Intermediate Accounting Volume 1 (Canadian) 13th edition Kieso Solutions Manual

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CHAPTER 2

CONCEPTUAL FRAMEWORK UNDERLYING FINANCIAL REPORTING

Learning Objectives

1. Indicate the usefulness and describe the main components of a conceptual framework for financial reporting.
2. Identify the qualitative characteristics of accounting information.
3. Define the basic elements of financial statements.
4. Describe the foundational principles of accounting.
5. Explain the factors that contribute to choice and/or bias in financial reporting decisions.
6. Discuss current trends in standard setting for the conceptual framework.

Summary of Questions by Learning Objectives and Bloom's Taxonomy

Item	LO	BT	Item	LO	BT	Item	LO	BT	Item	LO	BT	Item	LO	BT
Brief Exercises														
1.	2	K	5.	2	C	9.	2	C	13.	3	C	17.	1,2,5	C
2.	2	K	6.	2	C	10.	2	K	14.	3	C			
3	2	C	7.	2	C	11.	3	C	16.	3	K			
4.	2	C	8.	2	C	12.	3	C	16.	4	K			
Exercises														
1.	1	C	5.	3	K	9.	3,4	C	13.	2	C	17.	4,6	C
2.	2,5	C	6.	4	C	10.	4	C	14.	2,3,4	C			
3.	2	K	7.	4	K	11.	2	C	15.	4,5	C			
4.	2	C	8.	4	K	12.	1,2,4	C	16.	4	C			
Problems														
1.	4	C	3.	2,4	C	5.	3	C	7.	2	C			
2.	2,4	C	4.	2	C	6.	5	C	8.	2,4	C			
Cases														
1.	4,5	C	2.	3	C	3.	4	C						
Research and Analysis														
1.	4	C	3.	6	AP	4.	6	AN	5.	6	AN	6.	6	AN
2.	4	AP												

Legend**:** The following abbreviations will appear throughout the solutions manual file.

LO	Learning objective	
BT	Bloom's Taxonomy	
	K	Knowledge
	C	Comprehension
	AP	Application
	AN	Analysis
	S	Synthesis
	E	Evaluation
Difficulty:	Level of difficulty	
	S	Simple
	M	Moderate
	C	Complex
Time:	Estimated time to complete in minutes	
AACSB	Association to Advance Collegiate Schools of Business	
	Communication	Communication
	Ethics	Ethics
	Analytic	Analytic
	Tech.	Technology
	Diversity	Diversity
	Reflec. Thinking	Reflective Thinking
CPA CM	CPA Canada Competency Map	
	Ethics	Professional and Ethical Behaviour
	PS and DM	Problem-Solving and Decision-Making
	Comm.	Communication
	Self-Mgt.	Self-Management
	Team & Lead	Teamwork and Leadership
	Reporting	Financial Reporting
	Stat. & Gov.	Strategy and Governance
	Mgt. Accounting	Management Accounting
	Audit	Audit and Assurance
	Finance	Finance
	Tax	Taxation
	DAIS	Data Analytics and Information Systems

ASSIGNMENT CLASSIFICATION TABLE

Topic		Brief Exercise	Exercise	Problem
1.	Usefulness of the Conceptual Framework (CF) and main components of CF	17	1, 2, 13	
2.	Qualitative Characteristics	1, 2, 3, 4, 5, 6, 7,8, 9, 10, 17	2, 3, 4, 7, 8, 12, 13, 14	2, 3, 4, 5, 7, 8
3.	Elements	11, 12, 13,14,15	5, 9, 14	2, 3, 5, 8
4.	Foundational Principles	10, 16	7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17	1, 2, 3, 5, 7, 8
5.	Forms of organizations		6	
6.	Accounting choices and bias	4, 17	2, 15	2, 6, 7

ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
E2.1	Conceptual framework.	Moderate	20-25
E2.2	Qualitative characteristics.	Moderate	20-25
E2.3	Qualitative characteristics.	Simple	15-20
E2.4	Materiality	Moderate	20-25
E2.5	Elements of financial statements.	Simple	15-20
E2.6	Forms of organizations	Moderate	20-25
E2.7	Foundational principles	Simple	15-20
E2.8	Foundational principles	Moderate	20-25
E2.9	Foundational principles	Moderate	30-35
E2.10	Foundational principles	Simple	10-15
E2.11	Foundational principles	Moderate	20-25
E2.12	Foundational principles	Moderate	25-30
E2.13	Trade-offs in financial reporting	Moderate	15-20
E2.14	Accounting principles–comprehensive	Moderate	15-20
E2.15	Full Disclosure	Complex	35-40
E2.16	Going Concern	Simple	15-20
E2.17	Revenue recognition principle	Moderate	20-25
P2.1	Financial reporting issues	Simple	10-15
P2.2	Accounting Principles - comprehensive	Complex	30-35
P2.3	Accounting Principles - comprehensive	Complex	30-35
P2.4	Trade-offs in financial reporting	Moderate	20-25
P2.5	Accounting Principles - comprehensive	Complex	30-35
P2.6	Financial engineering.	Moderate	15-20
P2.7	Issues in financial reporting	Moderate	15-20
P2.8	Qualitative characteristics.	Moderate	20-30

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 2.1

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

LO 2 BT: K Difficulty: S Time: 15 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 2.2

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

LO 2 BT: K Difficulty: S Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 2.3

Tim is correct. Prudence is included as part of neutrality. Neutrality is supported by the exercise of prudence. Prudence is the exercise of caution when making judgements under conditions of uncertainty.

