Chapter 2: Accounting Judgements

Case	2-1	Symposium
	2-2	Aerotravel Inc.
	2-3	Dubois Limited

			Suggested Time
Technical	2-1	Underlying assumptions	10
	2-2	Underlying assumptions	10
	2-3	Qualitative characteristics	15
	2-4	Concepts identification	15
	2-5	Capital maintenance	15
	2-6	Capital maintenance	20
	2-7	Measurement methods	15
	2-8	Measurement methods	15
	2-9	Fair value measurement	10
	2-10	Fair value measurement	10
Assignment	2-1	Relevance versus faithful representation	15
	2-2	Relevance and faithful repesentation	15
	2-3	Questions on principles	15
	2-4	Questions on principles	15
	2-5	Application of principles (*W)	10
	2-6	Realization versus recognition	15
	2-7	Recognition of elements	10
	2-8	Elements of financial statements	10
	2-9	Questions on principles (*W)	10
	2-10	Identification of accounting principles (*W)	10
	2-11	Revenue recognition	15
	2-12	Recognition and elements	15
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	2-14	Application of principles	15
	2-15	Implementation of principles	30
	2-16	Implementation of principles	30
	2-17	Implementation of principles	30
	2-18	Recognition criteria	25
	2-19	Implementation of principles (*W)	30

*W The solution to this exercise/problem is on the text Web site and in the Study Guide. This solution is marked **WEB**.

Cases

Case 2-1

Notes for Symposium

1. Prudence
There are many examples where we are conservative in our accounting standards. For example, we recognize contingent liabilities as provisions if they are probable but do not recognize a contingent asset as an asset unless it is virtually certain. We recognize all deferred income tax liabilities but we do not recognize deferred income tax assets unless they are probable. For goodwill we have impairment. (Students could discuss a number of other examples of accounting standards where there is conservatism).

Yes I agree with the new definition since there could be both understatement and overtstatement of assets especially where estimates are being made for financial statements. Both of these would be a bias in reporting. Neutrality supports the new definition of prudence. Financial reporting should not have a bias.

2. Measurement of Assets and Liabilities
Historical cost has many advantages. It is easy to measure on initial recognition. It is more difficult to measure after initial recognition since it requires a number of estimates e.g. number of years an asset should be depreciated over. Impairment testing involves subjectivity. Current values after initial recognition are more relevant to decisions of users since they can be customized to the needs of those users. However, there are many alternatives in determining current values and measurement uncertainty therefore subjectivity.

Current values will provide a more up to date Balance Sheet for the users of the financial statements. However, unrealized and realized gains and losses will impact the Income Statement and create more volatility. Historical cost will create an outdated Balance Sheet and the estimates related to depreciation and impairment testing involve subjectivity.

For certain assets current values are more relevant e,g, derivatives where hedge accouting is not elected and investments which are traded on a frequent basis.

3. OCI and Comprehensive Income
One concern with OCI and comprehensive income is that there is not clear definition about what belongs in OCI and comprehensive income. OCI is useful since it allows for unrealized gains and losses related to certain remeasurements to not impact the income statement which would create volatility and it avoids accounting mismatches. For example, with a cash flow hedge e.g. a forward contract to protect against the change in the Euro for a future purchase of a machinery in Europe. Without OCI you would have an accounting mismatch. Without OCI the forward contract would be classified as a

derivative and impact net income but the forward contract would have no impact until the machinery is purchased in six months. So one side of the hedge would impact net income and the other side would have no impact. To solve this issue the forward contract would impact OCI only until the hedge is terminated. (Students could provide other relevant examples).

Case 2-2

Sample response

Dear Ms. Yang:

As you requested, I have studied the operations of AeroTravel Inc. with a view of identifying the accounting and reporting ramifications for the company. I believe that while the revenue and expense issues are fairly straight-forward on the surface, there are important estimates and accounting judgements that can affect the numbers reported. The necessary accounting policies involve the timing of revenue and expense recognition, as well as matching and periodic reporting. The principal issues are as follows:

Revenue recognition

ATI obtains its revenue by selling loyalty units to its corporate clients. Although the cash is received upon sale, the revenue will not be earned until the clients' customers redeem their units for travel or merchandise. Only then can the revenue be reported on the income statement. Until redemption, the amount received from clients must be shown as a liability on ATI's statement of financial position (i.e., as unearned revenue).

