CHAPTER 2

CONCEPTUAL FRAMEWORK UNDERLYING FINANCIAL REPORTING

ASSIGNMENT CLASSIFICATION TABLE

Topic		Brief Exercise	Exercise	Problem	Research and Analysis
1.	Usefulness of the Conceptual Framework (CF) and main components of CF	11	1, 2, 10		
2.	Qualitative Characteristics	1, 2, 3, 11	2, 3, 6, 7, 8, 9, 10	2, 3, 4, 5, 7, 8	5, 6
3.	Elements	5, 6, 7, 8, 9	4, 10	2, 3, 5, 8	
4.	Foundational Principles	4, 10	6, 7, 8, 9, 10, 11, 12, 13	1, 2, 3, 5, 7, 8	1, 2, 3, 4
5.	Forms of organizations		5		
6.	Accounting choices and bias	11	2, 11	2, 6, 7	

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ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
E2-1	Conceptual framework.	Moderate	20-25
E2-2	Qualitative characteristics.	Moderate	20-25
E2-3	Qualitative characteristics.	Simple	15-20
E2-4	Elements of financial statements.	Simple	15-20
E2-5	Forms of organizations	Moderate	20-25
E2-6	Foundational principles	Simple	15-20
E2-7	Foundational principles	Moderate	20-25
E2-8	Foundational principles	Moderate	25-30
E2-9	Tradeoffs in financial reporting	Moderate	15-20
E2-10	Accounting principles–comprehensive	Moderate	15-20
E2-11	Full Disclosure	Complex	35-40
E2-12	Going Concern	Simple	15-20
E2-13	Revenue recognition principle	Moderate	20-25
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

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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

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BRIEF EXERCISE 2-3

For internal reporting purposes, management may follow a rule of thumb that anything under 5% of net income is considered not material. This is by no means how materiality is actually determined. For external reporting purposes, the auditor must establish an amount or threshold by which to judge whether the financial statements are fairly presented. Many factors come into play, and the use of professional judgement is essential in determining whether an item is material or not.

(a) Because the change was used to create a positive trend in earnings, the change is considered material.
(b) Each item must be considered separately and not netted. Therefore each transaction is considered material.
(c) In general, companies that follow an "expense all capital items below a certain amount" policy are not in violation of the materiality concept. Because the same practice has been followed from year to year, Manion's actions are acceptable.
(d) In spite of the small size of the note payable, it is management's intention to deceive creditors concerning its liquidity and for that very reason the misclassification is material.

BRIEF EXERCISE 2-4

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

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BRIEF EXERCISE 2-5

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.

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BRIEF EXERCISE 2-5 (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.

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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 fulfill 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.

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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.

(e) Collection of cash for future delivery of services – air travel: Once the cash is received, a liability exists to deliver the service or issue a refund of the cash to the customer. Following the collection of the cash, the airline has the constructive obligation to deliver the service in accordance with the terms dictated in the charter contract. Until the flight takes place, the cash received remains an amount reported under Unearned Revenue. Westjet refers to this account as Advance ticket sales on their consolidated statement of financial position.

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BRIEF EXERCISE 2-7

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) **Should be debited to the Land account, as it is a necessary cost incurred in acquiring land (historical cost principle). The legal 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) **As a tangible asset, preferably recorded to a Land Improvements account. The driveway will last for many years, and therefore it should be capitalized and depreciated.**

(c) **As a tangible asset, the meat-grinding machine should be recorded to Equipment as it will last for a number of years and therefore will contribute to operations of those years. Once capitalized, depreciation expense will be recorded over the benefiting accounting periods.**

(d) **Assuming the partnership has a fiscal year end of December 31, this will all be an expense of the current year that can be charged to an expense account. If financial statements are to be prepared on some date before December 31, part of this cost would be an expense and part an asset. Depending upon the circumstances, the original entry as well as the adjusting entry for financial statement purposes should take the statement date into account.**

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BRIEF EXERCISE 2-7 (CONTINUED)

(e) **The building is a tangible economic resource being constructed by the company. Wages paid should be debited to the Buildings 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.**

(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. The payment is recorded to the Salaries and Wages Expense account as the service has already been received; the contribution to operations occurred in this period.**

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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 windshield washing liquid is not purchased for resale but is a supply used by Akamu in delivering of an oil change service. The liquid is purchased in bulk and is held in tanks for future dispensing. While held, the supply is an asset recoded to the Supplies account, and once used the cost is transferred to Supplies Expense.

