the transactions. Examples of this might include:

a. On the sale of a product, legal title is transferred, but the entity is still receiving royalties related to this asset. In substance, the future economic benefits have not been transferred, even though title has legally been transferred. In substance, this would not be recorded as a sale.

b. The entity issues preferred shares with a legal form of equity. However, the shares have a mandatory redemption, requiring the company to redeem the shares in five years at a fixed amount. In substance, these shares are a liability for the company.

WA 2-2 (continued)

(c) In preparing financial information there is a significant use of estimates that must be made. Historically, making conservative estimates were meant to ensure that the financial statements were not overly optimistic or biased by management. This was seen as a virtue, and desirable. Conservatism would result in understatement of assets, overstatement of liabilities, and understatement of net earnings. This practice would provide a safety margin for creditors. However, in the future, as these estimates reversed, income would be overstated. Conservatism would always result in biased statements reflecting an understatement of net assets or net earnings. This violates the concept of "neutrality" which means that the financial statements are free from bias of any sort. Neutrality implies that when there is uncertainty, the preparer must search for additional information to reduce the uncertainty, reflect the uncertainty using a range of probabilities and expectations, or use the midpoint in a range of probabilities.

(d) Certain transactions may be unique for a company. Being able to override a standard that ends up misrepresenting the reporting of a transaction allows the entity to ensure that the true economic substance of the transaction is properly reflected in the financial statements – which would result in faithful representation. However, this violates comparability of information between companies since different companies would report similar transactions in different manners. It might also violate understandability, if users are expecting a certain type of reporting and are given another by the entity. This could lead to confusion by the user. As a user then, the following information should be disclosed:

a. The nature of the standard that is being overridden
b. Why the company believes that a different presentation will more faithfully represent the economic substance of the transaction
c. How is the company different from peers in the industry, that have been able to follow the appropriate standard
d. What is the impact on the financial statements – specifically on assets, liabilities, revenue and expenses? In particular, what would the standard have required, and what how has the company presented the information. What are the differences?

WA 2-3

a) The definition of an expense is a “decrease in economic resources, either by outflows or reductions of assets or the incurrence of liabilities, which result from an entity’s **ordinary revenue-generating activities”** .Some costs are recognized as expenses on the basis of a presumed direct association with specific revenue. This presumed direct association has been identified both as "associating cause and effect" and as the practice of "matching”. This practice of matching dictates that expenses are matched with revenues they help produce.

Direct cause-and-effect relationships can seldom be conclusively demonstrated, but many costs appear to be related to particular revenue, and recognizing them as expenses accompanies recognition of the revenue. Generally, matching requires that the revenue recognized and the expenses incurred to produce the revenue be given concurrent periodic recognition in the accounting records. GAAP requires the use of a rational and systematic allocation policy to approximate the asset’s contribution to revenue. Thus, the practice of matching is a recognition of the cause-and-effect relationship that exists between money spent to earn revenues (expenses) and revenues themselves.

An example of matching is the allocation of the cost of a long-lived asset over the accounting periods during which the asset helps generate revenue (its useful life).

b) Matching has historically been an important concept in determining when an expense is recognized in the income statement. Historically, accounting standards considered the measurement of net earnings more important than the balance sheet’s recognition of assets and liabilities. There has now been a shift to ensure expenses cannot be represented as assets unless these deferred costs meet the definition of an asset (unless specifically allowed by a standard). The definition of an asset is that the costs incurred must represent present economic resources to which the entity has the right to access, where others do not. Examples of where the matching principles would defer costs that would not meet this definition would be:

- Pre-opening costs – A company requires time to set up and organize its business during which it does not earn any revenue. The costs to initially set up can be argued to be incurred to generate future revenues. Therefore, matching would allow the deferral of costs and then these costs would be expensed over the next 2 or three years. However, there is no direct link between the

WA 2-3 (Continued)

costs incurred and the right to economic benefits to flow to the organization.

- Advertising and promotion – A company launches a new product and spends a three times the normal amount to promote the product. The company argues that the promotional costs will generate sales for many years to come. Matching would allow the deferral of costs and then expensing these costs over the future revenues generated by the new product. However, the promotional costs do not meet the definition of an asset and would be required to be expensed immediately.

The definition of an asset should take precedence to ensure that the balance sheet assets are properly reflected.

(c) Some costs are assigned as expenses to the current accounting period because

1. their incurrence during the period provides no discernible future benefits;
2. they are measures of assets recorded in previous periods from which no future benefits are expected or can be discerned;
3. they must be incurred each accounting year, and no build-up of expected future benefits occurs;
4. by their nature they relate to current revenues even though they cannot be directly associated with any specific revenues;
5. the amount of cost to be deferred can be measured only in an arbitrary manner or great uncertainty exists regarding the realization of future benefits, or both;
6. uncertainty exists regarding whether allocating them to current and future periods will serve any useful purpose.