LO 2 BT: C Difficulty: M Time: 5 min. AACSB: Ethics CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 2.4

	(a)	(b)
Step 1: Identifying any information that might make a difference to primary users of the financial statements when they are making investing and lending decisions.	**Carrying amount, cost and accumulated depreciation are overstated. Gain or loss are understated but limited to 10% of the carrying amount.**	**Carrying amount of destroyed asset is near zero. Cost and accumulated depreciation are overstated. Gain will be substantial, as it will be the cost of the replacement asset.**
Step 2: Assess whether the information is material (including doing a quantitative and qualitative assessment).	**Carrying amount is overstated because the equipment which no longer exists is shown on the statement of financial position. The omission may be material if relied upon by users, for example for credit decisions.**	**The cost of the replacement asset is pure gain on the recording of the disposal. The omission is deemed material. The carrying amount of the destroyed asset is still shown on the statement of financial position but would not be material.**
Step 3: Make sure the information is organized in the financial statements in a way that is clear and concise so that the user may make an informed decision.	**No restatement of the financial statements is necessary if the carrying amount of the equipment is considered not material. The omission is deemed not material.**	**Remove the cost and accumulated depreciation of the asset disposed of. Record the insurance proceeds as the cost of the replacement asset and a corresponding gain on disposal.**

BRIEF EXERCISE 2.4 (CONTINUED)

	(a)	(b)
Step 4: Review the complete set of financial statements in the end to ensure that all material information has been included and presented appropriately for all items.	**Omission is deemed not material if the carrying amount of the equipment does not significantly affect ratios that rely on assets.**	**Provide an explanation of the unusual gain in the notes to the financial statements.**

Additional note: There is additional measurement uncertainty involved given the short time frame involved. It may be uncertain if insurance proceeds would in fact be received given that the investigation is not complete.

LO 2 BT: C Difficulty: M Time: 15 min. AACSB: Ethics CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 2.5

When writing the management discussion and analysis portion of the annual report, management emphasizes the company's financial results in terms of how the company's goals and objectives have been reached. There is invariably some bias factored in the information in favour of management, since management is interpreting the financial results. When it comes to the financial statements, the information is prepared in accordance with GAAP. Readers know that the financial statements included in the annual report have been audited and an opinion has been expressed by independent CPAs as to the fairness of the financial statements.

LO 2 BT: C Difficulty: M Time: 10 min. AACSB: Ethics CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 2.6

An analysis of the recoverable amount of goodwill should be done in a neutral, unbiased and fair way. Should the recoverable amount fall short of the carrying amount of goodwill, an impairment loss must be recorded. Once arrived at, this conclusion should be shared with the CEO. The emphasis should be placed on the process of arriving at the recoverable amount so that the CEO can develop some confidence in the validity of the analysis. The details surrounding the loss will be explained in the notes to the financial statements, and will need to be addressed by the CEO in the message to the shareholders contained in the annual report.

LO 2 BT: C Difficulty: M Time: 10 min. AACSB: Ethics CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 2.7

Step 1. Identify the economic event or transaction.
The law suit against Sider is an economic event.

Step 2. Identify the type of information about that transaction or event that would be relevant and can be faithfully represented.
The relevant information in performing an assessment of this contingent liability includes the probability of occurrence for the negative outcome upon settlement of the matter and the measurement of the estimated amount that will be paid.

Step 3. Assess whether the information is available and can be faithfully represented.
Sider's management has already taken steps, including using the opinion of legal counsel, to determine the likelihood and probable amount that will be paid to settle the litigation. With this assessment in place, the recording of a litigation loss / provision in the amount of $250,000 is appropriate.

LO 2 BT: C Difficulty: M Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 2.8

Step 1. Identify the economic event or transaction.
The submission of the sealed bid allows for the potential to be awarded the roads contract should Bradford Construction's price and terms be determined to be most favorable to the municipality. As of the date of the submission of the sealed bid, no contract exists. There is no transaction. There is uncertainty concerning whether the contract will be awarded.

Step 2. Identify the type of information about that transaction or event that would be relevant and can be faithfully represented.
Had the contract been awarded, the amount of the contract asset and contract liability would be recorded, in the amount of $14.5 million.

Step 3. Assess whether the information is available and can be faithfully represented.
Since the bid submission for the fixed price contract is for a specific price, this would be the best evidence of the asset and liability to be recorded, although no asset is recorded at this time.

LO 2 BT: C Difficulty: M Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 2.9

(a) Bradford is awarded the contract.

Step 1. Identify the economic event or transaction.
As of December 31, 2023, the only event that has occurred is the submission of the sealed bid which allows for the potential to be awarded the contract should Bradford Construction's price and terms be determined to be most favorable to the municipality. As of the date of the submission of the sealed bid, no contract exists. There is no transaction. As a subsequent event to the year end, Bradford is awarded the contract and there is no longer any uncertainty concerning the contract. On January 15, 2024, an economic event and transaction have occurred.

Step 2. Identify the type of information about that transaction or event that would be relevant and can be faithfully represented.
Because the contract is a fixed price contract and it has been awarded, the amount of the contract asset and contract liability would be recorded on January 15, 2024 in the amount of $14.5 million.

Step 3. Assess whether the information is available and can be faithfully represented.
The fixed price set out in the bid submission, along with the contract conditions are contractual terms and represent the best evidence of the asset and liability recorded.

BRIEF EXERCISE 2.9 (CONTINUED)

(b) Bradford is not awarded the contract.

Step 1. Identify the economic event or transaction.
At December 31, 2023, the only event that has occurred is the submission of the sealed bid and there is no transaction. Subsequent to the year end, on January 15, 2024, it is determined that there remains no hope of being awarded the contract. No future transaction will occur.

Step 2. Identify the type of information about that transaction or event that would be relevant and can be faithfully represented.
Because the contract was not awarded to Bradford and management had the benefit of becoming aware of the outcome of the bidding process by the date of the issuance of the financial statements, no information concerning this bid would be relevant for disclosure.

Step 3. Assess whether the information is available and can be faithfully represented.
The decision concerning the awarding of the contract is final and no other outcome is possible.