(b) The massage therapists' payment to a receptionist constitutes a salary and wage expense when paid. Salaries and wages are not paid in advance of performing the work but in arrears. The receptionist would have already performed his or her job prior to being paid by the business through payroll.

(c) The contract provides a right for the winter season that is not contingent on future events. A prepaid asset will be established and the snow removal expense from the service will be recognized over the winter season, allocated to the accounting periods when the services are performed.

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BRIEF EXERCISE 2-8 (CONTINUED)

(d) The chain saw is a tangible economic resource that will be used in the future to cut trees supplied to a saw mill. This future activity will generate revenue. The asset should be recorded to Equipment as it will contribute to operations for many years (historical cost principle). Once the period of benefit is established, depreciation will be recorded and the carrying value of the asset will be reduced by the accumulated depreciation.

(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 patent 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 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.

(g) The installation of flooring in a store rented in a mall has been done by the business to satisfy its needs to operate the store in the rented premises. Because the flooring is durable and will last for several accounting periods, it is recorded to the Leasehold Improvements account. Once the period of benefit is established, depreciation will be recorded and the asset will be reduced by the accumulated depreciation. The period of benefit cannot be extended beyond the term of lease for the store.

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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
(k) Periodicity

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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 about the economic resources and claims on them, as well as the financial performance. This objective represents the goals and purposes of financial accounting. It is assumed to include an assessment of management stewardship.

(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.

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SOLUTIONS TO EXERCISES

EXERCISE 2-1 (20-25 minutes)

(a) True.

(b) False – General-purpose financial reports help users who lack the ability to demand all the financial information they need from an entity and therefore must rely, at least partly, on the information in financial reports.

(c) False – Standard-setting that is based on individual conceptual frameworks will lead to different conclusions about identical or similar issues. As a result, standards will not be consistent with one another, and past decisions may not be indicative of future ones.

(d) False – Information that is decision-useful to capital providers may also be useful to users of financial reporting who are not capital providers.

(e) False – An implicit assumption is that users need reasonable knowledge of business and financial accounting matters to understand the information contained in the financial statements.

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EXERCISE 2-2 (20-25 minutes)

(a) Feedback value.

(b) It is generally the role of professional judgement to identify and balance trade-offs 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.

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EXERCISE 2-3 (15-20 minutes)

(a) Comparability
(b) Feedback value
(c) Consistency
(d) Neutrality
(e) Verifiability
(f) Relevance
(g) 1. Comparability
    2. Verifiability
    3. Timeliness
    4. Understandability
(h) Representational faithfulness
(i) Relevance and Representational faithfulness
(j) Timeliness

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EXERCISE 2-4 (15-20 minutes)

(a)

1. **Gains, Losses**
2. **Liabilities**
3. **Equity (increase)**
4. **Equity (decrease**
5. **Assets**
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 potential future economic benefit to which the entity is entitled and has control over. However, the transaction that will generate the benefit has yet to occur (the music has yet to be written). Once the probability threshold has been surpassed the asset would be recognized.**
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.**
3. **Liability – this contract represents an obligation that will result in the future outflow of resources, subject to the sale of the recordings. However, a liability will not occur until the recordings are sold.**

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EXERCISE 2-5 (20-25 minutes)

There are three common forms of business organizations:

A: Proprietorship
B: Partnership
C: Corporation

Form	Pros	Cons
A	- Simple to set up and maintain records - Does not have to file a separate tax return since the income is treated as income of the owner for tax purposes	- Not a separate legal entity and therefore any lawsuits against the business would be directed against the sole proprietor - Personal assets may be required to pay off business debts
B	- A basic partnership is simple to set up and maintain records for - Does not have to file separate tax returns as the income is treated as income of the partners for tax purposes	- Not a separate legal entity and therefore any lawsuits against the business would be directed against the partners - Personal assets may be required to pay off business debts
C	- Limited liability protection - Any obligations are the obligations of the corporation and not the owners	- More complex to set up and maintain records - Separate tax returns must be completed and filed for the corporation - Covered by the CBCA or provincial corporations act - legal requirements for reporting and maintaining records

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EXERCISE 2-5 (CONTINUED)

Limited Liability Partnerships (LLPs) and Professional Corporations (PCs) are organizational structures often used by professionals. These types of organizations are structured to limit the liability of the professional while at the same time ensure that the public is being well served by professionals who provide expertise in certain fields. Professionals must provide due care in the provision of their services and bear the risk, although somewhat reduced, of having to pay for the consequences of negative acts or negligent work.

