Chapter 1: The Environment of Financial Reporting

			Suggested Time
Case	1-1	Milton Kidd	
	1-2	Metropolitan Transit Incorporated	
	1-3	International Fashions Inc.	
Assignment	1-1	Chapter overview	10
	1-2	Chapter overview	10
	1-3	International comparisons	10
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	1-5	Accounting choices	10
	1-6	Effect of accounting policies (*W).	15
	1-7	Reporting alternatives	10
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	1-13	Impact of differing objectives	20
	1-14	International harmonization of accounting standards	20
	1-15	IASB standard-setting	25
	1-16	Accounting policy disagreement	15
	1-17	Accounting policies and reporting objectives	10
	1-18	Policy choice	20

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

Questions

1. A public company issues securities (debt and/or equity) to the public; a private company does not, but may raise capital through private placements. Public and publicly-accountable companies must use IFRS. Private companies (except publicly-accountable enterprises) may use IFRS, Canadian Accounting Standards for Private Enterprises (ASPE) as provided in the *CICA Handbook*, or a disclosed basis of accounting (DBA).

2. A control block is present when a small number of related or affiliated shareholders own a majority of the voting shares in a company. Financial reporting will often be tailored to the needs of the controlling shareholders, and not necessarily the minority shareholders.

3. Canadian accounting standards are set by the Accounting Standards Board, which is a unit of the Canadian Institute of Chartered Accountants. For public companies, the AcSB has chosen to comply with international accounting standards as set by the International Accounting Standards Board. For the optional use of private enterprises, the AcSB maintains Accounting Standards for Private Enterprises in Section II of the *CICA Handbook*.

4. Canadian private companies can choose to use IFRS, Part II of the *CICA Handbook*, or a disclosed basis of accounting (DBA).

5. A private company would choose to use IFRS if it is competing with international firms for debt or private equity funding. By being directly comparable to public companies, IFRS-basis statements will make it easier for prospective lenders or investors to compare potential investees on a common basis. The company may be able to lower its average cost of capital as a result.

6. A disclosed basis of accounting (DBA) is a set of accounting policies specifically chosen to meet specific needs, either for private companies that are not constrained by GAAP, or as special-purpose statements intended to meet the accounting measurement requirements of specific contracts.

7. IFRS is designed to facilitate the international financial markets, particularly to permit multiple stock exchange listings. Using IFRS goes a long way to improving the comparability of companies based in different countries.

8. The most important objective of general purpose financial statements is to serve the information needs public companies' suppliers of debt and equity capital who normally have no direct access to information and must rely on the company's general purpose financial reporting. Other users such as employees, customers, and regulators will find the information useful, but they are secondary users.

9. If an organization wishes to portray cash flows, accounting policies will be chosen that minimize inter-period allocations and provide maximum disclosure of future cash flow patterns.
10. Accounting policies that minimize revenues and maximize expenses (delay revenue recognition and speed up expense recognition) help to minimize income tax. These policies are only successful in meeting the tax minimization objective if they can be used for filing tax returns as well as financial reporting.

11. Income smoothing is the use of accounting policies and estimates to even out periodic fluctuations in earnings. Income smoothing is intended to produce a smooth record of earnings, free from peaks and valleys that imply risk. One way of accomplishing this objective is to make relatively small adjustments to accounting estimates that can, cumulatively, have a significant impact on net earnings in a particular period. The deliberate use of accounting estimates to manipulate net earnings is an unethical practice.

12. A "big bath" occurs when a company, in the year of an operating loss, uses the opportunity to recognize as many losses or write-offs in that year as possible, thereby maximizing the loss. This makes it easier to report a larger net income in future years because assets are written down, reducing amortization, and because pessimistic loss provisions may be established.

13. A covenant is a provision in a debt agreement that requires a company to maintain a certain level of performance, for example, a maximum debt/equity ratio, or minimum times-interest-earned ratios. Accounting policies chosen by a company with restrictive covenants would be those that help meet the restriction, such as maximize earnings, minimize debt, etc.

14. Managers may be motivated by self-interest rather than a desire to maximize return for shareholders. They may wish to maximize their compensation, reputation, or keep lenders from getting edgy. Policies chosen to maximize net income are common if managers receive bonuses based on net income.

15. Minimum compliance involves disclosure of the least amount of information possible in order to comply with the recommendations of the *CICA Handbook* and still get an unqualified audit report. This reporting has a lower immediate cash cost (as well as improved confidentiality) to the entity, but may result in lower share price as investors become disenchanted with the lack of information.

16. The world-wide use of IFRS may mislead investors into believing that financial statement can be compared directly between companies based in different countries. However, national practices concerning corporate debt differ between countries. In some countries, a high debt load is a bad sign; in others, a high debt load indicates that the banks and other lenders have confidence in the company and is a good sign.

17. A company's financial reporting is affected by its economic and political environment. Each company's reporting objectives is designed to suit its local environment. For example, in countries that require tax-book conformity, accounting judgements are driven by the tax law. In countries with high inflation, asset valuation will be affected, such as with substantial asset write-ups to reflect the higher nominal value of assets.

18. The AcSB is maintaining Canada's private-enterprise GAAP in Part II of the *CICA Handbook*. In contrast, companies in other countries may use IFRS-SME, especially in developing countries that do not have their own standard-setting structure. Canada chose to follow its own accounting standards for private enterprises (ASPE) in order to simplify life for Canadian private companies that already are comfortable with Canadian standards and are not in international competition for funding. The AcSB's approach also makes it feasible to provide standards that better suit the Canadian economic and business environment.

Cases

Case 1-1

Overview

This case is intended to get students to focus on the differences between companies and the various factors that have a bearing on their financial reporting objectives. Students are not asked to provide the objectives, but rather to prioritize the factors or characteristics that are most likely to affect each company's financial reporting.

Company Characterics

All three companies are private enterprises. Significant characteristics of each are as follows:

	Breeze Inc.	**Saturn Software**	**Intern'l Auto Parts**
Business	New mobile phone network	Custom software development	Auto parts for international auto makers
Owners	Private investors	Two entreprenuers, not wealthy	Wealthy family
Other capital sources	Egyptian fund	Pension fund—pref. shares Bank line of credit	Debt through investment funds and by U.S. and Cdn. banks
Capital requirements	Capital intensive start-up	Salary-based operation; working capital needed	Established mgfr; expanding to gain foreign customers
Constraints	Egypt fund has 3 board seats	Bank covenants: – dividend/salary payouts – new debt Preferred dividend required	Probable debt covenants
Reporting requirements	CRTC Egypt fund; Japan partner	Pension fund Bank	Investment funds and banks Potential new customers
IPO probable?	Not in the foreseeable future	Unlikely	Yes, antipicpated in 2-3 years

Prioritization

A possible ranking of significant factors may look as shown below. This listing is not definitive, but students should exhibit some logic as to why they rank some factors as more important than others.