Revenue measurement is complicated by the fact that not all units are redeemed. A significant portion of units are never redeemed and therefore represent "free" revenue for ATI—revenue that is never "earned" through the delivery of goods or services. The revenue from never-redeemed units must be estimated; this proportionate amount of revenue can be recognized as revenue in the year the units are sold. Each year, the company reviews its estimate of the proportion of outstanding units that will never be redeemed. Thus, the amount of revenue recognized from unredeemed units will fluctuate from year to year on the basis of both (1) the number of units sold during the year and (2) the accumulated quantity of unredeemed units from past years.

For "earned" revenue, recognition will occur when the units are redeemed and the rewards have been delivered, as mentioned above.

An additional source of revenue is obtained as fees from client corporations for marketing and for assisting client companies with their own loyalty programs. These revenues should be recognized as the services are rendered, however specified in the contracts. If billings lag expenses, ATI's net expenses should be shown as unbilled revenue on the SFP. If contract revenue is received in advance of incurring the expenses, the unearned amount should be shown as a current liability.

Expense recognition

When ATI buys airline seats, merchandise, or other rewards in response to redemption, the company can recognize the revenue and related cost once the rewards have been delivered. Expense recognition of merchandise occurs when it is shipped.

However, ATI does not always (and perhaps does not usually) acquire reward travel at the point of unit redemption. ATI buys blocks of airline seats in advance and makes them available to unit-holders, most likely via the ATI website.

For travel rewards, (primarily airline seats), delivery does not necessarily occur when the unit-holder selects his or her reward and relinquishes points, because the reward travel may be cancellable prior to use. Thus delivery occurs only when the travel rewards are actually used by the unit-holder—that is, after the cancellation period has expired or when the unit-holder actually makes the trip. Until "delivery", the travel rewards and merchandise that ATI has purchased must remain as inventory on ATI's statement of financial position.

Estimation issues

The revenue and expense recognition issues for ATI are rather complex because there are multiple parties involved. Also, the timing of revenue receipt and cost incurrence do not coincide.

Estimation is a signficant issue. The information given to me does not reveal the level of unclaimed rewards. However, one can surmise that the inventory of outstanding loyalty units is very large, given the tendency of clients' customers to accumulate units with little regard to actually using them. Therefore, a small change in estimated redemption rate (or, conversely, non-redemption) most likely can have a material impact on reported revenue. While the revenue recognized by adjustments in the non-redemption estimate may be relatively small as a part of total revenue, it can have a quite significant impact on net income because it flows directly into earnings without incurring related expense.

Therefore, estimation involves an important **ethical** dimension. It is important that our firm, Hetu & Fauré, endeavour to verify ATI's annual estimate of non-redemption via independent consultants and analysis. Other estimates are important too, but the non-redemption estimate is the most important one, in my estimation.

In conclusion, I would like to thank you for this opportunity to review the operations of ATI. I hope that I have fulfilled your expectations.

Sincerely,

James Ehnes

Case 2-3

Overview

Essentially, this case requires students to perceive how the reporting environment of a company has changed. A private company has tapped new sources of financing in order to meet competition, and those sources are imposing a GAAP constraint on the company for the first time. The company's must reconsider its financial reporting objectives and therefore the company's accounting policies.

The "required" asks for a report from an accounting advisor to the company's board of directors. A good response should be in report format.

The case also can be used later in the course, following Chapter 9 or 10.

Sample response

Dear Ms. Bissau:

I am pleased to honour your request for advice concerning Dubois Limited's financial reporting objectives and financial measurement methods. Congratulations on obtaining the necessary financing for your new and expanded facilities and processes.

Dubois Limited has been a private enterprise since its inception. As a private enterprise, it has not been necessary for your company to provide financial statements to external users, except perhaps occasionally to a bank for a credit line or a short-term loan.

However, you have issued a significant number of shares to a venture capital company that now owns 35% of the company's outstanding shares. Although you are still a private company, Dubois will henceforth be required to provide audited financial statements to the Mangle Group, prepared on the basis of generally accepted accounting principles.

As well, you have an arrangement with a major bank to provide substantial secured working capital support. In our discussion, you didn't mention whether the bank requires audited statements, but most likely they do because they need assurance that the collateral (i.e., accounts receiveable, inventory, and buildings and equipment) is reported at an amount that is not in excess of net realizable value or fair value.