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EXERCISE 2-6 (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

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EXERCISE 2-7 (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 and control
12. Periodicity
13. Matching/fair value
14. Historical cost
15. Matching

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EXERCISE 2-8 (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 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.)

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EXERCISE 2-9 (15-20 minutes)

While both of the fundamental qualities (relevance and representational faithfulness) should be present for financial information to be decision-useful, trade-offs 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.

- **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.**
- **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.**
- **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.**

Professional judgement must be exercised to ensure that the end product assists users in their decision making.

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EXERCISE 2-10 (15-20 minutes)

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

Repairs and Maintenance Expense...	**2,500**	
Accounts Payable......................		**2,500**

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

Cash	**8,000**	
Unearned Revenue....................		**8,000**

3. **Definition of element – asset**
   Qualitative characteristic – representation faithfulness Inventory held on consignment is not an economic resource of Trimm; it is an economic resource to Rubber and Rubber has the right to this inventory. NO journal entry should be made by Trimm 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. This is not likely as the payment was made on the last day of the fiscal year.

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EXERCISE 2-11 (35-40 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 trade-offs. 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. **in supplementary information, including the Management Discussion and Analysis (MD&A)**

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EXERCISE 2-11 (CONTINUED)

(a) (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.**

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EXERCISE 2-11 (CONTINUED)

(b) (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 that is cross-referenced to the balance sheet.**

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EXERCISE 2-11 (CONTINUED)

(b) (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.**

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EXERCISE 2-12 (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 an issue with allocating costs to future revenues.

1. **Net realizable value**
2. **Would not be disclosed as there would be no future accounting periods that would allow the business to continue to amortize the premium. 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).**

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EXERCISE 2-13 (20-25 minutes)

(a) Under the ASPE, revenue is recorded when:

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

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 a returns allowance, a contra account to sales revenue 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.**

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EXERCISE 2-13 (CONTINUED)

(b) Using the new IFRS 15 model, a five step approach would be used in determining when revenue is recognized:

1. **Identify the contract with the customer,**
2. **Identify the performance obligations in the contract (promises to transfer goods and/or services that are distinct),**
3. **Determine the transaction price,**
4. **Allocate the transaction price to each performance obligation, and finally**
5. **Recognize revenue as each performance obligation is satisfied.**

For all 4 transactions given in the exercise, the timing of the revenue recognition will be the same as was given for ASPE as the critical event used to trigger revenue corresponds to the timing for satisfaction of the performance obligation.

These models will be further discussed in Chapter 6.

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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.

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TIME AND PURPOSE OF PROBLEMS (CONTINUED)

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.

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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 vs. long term; current vs. noncurrent; operating vs. non-operating, debt vs. 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.

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PROBLEM 2-2

(a) The users of Fusters' financial statements are sensitive to the company'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 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. As such, making no entry violates the matching principle.

This error will affect the equity and assets used in determining if the covenants have been followed. 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 would be true in spite of the increase in the assets due to not depreciating the building. This error likely does not affect the management bonus, which is based partially on revenues reported, unless the other part of the bonus calculation is based on net income.

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

An asset should be recognized only when the equipment is actually purchased or the current 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.

This error affects both the asset and liability numbers in the debt covenants. The entry does not impact the revenue part of the bonus calculation, however it may impact other parts of the calculation.

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PROBLEM 2-2 (CONTINUED)

(b) (continued)

Transaction 3.
The disposal and associated gain must 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 would impact the equity component in the covenant calculation since the gain would be recognized as a depreciable asset, with only a small amount flowing through net income to retained earnings in each accounting period. The return on assets ratio would also be impacted, as net income is likely the numerator for that ratio. The gain arises from peripheral activities and likely does not impact the bonus calculation, which is based on revenues.

Transaction 4.
Based on the information provided, the sale should be recorded in 2017 instead of 2016. In this situation, it is irrelevant whether the shipping terms are FOB shipping point or FOB destination since the transaction occurred in 2017. As well, the inventory sold would have been included in the 2016 year-end inventory count.

This error impacts equity and assets (accounts receivable) in the debt covenant calculations. It also affects revenue, thus impacting the management bonus. Revenue would be higher in 2016 and lower in 2017.

(c) Option exists for Transaction (1)

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 as part of 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.

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PROBLEM 2-3

1. This entry may have been correct if the land had actually been sold. With a modification of the accounts used, the entry could be appropriate as long as the land is determined to be impaired or is designated as held for sale by the company. The debit in the entry should have been to an Impairment Loss account. 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 which is the higher of the value in use and the 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.