LO 2 BT: C Difficulty: M Time: 20 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 2.10

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

LO 2,4 BT: K Difficulty: S Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 2.11

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

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

BRIEF EXERCISE 2.11 (CONTINUED)

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

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

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

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

LO 3 BT: C Difficulty: M Time: 20 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 2.12

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

b. Environmental remediation after a chemical spill when no law has been broken: If there is no legal burden or requirement to bear the remediation costs, whether there is a liability will depend on whether the entity actually has an obligation for remediation. It must be determined whether there are other means by which remediation is enforceable on the entity, that is, whether there is little or no discretion for the entity to avoid the costs. In some jurisdictions, specific actions by the entity, such as a statement accepting responsibility and agreeing to clean-up costs, may be sufficient to be enforceable in a court of law. Alternatively, it may represent a constructive obligation (i.e. the company has remediated for similar spills in the past even though not legally obligated to do so); constructive obligations are discussed in Chapter 6 and 13. Again, it is assumed that the spill took place prior to the balance sheet date so that if the entity is obligated, it is a present duty or responsibility.

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

BRIEF EXERCISE 2.12 (CONTINUED)

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

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

LO 3 BT: C Difficulty: M Time: 20 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 2.13

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

1. **They represent a present economic resource — a right that has the potential to produce economic benefit.**
2. **The entity has control over that resource.**
3. **The resource results from a past transaction or event.**

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

a. Should be debited to the Land account, as it is a necessary cost incurred in acquiring land (historical cost principle). The legal costs are associated with the land. They are not expenses associated with revenue-generating activities and do not meet the definition of an expense.

b. As a present tangible asset, preferably recorded to a Land Improvements account. The driveway will last for many years, and therefore it should be capitalized and depreciated. (Capitalizing to Land would result in no depreciation which is not appropriate for a driveway).

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

BRIEF EXERCISE 2.13 (CONTINUED)

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

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

f. The delivery driver's wages do not represent a present economic resource; they represent an operating expense, as the benefits are used up as the service is provided. There are no future economic benefits. The payment is recorded to the Salaries and Wages Expense account as the service has already been received; the contribution to operations occurred in this period.

LO 3 BT: C Difficulty: M Time: 20 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 2.14

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

1. **They represent a present economic resource — a right that has the potential to produce economic benefit.**
2. **The entity has control over that resource.**
3. **The resource results from a past transaction or event.**

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

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

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

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

BRIEF EXERCISE 2.14 (CONTINUED)

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

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

f. **The flowers represent a present economic resource. The shipping costs are related to the flowers for sale and should be debited to the Inventory account as part of their historical cost. These costs are directly associated with the acquisition of the inventory – they are not expenses from revenue-generating activities until the flowers are sold to customers.**

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

LO 3 BT: C Difficulty: M Time: 20 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 2.15

a. Equity – residual interest of owners
b. Revenues – ordinary activities of company
c. Assets,
d. Assets
e. Expenses – ordinary activities of company
f. Losses – peripheral or incidental activities
g. Liabilities
h. Equity – Distributions to owners
i. Equity – Investments by owners

LO 3 BT: K Difficulty: S Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 2.16

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

LO 4 BT: K Difficulty: S Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 2.17

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

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

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

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

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

LO 1,2,5 BT: C Difficulty: M Time: 15 min. AACSB: None CPA: cpa-t001 CM: Reporting

SOLUTIONS TO EXERCISES

EXERCISE 2.1

a. **True.**

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

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

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

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

LO 1 BT: C Difficulty: M Time: 20 min. AACSB: None CPA: cpa-t001 CM: Reporting

EXERCISE 2.2

a. Feedback value.

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

c. Neutrality.

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

e. Neutrality.

f. Understandability.

g. Timeliness.

h. Relevance.

i. Comparability.

j. Verifiability.

k. Freedom from material error or completeness.

LO 2,5 BT: C Difficulty: M Time: 20 min. AACSB: None CPA: cpa-t001 CM: Reporting

EXERCISE 2.3

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

LO 2 BT: K Difficulty: S Time: 15 min. AACSB: None CPA: cpa-t001 CM: Reporting

EXERCISE 2.4

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

EXERCISE 2.4 (CONTINUED)

	(a)	(b)
Step 1: Identifying any information that might make a difference to primary users of the financial statements when they are making investing and lending decisions.	**Bad debt expense would be understated, income and retained earnings would be overstated and the carrying amount for accounts receivable would be overstated. These misstatements create a trend that would not otherwise exist and is qualitatively material as it may impact the decisions of users.**	**The disclosure of the gain and of the loss should be presented separately as individually, each amount is significant although the amounts result in opposite effects on the net income.**
Step 2: Assess whether the information is material (including doing a quantitative and qualitative assessment)	**Because the motivation in recording the adjustment is to increase income, and to create a trend that would not otherwise exist it is qualitatively material.**	**Each item is material in amount and would affect the interpretation of the results for the year.**
Step 3: Make sure the information is organized in the financial statements in a way that is clear and concise so that the user may make an informed decision.	**The adjustment to bad debt expense must be removed.**	**The gain should be reported under other revenues and gains and the loss reported under other expenses and losses in the statement of income.**

EXERCISE 2.4 (CONTINUED)

	(a)	(b)
Step 4: Review the complete set of financial statements in the end to ensure that all material information has been included and presented appropriately for all items.	Once corrected the financial statements can be issued.	Once corrected the statement of income is complete in all of its details.

	(c)	(d)
Step 1: Identifying any information that might make a difference to primary users of the financial statements when they are making investing and lending decisions.	The practice to expense all capital equipment under \$10,000 would understate property, plant, and equipment. Since we do not know how significant \$10,000 is in relation to Manion's financial statements, we cannot say whether this practice misstates the assets on the company's statement of financial position although policies to expense capital items below a certain amount are not in violation of materiality.	The note payable should be classified as a current liability on the SFP as it is due in five months. The amount is misclassified on the SFP. The incorrect classification likely affects the current ratio and misleads creditors in making credit decisions.