In the past, you probably prepared financial statements primarily for your own assessment of operations and for income tax purposes. So far as you indicated, you had no external users of your financial statements (other than CRA). Clearly, that situation has changed.

Both Mangle and the bank will be quite interested in cash flow prediction, since the cash flow will provide dividends for Mangle and debt service for the bank. The bank most likely will not object to increasing assets (and credit based on those assets) as long as the cash flow remains strong. In addition, Mangle will be interested in evaluating the general economic performance of Dubois, with a particular eye on the quality of management in an increasingly competitive international market.

Dubois will no longer be able to use accounting measurement methods that are not generally accepted. For example, the company must begin to use acceptable depreciation methods for its tangible capital assets. Impairment tests will still be relevant, but those tests will not eliminate the need for systematic depreciation. Company managers must be able to show the auditors suitable rationales for their many estimates used in preparing the financial statements.

There remains the question of selecting the most appropriate accounting and reporting basis. Clearly, the previous methology (known in the profession as a "disclosed basis of accounting") will not result in the unqualified audit report that Mangle requests. The two other options are (1) international financial reporting standards (IFRS) or (2) Canadian accounting standards for private enterprises (ASPE).

IFRS are mandatory for Canadian public companies, but they are much more complex than ASPE. Dubois is still a private company, although some directors indicate that Dubois may issue share to the public in the future. My advice is to use ASPE for the foreseeable future. ASPE has far fewer reporting requirements and more closely corresponds to the historical-cost accounting that Dubois has been using. As well, the financial statements are simpler and will be quite adequate for Mangle and the bank.

If the company decides to "go public" in the future, the accounting basis will need to change to IFRS. The prospectus for an initial public offering (IPO) must have comparative financial statements prepared on the basis of IFRS. Therefore, if and when Dubois becomes a public company, prior year's financial statements will need to be adjusted to a new basis. I see little reason to use IFRS at present, however. The company will need to determine historical cost and the net book value of assets to obtain an unqualified opinion. The revaluation of capital assets is not permitted under ASPE. The adjustment will need to be made retrospectively.

I am very glad to be of assistance. If I can provide any additional information or advice, please contact me at 555-217-1937.

Sincerely,
G. Washbourne Wells, ACE (Accounting Consultant Extrodinaire)

Note: While this sample response ends with a recommendation for ASPE, students could also recommend IFRS on the basis that if an IPO is in the future, it would be better to get the accounting system operating on that basis. Also, depending on students' knowledge from introductory accounting, they may perceive that IFRS's relatively increased emphasis on NRV and its option for revaluation accounting for capital assets could enhance the financial statements, especially for the bank because the bank is concerned about the value of collateral.

TECHNICAL REVIEW

TR 2-1

1. T
2. T
3. T
4. T
5. F

TR 2-2

1. T
2. F
3. F
4. F
5. F

TR 2-3

1. Qualitative criteria require that a measure be a faithful representation of the value of the land, but also verifiable and free from material misstatement or bias. An *independent* appraisal may be acceptable (preferrably two or three independent appraisals, to establish verifiability), but not an internal appraisal by a company "expert".
2. Delaying the statements would most likely increase the accuracy of the accounts receivable and improve the estimate of uncollectible accounts. However, issuing statements six months after year-end definitely would decrease relevance—old information with little usefulness for predictive purposes; the following year is half over by that time.
3. It is true that many intangible 'assets' are not shown on the company's balance sheet because they were internally generated. There is no assurance that those assets will produce revenue-generating products, even though the company believes they will. Costs were expenses when incurred due to the impossibility of estimating future revenues; revenues cannot be recognized until earned. The company should attempt to disclose of the nature of the assets rather than try to measure it by a highly biased and unverifiable quantitative measure.
4. A long-term rental arrangement, or lease, may be the same in substance as buying the asset and borrowing the money to finance the purchase. When this is true, the financial statements show the rented asset as a capital asset, and the future rent payments as a liability. The resulting measurements have high representational faithfulness because the asset and liability reflect the true substance of the long-term leases.

TR 2-4

C/E 1. Any accounting method is acceptable for small items that will not change users' decisions.

I 2. Assumes that all financial statement elements can be meaningfully described in dollar terms.

H 3. Long-term assets that increase in value are not normally written up in the financial statements.