   The entry that was made reduces net income and would lower the divorce settlement available to the president's spouse. Care should be taken regarding the above analysis to ensure that it is properly supported with evidence of current market prices.

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 actually selling it. It should further be noted that the revenue recognition principle provides the answer as 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 inflates net income, would have increased the divorce settlement available to the president's spouse.

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 and might be covered partially by some insurance. 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 violated by this overly conservative accounting. It might appear as if the loss had been recorded in order to reduce net income and to lower the divorce settlement available to the president's spouse.

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PROBLEM 2-3 (CONTINUED)

4. Accounting standards 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 a matter of valuation, but rather 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 to earn income. This error, by reducing net income, would incorrectly lower the divorce settlement available to the president's spouse.

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 Gravenhurst, 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 an Impairment Loss - Goodwill account – not directly to retained earnings as indicated in the journal entry provided (further discussed in Chapter 12).

   This error causes a direct reduction to retained earnings and to assets. It does not impact net income, and therefore would not impact the divorce settlement.

6. The historical cost principle indicates that assets and liabilities are accounted for on the basis of cost. The equipment should have been recorded at its cash cost. The gain would have the effect of increasing the divorce settlement.

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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 comparisons of an enterprise's results with other businesses in the industry, which have not yet adopted the new methods, difficult or impossible.

3. Before issuing financial statements, a business experiences a loss due to a fire. If the business postpones the issuance of the financial statements for three weeks, it will be in a better position to provide information to the financial statement users. In this case, not postponing issuing the financial statements would hurt relevance but would improve the timeliness in which the information reached the users.

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 professional judgement about the users' needs.

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

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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 (control) be transferred to the purchaser in order for the sale to be recognized. That is when the performance obligation is satisfied. 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 in 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 likely to last longer and is not a change simply to reduce annual depreciation expense and thereby increase income.

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.

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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 establishing an appraisal value for the given item without selling it, and verifiability would be 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 based on a sale of the developed 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, which is an economic resource, not with an expense that is 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 similar transactions be given 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. The information should be neutrality and free from bias. It might be useful for Sheridan report 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 2022. A liability does not exist in fiscal 2017.

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.

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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. The term of the new loan must be reasonable. 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 is an aggressive interpretation of GAAP. Capital assets should be tested regularly for impairment and written down when their cost will not be recovered through use or through resale. In this particular situation, a total write-off may not be called for. The timing of the write off that coincides 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 off several capital assets, thereby improving future years' results when impairment losses or 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 qualifying assets; under ASPE, companies have an accounting policy choice. Therefore under IFRS this is appropriate. Under ASPE, care would have to be taken to ensure that this choice was not done to manipulate net income and the profitability ratios. .

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 relationship with the business associate? Care should be taken to investigate whether all the revenue recognition criteria have actually been met.

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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.

7. In this case, the transaction has been entered into for the sole purpose of making the financial statements look a certain way. The accrual of any amount of litigation loss is not justified as the outcome of the case is deemed to be uncertain as assessed by the corporate litigation lawyer. Management is attempting to be prudent and is conscious of the effect of any settlement on future profits and corresponding ability for the Board of Directors to maintain dividend payments. Although the motive may be to exercise prudence, recording the accrual violates GAAP, in that the liability cannot be reasonably determined or measured. All that should have been done is disclosure of the litigation in the notes to the financial statements under the heading Contingencies.

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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, should it be available. Competitors may be private companies, making the information unavailable.

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.

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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.

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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

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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.

Note: The case uses the conceptual framework only to analyze the issues. It does not use any specific GAAP standards such as IFRS or ASPE.

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CA 2-1 BRE-X (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 development of the property 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 relevant to the investors.

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CA 2-2 BENNETT ENVIRONMENTAL

Overview

The company is in the business of treating and 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. Its shares are traded on the TSX, and therefore IFRS is a constraint.

The conceptual framework may be used for the analysis of this case.

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.

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CA 2-2 BENNETT ENVIRONMENTAL (CONTINUED)

Issue: Lawsuit

Recognize a liability/disclose	Do not recognize/disclose
- The entity should recognize a liability for the lawsuit if the company's management and 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 exists – thus the information would not add value. - Since the proceedings have been halted, this adds additional uncertainty. - Other.

Even though the proceedings were stayed more than two years ago, it would be more transparent to continue to disclose.

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CA 2-3 TIMBER COMPANY

Overview

This analysis may be prepared using the conceptual framework only, without reference to specific GAAP.