EXERCISE 2.4 (CONTINUED)

Step 2: Assess whether the information is material (including doing a quantitative and qualitative assessment).	**Because the practice has been followed consistently over several years, the effect on income is likely immaterial.**	**Although the amount is small, the motivation in classification as non-current is to improve the current ratio and deceive creditors concerning its liquidity. The misclassification is material.**
Step 3: Make sure the information is organized in the financial statements in a way that is clear and concise so that the user may make an informed decision.	**No restatement of the financial statements is necessary as not material.**	**Classify the loan as a current liability on the SFP.**
Step 4: Review the complete set of financial statements in the end to ensure that all material information has been included and presented appropriately for all items.	**Practice is deemed acceptable.**	**Once corrected the SFP is complete and accurate.**

LO 2 BT: C Difficulty: M Time: 20 min. AACSB: Ethics CPA: cpa-t001 CM: Reporting

EXERCISE 2.5

a.

1. **Gains, Losses**
2. **Liabilities**
3. **Equity (increase)**
4. **Equity (decrease**
5. **Assets**
6. **Expenses**
7. **Revenues (inflows of net assets) or expenses (outflows of net assets)**
8. **Equity**
9. **Revenues, it is the sale of a product sold in the normal course of business**
10. **Equity (decrease)**

b.

1. **Asset – the contract represents a right that has the potential to produce future economic benefits to which the entity is entitled and has control over. However, the transaction that will generate the benefit has yet to occur (the music has yet to be written).**

2. **Asset – consignment inventory belongs to ReadyMart until it is sold to the final customer. It represents a resource as it can be sold. The company still controls/has access (through legal title) even though physical possession is with the local retailer.**

3. **Liability – this contract represents an obligation that will result in the future outflow of resources, subject to the sale of the recordings. Assuming that sales occur, the company has no practical ability to avoid the obligation, however, a liability will not occur until the recordings are sold.**

LO 3 BT: K Difficulty: S Time: 15 min. AACSB: None CPA: cpa-t001 CM: Reporting

EXERCISE 2.6

a.

There are three common forms of business organizations:

A: Proprietorship
B: Partnership
C: Corporation

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

EXERCISE 2.6 (CONTINUED)

b.

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

LO 4 BT: C Difficulty: M Time: 20 min. AACSB: None CPA: cpa-t001 CM: Reporting

EXERCISE 2.7

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

LO 4 BT: K Difficulty: S Time: 15 min. AACSB: None CPA: cpa-t001 CM: Reporting

EXERCISE 2.8

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

LO 4 BT: K Difficulty: M Time: 20 min. AACSB: None CPA: cpa-t001 CM: Reporting

EXERCISE 2.9

a.

Under the recognition criteria of IFRS, the elements of financial statements must:

- **meet the definition of the element,**
- **provide users with relevant information, and**
- **faithfully represents the underlying transaction or event and have fundamental qualities associated with useful information.**

Under ASPE the elements have been recognized when they:

- **meet the definition of an element,**
- **are probable, and**
- **are reliably measurable.**

The recognition criteria differ in probability and measurability are explicit criteria under ASPE but under IFRS they are assessed as part of the assessment of relevance and representational faithfulness. Note that the IFRS conceptual framework provides guidance on incorporating probability into the measurement and that ASPE has a higher threshold for recognition as items must be probable.

b.

Liabilities have the following three essential characteristics:

- **They represent a present duty or responsibility (there is no practical ability to avoid them).**
- **The duty or responsibility obligates the entity to transfer an economic resource.**
- **The obligation results from a past transaction or event.**

Note that where there is significant uncertainty of any of the 3 kinds, the relevance criteria might not be met under IFRS.

EXERCISE 2.9 (CONTINUED)

c. Existence uncertainty refers to the question as to whether the financial statement element exists or not and can be recognized. The IFRS conceptual framework provides guidance on incorporating probabilities into the measurement of an element whereas the ASPE conceptual framework does not.

Outcome uncertainty relates to uncertainty about amounts and timing of future cash flows.

Measurement uncertainty refers to the question of the amount to be used at the point of recognizing an element. If the business is unable to objectively identify a value, and is forced to estimate a value, the resulting imprecision is called measurement uncertainty. Both existence and outcome uncertainty may contribute to measurement uncertainty.

d. Based on the definition of a liability, under ASPE, the obligation is not probable and therefore not recognized. Under IFRS, the obligation may have to be recognized since the existence uncertainty is at an acceptable level if they are able to measure the potential loss (measurement uncertainty).

If IAS 37 and CPA Canada Handbook Section 3290 for ASPE are used to assess the lawsuit (as they would normally be) – both these standards have a probability criterion but the threshold for recognition under IAS 37 is lower as probability is assessed as more likely than not versus a high probability of occurrence under Section 3290).

Specific standards would override the conceptual framework.

LO 3,4 BT: C Difficulty: M Time: 30 min. AACSB: None CPA: cpa-t001 CM: Reporting

EXERCISE 2.10

a. Executory contracts are agreements between two or more parties under which the parties to the contract have not yet performed.

b. The purchase order for the butter is an executory contract and is not recognized because the farmer has not yet delivered the butter to Jasper Bakery and the buyer has not paid for the goods. Neither party has performed under the contract.

LO 4 BT: C Difficulty: S Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

EXERCISE 2.11

a. Historically, the concept of conservatism has meant that net assets and net income must not be overstated. The framework states that if doubt exists between two acceptable alternatives, the accountant should choose the alternative that will result in a lesser asset amount and/or a lesser income. The conservatism principle requires that losses be recognized as soon as they can be quantified and that gains are recorded only when they are realized.

b. Prudence requires accountants to exercise a degree of caution in the adoption of policies and significant estimates so that the assets and income of the entity are not overstated whereas liability and expenses are not under stated. Notwithstanding the above, prudence does not allow for the understatement of assets/income nor the overstatement of liabilities/expenses. The definition in the new IFRS Conceptual Framework is thus more even-handed and balanced.

c. The use of conservatism in making judgements under conditions of uncertainty affects the neutrality of financial statements in an acceptable manner. When uncertainty exists, estimates of a conservative nature attempt to ensure that assets, revenues and gains are not overstated and, conversely, that liabilities, expenses and losses are not understated. However, conservatism does not encompass the deliberate understatement of assets, revenues and gains or the deliberate overstatement of liabilities, expenses and losses. Standard setters feel that conservatism counteracts a pre-existing tendency to overstate assets /income and therefore is not in conflict with neutrality.