Thus, many costs are called "period costs" and are treated as expenses in the period incurred because they have neither a direct relationship with revenue earned nor can their occurrence be directly shown to give rise to an asset. Examples of costs treated as period expenses would include officers' salaries, advertising, research and development, and auditors' fees.

WA 2-3 (Continued)

(d) A cost should be capitalized, that is, treated as a measure of an asset when it meets the definition of an asset – that is, at the reporting date, it is a resource controlled by the entity as a result of past transactions or events and from which the entity expects to receive future economic benefits. The important idea here is that the incurrence of the cost has resulted in the acquisition of an asset (has future economic benefit). If a cost is incurred that resulted in the acquisition of an asset from which benefits are not expected beyond the current period, the cost must be expensed as a measure of the service potential that expired in producing the current period's revenues. Not only should the incurrence of the cost result in the acquisition of an asset from which future economic benefits are expected, but also the cost should meet the definition of an asset. Examples of costs that should be treated as measures of assets are the costs of merchandise on hand at the end of an accounting period, costs of insurance coverage relating to future periods, and the cost of self-constructed plant or equipment.

(e) In the absence of a direct basis for associating asset cost with revenue and if the asset provides benefits for two or more accounting periods, its cost should be allocated to these periods (as an expense) in a systematic and rational manner. Thus, when it is impractical, or impossible, to find a close cause-and-effect relationship between cost and revenue, this relationship is often assumed to exist. Therefore, the asset cost is allocated to the accounting periods by some rational and systematic method. The allocation method used should appear reasonable to an unbiased observer and should be followed consistently from period to period. Examples of systematic and rational allocation of asset cost would include amortization of capital assets, and allocation of rent and insurance to the time periods they cover.

(f) A cost should be treated as a loss when no economic benefit results. The matching of losses to specific revenue should not be attempted because, by definition, they are expired service potentials not related to revenue produced. That is, losses result from events that are not anticipated as necessary in the process of producing revenue.

There is no simple way of identifying a loss because ascertaining whether a cost should be a loss is often a matter of judgement. The accounting distinction between an asset, expense and loss, is not clear-cut. For example, an expense is usually voluntary, planned, and expected as necessary in the generation of revenue. But a loss is a measure of the service potential expired that is considered abnormal, unnecessary, unanticipated, and possibly nonrecurring and is usually not taken into direct consideration in planning the size of the revenue stream.

WA 2-4

In all cases, the company should disclose the method used to prepare the valuation. The discussion for each situation along with the additional disclosures required is as follows:

(a) The independent appraisal of the investment property would be level 2 – market model. The appraiser is looking at current market prices for similar buildings. The notes should disclose that an independent appraiser has been hired and his credentials.

(b) The royalties based approach would be level 3 since there are many inputs that are required. The cost model approach is being used since it is the cost of what a similar asset would have been. Additional disclosure would be the type of model used, how the sales were forecasted and the rates of growth used.

(c) The prices for publicly traded shares are readily observable and no adjustments are required. This is level 1, market based method and no additional disclosure would be required.

(d) The value of the equipment is based on the cost model, level 2, since it was determined using costs of similar machines using inputs from the supplier for replacement equipment. Any adjustments made to the price would be noted.

(e) The brand names' valuation requires a lot of management inputs which makes it a level 3. In this case it is an income model that has been used. All of the significant inputs such as sales growth rates, terminal growth rates, margins and discount rate should be disclosed. In addition, the company should provide disclosure about what management based their input assumptions on - ie. market data? Finally, some sensitivity analysis would be useful such as explaining how a 1% change in sales growth rate or discount rate estimates would affect the final valuation.

WA 2-5

a) Country X – At the reporting date, Silverstrike has dug 4 mine shafts of 17 metres, which is greater than the 15 metres specified in the regulations. The government of Country X can enforce this law and force Silverstrike to either pay the fine or fill in the shafts. Silverstrike will have an economic obligation in that it will have to either pay the fines or pay for the costs to fill the shafts. So there is an enforceable economic obligation. However is it a present obligation? Silverstrike only needs to pay when the mining operations cease, over which they have control – this could either be as early as next year, or when all the silver is gone and the company closes the mining operation, which is predicted to be in 25 years. However, although the timing of when the obligation must be paid is uncertain, the costs will eventually have to be paid, since the life of the mine is not indefinite. Therefore, there is a present obligation and this is a liability. In determining how much to recognize, the company would have to determine based on probabilities as to when the costs would be incurred and the amount to recognize.