J 4. Assets and earnings should be neither understated nor overstated.

G 5. The estimated future cost of fulfilling warranties that may not arise until two years into the future are accrued in the period of the sale.

C/E 6. It is not necessary to use a complex accounting method for minor items that are highly unlikely to improve the decisions of financial statement users.

K 7. It must be possible to numerically confirm all amounts reported in the body of the financial statements.

G 8. The various costs associated with a revenue transaction may be deferred until the revenue is earned.

A 9. The personal transactions of owners should be kept separate from transactions of the business.

L 10. Significant recognized and many non-recognized items should be fully described in the notes to the financial statements.

B 11. Enables historical cost, rather than liquidation values, to be used.

D 12. Enables measurement of the income and financial position of entities at regular intervals.

TR 2-5

Requirement 1

Three measures of income:

a. Nominal dollar financial capital maintenance:
$140,000 – $94,000 = <u>$46.000</u>

b. Constant dollar financial capital maintenance:
$140,000 – ($94,000 × 1.05) = <u>$41,300</u>

c. Physical capital maintenance:
$140,000 – $115,000 = <u>$25,000</u>

Requirement 2

Cash remaining

a. Nominal dollar financial capital maintenance: $140,000 – $46,000 = $94,000; this is the original dollar investment in inventory.

b. Constant dollar financial capital maintenance: $140,000 – $41,300 = $98,700; this is the original dollar investment of $94,000 stated in inflation-adjusted dollars:
$94,000 × 1.05= $98,700.

c. Physical capital maintenance: $140,000 – $25,000 = $115,000; this is the replacement value of the physical capacity.

In each case, the company has 'capital' left over in dollars—either (1) the original financial investment in dollars, (2) the original financial investment in constant dollars, or (3) the ability to replace the physical capital in units.

Requirement 3

Only in alternative c is there enough money left to replace inventory. In the first two cases, the company does NOT have enough money left over to replace inventory, and would have to raise additional capital to do so.

Requirement 4

Nominal dollar financial capital maintenance is by far the most common in Canada and USA, but physical capital mainenance is permitted under IFRS.

TR 2-6

1. Nominal dollar capital maintentance

Sales revenue		$160,000
Cost of goods sold ($64,000 – $25,000)	$ 39,000	
Depreciation ($300,000 × 20%)	60,000	
Total expenses		$ 99,000
Net income		$ 61,000

2. Physical capital maintenance

Sales revenue		$160,000
Cost of goods sold ($64,000 – $25,000) × 0.90	$ 35,100	
Depreciation ($300,000 × 20% × 1.03)	61,800	
Total expenses		$ 96,900
Net income		$ 63,100

TR2-7

1. Inventory – lower of cost and net realizable value
2. Shares in a public company – Fair value
3. Land – Historical cost (ASPE) or historical cost or fair value (IFRS – depends on measurement model selected and use of land e.g. rental property)
4. Lease – Present value
5. Long term receivable – Present value

TR2-8

1. Inventory – lower of cost and net realizable value
2. Derivative – Fair value
3. Building – Historical cost (ASPE) or historical cost or fair value (IFRS – depends on measurement model selected and use of building e.g. rental property)
4. Bond – Present value
5. Note receivable – Present value

TR2-9

1. Shares in a public company – level 1
2. Land – level 2 if similar piece of land otherwise level 3
3. Patent – level 3
4. Beef Cattle – level 2 from similar cattle on exchange
5. Unique machinery – level 3

TR2-10

1. Shares in a private company – level 3
2. Building - level 2 if similar building otherwise level 3
3. Patent – level 3
4. Pigs – level 2 from similar pigs on exchange
5. Shares in a public company – level 1

ASSIGNMENTS

Assignment 2-1

Relevance is the characteristic of usefulness. Information should be useful for making decisions. *Faithful representation* includes several characteristics: completeness, neutrality, and freedom from material error. This investment portfolio can be reported at historical cost or at fair market value.

Tannino Ltd. is a private investment company. Its stakeholders are the 30 investors, the two owner-managers (who own all of the shares), and the bank. The investors need to know the value of their holdings and need to be able to evaluate the investment performance of the managers. The bank needs to know the value of assets against which it is lending money. The shareholders need to know how much the company is earning so they can judge their return accordingly. For all three types of investments, market value would theoretically be more useful than historical cost.