Breeze Inc.	Saturn Software	Intern'l Auto Parts
Major foreign investor must be kept happy—ASPE may not be understood	Liquidity requirements—cash flow/prediction primary objective	IPO likely in near future—compliance with IFRS will be necessary (ASPE not appropriate)
Important Japanese partner	Bank covenants—protect lines of credit to be able to pay preferred dividends	Reflect good management performance to help attract new auto companies as customers
Need for major capital investment	Complex reporting not necessary; ASPE probably best, plus disclosure of salary information	Satisfy investment funds' reporting expections (e.g., re covenants)
Clear reporting of revenues on which 2% fee is based	Continuously profitable—minimize income taxes to conserve cash	Exhibit sucess in attracting new customers
		Minimize income taxes

Case 1-2

Possible financial reporting objectives:

- *Cash flow prediction* – the bank holds mortgages on most of the company's bus fleet, and therefore will be concerned about the ability of the company to earn sufficient cash from operations to pay the mortgages.
- *Income tax deferral* (or *minimization*) – reducing taxes will increase net earnings and conserve cash.
- *Management performance* – the company will want to be perceived as good managers so that the contract will be renewed at the end of 10 years.
- *Subsidy maximization* – since the town is willing to subsidize the bus company, the company may choose accounting policies that will minimize its net income and thereby attract more subsidy, which will benefit cash flow.

Prioritization:

- Cash flow prediction is probably the least important objective. The bank can see the cash flow from the cash flow statement. The bank also can ask for special-purpose statements.
- Income tax minimization is usually a valid objective, but in this case, there is unlikely to be much opportunity to influence taxation through accounting policy choice, since CCA takes the place of accounting amortization.
- Management performance and subsidy maximization are conflicting objectives. Prioritization depends on management intent. But subsidy maximization is a short-run goal, since it may lead to losing the contract renewal. The most important objective therefore probably is to help the town council evaluate the performance of management – a long-run goal.
- A policy of subsidy maximization raises **ethical** questions, since the intent of the subsidy is to reward good management and permit the company to earn a reasonable return on investment. It is unwise and unethical to "milk" the town council by maximizing the subsidy through accounting policy choices.

Case 1-3

Memo to: Manager
Subject: Reporting objectives for International Fashions Inc.

I have reviewed the ownership, organization, and financing of International Fashions Inc. (IFI). There seem to be several conflicting financial reporting objectives. The principal factors that affect the reporting objectives are as follows:

- The company has been internally financed. However, they expect to need additional financing as they expand in China. The possible source of this financing has not be identified. If the source is from Canada or U.S.A., GAAP is likely to be a constraint. However, financing might also be obtained through private equity sources or through debt sources in Asia (e.g., P.R.C., Hong Kong, Taiwan, or Singapore), in which case GAAP compliance may not be necessary.
- Most of the IFI inventory is supplied by a parallel company that is under common ownership. The bulk of IFI's activities is through related-party transactions, both for supplying inventory and for profit transfer via management fees.
- There is a China-based partner for the P.R.C. subsidiary. The local partner is entitled to receive 35% of the subsidiary's net income. This provides motivation for IFI to keep the subsidiary's profits down, perhaps by charging high prices for inventory that is supplied by the owners' Xiamen manufacturing facility.
- The company is privately owned. The two shareholders are the active managers of the company. Differential reporting is an option for this company.
- The IFI head office is a Canadian corporation. Essentially, it is a holding company for the Asian subsidiaries. As a private company, they could use the differential reporting option of not consolidating their subsidiaries, in which case the parent company's assets would consist mainly of IFI's investment in its subsidiaries.

The company relies extensively on internal financing, but since there are no external users, there is no need to try to maximize earnings. Tax minimization (deferral) is a good objective because tax savings will retain earnings in the company for future expansion.

In view of the tight control maintained by the owners, and the intercompany and related company operating structure, I would recommend minimum compliance as a principal reporting objective. We must be careful to give proper disclosure of the related party transactions, though, in order to give an **ethical** presentation. We don't want to be party to hiding important information from possible future users of the statements.

Because the company is Canadian, and because the future sources of financing are unclear, the company should use a version of IRFS, thereby satisfying both Canadian and international GAAP. I suggest that IFRS for SMEs should be used to simplify the statements and reduce accounting costs. Consolidated statements may not be needed, since the owner-managers are in such tight control. Nevertheless, the owners may want consolidated statements in order to get a better view of the overall status of the company and its operations. The decision on consolidation should be left to them.

In summary, I recommend the following policies:

- Tax minimization

- IFRS-SME compliance
- Full disclosure of related party transactions
- Minimum compliance

I believe that there is minimal conflict between these objectives. For **ethical** reasons, full disclosure of related party transactions should take precedence over minimum compliance.

Assignments

Assignment 1-1

F 1. The International Accounting Standards Board has authority for setting Canadian accounting standards.

F 2. All Canadian corporations must comply with international accounting standards.

T 3. IFRS were developed in order to facilitate international capital markets.

T 4. IFRS must be used for the financial statements of every Canadian public corporation.

T 5. The primary objective of general purpose financial reporting is to serve the information needs of the suppliers of capital—lenders and shareholders.

F 6. The primary objective of financial accounting is to reveal all information about an enterprise's financial performance.

F 7. If a corporation has a restrictive bond covenant that specifies a minimum times-interest-earned ratio, the corporation's management will be motivated to pick discretionary accounting policies that minimize income. (Note: Times-interest-earned is calculated as income before interest and taxes, divided by interest.)

F 8. Income tax law has no impact on the accounting choices made by management.

T 9. The presence of a control block can have an impact on a public company's choice of accounting policies.

F 10. Most Canadian corporations are listed on the Toronto Stock Exchange.

Assignment 1-2

F 1. IFRS and the *CICA Handbook* have equal status in Canada for financial reporting.

F 2. In a private corporation, the needs of external users have no impact on the company's financial reporting objectives.

T 3. IOSCO was instrumental in the development and wide-spread acceptance of international accounting standards for public companies.

F 4. Canadian accounting standards are governed by the Canada Business Corporations Act.

F 5. The debt and equity securities of a private company cannot be traded on public exchanges. Therefore, private companies have no external sources of financing.

T 6. A company may take a "big bath" in a loss year if management wishes to minimize future earnings.

T 7. A public company may not use DBA for external public financial reporting.

F 8. When an enterprise's primary reporting objective is cash flow assessment, the enterprise will use a cash basis of reporting rather than an accrual basis.

F 9. The AcSB plans to shut down and let all Canadian companies use international standards.

T 10. The IASB cannot require transnational corporations to use IFRS.

Assignment 1-3

Memo to: Manager
Subject: Viewpoint of conference speaker

I attended the conference where I heard Mr. Steans claimed that the financial statements of all companies can now easily be compared between nations because they all are prepared using IFRS.

In my view, Mr. Stearns is somewhat naive about the economic realities that underlie financial statements. Financial statements are a product of their reporting environment. The application of IFRS requires a great many accounting decision, especially accounting estimates. Management's estimates will be affected by their reporting objectives, such as to minimize current income taxes or to maximize earnings in order to support their stock price. Each company's legal, economic and political environment affects its financial reporting, as do the ways of doing business in a country. While IFRS gives the appearance of uniformity in financial statement presentation, there is a great deal of variance in the substance underlying the apparent comparability.

As a banker, Mr. Stearns will be dealing with private companies as well as public companies. The reporting requirements for private companies will vary among nations, and although private companies' financial statement may look uniform, in fact they may be prepared on quite different bases.