Country Y – the situation with Country Y is slightly different. In this case, the company is held by a contract which is legally enforceable. However, the company only has shafts of 10 metres and the contract come into effect when the shafts are 15 metres. Although they plan (and their intent) is to dig deeper to 17 metres (which is beyond the 15 metres), they have not yet done so. Consequently, there is no present obligation. On December 31, 2014, the government of Country Y cannot force Silverstrike to pay fines now or in the future. So there is no liability existing at this point in time. Even though it is highly probable (95%) the depth of the shafts will be more than the 15 metres in one year, this is not used to determine the definition of a liability. The definition specifically looks at the present obligation.

WA 2-5 (Continued)

b) Is there a present economic obligation for Zion? The company has the ability to terminate the employee prior to the 15 year period, and if this happens, the company will not have to pay any benefits. In other words, there are no consequences for early termination. The employee has no ability to enforce the payment of the benefits if he leaves before the 15 years has passed. Therefore, there is no present enforceable obligation. Only once the 15 years has passed does the company have an obligation. So there is no liability at this time, with respect to this employee. Even though, if we used probabilities, the chances of the employee staying are very high, this does not represent a present obligation and therefore, no liability needs to be recognized.

c) Beatonville Soccer Team has signed a contract, which is enforceable by Masonry. The Team has an obligation to ensure that Masonry's name is displayed on the recreation centre. If it does not, then the Team would either have to pay back a part of the $2 million received, or pay a fee to break the contract in some manner. So there is an economic obligation that is legally enforceable. Finally, the obligation is a present obligation since it could right now be enforced by Masonry if the Team did not comply. Masonry has paid the fee and expects to see their name on the stadium for the next 8 years.

RESEARCH AND FINANCIAL ANALYSIS

RA 2-1 TECK RESOURCES LIMITED

Teck Resources Limited, formerly Teck Cominco Limited, December 31, 2011 financial statements were used.

(a) Teck Cominco Limited recognizes revenue when price is reasonably determinable and the risks and rewards of ownership have passed to the customer. In the majority of sales of its metal concentrates, quoted market prices subsequent to the date of sale are used to determine pricing. Therefore, in these cases where there are variations in price there is the need for revenue adjustments. The primary method of revenue recognition is conservative since no revenue is recognized until title has passed. The sales contract method is more aggressive since revenue is recognized at an earlier point in the performance process. The receivable and revenue amount is adjusted to the forward commodity price each period reflecting changes in revenue on an ongoing basis.

(b) Teck Cominco Limited's investments in associates are recorded at cost plus its share of earnings (less dividends received). The equity method is used to account for these investments. Other investments include available-for-sale instruments and marketable securities which are recorded at fair value (Note 12). Land is recorded at historical cost on the financial statements (Note 3). Another item measured at fair value is receivables which are reported at fair value each reporting period (Note 3).

RA 2-1 (Continued)

(c) The restatement of the 2010 financial statements was required as part of the company's conversion to IFRS. The restatement resulted in a reduction of equity of $147 million at December 31, 2010. Some of the pros of restating the 2010 financial statements under IFRS are that the information is more comparable with the current period financial statements since the same standards are used. Another pro to restating the financial statements for the previous year (2010) is that it gives the company the opportunity to recognize reversals of impairment loss, specifically a $22 million impairment loss was reversed as a result of restatement under IFRS. Cons related to the restatements would be the time and expense required to make the IFRS adjustment and the reduction of comprehensive income by $147 million under IFRS which investors may see as a sign the previous statements were misleading, or they might question the company's profitability if they do not fully understand all of the necessary adjustments.

(d) When the company restated 2010 financial statements under IFRS there was a decrease in comprehensive income of $147 million. This happened as a result of differences in old Canadian GAAP standards and IFRS where different measurement is required, resulting in some financial statement accounts adding to or reducing the comprehensive net income reported. The largest changes were to employee benefits (reduced by $119 million), and income and resource taxes (reduced by $51 million).

The first adjustment relates to employee benefits actuarial gains and losses. Under Canadian GAAP, Teck recorded these as deferred and amortized them over the average remaining service life of related employees. Under IFRS, Teck recognizes actuarial gains and losses immediately through other comprehensive income and retained earnings. This resulted in a loss of $119 million that was previously amortized to be recognized immediately.