For investments in publicly traded securities, market value is readily obtainable and is highly reliable. Investors will be able to see how well the investments are performing, and will be able to see if the managers miss opportunities to realize earnings (e.g., sell prior to a fall in prices). Historical cost is of little or no relevance.

Market value information for investments in real estate are less reliable, because there is no open auction market as there is for securities. Market value for real estate investments is often established as the discounted prospective cash flow. Professional appraisers would be required to estimate real estate market values, and estimates would vary among appraisers. Real estate investments cannot be liquidated quickly, and therefore market values have less relevance. Historical cost may be used on the financial statements for verifiability and freedom from bias. If appraisals occasionally are carried out, the appraised values can be presented in the notes.

Venture capital is the most difficult type of investment to report at market value. By definition, venture capital investments involve a high level of risk. Risk leads to volatility in price (or value). Therefore, it would likely be impossible to report market values with any reasonable degree of reliability.

Assignment 2-2

1. Verifiability
2. Feedback value
3. Predictive value
4. Verifiability (also freedom from bias)
5. Freedom from bias (also representational faithfulness)
6. Timeliness
7. Representational faithfulness
8. Predictive value
9. Representational faithfulness
10. Predictive value (also freedom from bias)

Assignment 2-3

1. Disagree. Historical cost violated; inventory must be carried at cost unless recoverable value is lower.
2. Disagree. Timeliness violated because statements are needed more frequently than every three years
3. Disagree. Faithful representation or neutrality violated because the estimate chosen was the lowest one.
4. Disagree. Separate entity concept was violated because this is a personal asset carried on the company's books.
5. Disagree. Faithful representation is violated because netting is not generally allowed. Financial statement elements are not appropriately stated. Note a student could also state they Agree since netting is with the same party.
6. Agree. Because the item is not material, it does not need to be corrected.

Assignment 2-4

1. False. A company could not possibly disclose EVERYTHING; that would be counter-productive. Only information that would affect users' decisions should be disclosed.
2. False. Although it's true that revenue is normally recognized in the period in which it is earned, that is not the definition of matching. Match means to "match expenses to revenue", not "to time period."
3. False. A company is assumed to stay in business long enough to recoup investment in capital assets (the inventory cycle cited in the statement is too short).
4. True.
5. False. Many liabilities are not an amount owed by the company e.g. provisions for warranty costs, decommissioning provisions.
6. False. Relevance is typically enhanced when market values are used.
7. False. Better accounting policies are always encouraged; retrospective restatement addresses comparability.
8. False. Nominal dollar capital maintenance refers to inflation; human capital fails the unit of measure or reliability tests.
9. False. Materiality is also based on the nature an item.

Assignment 2-5 (WEB)

Issue	1 Correctness	2 Principle	3 Comment
a.	Correct	Separate-entity	Does not always correspond to the legal entity.
b.	Incorrect	Faithful representation	Transactions must be analyzed to see if the recorded elements are true to the nature of the transaction. Does what is recorded convey substance? If not, substance should be reflected in the financial statements.
c.	Correct	Matching; Comparability (lack thereof!)	Companies must trade off what they consider to be the best accounting principle against comparative industry practice; this is acceptable.
d.	Incorrect	Full disclosure Materiality	Too much detail is as harmful as not enough detail—GAAP requires full disclosure but excessive detail obscures more significant information.
e.	Correct	Net asset principle	If inventory cost is higher than its recoverable value, the inventory value must be written down to lower of cost and net realizable value to avoid overstating net assets' future benefit.
f.	Incorrect	Historical cost measurement	This principle applies to most transactions and to the SFP as well as the income statement.
g.	Incorrect	Revenue recognition	Revenue must be recognized when earned, measurable, and realizable, regardless of the timing of the related cash flow.
h.	Incorrect	Time-period assumption	Accruals and deferrals arise because short-term (i..e., annual) financial statements must be prepared. Revenues and expenses must often be recognized at times other than when cash is received.
i.	Incorrect	Revenue and matching; Faithful representation; Freedom from bias	Measurement should be free of bias. Revenues are recognized when earned measurable and realizable. Expenses must be matched with revenue to obtain an earnings measure that is a faithful representation of the operating results of the company.