This issue is one of measurement or valuation of the assets. 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 under the historical cost principle. The asset recorded on the books would include the price to purchase the land, if owned, plus growing costs and labour directly related to getting the trees ready for sale. Therefore – as noted – the financial statements are not that useful.

Using historical cost, the main asset on the balance sheet may be understated – therefore perhaps the fair value principle should be used. Care would have to be taken to ensure that the fair value measurement was based on good quality evidence.

It appears as though the historical cost principle has been applied for Timber Company and therefore as an analyst, we would have to recognize that management may be looking to make the statements look better in other areas to compensate.

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CA 2-3 TIMBER COMPANY (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.

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CA 2-3 TIMBER COMPANY (CONTINUED)

Value the property at laid down cost	Value the property at fair value
- 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.

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.

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RESEARCH AND ANALYSIS

RA 2-1 TECK RESOURCES LIMITED

Teck Resources Limited, formerly Teck Cominco Limited, December 31, 2014 financial statements were used.

(a) Sales of product, including by-product, are recognized in revenue when there is persuasive evidence that all of the following criteria have been met: the significant risks and rewards of ownership pass to the customer, neither continuing managerial involvement nor effective control remains over the goods sold, the selling price and costs to sell can be measured reliably, and it is probable that the economic benefits associated with the sale will flow to the company. All of these criteria are generally met by the time the significant risks and rewards of ownership pass to the customer. In the majority of sales of its cathode 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 3). 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).

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RA 2-1 TECK RESOURCES LIMITED (CONTINUED)

(c) A change in the accounting of levies was made by Tech in 2014 as a result of new pronouncements under IFRS.

Tech adopted IFRIC 21, Levies (IFRIC 21) on January 1, 2014. IFRIC 21 provides guidance on the accounting for a liability to pay a levy, if that liability is within the scope of IAS 37, Provisions, Contingent Liabilities and Contingent Assets. The change in the treatment of levies was given retroactive treatment.

The conceptual framework foundational principle involved in the treatment of this pronouncement by Tech is the going concern principle. As explained in the financial statement notes, “The fact that an entity is economically compelled to continue to operate in the future, or prepares its financial statements on a going concern basis, does not create an obligation to pay a levy that will arise in a future period as a result of continuing to operate.” Consequently, the adoption did not affect Tech’s financial results or disclosures.

(d) Additional pronouncement under IFRS, concerning the recognition of revenue from contracts with customers and the treatment of financial instruments were issued and had implementation dates subsequent to the publishing of Tech’s 2014 financial statements. Although earlier adoption is permitted, Tech has decided to delay the implementation of these new pronouncements until the annual period for which the pronouncement is first required. The reason given is that management is currently assessing the effect of the standards on the financial statements.

From the perspective of the user, I would be satisfied that the explanation given by management is adequate under the circumstances. The benefit of the adoption of the new standards may be outweighed by the additional costs of earlier implementation. There might also be a benefit in delaying to enhance comparability with other businesses in the industry that are taking the same stance concerning the adoption of the new pronouncements.

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RA 2-2 AIR CANADA

The following information is from a review of Note 3 of Air Canada's financial statements for the year ended December 31, 2014.

(a) The main accounting estimates and judgements disclosed by Air Canada are: employee future benefits, depreciation and amortization period for long-lived assets, impairment considerations on long-lived assets, maintenance provisions and income taxes. Employee future benefits are estimated using actuarial valuations, the long-term nature of these valuations exposes the liability to uncertainty. Useful lives and expected residual values of long-lived assets are all estimated and could change based on a variety of market factors. Impairment tests are subject to similar factors as the useful lives and residual values of long-lived assets. Maintenance provisions are estimated using current costs and expected inflation and usage rates, both of which are subject to fluctuations. Deferred income tax assets are recognized to the extent that the realization of the related tax benefit is probable.

(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. Looking at the consolidated statement of changes in equity, one notices the remeasurements on employee benefit liabilities in 2013 which reduced the deficit by 44%. This change in estimate had a large impact on the equity and liabilities of Air Canada for that fiscal year. Investors can draw their own conclusions concerning the quality of these earnings adjustments. In the case of the unrecorded deferred income tax assets, the magnitude of the amount of loss carry forwards for which management has not accrued any benefits would undoubtedly affect the user's expectations concerning any future income taxes expense that can be avoided, assuming profitable operations.