LO 2 BT: C Difficulty: M Time: 20 min. AACSB: None CPA: cpa-t001 CM: Reporting

EXERCISE 2.12

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

b. **Foundational principle or characteristic violated:**

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

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

LO 1,2,4 BT: C Difficulty: M Time: 25 min. AACSB: None CPA: cpa-t001 CM: Reporting

EXERCISE 2.13

While both of the fundamental qualities (relevance and representational faithfulness) should be present for financial information to be decision-useful, trade-offs are often necessary. As an example, in an attempt to provide more relevant information, some additional time may be needed to compile the data (i.e. affecting timeliness), or perhaps some additional estimates or assumptions must be made (i.e. affecting verifiability). Providing complete and full information may impact understandability of the information.

- **Additionally, there is a constraint in financial reporting: Cost/Benefit – information is not cost-free. The costs of providing the financial information should not outweigh the benefits of the financial information to its users.**
- **Further, materiality must be considered when assessing the relevance of information – information must have the potential to make a difference in the decisions being made, otherwise it is irrelevant.**
- **The goal is to provide a balance between the required level of detail but also make it condensed enough so that it is understandable at a reasonable cost. More is not always better.**

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

LO 2,3,4 BT: C Difficulty: M Time: 15 min. AACSB: None CPA: cpa-t001 CM: Reporting

EXERCISE 2.14

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

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

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

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

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

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

Prepaid Insurance	**4,000**	
Cash		**4,000**

For item 4, a principle is not necessarily violated if the company is using the alternative method of recording prepayments and the appropriate adjusting entry is created as part of the year-end process. This is not likely as the payment was made on the last day of the fiscal year.

LO 4,5 BT: C Difficulty: M Time: 15 min. AACSB: None CPA: cpa-t001 CM: Reporting

EXERCISE 2.15

a.

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

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

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

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

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

EXERCISE 2.15 (CONTINUED)

a. (continued)

Some important points to remember:

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

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

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

b.

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

EXERCISE 2.15 (CONTINUED)

b. (continued)

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

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

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

EXERCISE 2.15 (CONTINUED)

b. (continued)

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

LO 4,5 BT: C Difficulty: C Time: 35 min. AACSB: None CPA: cpa-t001 CM: Reporting

EXERCISE 2.16

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

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

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

LO 4 BT: C Difficulty: S Time: 15 min. AACSB: None CPA: cpa-t001 CM: Reporting

EXERCISE 2.17

a. Under the ASPE, revenue is recorded when:

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

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

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

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

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

EXERCISE 2.17 (CONTINUED)

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

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

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

These models will be further discussed in Chapter 6.

LO 4,6 BT: C Difficulty: M Time: 20 min. AACSB: None CPA: cpa-t001 CM: Reporting

TIME AND PURPOSE OF PROBLEMS

Problem 2.1

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

Problem 2.2

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

Problem 2.3

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

Problem 2.4

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

Problem 2.5

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

Problem 2.6

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

Problem 2.7

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

TIME AND PURPOSE OF PROBLEMS (CONTINUED)

Problem 2.8

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

SOLUTIONS TO PROBLEMS

PROBLEM 2.1

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

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

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

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

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

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

The broad principle associated with presentation and disclosure is full disclosure.

LO 4 BT: C Difficulty: S Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

PROBLEM 2.2

a. The users of Fusters' financial statements are sensitive to the company's debt, equity, and asset amounts since they are used to calculate debt covenant requirements. If these amounts are not appropriately recognized, measured, presented, and disclosed, the users could make incorrect decisions.

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

b. Appropriate accounting for each transaction:

<u>Transaction 1.</u>
Depreciation is an allocation of cost, not an attempt to value assets. So, even if the value of the building is increasing, the remaining costs related to this building should be matched with revenues on the income statement. As such, making no entry violates the matching principle.

This error will affect the equity and assets used in determining if the covenants have been followed. By failing to record depreciation expense in the year, net income and ending shareholders' equity are both overstated, as is the return on assets ratio. This would be true even though the book value would be higher due to not depreciating the building. This error likely does not affect the management bonus, which is based partially on revenues reported, unless the other part of the bonus calculation is based on net income.

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

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

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

PROBLEM 2.2 (CONTINUED)

b. (continued)

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

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

Transaction 4.
Based on the information provided, the sale should be recorded in 2024 instead of 2023. In this situation, it is irrelevant whether the shipping terms are FOB shipping point or FOB destination since the transaction occurred in 2024. As well, the inventory sold would have been included in the 2023 year-end inventory count.

This error impacts equity and assets (accounts receivable) in the debt covenant calculations. It also affects revenue, thus impacting the management bonus. Revenue would be higher in 2023 and lower in 2024.

c. Option exists for Transaction (1)

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

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

LO 2,4 BT: C Difficulty: C Time: 30 min. AACSB: Ethics CPA: cpa-t001 cpa-e001 CM: Reporting and Ethics

PROBLEM 2.3

1. With a modification of the accounts used, the entry could be appropriate as long as the land is determined to be impaired or is designated as held for sale by the company. The debit in the entry should have been to an Impairment Loss account. Losses are generally recognized when they are likely or probable and measurable. As prices are depressed, the company should review for impairment (further discussed in Chapter 11) and/or make a decision as to whether the land is held for sale (further discussed in chapter 4). If impaired, the land would be reduced to its recoverable amount which is the higher of the value in use and the fair value less cost to sell. If designated as held for sale, the land would be written down to fair value less cost to sell.

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

2. The historical cost principle indicates that assets and liabilities are accounted for on the basis of cost. If we were to select sales value, for example, we would have an extremely difficult time establishing a sales value for a given item without actually selling it. It should further be noted that the revenue recognition principle provides the answer as to when revenue should be recognized. Revenue should be recognized when the performance obligations have been satisfied. In this situation, this has definitely not taken place. This error inflates net income and would increase the divorce settlement available to the president's spouse.