Assignment 1-4

1. K IASB
2. C IOSCO
3. A AcSB
4. J FASB
5. I TSX
6. L OSC
7. J KFC
8. C CICA
9. B SEC
10. G CBCA
11. H DBA
12. F ASPE
13. E IFRS

Assignment 1-5 WEB

The following accounting policy choices or accounting estimates are necessary:

1. The company must consider whether to:
   a. provide for possibly returning at least part of the inventory to the supplier, and
   b. write down the remaining inventory to lower of cost or market, which requires the company to estimate its net realizable value.
2. The company must make a conservative estimate the amount of recovery that is probable and write off the rest of the receivable. Note disclosure will be required for the circumstances and the court action.
3. The company must estimate the probability that the legal judgement will be upheld on appeal, and if the probability is greater than not, the company must estimate the actual amount of the final financial judgement. If the probability is >50%, and if the amount is reasonably estimable, the company must recognize the liability. If neither condition is fulfilled, the company must prepare a disclosure note.
4. The company must estimate the costs for completion which had been escalating but might not hold steady or decline due to the recession. The company also must estimate whether a loss should be recorded on the building (i.e., if the total cost is estimated to exceed the potential revenue).
5. The company must estimate:
   a. whether the full production cost can be recovered over the next 3 years, and
   b. how the production cost should be amortized (i.e., on the basis of revenues or on a time-basis)

Assignment 1-6

1.	Debt/equity ratio decreases	Income and equity increase
	Times-interest-earned ratio increases	Income increases*
2.	Debt/equity ratio increases	Income and equity decrease
	Times-interest-earned ratio decreases	Income decreases*
3.	Debt/equity ratio decreases marginally	Lower discount amortization, lower debt compared to effective interest method
	Times-interest-earned ratio increases	Income increases, interest expense decreases*
4.	Debt/equity ratio increases	Debt increases
	Times-interest-earned ratio decreases**	
5.	Debt/equity ratio increases	Income and equity decline; warranty liability increases
	Times-interest-earned ratio decreases	Income decreases*
6.	Debt/equity ratio decreases	Income and equity increases
	Times-interest-earned ratio increases	Income increases*

* Income effect is in the first or early years; later the difference would reverse and the effect would be the opposite.

** Dividends on shares are reclassified from the retained earnings statement to the income statement as "interest," decreasing earnings and increasing "interest."

Assignment 1-7

1. It is acceptable to use U.S. dollars and IFRS for reporting to the SEC.
2. The subsidiary is a private company in Canada. As such, the company is not constrained by Canadian accounting standards and can use UK standards whether or not they are compatible with IFRS. The statements can be presented in U.K. pounds sterling (which effectively may be the functional currency of the subsidiary if the majority of its costs are the import cost of the carpets).
3. There will be no problem with using IFRS for a private company. Ineed, it is wise to use IFRS if a future public offering or listing is anticipated.
4. Special purpose reports can always be prepared for specific users. They cannot be issued publicly, however.

Assignment 1-8 WEB

Dear Manager:

International Financial Reporting Standards (IFRS) became the required reporting standard for public companies starting in 2011, including comparative statements for the year earlier, which really made 2010 the required date for compliance. Since your company is privately-held, you have some options. One option is to use IFRS as planned, especially since your company is ready for it. An alternative that is available to all Canadian private companies is to use Canadian accounting standards for private enterprises, as contained in Part II of the *CICA Handbook*. The differences are mainly in some measurement and disclosure requirements that are more appropriate for public companies than for the more limited user group of private company statements.

Since your company has adapted its systems to conform with IFRS, I suggest that you do use IFRS, but perhaps with the lesser disclosure requirements permitted by the *CICA Handbook*. That way, you will be in a position to receive an unqualified audit opinion, if you do engage an auditor. Furthermore, should wish to "go public" or obtain new debt or equity financing, your financial reporting will need very little change.

Assignment 1-9

1. Moonburst needs a private capital infusion. Negotiations are under way with three American and one Canadian potential equity investors. As a private Canadian company, Moonburst has a wide range of possible reporting standards. IFRS is a possibility, but since none of the potential investors operates in an IFRS environment, IFRS seems an unnecessary burden at this time. The choice would seem to be between U.S. standards (i.e., FASB) or Canadian private-company reporting. Three of the potential investors are U.S.-based, which suggests that U.S. standards would be desireable from their point of view. However, U.S. standards are at least as complex as IFRS. If the investors are negotiating with Moonburst, they probably are already well aware of Canadian standards. Moonburst should use Canadian standards as reflected in Part II of the *CICA Handbook*. The company can prepare special-purpose statements for the investment firms, if necessary.

   There seems to be no reason use any reporting currency other than Canadian. Although the source of its raw material is South America, the bulk of its expenses and all of its revenue will be in Canadian dollars.

2. As a public company, Pangal should report on the basis of IFRS. If the company decides to register with the SEC, IFRS will be an acceptable reporting basis.

   There is some hint that US$ would be a possible reporting currency since 70% of the output is currently sold into the US, but the expenses are in Canadian dollars and US-sourced sales are expected to decline. Canadian dollars should be the reporting currency.

3. EI is a private Canadian company. It is unclear as to whether it is a corporation or a partnership (the consultants have to make an equity investment to become a *senior* consultant, which suggests that EI is a partnership). As a consultancy, its financial reporting probably is relatively simple (e.g., as compared to a manufacturer). Nevertheless, its primary financial statement users will be its shareholders/partners. A disclosed basis of accounting might be most appropriate, although reporting on the basis of Canadian accounting standards for private enterprises also can be appropriate.

   Since most of the company's business is with European companies, its functional currency may well be the euro. This is not clear, however, since billings can be in US$, C$, £, and other European currencies. If the consultants are mainly Canadian residents, C$ would be most appropriate.

4. CEC is a private Canadian company with extensive operations in the U.S. and in U.S. dollars. The most relevant GAAPs would be (1) Canadian accounting standards for private companies (ASPE) and (2) DBA. FASB standards (i.e., U.S. GAAP) are designed for public companies and international standards have no advantage in this situation; thus, neither is suitable for CEC. The best might be Canadian private-company GAAP, with possible variations based on industry practice (which effectively turns it into DBA).

U.S. dollars would probably be the most relevant reporting currency given that most of its operations are in the USA.

Assignment 1-10

1. CCL should continue to use Canadian private enteprise accounting standards as prescribed in the *CICA Handbook*. If the investment fund insists on near-cash basis, CCL should prepare special-purpose reports for the fund by backing out accruals and interperiod allocations other than those "permitted" by the fund. CCL can continue to have its regular financial statements audited; the auditor can then review the special purpose reports and give some assurance on them to the fund.

2. Since the company is searching for funds internationally, Canadian GAAP statements will be unfamiliar to potential investors. SEI might move to IFRS, but a better solution may be to use IFRS for SMEs, as those standards are compatible with full IFRS (and thus familar to the potential sources of financing) without involving the full range of rather onerous measurements and disclosures that full IFRS requires.

Assignment 1-11

To: Controller, Thistle Whistle Corporation
From: Accounting advisor
Subject: Revenue recognition policy

Discussion

You have asked my advice on the adequacy of authoritative support for Thistle's innovative revenue recognition policy. You have cited four sources of external "support" for your policies. However, all of these sources are quite weak:

1. An industry guide is likely to be biased in favour of enhancing the industry. In any case, a general encouragement for early revenue recognition does not constitute authoritative support for Thistle's specific method.
2. The IASB Discussion Paper lists Thistle's choice as one "possible" option, but that does not constitute support for the option. The IASB could easily refuse to accept Thistle's method when it develops an Exposure Draft, which is the next step in the standard setting process.
3. Thistle's method might "recognize the full earnings potential", but potential is not the same as earnings that are measurable and probable of realization.
4. Citing Thistle's method as "particularly innovative" does not constitute approval or authoritative support. "Innovative" or "creative" accounting is usually viewed negatively, not positively.