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RA 2-2 AIR CANADA (CONTINUED)

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

Pension and other benefits liabilities	$2,403
Depreciation, amortization and impairment:	$543
Maintenance provisions	$796
Deferred income tax asset	nil
Total unrecognized temporary differences	$6,293

Unrecognized temporary differences totalling $6,293 (outlined in note 12 of the financial statements) represent amounts that can reduce income tax expenses and liabilities in future years. The benefit of these tax deductions have not been accrued by Air Canada as deferred income tax assets.

Comparing the values above to Air Canada's net income for 2014 of $105, 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 income and would be very significant to users.

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RA 2-3 RETRIEVAL OF INFORMATION ON PUBLIC COMPANY

Answers will vary by the article and the company selected.

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RA 2-4 FAIR VALUES

(a) Using fair values means that assets are valued at what they could be sold for and liabilities are measured at what would have to be paid to transfer the associated obligation, both in orderly transactions between market participants at the reporting date. When the changes in these fair values are reported in earnings, this causes net earnings to be volatile. As asset fair values increase and liability fair values decrease, earnings will increase; and as asset fair values decline and liability fair values increase, 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 many 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 assets 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 at any specific date but 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 in support of fair value accounting 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 of the financial 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 methods and the impairment tests, making comparisons difficult.

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RA 2-4 FAIR VALUES (CONTINUED)

(c) (continued)

- If volatility results from using fair values, this simply reflects 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 low at a specific date 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, using fair values better represents economic reality, provides for more transparency and assists the user in understanding the risks associated with a company. That is, they provide better predictive value (relevance), more faithfully represent the elements being measured in terms of their economic values and the impact of the financial risks to which the entity is exposed, are more complete measures, and provide for increased comparability among entities.

(e) IFRS does allow for a greater use of fair values in financial statements than does ASPE. 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 is the measurement of biological assets based on fair values under IAS 41.

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RA 2-5 CONSERVATISM/NEUTRALITY

(A) Steve Cooper indicates that the two different meanings of “prudence” are as follows:

1. Prudence means *conservative accounting*: That is, prudent accounting choices would favour a conservative bias in making judgement decisions; accepting lower asset and higher liability values and therefore lower net income choices.
2. Prudence means *neutral accounting*: that is, prudent accounting choices would not exhibit any systematic bias. They would favour neither a negative nor a positive bias in making judgement decisions. They would not promote an overly optimistic bias or reflect an overly pessimistic one. The decisions would be balanced and neutral.

(B) By proposing to put “prudence” back into the conceptual framework, after not making any explicit reference to the term in the 2010 “framework,” the IASB and Steve Cooper provide support for the second meaning of prudence (neutral accounting). In the 2015 exposure draft, it is proposed to reintroduce the term, this time with an explanation of how the term is intended to be interpreted.

One explanation for the choice of “neutral accounting” is that consistently making optimistic choices and/or pessimistic choices leads to benefits for some user groups over others, resulting in less-than-optimal resource allocation decisions. Management may benefit from overly optimistic results at the expense of existing shareholders, while overly pessimistic results may favour potential shareholders at the expense of existing shareholders.

Those favouring a conservative bias meaning of prudence contend that it is a good and reasonable offset to the likely overoptimistic biases related to management’s judgements and estimates. They contend that the penalties associated with corporate conservatism are far less than those related to overly optimistic results. They suggest that perhaps more conservatism might be applied to decisions on asset and revenue recognition and measurement, with less conservative approaches for liability and expense decisions to protect the entity from making excessive dividend distributions. The IASB counters that conservatism is not the best method for controlling shareholder distributions. In addition, unless investors are aware of the extent of downside bias being exercised, information provided to them is less relevant than it would be with a neutral approach to prudence.

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RA 2-5 CONSERVATISM/NEUTRALITY (CONTINUED)

(B) (continued)

Taken to an extreme that lower profit/net asset values are preferable to higher profit/net asset values (following the conservative bias view) produces financial information that does not faithfully represent the underlying economic reality and is not relevant to investors and creditors for their purposes.

The IASB solution, therefore, is to use the term “prudence” and explain that it means neutral accounting recognition and measurement. Neutrality, and therefore, prudence, supports the qualitative characteristic of faithful representation of financial reports and the qualitative characteristic of relevance, providing information that is more useful for resource allocation decisions.

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RA 2-6 FAITHFUL REPRESENTATION

(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 relating to 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.

c. An entity uses a finance lease to acquire a long-lived asset. Although the entity does not legally own the asset that is being leased, it does record the lease transaction as a purchase with the corresponding debt because the lease transfers substantially all of the benefits and risks of property ownership to the lessee.

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