3. Under IFRS, in order to be recognized, the element must meet the definition of the element and provide users with relevant information that faithfully represents the underlying transaction or event. In this case, the lawyers have given an opinion that the loss is not probable. Further, the definition of a liability has not been met as there is not a current obligation requiring future settlement. The payment is contingent upon a future event and might be covered partially by some insurance. It is not clear that the company is at fault and at present, they have broken no laws or created any expectations that they will settle. The existence uncertainly would not require recognition based on these general criteria.

   Further, neutrality is likely violated by this overly conservative accounting. It might appear as if the loss had been recorded to reduce net income and to lower the divorce settlement available to the president's spouse.

PROBLEM 2.3 (CONTINUED)

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

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

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

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

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

LO 2,4 BT: C Difficulty: C Time: 30 min. AACSB: None CPA: cpa-t001 CM: Reporting

PROBLEM 2.4

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

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

2. Proposed new accounting methods may be more relevant to many decision makers than existing methods. However, if adopted, they would make comparisons of an enterprise's results with other businesses in the industry, which have not yet adopted the new methods, difficult or impossible.

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

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

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

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

LO 2 BT: C Difficulty: M Time: 20 min. AACSB: None CPA: cpa-t001 CM: Reporting

PROBLEM 2.5

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

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

3. Disagree. As estimate is used as the basis for arriving at the amount of accounts receivable that is expected to be uncollectible. The change in the estimate should not be applied retroactively to the previous 2022 fiscal year. The additional bad debt expense of $50,000 for 2022 should not be recorded. The deterioration in the age of the accounts is a current-year event and is a reflection of the conditions that exist for the current year. These conditions did not exist in the previous fiscal year and the percentage used in 2022 of 4.5% was judged appropriate at that time and was not an error.

PROBLEM 2.5 (CONTINUED)

4. Disagree. While it may be more appropriate to classify the expense as an administrative instead of selling expense, failing to disclose the reclassification is not allowed. Users of the financial statement rely on the consistent application of grouping of accounts in captions appearing on the statement of comprehensive income from year to year. This assists in assessing performance and predicting future cash flows. A note to the financial statement should be added stating that the classification of the expense adopted in the current fiscal year has been applied to the comparative statement of comprehensive income to allow for better comparisons.

5. Disagree. Although it is reasonable for the controller to argue that the realizable value of the equipment held for resale may not differ materially from its historical cost, there is an issue is in classifying the equipment as property, plant, and equipment. Instead, the assets should be classified with current assets as equipment held for sale. In addition, no depreciation should be recorded on the equipment held for sale as the equipment has not been used in operations.

6. Disagree. While there is an economic burden as a result of the new legislation, this is not a present obligation since the new law cannot be enforced until 2028. A liability does not exist in fiscal 2023.

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

LO 3 BT: C Difficulty: C Time: 30 min. AACSB: None CPA: cpa-t001 CM: Reporting

PROBLEM 2.6

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

2. This is an aggressive interpretation of GAAP. Capital assets should be tested regularly for impairment and written down when their cost will not be recovered through use or through resale. In this particular situation, a total write-off may not be called for. The timing of the write off that coincides with lower levels of net income indicates that the controller may be trying to show improved financial results in future years. The controller is taking advantage of current poor financial results to write off several capital assets, thereby improving future years' results when impairment losses or write-downs would have otherwise been recorded.

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

4. Under IFRS, companies must capitalize interest on self-constructed qualifying assets; under ASPE, companies may make an accounting policy choice to do so. Therefore, under IFRS this is appropriate. Under ASPE, care would have to be taken to ensure that this choice was not done to manipulate net income and the profitability ratios.

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

PROBLEM 2.6 (CONTINUED)

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

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

LO 5 BT: C Difficulty: M Time: 15 min. AACSB: Ethics CPA: cpa-t001 cpa-e001 CM: Reporting and Ethics

PROBLEM 2.7

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

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

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

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

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

LO 2 BT: C Difficulty: M Time: 15 min. AACSB: None CPA: cpa-t001 CM: Reporting

PROBLEM 2.8

Dear Uncle Warren,

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

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

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

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

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

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

PROBLEM 2.8 (CONTINUED)

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

Sincerely,

Your Nephew

LO 2,4 BT: C Difficulty: M Time: 20 min. AACSB: Communication CPA: cpa-t001 CM: Reporting

CASES

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

CA 2.1 BRE-X MINERALS

Overview

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

Management was biased in their decision to withhold the information from the market (i.e. the fact that there were no gold deposits).

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

Analysis and Recommendations

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

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

CA 2.1 BRE-X MINERALS (CONTINUED)

Write assets down/disclose	Do nothing
- The main asset on the balance sheet is the property. Therefore, this is a **material** issue. - Note that the full value of the gold deposit would not have been capitalized on the balance sheet – only the costs to develop the mines. Nonetheless, even the **future benefit** of those values would be in question if there was very little or no gold. - Management knew, or should have known, that the gold discovery was driving the share value. Therefore, this information was **decision relevant.** - The salting of the sample is fraud – a deliberate intent to mislead. The information was **biased.** - The **full disclosure** principle dictates disclosing the problem as soon as it is discovered.	- Perhaps management believed that it was too early in the development of the property to disclose the bad news. For example, they may have delayed disclosing the information anticipating that further exploration would lead to the discovery of additional gold. There was significant **uncertainty** regarding whether there was a problem or not. - Given **measurement uncertainty**, it would have been difficult to measure the potential loss. There is existence uncertainty as to the existence of the gold as well as outcome uncertainty – reflecting the potential amount and value of cash flows that might be generated if the gold exists. - Sending a message without trying to explain the outcome may have panicked investors.

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

LO 4,5 BT: C Difficulty: C Time: 20 min. AACSB: Ethics CPA: cpa-t001 cpa-e001 CM: Reporting and Ethics

CA 2.2 ENVIRONMENTAL INC.