Recommendation

While the *CICA Handbook* may not explicitly deal with Thistle's methodology, it does provide general guidelines for revenue recognition that should be sufficient to cover Thistle's earnings process. Thistle should not attempt to override the *CICA Handbook* recommendations.

Ethical considerations

Thistle is using a complex series of third parties and agents in its revenue-generating activities. Objective observers may well wonder whether Thistle is being **ethical** in its revenue recognition policy. The extensive use of various types of offshore intermediaries will raise 'red flags' in the minds of many readers of the financial statements.

Therefore, it behooves Thistle to give full disclosure of its accounting policies, estimates, and disclosures in order to give comfort to financial statement readers. Uncertainty about Thistle's measurement methods may lead to lower values for the company's shares and/or lower credit limits from suppliers and bankers. Management should be cautioned to exercise some restraint when selecting a revenue recognition policy.

Assignment 1-12

The *IFRS Framework* cites the objectives of general purpose financial statements as:

> ... to provide financial information ... that is useful to present and potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers. Information that is decision-useful to capital providers may also be useful to other users of financial reporting who are ot capital providers.

These objectives are very broad and applications of accounting standards can still be affected by the entity-specific objectives of financial reporting. A summary follows:

Objectives	*Policy*
1. Assessing and predicting cash flow	Revenues and expenses recognized close to the related cash flows. Extensive disclosure notes regarding cash flow.
2. Income tax minimization	Defer revenues as long as possible. Recognize expenses as soon as possible. (As long as policies also acceptable for tax)
3. Contract compliance	Maximize or minimize variables specified in contract. Comply with policies required by contracts.
4. Performance evaluation	Recognize revenue when effort expended. Match expenses to revenues.
5. Maximize income (manager motivation, possibly related to bonus)	Maximize revenue or minimize expenses.
6. Minimize income	Minimize revenue or maximize expenses
7. Adhere to a pattern (smoothing or a big bath)	Maximize expenses in a loss year (big bath). Spread out revenues and expenses to reduce profit variation (smoothing).
8. Minimum compliance	Minimize bookkeeping costs by minimizing disclosures.

Assignment 1-13

Issue	Earnings maximization	Cash flow prediction	Earnings minimization
1	Average cost with LCM	FIFO with LCM	FIFO[1] with LCM
2	S.L. amortization	Amortize by unit-of-sale	Accelerated deprec.
3	*Bldgs*: straight line *Leases*: operating *Fixtures*: straight line	SL or accelerated Operating SL or accelerated	Accelerated deprec. Capital lease Accelerated deprec.
4	Defer and amortize[2]	Expense	Expense
5	*New*: capitalize and amortize *Closed*: expense–report as unusual item below operating earnings	Expense Expense–report as operating expense	Expense Expense–report as operating expense

[1] With declining inventory costs, FIFO gives higher CGS than average cost. LCM is necessary under GAAP.

Assignment 1-14

The IASB is the London-based standard-setting organization dedicated to establishing and improving accounting standards, known as International Financial Reporting Standards, or IFRS. The IASB is international in its membership, and it has direct liaisons with the major national standard-setters around the world, including the CICA.

Without common standards, transnational or multinational companies would have to comply with different accounting standards in each country in which they operate. Common international standards reduce that cost and inconvenience. Common standards also help international accounting firms because staff can be transferred around the world without special training, and the general quality of professional education, staff training, and audit work can be improved and made more consistent. Common standards facilitate financial statement transparency and compliance with security regulations.

IFRS has been adopted for public reporting by most countries, with the current exception of the U.S.A. More importantly, IFRS is accepted for foreign company reporting by most securities exchanges around the world, including Canada and USA. By adopting IFRS for public companies, the AcSB has made the international capital markets more accessible to Canadian companies because now Canadian companies will report with the same standards as everone else instead of unique standards that may not be understood outside of Canada.

While adopting IFRS for public companies, the AcSB has avoided imposing the burden of IFRS compliance on private companies by continuing Canada-specific accounting standards for private enterprises (ASPE) in the *CICA Handbook*.

Overall, this is good for Canada in an international context.

Assignment 1-15

The IASB website indicates six stages of IFRS development:

1. Setting the agenda
2. Planning the project
3. Developing and publishing the discussion paper
4. Developing and publishing the exposure draft
5. Developing and publishing the standard
6. After the standard is issued

The last stage can properly be viewed by students as not being a part of developing the standard, and thus a satisfactory response will focus on the first five stages.

Setting the agenda

Items are added to the agenda after receiving suggested topics from staff, from the Standards Advisory Council, from national standard-setting bodies, and from the corporate sector. After deliberation, the IASB decides which topics merit development and which ones either are already covered adequately by current standards or are not of sufficient economic importance to be added to the agenda.

Planning the project

The IASB decides how to go about developing a potential new standard. The IASB may decide to develop a new standard on its own, or the Board may invite other standard-setting bodies (e.g., the U.S. FASB) to enter into a cooperative development plan. The IASB may also choose establish a "working group" to help in developing the project.

Discussion paper

In some projects (but not all), the Board may decide that there is sufficient complexity and/or controversy about the topic that the various views should be gathered together and published as a discussion paper for broad circulation. The paper typically includes:

- a comprehensive overview of the issue;
- possible approaches in addressing the issue;
- the preliminary views of its authors or the IASB; and
- an invitation to comment.

Exposure draft

Issuance of an exposure draft is a mandatory step in the process. After the IASB collects and analyzes responses to its discussion paper, the Board begins deliberations that lead to an exposure draft, which is a draft of a proposed final standard. Issuance of the ED is followed by a limited comment period.

Final standard

After the comment period on the ED has ended, the Board considers the received comments and may make slight changes to the ED. Board members then vote on the proposed standard. If the new standard is accepted, the Board then publishes the final standard.

After the standard... (not required in the student responses)

After an IFRS is issued, the staff and the IASB members hold regular meetings with interested parties, including other standard-setting bodies, to help understand unanticipated issues related to the practical implementation and potential impact of its proposals.

Assignment 1-16

Dear Ms. Hari,

I am not yet an accounting expert, but I did learn in my accounting course that since our company is a public company, our financial statements should comply with Canadian generally accepted accounting principles. Canadian public companies should comply with IFRS, the international standards.

IFRS offers flexibility in some instances. However, for research and development costs, both IFRS and Canadian private-company GAAP require research costs to be expensed while development costs can be capitalized. The only way that I can see towards accomplishing your reporting objective is to try to draw the line between research and development costs to permit more expenditure to fall on the "development" side of the line.

If the company is willing to accept a qualified audit report, then the matching arguments become stronger, but future cash flow resulting from the expenditures must be "more probable than not" in order to justify the deferral. Since the company is publicly traded, an unqualified audit opinion is necessary.

Sometimes, a company will prepare a special-purpose report. In a special-purpose report, full compliance with GAAP is not a requirement. The problem is that you wish to report higher earnings to the shareholders. Unfortunately a special-purpose report will not be possible if it is to be given general distribution.