Assignment 2-6

	Initial transaction ***recognized***	*Element* ***realized*** *by cash*
1.	14 August	12 September
2.	13 November	1 February
3.	Warranty liability recognized at time of sale	Upon payment of claim
4.	a. 20 February — Cash receipt and unearned revenue recognized b. March 10 - Revenue recognized	20 February
5.	a. During the year, expense recognized when bill received b. At year-end, unbilled expense accrued (if material)	When each bi-monthly bill is paid
6.	1 February	1 March

Assignment 2-7

1. Utilities expense and account payable.
2. Patent, intangible asset; recorded at cost to create and register, usually a fraction of real worth due to measurement problems due to market uncertainty in determining fair value at registration.
3. Employee expense
4. Not recorded; not a financial statement element because no shares issued as yet, no proceeds received, and no issuance contract exists.
5. Inventory (i.e., work in progress) as cost of work completed so far.
6. Provision accrue at estimated amount. [If cannot be estimate would be disclosed in a note.]
7. Not recognized. No measurable amount, and no control over the 'asset'.
8. Not recorded; no reliably measurable past cost or future benefit.
9. Cash, unearned revenue
10. Lease expense if considered an operating lease otherwise record as a leased asset or employee compensation if for CEO's personal use not business use.

Assignment 2-8 WEB

1. E (or G if peripheral)
2. A
3. D (or F if peripheral)
4. C
5. F
6. F, G
7. B
8. D, E

Assignment 2-9 WEB

1. J
2. E, (and G)
3. G
4. M
5. D
6. F (and K)
7. H
8. I
9. C
10. A, I

Assignment 2-10

Case A:

Consistency and comparability are violated. The accounting information is not comparable because the depreciation method is inconsistent from period to period.

Case B:

Faithful representation is not achieved. The note receivable is not worth its face value at the time of sale; it is over-valued. The note (and the sale transaction) must be shown at the note's present value: [($55,000 ÷ 1.21 = $45,455).

However, if a time period to maturity is short, implicit interest often is ignored as immaterial.

Case C:

This situation violates relevance and timeliness, even if the information may have faithful representation. The statements are out of date.

Case D:

Revenue recognition is inappropriate. Accrual accounting is usually appropriate.

Case E:

The matching principle is violated. The time period during which the interest is earned is not properly accounted for. Accrual accounting must be followed.

Case F:

The separate-entity assumption is violated.

Case G:

Full disclosure is violated; also, relevance is likely to be violated.

Assignment 2-11

1. No revenue recognition (collection of accounts receivable). Revenue was already recognized, on delivery.
2. No revenue recognition (unearned revenue is created).
3. Revenue recognition—one-twelfth of the subscription price received; the remaining unrecognized amount must be shown as unearned revenue.
4. No revenue recognition—there must be a sale transaction either (1) to recognize the increased cost of the inventory (under physical capital maintenance) or (2) to recognize the increase in value via an increase in net assets (under nominal dollar capital maintenance).
5. No revenue recognition – unearned revenue since performance has not occurred even when non-refundable.
6. Revenue recognition on delivery—a slow-paying customer is still a valid customer; if payment was not probable, the sale would not be made.

Assignment 2-12

1. The commitment is an executory contract. There will be no elements recognized until the inventory has been delivered or payment (full or partial) has been made, whichever happens first.
2. No financial statement element has been created. The decreased value of the shares impacts the shareholders directly, not TelCan as a corporation.
3. Rent revenue and rent receivable are recognized because the services were rendered and measurable under the terms of the lease, and collection is probable.
4. The minimum sales value received from (or commited to by) the buyer is recognized as an asset, either cash or receivable, unearned revenue should be recognized as revenue annually over the five years of the contract. If the sales price is variable, such as depending on the level of the Taiwanese company's sales volume, any additional revenue above the guaranteed or minimum amount should be recognized only year-by-year, not estimated and included in the amount of the asset.
5. Changes in value of foreign currency are recognized on the income statement as a gain (or loss) and on the balance sheet as an increase (or decrease) in an asset (cash).
6. Training costs should have a future value, but the future benefit cannot be measured. Therefore, training costs are recognized as an expense in the financial statements. There is no reliable measure of the value of the "asset".
7. The cost of acquiring the competitor's customer list should be recognized as an intangible asset (subject to periodic impairment tests, as explained later in the book).
8. If TelCan can reliably estimate the cost of settling the law suit, that amount should be recognized as a liability and an expense or loss (with full note disclosure), subject to revisions in future periods as necessary.