Overview
The company is in the business of treating and neutralizing contaminated material. Therefore, the company is at risk for potential claims for environmental damage – either resulting from the treatment process or because the cleanup site was not properly treated. Given that the company transports the contaminated material, there is also a risk of spillage and further environmental damage.

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

The company is a public company; IFRS is a constraint.

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

Analysis and Recommendations

Issue: How to treat the transportations costs

Expense	Capitalize
- These costs do not add to the value of a non-financial asset and should be expensed. - Since this is a service, not a product, there are no "product" costs. - When the amount is reimbursed, it should be credited to the expense line.	- These costs are part of the costs to get the "raw materials" in place and ready for processing. Therefore, these costs make up part of the asset value. Since the costs are reimbursable, they represent a present economic resource through future cash flows. - Given the unique business model, it makes sense to capitalize these costs. - Since the expenditure is reimbursable, it could be considered a "receivable" that will be collected from the customer.

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

CA 2.2 ENVIRONMENTAL INC. (CONTINUED)

Issue: Lawsuit

Recognize a liability/disclose	Do not recognize/disclose
- The company should recognize a liability for the lawsuit if management and the lawyers believe that a liability exists (definition of a liability met). - Since the government has issued a subpoena, it adds to the argument for recognition as it implies that the company did something wrong and now has an obligation. - All information would be considered. This includes whether there is any evidence that the company did indeed commit fraud (the event), and if so, the estimated potential settlement. - The company lawyers would assist in assessing whether there was more than a low probability of a settlement, in which case an obligation would likely exist under IFRS. - There would be significant measurement uncertainty in estimating any potential settlement because the company does not have any information pertaining to the amount of potential losses (outcome uncertainty). Notwithstanding this, the company would have to try to make an estimate, assuming that this information would be relevant to users. - Relevant information – most users would likely want to know if fraud had been committed. This is consistent with the Full Disclosure principle.	- Disclosure/recognition might prejudice the court case. - At year-end, too much uncertainty exists. Specifically, there is uncertainty related to committing a fraudulent act (existence uncertainty) and the amount of potential payouts (outcome uncertainty). Both contribute to a high level of measurement uncertainty; therefore, attempting to recognize a liability would not add value. - Since the proceedings have been halted, this adds additional uncertainty and provides evidence that no obligation exists. It appears as though the company may be able to avoid any settlement given the fact that proceedings have been halted.

Even though the proceedings were stayed, it would be more transparent to at least disclose.

LO 3 BT: C Difficulty: M Time: 20 min. AACSB: Ethics CPA: cpa-t001 cpa-e001 CM: Reporting and Ethics

CA 2.3 TIMBER CORPORATION

Overview

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

This issue is one of measurement or valuation of the assets. The nature of the industry is such that the main asset is the property including the timber, which is still growing. Much of this value will be unrecognized under the historical cost principle. The asset recorded on the books would include the price to purchase the land, if owned, plus the growing costs and labour directly related to getting the trees ready for sale. As noted, the financial statements are not as useful or relevant to users.

Using historical cost, the main asset on the balance sheet may be understated, as compared to its fair value. The fair value of the timber property would increase over time as the trees grow and create more value for the company. These fair value measures would provide more relevant information about the expected cash flows related to the timber properties.

Certain factors may affect the company's decision to use a historical cost basis as opposed to a fair value basis for this asset. There may be significant measurement uncertainty with respect to the exit price that exists for timber that is not yet mature. The company's future selling prices may also be subject to significant changes that would impair its ability to realize the increase in fair value, such as the effect of climate change, insect infestations and forest fires.

It appears the historical cost principle has been applied for Timber Corporation. As an analyst, we would have to compare the financial statements of Timber Corporation to those of other companies in the same industry to assess if its choice of policy is consistent with the industry. This may indicate that the reasons for the choice of policy are consistent across different companies and that measurement uncertainty is too great to provide reliable information using fair value.

CA 2.3 TIMBER COMPANY (CONTINUED)

Analysis and Recommendation

Value the property at laid down (historical) cost	Value the property at fair value
- The **historical cost principle** supports valuing the property at the **laid down cost** (i.e. the acquisition cost) plus any costs incurred to **get the asset ready for the intended use.** - The trees will grow and increase in value each year. This is similar to **self-constructed assets** and any costs incurred in "producing" the trees would be capitalized. This might include **direct material** (such as fertilizers) and **direct labour** (the labour costs to facilitate growth) and a **reasonable allocation of overhead** – all **similar to inventory**. - Costs such as pesticides etc. might be seen as **maintenance** costs rather than part of the cost of the asset since they must be incurred as part of the ongoing daily operations to maintain the value of the assets (rather than increasing the value). - The **historical cost principle** precludes measurement at selling price due to the **measurement uncertainty** associated with that value. - Lumber is a commodity, and the price is affected by supply and demand. Wood may easily be damaged by infestations (and become worthless). As a result, there is significant **measurement uncertainty** surrounding valuing the asset at anything other than historical cost.	- Using fair value accounting would provide more **relevant** information for the user. - Without this information, the investor is left with uncertainty related to the value of the timber. Given this, the financial statements do not provide **useful information**. - It is easier for management to assess the value of the timber since they have more information than the investor. If investors are relying on this information to make a decision, then management would want to publish the information to facilitate this process. - The company knows how many hectares of trees it has and should be able to convert this to lumber yield based on history. Lumber costs are readily available. Therefore, the **value is measurable** if only within a range.

CA 2.3 TIMBER COMPANY (CONTINUED)

Value the property at laid down (historical) cost	Value the property at fair value
- A **reciprocal exchange with an outside party** will not occur until the trees are sold. At this point, the measurement uncertainty is resolved.	

In conclusion, given the measurement uncertainty, the trees should be reported at cost. To provide more meaningful information, the company could always provide detailed additional note disclosures regarding its opinion on the fair value of the timber.

Note that IAS 41 deals with biological assets and requires fair value accounting where the activity is managed by the entity and fair values can be reliably measured. This is often the case in established industries like this one. In general, the measurement uncertainty issue is resolved by increased disclosure requirements about how fair value measures are determined.