I regret that I cannot be encouraging about the prospect of capitalizing the research costs. Perhaps you should discuss this with your audit committee or with the audit partner. I regret that I cannot be of greater assistance, since I greatly enjoy my job here.

Faithfully yours,

Assignment 1-17

1. C and D
2. A
3. C and D
4. B
5. D (and perhaps C, if revenue would be recognized earlier)
6. A (and perhaps C, if payment is later than the time that expense recognition would otherwise be appropriate)

Assignment 1-18

1.	Defer depreciation	Trend is smoother if depreciation is matched.
2.	Defer depreciation	Managers will try to maximize income.
3.	Defer depreciation	Net income will be higher (partially offset by higher assets, but income is more significant).
4.	Indifferent	Accounting policy does not dictate tax policy for depreciation.
5.	Could go either way	Depreciation on idle properties could be viewed as an indication of opportunity cost. (depreciate)
		Delay of depreciation is better matching, for performance appraisal. (defer depreciation)
6.	Depreciate during idle period	Managers will try for the 'big bath'.

Chapter 2: Accounting Judgements

			Suggested Time
Case	2-1	Dubois Limited	
	2-2	BLX Shipping Limited	
	2-3	SpaceSat Limited	
Assignment	2-1	Underlying assumptions	10
	2-2	Qualitative characteristics	15
	2-3	Concepts identification	15
	2-4	Capital maintenance	15
	2-5	Capital maintenance	20
	2-6	Relevance and reliability	15
	2-7	Relevance and reliability	15
	2-8	Questions on principles	15
	2-9	Questions on principles	15
	2-10	Applications of principles (*W)	10
	2-11	Realization versus recognition	15
	2-12	Recognition of elements	10
	2-13	Elements of financial statements	10
	2-14	Questions on principles (*W)	10
	2-15	Identification of accounting principles (*W)	10
	2-16	Revenue recognition	15
	2-17	Recognition and elements	15
	2-18	Application of principles	15
	2-19	Application of principles	15
	2-20	Implementation of principles	30
	2-21	Implementation of principles	30
	2-22	Implementation of principles	30
	2-22	Implementation of principles	30
	2-23	Recognition criteria	25
	2-24	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**.

Questions

1. Accounting principles include:

   (a) Underlying assumptions – basic underlying assumptions that make accounting possible.
   (b) Qualitative criteria – standards to judge policy choices in conjunction with reporting objectives.
   (c) Measurement methods – ways to measure results and financial position.

2. The importance of establishing a document such as the IASB's Framework is that this material helps standard setters when setting new standards or evaluating old ones, and also helps those trying to (1) provide the most useful information to financial statement users, (2) understand and interpret standards, (3) set policy in areas where there are no specific standards, or (4) interpret information prepared in conformity with the concepts.

3. Ethical professional judgement is important in accounting because of the pervasiveness of choice in accounting policy and estimates. The credibility of accounting information rests on appropriate judgement, applied to be fair to all stakeholders.

4. Underlying assumptions include:

   1. Time-period—financial information can be reported over a series of time spans shorter than the total life of the enterprise.
   2. Separate-entity—financial reports relate to the activities of the business enterprise separate from its owners.
   3. Continuity—the business entity will continue in operations for the foreseeable future (going concern assumption).
   4. Proprietary approach—results are reported from the perspective of the owners, who hold residual return and risk.
   5. Unit-of-measure—results can be meaningfully expressed in monetary terms.
   6. Nominal dollar financial capital maintenance—profits are earned after historical cost is recovered; neither general inflation nor specific changing prices are considered.

5. The time-period assumption requires accruals and deferrals in accounting because cash transactions are not always completed in the accounting period to which the underlying transaction relates. Accruals and deferrals move income recognition to the year to which they relate. Accruals record revenues and expenses for which there have as yet been no cash transaction; deferrals delay recognition of revenues and expenses.

6. The continuity assumption justifies the use of historical cost to record assets, because the cost will be recovered over the assets' economic life in operations. If this assumption is not valid, assets should be valued at net recoverable amounts.

7. Owners are viewed as the residual risk-takers in the proprietary view; they receive the residual profit or loss, after all other claims are met. Under the entity view, the shareholders are only one of several stakeholders in the financial success of an entity.

8. Inflation is a major factor when dealing with the nominal dollar financial capital maintenance assumption. This presumes that income has been earned when the financial capital invested in an item, not adjusted for inflation, has been recouped. The stable dollar assumptions is made.

   For example, if an item bought for $10 is sold for $14.50, $4.50 of income is earned. But if invested capital, $10, has been eroded by inflation, then income is overstated. If inflation had been 10% during the holding period, the entity should retain $11 ($10 × 1.10) and only consider $3.50 ($14.50 – $11.00) income. This would be an application of *constant dollar* financial capital maintenance.

9. Financial capital maintenance is the concept that residual (and distributable) income remains only after preserving financial capital; the closing amount of net assets must exceed the amount at the start before net income is present. In contrast, physical capital maintenance is the concept that residual income results only after preserving physical capital or productive capacity.

   The difference between the two concepts relates to the amount of income earned through a given transaction. For example, if an item bought for $10 is sold for $14.50, $4.50 of income is earned under financial capital (measured in nominal dollars). But if it would cost $12 to replace the item, then income is only $14.50 – $12 = $2.50. The entity must retain $12.00 in order to replace its physical capacity.

10. Three measures of income:

    a. Nominal dollar financial capital maintenance: $1,500 – $1,000 = $500. Income is earned as long as the original investment, $1,000, is retained.

    b. Constant dollar financial capital maintenance: $1,500 – ($1,000 × 1.04) = $460. Income is earned as long as the inflation-adjusted original investment, $1,040, is retained.

    c. Physical capital maintenance: $1,500 – $1,120 = $380. Income is earned as long as the amount need for (physical capital) inventory replacement value is retained.

11. The two fundamental characteristics of accounting information are:
    (1) Relevance—accounting measurements must be useful to the needs of financial statement users for making decisions.
    (2) Representational faithfulness—accounting measurements must be reasonably accurate measures of what they purport to measure, without out bias.

12. To be relevant, information must be presented in a timely fashion. However, in many instances, accuracy (i.e., representational faithfulness) can be improved with the passage of time when the ultimate outcomes of year-end balances (such as accounts receivable, inventory, contingent liabilities, etc.) become known. Such a delay makes the information less relevant, however, because it comes too late for effective decision-making by users.

13. The statement is not true. Accounting measures complex economic phenomona and the results cannot be understood unless the financial statement user is reasonably knowledgeable about (1) business and economic activities and (2) accounting concepts and measurement methods. Users who are not sophisticated or knowledgeable about accounting, they are expected to hire experts who will provide interpretation and advice.

14. Comparability is the ability to ascertain differences and similarities between two pieces of information. Consistency eliminates differences between years, as it requires entities to use the same policies from year to year. Uniformity eliminates differences between companies, as it requires different companies to use the same policies for similar transactions, if all circumstances are similar.

15. When evaluating cost/benefit effectiveness, costs refer to the costs to prepare the information, and also the costs of, for example, making information available to the general public, which would include competitors. Benefits are felt by the user groups, in the form of 'better' decisions. The entity participates in these decisions only indirectly, through a 'more accurate' share price or loan cost.

16. The definitions of assets and liabilities embody three components and three time frames:

    (a) Economic benefits must be received or given up in the **future**.
    (b) The rights (obligations) to (for) economic benefits must be clear in the **present**.
    (c) The asset or liability must be the result of a **past** event.