RA 2-1 (Continued)

The adjustment for income and resource taxes relates to the Alaska Mining License Tax that was accounted for as an operating expense under Canadian GAAP but is recorded as a deferred tax liability under IFRS as it is considered a resource tax to be included in income tax. Another part of the income tax adjustment relates to uncertain tax positions which are recorded differently under IFRS as there is no specific standard relating to them items and they have been recorded using criteria in IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

RA 2-2 GOING CONCERN ISSUES

The following information is from a review of Note 4 of Air Canada's financial statements for the year ended December 31, 2011.

a) The main accounting estimates and judgements disclosed by the company are employee future benefits, passenger revenues, depreciation/amortization period for long-lived assets, impairment considerations on long-lived assets, and maintenance provisions. Employee future benefits are estimated using actuarial valuations, the long-term nature of these valuations exposes the liability to uncertainty. Passenger revenue is estimated based on historical experience which could result in some differences from the recorded amount. Useful lives and expected residual values of long-lived assets are all estimated and could change based on usage or market factors. Impairment tests are subject to similar factors as the useful lives and residual values of fixed assets. Maintenance provisions are estimated using current costs and expected inflation and usage rates, both of which are subject to fluctuations.

b) It is important that Air Canada disclose this information as any change in the assumptions made could impact the results of operations. Many of the assumptions could have a material effect on the financial statements which would alter the decisions of users of the statements. One example is that if passenger revenue is based on poor estimates that turn out to be significantly different than the actual revenue, investors would be misled and might have invested more in the company than they otherwise would choose to.

RA 2-2 (Continued)

(c) The value of the significant estimate accounts are as follows (in millions):

Net benefit obligation:	$5,635
Passenger revenue:	$10,208
Depreciation/amortization expense:	$728
Maintenance provision:	$548

Comparing the values above to Air Canada's net loss position of ($249), it is clear that these are major accounts on the financial statements and changes in their value could greatly impact the financial results. Each account is greater than the net loss and would be very significant to users.

RA 2-3 RETRIEVAL OF INFORMATION ON PUBLIC COMPANY

Answers will vary by the article and the company selected.

RA 2-4 ARGUMENTS FOR AND AGAINST THE USE OF FAIR VALUES IN LIGHT OF THE FINANCIAL CRISIS

a) Using fair values means that assets are valued at what they could be sold for in an open market. When the changes in these fair values are reported in earnings, this causes net earnings to be volatile. As fair values increase, earnings will increase; and as fair values decline, earnings will decline.

b) Arguments against the use of fair values, particularly in a climate of financial crisis, are the following:

- The markets are not perfect, and therefore current fair values in the market may not truly represent the underlying value. This is particularly true in a recession, when the value of all assets is significantly reduced.
- Determining fair values in an inactive market is difficult or impossible.
- Many of these assets are not held to be sold, but are held for the long term until maturity (example mortgages) and therefore to report based on fair value causes erroneous and distorted results.
- Some argue that assets should not be valued based on fair values at what they could be sold for, but on how they perform in comparison to how the asset are expected to perform.
- Fair value accounting causes too much unrealized volatility in the earnings reported by companies when in reality these are only "paper" gains and losses.
- Many of these fair values are artificially low now and will recover in the future before the asset is sold. Consequently, why should a loss be reported, when this might not even occur?

c) The arguments for fair value accounting (and to counter the arguments above) are as follows:

- From a user's perspective, fair values provide more transparency – rather than hiding potential losses on investments, these are now highlighted. This allows users to gain a better understanding as to the health of the company.
- Users need unbiased, up-to-date information to make informed decisions. Fair values are not affected by accounting policies, when the assets were purchased, who owns the assets or what their intended use was. It allows better comparability across companies. In using the cost basis, the carrying amount of a reported asset will depend on the age of the asset, the depreciation policies and the impairment tests making comparisons difficult.

RA 2-4 (continued)

- If volatility results from using fair values, this is simply reflecting that there is volatility in the market. Why should companies be able to smooth out their reported earnings, when this is not happening in reality?
- Fair value estimations in an inactive market are difficult. However, there are several acceptable methods to determine fair values – and using observable market prices is only one. Other valuation techniques such as discounted cash flows are also acceptable and do not rely on observed market prices.
- In a survey of users, 79% of respondents indicated support for the use of fair values as it results in more transparency and a greater understanding of the risks a company faces and their impact.
- Volatility is not invented, nor did it cause the crisis. Using fair values simply reports what has happened from an economic perspective and all companies are impacted by economic events.
- The crisis was caused by bad lending, and how it gets reported only reflects the true economic impact of this.
- While it is true that fair values may be currently low and may recover in the future, there is no guarantee of this. The financial statements should reflect the current situation, not what might be probable in the future.

d) Yes, I believe that using fair values better represents economic reality, provides for more transparency and assists the user in understanding the risks associated with a company.

e)IFRS does allow for a greater use of fair values in financial statement presentation compared to Accounting Standards for Private Enterprises. One example is the revaluation model under IAS 16 which allows for the revaluation of property, plant & equipment at their fair value rather than at amortized cost. A similar option exists under IAS 40 which allows investment property to be measured at fair value. A third example of increased fair value reporting under IFRS is the treatment of Employee Future Benefits, where plan assets are required to be measured at fair value.