LO 4 BT: M Difficulty: C Time: 30 min. AACSB: None CPA: cpa-t001 cpa-t005 CM: Reporting and Finance

RESEARCH AND ANALYSIS

RA 2.1 AIR CANADA

The following information is from a review of Note 3 of Air Canada's financial statements for the year ended December 31, 2020.

a. The main accounting estimates and judgements disclosed by Air Canada are: impairment considerations on long-lived assets, employee future benefits, income taxes, Aeroplan loyalty program, depreciation and amortization period for long-lived assets, and maintenance provisions. Employee future benefits are estimated using actuarial valuations, the long-term nature of these valuations exposes the liability to uncertainty. Useful lives and expected residual values of long-lived assets are all estimated and could change based on a variety of market factors. Impairment tests are subject to similar factors as the useful lives and residual values of long-lived assets. Maintenance provisions are estimated using current costs and expected inflation and usage rates, both of which are subject to fluctuations. Deferred income tax assets are recognized to the extent that the realization of the related tax benefit is probable. The Aeroplan loyalty program includes estimates for Equivalent Ticket Value (ETV) and breakage (the amount of points that will not be used) to determine the overall liability.

b. It is important that Air Canada disclose this information since any change in the assumptions made could impact the results of operations. Many of the assumptions could have a material effect on the financial statements, which could alter the decisions of users of the statements. Looking at the consolidated statement of changes in equity, the reader notices the remeasurements on employee benefit liabilities in 2020, which reduced the deficit significantly. This change in estimate had a large impact on the equity and liabilities of Air Canada in this fiscal year. Investors can draw their own conclusions concerning the quality of these earnings adjustments. In another example, the liability for non-current maintenance provisions has significantly reduced year over year from $1,240 in 2019 to $1,040 in 2020. These estimates are based on a variety of factors, but the user could conclude that Air Canada anticipates less wear and tear on its fleet in the upcoming operating period. This certainly makes sense given the effect of the current Covid-19 pandemic on the travel industry. In addition, the company states in Note 1 that the pandemic significantly affected operations starting in March 2020, including reduced earnings and cash flows. The company also states that the ongoing impact of the pandemic cannot be measured in terms of its estimates and financial statements. As a result, the company has reduced its recognition of deferred tax assets since the company cannot reasonably estimate future taxable income to use existing deferred tax assets.

RA 2.1 AIR CANADA (CONTINUED)

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

Pension and other benefits liabilities	$3,015
Depreciation, amortization and impairment (Note 6)	1,849
Maintenance provisions – non current	$1,040
Maintenance provisions – current	313
Deferred tax liability	75
Deferred tax asset	25
Aeroplan and other deferred revenue - Current	572
Aeroplan and other deferred revenue – Long Term	4,032

Comparing the values above to Air Canada's net loss for 2020 of $(4,647) million, it is evident that these are major accounts on the financial statements and changes in their values significantly impact the financial results.

RA 2.2 RETRIEVAL OF INFORMATION ON PUBLIC COMPANY

Answers will vary by the article and the company selected.

RA 2.3 CONSERVATISM/NEUTRALITY

a. Steve Cooper indicates that the two different meanings of "prudence" are as follows:

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

By putting "prudence" back into the conceptual framework, after not making any explicit reference to the term in the 2010 "framework," the IASB and Steve Cooper provide support for the second meaning of prudence (neutral accounting). The term has been reintroduced with an explanation of how it is intended to be interpreted.

b. Prudence is included as part of neutrality. "Neutrality is supported by the exercise of prudence. Prudence is the exercise of caution when making judgements under conditions of uncertainty."

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

RA 2.3 CONSERVATISM/NEUTRALITY (CONTINUED)

b. (continued)

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

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

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

RA 2.4 FAITHFUL REPRESENTATION

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

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

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

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

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

RA 2.5 MEASUREMENT OF UNCERTAINTY

a. **Existence uncertainty** reflects whether something exists or not. **Outcome uncertainty** relates to the amount of future cash flows. **Measurement uncertainty** relates to the amount of an estimate on a financial statement element with the purpose of recognition in the financial statements.

b. **Existence uncertainty** is present for BC since the company must interpret its situation within the Income Tax Act. The amount may or may not be deductible. In addition, there is a chance that the government may audit the interpretation in the future and disallow the deduction. **Outcome certainty** is likely not an issue – the estimated liability will be the amount of deduction times the tax rate (which is not expected to change). However, the existence uncertainty has a large impact on **measurement uncertainty**.

RA 2.6 MEASUREMENT UNCERTAINTY AND ARTIFICIAL INTELLIGENCE/BIG DATA

a. Many companies are using available data and data tools combined with artificial intelligence to gather evidence to support measurements. In a situation like this, where there is significant measurement uncertainty, it would be useful to analyze past CRA rulings and compare that to BC's situation to help predict whether the deduction is acceptable or not (or whether an additional tax liability exists). This is a huge task. The volume of data documenting past rulings would certainly be considered extensive and it would take a significant amount of time to comb through unless you had expertise. The company could certainly hire a tax expert to review the deductibility (or it may have some in-house expertise). Alternatively, the company could use a data analysis tool that utilizes artificial intelligence. A combination of expertise and automation would be optimal.

b. The company must make every attempt to ensure representational faithfulness as it is a fundamental qualitative characteristic of useful information. The question becomes, how much effort should go into refining the estimate and how much evidence is sufficient to support the measurement.

   Additional information is generally better in terms of developing a more robust estimate; however, obtaining additional evidence and assurance regarding any uncertainty costs money. There is a trade-off here. The company must do a cost benefit analysis to determine how much assurance is needed (and how much supporting evidence) to determine the estimate of the liability. Conversely, an assessment should be made regarding how much measurement uncertainty is tolerable to users.
   Note that tax experts are also expensive. As an investor, what you are giving up is profits today for reduced uncertainty. There is a trade-off here as well.

LEGAL NOTICE

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