17. A revenue is derived from ordinary business activities of the enterprise; a gain arises from peripheral or incidental transactions or events.

18. Recognition means recording a transaction or event in the books, while realization means cash flow. Realization always triggers simultaneous recognition because cash transactions require immediate recognition in the accounts.

19. Revenue can be recognized when:
    - all significant acts required of the seller have been performed, and the rists and rewards of ownership have been passed to and accepted by the buyer;
    - the amount of consideration is measurable; and
    - collection of the revenue is reasonably assured.

20. Ethical professional judgement is a necessary element in the process of selecting accounting policies. It involves the ability to weigh the objectives of financial reporting in a given situation, the facts of the business environment and operations, the organization's reporting constraints, blended with appropriate reference to qualitative criteria.

Cases

Case 2-1

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.

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

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.

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, Mange 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 enteprises (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.

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.

Case 2-2

Overview

BLX Shipping Limited is a public company with considerable incentive to manipulate financial results. They have not met market expectations in the past year, and share price has declined from $20 to $14. The company had to restate prior earnings, and they replaced the CFO. The container shipping industry in which they operate is highly price competitive and cyclical. There may be **ethical** issues in the accruals and estimates used.

Issues – Accounting policy for:

1. Revenue recognition
2. Dry-docking expenditures

Analysis

1. Revenue is recognized when all significant acts of the seller have been performed, consideration is measurable and collection is reasonably assured. There do not seem to be any direct concerns about these criteria, except that the costs associated with the revenues must be measured. Actual invoices for costs are slow to surface. Because of the distance – and perhaps cultures – involved, time spans are long for receiving actual cost data. One of the recognition criteria is that items must be measurable to be recognized. If costs are not measurable, they cannot be recognized. Accrued liabilities are improperly stated if not completely measured. If costs can't be accrued, then revenue should not be, either. Matching cannot be accomplished unless costs are accrued to match to revenue.

   On one hand, management may be well qualified to make estimates, and since revenue has clearly been earned in the year (delivery has been made) the financial statement reader is better informed with the revenue recongnized as it is now. On the other hand, the material restatement of prior years provides evidence that management has not always been correct in their estimates. While the mis-estimate was flagged as related to unsettled industry conditions and adverse exchange rates, this can hardly be viewed as unusual in the industry or world economy. Concern about the policy chosen seems justified. One wonders whether management was acting **ethically**, and whether the replacement of the CEO was somehow related.

   Financial statement readers may be misled by the trends in revenue and net income shown that include the accrued amounts. See the discussion below.

2. The company defers and amortizes dry-dock expenditures. One can argue that the expenditures create future benefit in that they ensure that the vessels are in working order until the next scheduled dry-dock. Since dry-dock costs are sporadic, matching is better served by deferral and amortization. Future revenue from the vessel establishes the future benefit. On the other hand, regular maintenance does not make

the vessel "better" or enhance its future revenue generation, and normal repairs are expensed. Recognition criteria are not met because future benefit is not proven.

Deferred costs are an an internally developed intangible asset. Standards in the area must be reviewed and satisfied if amounts are to be capitalized. Here, the product is defined and the costs appear to be known. Probable future revenue is likely present. However, deferred costs do not qualify for deferral because there is only an asset if there is a severable asset, or one created through contractual right or legal contract. This is problematic for this type of cost. (Note that this material is the subject of later text discussion and may not be cited by the student at this point.)

Accrual of the costs in advance of dry-docking is even more problematic. BLX would need to estimate the future cost of dry-docking. Given the erratic history of the dry-docking expenditures, estimation would be fraught with difficulties, and also an invitation to unethical manipulation with intent (conscious or subconscious) to affect net income.

Financial statement readers may be misled by the trends in revenue and net income shown that include the accrued amounts. See the discussion below.

Impact on revenue and net income

Refer to Exhibit 1 for restated revenue and net income. Revenue from contracts for which costs are not known is apparently up and down. Trends are changed when one adjusts this revenue, delaying it until the following year when costs would presumably become known. While the *reported* revenue showed a steadily increasing trend, the *revised* revenue stream looks negative for the last two years ($932 versus $1,035), and has shown great volatility (reducing to $658 in 20X3, and rebounding to $1,035 in 20X4). It should be emphasized that, since the reported numbers are based on containers actually delivered to customers, the originally reported numbers are a better indication of the effort expended in the year. However, the reasons for the volatility of accruals is not clear.

In particular, there appears to be a wide range associated with the cost of services accrued. In 20X5, for instance, the $95 cost is 30% of revenue, while the 20X4 restated cost, presumably now accurate after restatement, is 41%. The 20X3 year has 35% cost, and 20X2, 38%. The low cost percentage in 20X5 is suspicious because it is out of line with prior years.

Dry-docking cost is sporadic, and amortization is a smoother pattern. If dry-docking is expensed as incurred, the overall pattern of net income is less smooth.

Overall, when both revenue and dry-docking costs are adjusted, net income becomes far more volatile, with losses recorded in two years (20X5 and 20X3) and higher net incomes in the other two years. Perhaps accounting policies are being used to smooth income, a result that might have **unethical** overtones.

Conclusion

An individual investor is in no position to change the accounting policies of a company. Their task is to understand the implications of these policies. For BLX, accrual of revenue where costs are unknown may or may not be defensible. Dry-docking costs appear to fail the recognition tests and are more approriately expensed. The outcome of the two chosen policies is that the financial statement reader might believe that BLX had more stable revenue and earnings history that the underlying economics of the industry might support. Knowledgeable readers and efficient markets should not be fooled by this, and the reduced stock price in the current year might indeed reflect current economic realities for the company.

Exhibit 1
BLX Shipping Ltd
Restated revenue and income
(amounts in millions)

YEAR	**20X5**	**20X4***	**20X3***	**20X2***
Revenue	$1,100	$ 939	$ 807	$ 795
Current year	(316)	(148)	(244)	(95)
Prior year	148	244	95	152
Revised	$ 932	$1,035	$ 658	$ 852
Net income	$ 27.2	$ 30.6	$ 22.8	$ 41.7
Revenue (1):				
Current year	(132.6)	(52.8)	(94.8)	(35.4)
Prior year	52.8	94.8	35.4	59.4
Dry-docking (2)	(9.6)	4.8	8.4	(4.2)
Revised NI	$(62.2)	$ 77.4	$(28.2)	$ 61.5
(1) *Revenue*				
Current year	$ 316.0	$ 148.0	$ 244.0	$ 95.0
Expense	95.0	60.0	86.0	36.0
Gross profit	221.0	88.0	158.0	59.0
Tax (40%)	88.4	35.2	63.2	23.6
Net	$ 132.6	$ 52.8	$ 94.8	$ 35.4
(2) *Dry-docking*				
Spent	$(30.0)	$(10.0)	$ (2.0)	$(24.0)
Amortization	14.0	18.0	16.0	17.0
Difference	(16.0)	8.0	14.0	(7.0)
Tax (40%)	6.4	3.2	5.6	2.8
Net	$ (9.6)	$ 4.8	$ 8.4	$ (4.2)

* As restated

Case 2-3

SpaceSat Limited is a federally regulated monopoly in the communications industry; as such, we are politically visible and interested in full accountability. We have to give recognition to the public interest. SSL has significant capital investment in high technology assets and has reasonably high debt levels (65% of assets). SSL's pattern of stable but low income and respectable returns is consistent with our political visibility. Financial statement users include investors, creditors, and the general public.