Assignment 2-13

Situation A

1. Cost/Benefit Effectiveness. Any accounting measurement should result in greater benefits to the users than the cost to prepare and present.
2. The company appears to have properly applied the principle, but the decision should be regularly reassessed to ensure that the balance of cost versus benefit has not changed.

Situation B

1. Comparability and consistency. Accounting standards and procedures should be applied consistently from period to period within a given entity to enhance inter-period comparability.
2. The company violated consistency; to implement consistency the company should keep the same inventory cost-flow assumption. They should retrospectively restate comparative statements to a single valuation basis and make full disclosures.

Situation C

1. Relevance, full disclosure, comparability, predictive value. Information should be complete to be helpful in making users' decisions. Predictive ability is an issue here. Also, the information is not available to compare the company to its competitors.
2. The company is not including all relevant information, despite industry norms. This information should be provided.

Situation D

1. Faithful representation, neutrality. Accounting information should be free from error and bias. It should represent what it purports to represent.
2. The company policy is inappropriate. It is using significant bias to consistently understate depreciation expense. This is not true to the real life of the assets. The company policy should be changed to use the most reliable estimate of useful life as based on historical evidence for similar equipment.

Situation E

1. Materiality, faithful representation, full disclosure. Reporting should correspond to what it purports to represent, so the basic treatment (netting) is wrong. However, because the item is too small to change users' decision, it does not have to be corrected.
2. The policy is acceptable as long as the separate amounts of both revenue and expense are immaterial. If the gross amounts become material, then Fluidity should report the amounts of interest expense and interest revenue on the face of the income statement.

Assignment 2-14

a. This entry violates the cost principle (and faithful representation) because the merchandise cost was $78,400, not $80,000. The entries should have been:

Inventory ($80,000 × .98)	78,400	
Accounts payable		78,400
Accounts payable	78,400	
Cash		78,400

b. The recording and reporting violated the matching principle and faithful representation. Depreciation meets the definition of an expense. Depreciation expense should be matched with the revenues of the period and reported on the income statement as an expense, not charged directly to retained earnings.

The correct entry is:

Depreciation expense	227,000	
Accumulated depreciation		227,000

c. This entry violated the cost and matching principles as well as faithful representation. Repairs do not meet the definition of an asset. Usual and ordinary repairs constitute a current expense, not an increase to the value of capital assets. However, no correction is needed because the amount is not material.

d. The reporting of the storm loss was in violation of faithful representation as well as the the recognition principle. The loss occurred in a single period—it should not be deferred and recognized as an expense over future years. The entire amount of the loss should be recognized in the income statement and the company should describe the loss event in a disclosure note. The original entry should have been:

Storm loss (reported on the income statement)	96,000	
Cash, inventory, etc.		96,000

e. Both the full disclosure and faithful representation principles were violated because the loan should have been reported as a non-current asset, as it is not due for three years. Also, the faithful representation characteristic was violated because the accounts receivable did not correctly report the amounts due from customers. Because the president is a related party, any such loans should be separately disclosed as being material items. The loan should have been recorded as follows:

Receivable from company president (non-current)	42,000	
Cash		42,000

Accounts receivable should be reported at $53,000.

Assignment 2-15 WEB

a. This entry violated the revenue principle and faithful representation. Dividends cannot be paid on retired shares and then reported as income to the issuing company. A company cannot pay revenue to itself. The correct entry is:

Retained earnings (94,000 shares @ $8)	752,000	
Cash		752,000

b. This entry violated the cost principle as well as revenue recognition. The asset should be recorded at the current market value of the consideration given. In this situation, the market price per share should be used as the value of the consideration. A gain cannot be recorded on issuing shares.

The correct entry is:

Machine (10,000 × $8.50)	85,000	
Share capital		85,000

c. This entry violated the cost and revenue principles. The actual cost of $542,000 should be recorded as the cost of the warehouse. Also, there was no revenue because no goods or services were transferred to customers. The correct entry is:

Buildings—warehouse	542,000	
Cash		542,000

d. This entry violated faithful representation. The definition of an expense has been met. The loss should be reported as an expense and not deducted directly from retained earnings. The correct entry is:

Loss from flood damage	97,000	
Cash		97,000

e. This entry violated faithful representation: revenue has not been earned. The company has an obligation (liability) to provide the goods or return the customer's money. Hence, an obligation should be reported.