The **ethical** issue for the company is whether to perform the clean-up. This is a separate from the accounting issue of how to account for the company's intentions. The Board of Directors should be kept fully informed so as to make this important decision, in the best interests of all stakeholders.

Issue/Alternatives

Accounting for the potential disposal costs of obsolete satellites is under consideration. The alternatives are:

1. Do nothing.
2. Disclose the situation and the potential for liability.
3. Record an estimated liability.

Analysis

A liability must be recorded if:

1. The definition of a liability is met (a future sacrifice of economic benefits based on past transactions).
2. There is an appropriate basis of measurement, for which a reasonable estimate can be made.
3. The sacrifice of benefits is probable.

Cleanup costs based on past use and abandonment of a satellite would clearly require the sacrifice of economic benefits, or the outflow of cash or other resources to fund a cleanup as a result of a past transaction. Thus, these costs meet the definition of a liability. The basis of measurement would be the cost of the cleanup program (or its present value), but the availability of a reliable estimate is a problem to be faced. Another problem is criteria 3, the probability of a cleanup being necessary. Payment is probable if the cleanup is legistatively required or if the Baord of Directors had decided to commit to the cleanup.

Following are the alternatives:

1. *Do nothing*:
   With this alternative, there would be no accrual and no disclosure. It would be appropriate if the probability of the liability is deemed so low that the liability should

not be recognized. At present, there is no precedent for such a liability, as there is no legislation or court decision establishing the need for a cleanup. "Talk" in government circles does not constitute enacted legislation. This approach is consistent with the proprietary view of ownership interests, which focuses on direct costs paid by shareholders, and under which acknowledging other stakeholders affected by environmental problems is inappropriate.

On the other hand, it can be argued that we have an ethical responsibility to take care of our waste problems. This view is becoming the political norm, and the likelihood of future legislation is greater because of the prevailing social climate. Lack of recognition and disclosure is less consistent with SSL's political visibility. The presence of a "surprise liability" that must be absorbed into income in the future would not promote stable earnings or debt levels.

2. *Disclosure*:
   Disclosure is appropriate for loss contingencies that are probable (or indeterminable, in certain circumstances) but for which no estimate is obtainable. Since technology for cleanup is not yet established, any estimate for cleanup costs would be a guess. Financial statements should not be contaminated by unreliable numbers; otherwise, usefulness will suffer. Disclosure would demonstrate our social conscience, ensure that financial statement users are aware of the potential problem, and provide full public accountability. An estimate of cost ranges, if reasonably determinable, could be provided. Investors, creditors, and the general public could be made aware of the situation and benefit from the information provided.

   It could be argued that disclosure goes too far—that to do nothing is still the best alternative. The probability of cleanup is remote, making note disclosure misleading and unnecessary; it might scare creditors and investors.

3. *Record liability*:
   Note that if a liability is recorded, a debit must be created. The result will be an expense over some period.

   This alternative is appropriate if the outflow of economic resources is probable and an amount is estimable. What is the likelihood of government legislation? Would we invest shareholder's funds in such a cleanup if there were no legislation? How strong is the corporate ethic that SSL is responsible for waste? Furthermore, an estimate would be needed, which may prove to be inaccurate.
   However, recording the liability would reflect a strong social ethic and be consistent with political visibility. It would match the cost of the eventual cleanup with the revenue generated currently.

   This alternative is consistent with the entity view of ownership interests because it acknowledges the general public as a stakeholder with respect to the environmental impact of the firm's actions. This is the **ethical** high road.

The negative points are that the liability may not be likely and that the amount is uncertain; therefore, it cannot be recorded. Investors and creditors may be hurt if SSL is made to look risky or less profitable. This is especially true if the potential liability never materializes.

Recommendation

The overall assessment is that this potential future liability has the following characteristics:

Probability—undeterminable
Measurability—undeterminable

A reasonable conclusion for such an item is "do nothing"—do not disclose or record in the financial statements. Items which are in the news could be addressed by the company in the MD&A or other disclosures to the public that are not audited and where more explanation is allowed. It is often unwise to be totally silent on an issue that most reasonably informed investors are concerned about. Alternatively, due to the political environment in which we operate, disclosure could be considered very desirable.
The situation should be monitored carefully. When and if the likelihood of payment becomes higher, strenuous efforts should be made to develop a cost estimate that can be recorded. In this fashion, SSL can provide evidence of its social responsibility and **corporate ethics.**

Assignments

Assignment 2-1

1. T
2. T
3. F
4. F
5. F
6. F
7. T
8. T
9. T
10. F

Assignment 2-2

1. Qualitative criteria require that a measure be a faithfull 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 uncollectible accounts estimates. 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. Completed contract does require far fewer estimates than percentage-of-completion, and therefore representational faithfulness is increased. On the other hand, the absence of any profitability information prior to completion definitely decreases relevance, giving the earnings information little predictive or confirmatory value. As well, comparability is greatly impaired because other companies in the industry are using the percentage-completion method.
4. 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.
5. In substance, 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.

Assignment 2-3

Solution:

I	1. Any accounting method is acceptable for small items that will not change users' decision.
E	2. Assets that increase in value are not written up in the financial statements.
K	3. Means consciously understating assets and income.
G	4. Warranty expense that takes place two years after a sale is accrued in the (earlier) period of the sale.
L	5. A complicated accounting method that will not improve decisions of financial statement users will not be required in the financial statements.
J	6. Information must be verifiable.
F	7. Determines the timing of recognition of revenues.
A	8. Distinguishes personal transactions of the owners from transactions of the business.
B	9. Enables historical cost, rather than liquidation values, to be used.
D	10. Enables measurement of the income and financial position of entities at regular intervals.
H	11. Requires recognized and many non-recognized items to be fully described in the notes to the financial statements.
C	12. Assumes that all financial statement elements can be meaningfully described in dollar terms

Assignment 2-4

Requirement 1

Three measures of income:

a. Nominal dollar financial capital maintenance:
$90,000 – $64,500 = $25,500

b. Constant dollar financial capital maintenance:
$90,000 – ($64,500 × 1.04) = $22,920

c. Physical capital maintenance:
$90,000 – $74,300 = $15,700

Requirement 2

Cash remaining

a. Nominal dollar financial capital maintenance: $90,000 – $25,500 = $64,500; this is the original dollar investment in inventory.

b. Constant dollar financial capital maintenance: $90,000 – $22,920 = $67,080; this is the original dollar investment of $64,500 stated in inflation-adjusted dollars: $64,500 × 1.04 = $67,080.

c. Physical capital maintenance: $90,000 – $15,700 = $74,300; 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.

Assignment 2-5

1. Nominal dollar capital maintentance

Sales revenue		$100,000
Cost of goods sold ($40,000 – $16,000)	$ 24,000	
Depreciation ($200,000 × 20%)	40,000	
Total expenses		$ 64,000
Net income		$ 36,000

2. Physical capital maintenance

Sales revenue		$100,000
Cost of goods sold ($40,000 – $16,000) × 0.90	$ 21,600	
Depreciation ($200,000 × 20% × 1.03)	41,200	
Total expenses		$ 62,800
Net income		$ 37,200

Assignment 2-6

Relevance is the characteristic of usefulness. Information should be useful for making decisions. *Reliability* includes several characteristics: representational faithfulness, verifiability, and freedom from bias. 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 2-7

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

Assignment 2-8

1. Disagree. Historical cost violated; inventory must be carried at cost, not market.
2. Disagree. Timeliness violated because statements are needed more frequently than every three years
3. Disagree. Reliability or representational faithfulness (or conservatism) 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. Representational faithfulness is violated because netting is not generally allowed. Financial statement elements are not appropriately stated.
6. Agree. Because the item is not material, it does not need to be corrected.

Assignment 2-9

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 things that are owned, such as processes and other intangible assets, are not shown as assets. The asset definition involves future benefit (future cash flow) from costs incurred in the past, not ownership.
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; Intangible assets often fail the unit of measure or reliability tests.
9. False. Materiality is also based on the nature an item.

Assignment 2-10 (WEB)

Issue	*(1) Correctness*	*(2) Principle*	*(3) Comment*
1.	Correct	Separate-entity	Does not always correspond to the legal entity.
2.	Incorrect	Representational faithfulness (Substance over form)	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.
3.	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.
4.	Incorrect	Full disclosure	Too much detail is as harmful as not enough detail—GAAP requires full disclosure but excessive detail obscures more significant information.
5.	Correct	Net asset principle	If inventory cost is higher than its recoverable value, the inventory value must be written down to LCM to avoid overstating net assets' future benefit.
6.	Incorrect	Historical cost measurement	This principle applies to most transactions and to the SFP as well as the income statement.
7.	Incorrect	Revenue recognition	Revenue must be recognized when earned, measurable, and realizable, regardless of the timing of the related cash flow.
8.	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.
9.	Incorrect	Revenue and matching; Representational faithfulness; 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 2-11

	Initial transaction recognized	*Element realized by cash*
1.	On sale	On payment
2.	1 August	12 September
3.	Cash receipt recognized and unearned revenue recognized	20 February
	Revenue recognized—	10 March
4.	1 July	1 July
5.	Daily	End of six months
6.	1 February	1 March

Assignment 2-12

1. Account payable (and utilities expense)
2. Patent, intangible asset; recorded at cost to create and register, usually a fraction of real worth due to reliability (measurement) problems in determining fair value at registration.
3. Not recognized; value to the company cannot be reliably measured.
4. Not recorded; not a financial statement element. If a contract existed with a future shareholder, the account receivable and subscribed common shares could be recognized.
5. Recognized, cost of work completed so far (as inventory).
6. Not recognized; the amount of loss (if any) usually cannot be estimated accurately.
7. Not recorded; not reliably measurable past cost or future benefit, and not the result of a transaction
8. Unearned revenue, a liability to perform work. Cash has also increased.

Assignment 2-13

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 2-14 WEB

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

Assignment 2-15 WEB

Case A:
Comparability is violated. The accounting information is not comparable because the depreciation method is not consistent between periods.

Case B:
Representational faithfulness 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 of $45,455: [($55,000 ÷ 1.21 = $45,455).

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

Case C:
This situation violates relevance, including timeliness, even if the information may be more representationally faithful. 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.

Assignment 2-16

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.
4. No revenue recognition—there must be a sale transaction to recognize the increase in value.
5. Revenue recognition of two months' interest, to reflect the passage of time.
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. (If collection is considered to be especially problematic, installment sales or cost recovery might be applicable.)

Assignment 2-17

1. The commitment is an executory contract. There will be no elements recognized until the equipment has been delivered or payment (full or partial) has been made, whichever happens first.
2. No financial statement element has been created. The potential value of unissued stock is not an asset.
3. Rent revenue and rent receivable are recognized because the services were rendered, measurable (assuming there is a lease that sets the price), and collection is probable.
4. The cost of the trademark is recognized as an intangible asset, to be amortized as an expense over the five years.
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. Competitor status is not recognized in the financial statements. There is no basis for recognition because no identifiable revenue has yet been received.
8. Future costs of site restoration are estimated and recognized as an asset and a liability. The asset is amortized over time, creating an expense.

Assignment 2-18

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 (consistency). Accounting standards and procedures should be applied consistently from period to period within a given entity.
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. Information should be complete to be helpful in making the decisions users face. 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. There could be a cost/benefit issue if making this information public helps competitors.

Situation D

1) Reliability, representational faithfulness, neutrality. Accounting information should be reliable; it should be free from error and bias. It should represent what it purports to represent.
2) The company policy is inappropriate. There is a 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.

Situation E

1) Materiality, representational faithfulness, full disclosure. Reporting should correspond to what it purports to represent, so the treatment 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 gross amounts continue to be immaterial.

Assignment 2-19

a) This entry violated the cost principle (and representational faithfulness) because the merchandise cost $78,400. The entries should have been:

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

b) The recording and reporting violated the matching principle and representational faithfulness. 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.

The correct entry is:

Depreciation expense	227,000	
Accumulated depreciation		227,000

The debit item is reported on the income statement.

c) This entry violated the cost and matching principles as well as representational faithfulness. 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) This reporting of the storm loss was in violation of the matching principle, and representational faithfulness. The definition of an asset is not met. A known loss should be reported as a loss when it occurs; no part of the loss should be deferred as an asset. There are no future benefits. 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 entry should have been:

Storm loss	96,000	
Cash, accounts payable, etc.		96,000

The loss should be reported as follows:

Income Statement:
Unusual item—Storm loss 96,000

SFP: No specific reporting, although assets do decrease.

e) Both the full disclosure principle and the materiality constraint were violated because the loan should have been reported as a non-current asset, as it is not due for three years. Also, the representational faithfulness 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 2-20

a) This entry violated the revenue principle and representational faithfulness. Dividends cannot be paid on retired shares. 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, revenue recognition and conservatism. The asset should be recorded at the current market value of the consideration given or the value of the asset received, whichever is the more reliably determinable. A gain cannot be recorded on issuing shares. In this instance the market price per share should be used, as the value of the consideration given up. It also provides a more conservative value.

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 representational faithfulness. 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:

Repair expense—flood damage	97,000	
Cash		97,000

e) This entry violated representational faithfulness: 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 2-21

Cash:

The cash should be reported at $314,286; i.e., [$300,000 + ($100,000 ÷ 7)] The HK$ must be reported at its Canadian dollar equivalent.

Babcock has violated the principle of representational faithfulness, 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 available-for-sale.

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

When standard setters elected to recognize market values (fair values) for investments such as this, they had to decide whether to report the reliable data (cost) or the more relevant number (market value). Relevance won, although some reliability was sacrificed since the market value number is not as objective as cost.

Accounts receivable:

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

Babcock 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. Conservatism is also violated.

Sundry payables:

Babcock 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 reliability of the financial statements is reduced when this liability is omitted. Babcock has violated the principle of representational faithfulness, and also full disclosure.

Assignment 2-22

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 justified 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 probable that the outflow will happen, and the lawsuit will be lost or voluntarily settled.

Disclosure of the lawsuit satisfies the full disclosure requirement.

Assignment 2-23

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. GAAP requires 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 cannot be estimated 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 cost will have a significant impact on future earnings.

Assignment 2-24 WEB

Case A

The financial statements are not reliable (not free from bias) 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 reliable, in that they are not free from bias. 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

Reliability is violated by netting current assets with current liabilities. The financial statements are not representationally faithful. 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.