The correct entry is:

Cash	76,000	
Unearned revenue (or revenue collected in advance)		76,000

Assignment 2-16 WEB

Cash:

The cash should be reported at $313,333; i.e., [$300,000 + ($100,000 ÷ 7.5)] The HK$ must be reported at its Canadian dollar equivalent.

Branford has violated the principle of faithful representation, since the $100,000 reported is not an accurate reflection of the value of the cash in a Canadian dollar financial statement.

Marketable securities:

Marketable securities should be reported at market value (here, $987,000); as "temporary investments", they are either FVTPL or FVTOCI.

Branford has violated the principle of relevance, since the $900,000 reported cost is not the most important information with respect to the investment.

Accounts receivable:

The revenue recognition criteria have not been met. The vendor, Branford, has not performed all acts required—the product has not yet been delivered. The order is an executory contract at this point and should not be recognized.

Branford has violated the the revenue recognition concept. He has also violated the principle of reliability, since there is no account receivable or revenue until delivery, so the $500,000 reported is not representationally faithful to its real identity.

Contract liability:

This is an executory contract. There is a contract between Branford and the contractor, but Branford has not yet paid anything nor has the contractor begun work. This amount should not be recorded or recognized until at least one party to the contract has 'executed' its obligation (or a part thereof).

Other liabilities:

Branford knows that it has an obligation to pay $75,000 next year but has not recorded the liability in the financial statements. The amount should be recorded.

The faithful representation of the financial statements is reduced when this liability is omitted.

Assignment 2-17

Requirement 1

The recognition criteria are:

1. The item meets the definition of a financial statement element.
2. The item has an appropriate basis of measurement and a reasonable estimate can be made of the amount.
3. For assets and liabilities, it is probable that economic benefits will be received or given up.

Requirement 2

The lawsuit accounting policy can be explained as follows:

1. The element in question is a potential liability, which may require the outflow of economic resources (cash) with no discretion to avoid payment (based on a court order), based on a past transaction with the ex-customer.
2. The element is only recorded if it can be measured or estimated, based on past legal precedent, the amount of the lawsuit, and/or the company's willingness to offer a settlement.
3. The element is only recorded if it is likely that the outflow will happen, and the lawsuit will be lost or voluntarily settled.

Disclosure of the lawsuit satisfies the full disclosure requirement.

Assignment 2-18

Case A

The value of the Coca Cola trademark has developed over time. The company never incurred a direct cost for the trademark, and thus there is no market-based value or arm's-length transaction to use as a valuation basis. Accounting standards require a transaction-based historical cost value and, hence, only costs incurred in registering the trademark, legal fees incurred in litigation to successfully defend the trademark, and similar expenditures can be capitalized. Thus, in this case, the value reported would be nominal.

Case B

Only two of the three requirements for revenue recognition have occurred: the amount is both measurable realizable because the revenue has already been collected. However, not all significant acts have been fulfilled. Revenue cannot be recognized even though the future costs are measurable because Aeroplan hasn't fulfilled its obligation.

Case C

Reclamation and restoration costs should be estimated and recorded as a liability as the oil sands work progresses and the environmental damage occurs. However, Suncor says that the amount is based on estimates due to changing legislative obligations and also because the extent and technology of remedial action will continue to change in future years. Suncor acknowledges that the changes in the estimates will have a significant impact on future earnings.

Assignment 2-19

Case A

The financial statements are not neutral and do not conform with the historical cost principle. This is perhaps an attempt to take a 'big bath' to protect future profits; no justification for the write-down is provided.

Case B

The financial statements are not neutral. Management's excessive conservatism, which is not a virtue, is displayed.

Case C

Comparability is violated in this example. The company is not consistently using a particular accounting policy nor did they retrospectively restate balances to provide some consistency. Full disclosure is also violated, as there was no comment or explanation of the change.

Case D

Faithful representation is violated by netting current assets with current liabilities. Full disclosure is also violated as a one-line balance sheet does not contain enough detail. Offset is not permitted.

Case E

Comparability is in evidence, as promoted by use of uniform accounting policies within an industry. Since opening balances have not materially changed, retrospective restatement would not enhance comparability because restatement would not change financial statements users' decision – this is the essence of materiality.