Solutions Manual for Intermediate Accounting Volume 1 Canadian 7th Edition by Beechy IBSN 1259108015
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Chapter 2: Accounting Judgements

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

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Cases

Case 2-1

Notes for Symposium

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

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

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

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 Historical cost will create an outdated Balance Sheet and the estimates related to depreciation and impairment testing involve subjectivity.

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

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

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

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Case 2-2

Sample response

Dear Ms. Yang:

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

Revenue recognition

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

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

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

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

Expense recognition

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

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

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

Estimation issues

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

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

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

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

Sincerely,

James Ehnes

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Case 2-3

Overview

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

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

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

Sample response

Dear Ms. Bissau:

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

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

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

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

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

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

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

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

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

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

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

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

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

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TECHNICAL REVIEW

TR 2-1

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

TR 2-2

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

TR 2-3

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

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TR 2-4

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

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

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

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

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

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

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

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

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

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

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

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

TR 2-5

Requirement 1

Three measures of income:

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

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

c. Physical capital maintenance:
$140,000 – $115,000 = $25,000

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Requirement 2

Cash remaining

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

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

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

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

Requirement 3

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

Requirement 4

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

TR 2-6

1. Nominal dollar capital maintentance

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

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2. Physical capital maintenance

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

TR2-7

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

TR2-8

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

TR2-9

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

TR2-10

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

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ASSIGNMENTS

Assignment 2-1

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

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

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

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

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

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Assignment 2-2

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

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Assignment 2-3

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

Assignment 2-4

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

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Assignment 2-5 (WEB)

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

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Assignment 2-6

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

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Assignment 2-7

1. Utilities expense and account payable.

2. Patent, intangible asset; recorded at cost to create and register, usually a fraction of real worth due to measurement problems due to market uncertainty in determining fair value at registration.

3. Employee expense

4. Not recorded; not a financial statement element because no shares issued as yet, no proceeds received, and no issuance contract exists.

5. Inventory (i.e., work in progress) as cost of work completed so far.

6. Provision accrue at estimated amount. [If cannot be estimate would be disclosed in a note.]

7. Not recognized. No measurable amount, and no control over the ‘asset’.

8. Not recorded; no reliably measurable past cost or future benefit.

9. Cash, unearned revenue

10. Lease expense if considered an operating lease otherwise record as a leased asset or employee compensation if for CEO’s personal use not business use.

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Assignment 2-8 WEB

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

Assignment 2-9 WEB

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

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Assignment 2-10

Case A:

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

Case B:

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

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

Case C:

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

Case D:

Revenue recognition is inappropriate. Accrual accounting is usually appropriate.

Case E:

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

Case F:

The separate-entity assumption is violated.

Case G:

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

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Assignment 2-11

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

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Assignment 2-12

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

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Assignment 2-13

Situation A

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

Situation B

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

Situation C

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

Situation D

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

Situation E

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

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Assignment 2-14

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

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

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

The correct entry is:

Depreciation expense	227,000	
Accumulated depreciation		227,000

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

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

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

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

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

Accounts receivable should be reported at $53,000.

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Assignment 2-15 WEB

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

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

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

The correct entry is:

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

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

Buildings—warehouse	542,000	
Cash		542,000

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

Loss from flood damage	97,000	
Cash		97,000

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

The correct entry is:

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

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Assignment 2-16 WEB

Cash:

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

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

Marketable securities:

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

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

Accounts receivable:

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

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

Contract liability:

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

Other liabilities:

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

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

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Assignment 2-17

Requirement 1

The recognition criteria are:

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

Requirement 2

The lawsuit accounting policy can be explained as follows:

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

Disclosure of the lawsuit satisfies the full disclosure requirement.

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Assignment 2-18

Case A

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

Case B

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

Case C

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

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Assignment 2-19

Case A

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

Case B

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

Case C

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

Case D

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

Case E

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

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Concept Review Solutions

CHAPTER 2: ACCOUNTING JUDGEMENTS

Page

1. The financial statement concepts comprise the general body of accounting principles (GAAP) and are used by:

   1. Management when they adopt certain accounting policies and make accounting estimates. In particular, preparers can use the concepts to assess whether transactions should be recorded, how they should be measured and how they should be reported in the financial statements.
   2. Auditors to assess whether an entity has exercised appropriate professional judgment in selecting its accounting policies and preparing its financial statements.
   3. Standard setters to ensure standards are developed on a consistent and coherent framework.

   As we will continue to emphasize through this text, accounting is full of estimates—virtually every amount on a company's financial statements is the result of multiple estimates.

2. General-purpose financial statements are those prepared for distribution to a wide, undefined public. As such, the statements have not been designed, and may not be suitable, for use in specific decisions.

3. In exercising ethical professional judgement, a professional accountant must take into account a variety of factors including, but not limited to, the following:

• The users of financial statements, and their specific decisions and informational needs.

• The motivations of managers.

• The organization's operations (e.g., type of ownership, sources of financing, nature of its operating cycle).

• Reporting constraints, if any.

Page

1. The separate entity assumption may not be valid for a small corporation with a single shareholder, as the shareholder may enter into various (non-arm's length) transactions with the corporation, thereby blurring entity definitions. While a corporation is legally a separate entity, the owner of a small corporation, having full control over the affairs of the corporation, may mix business and personal affairs by, for example, intermingling cash funds and interchanging business and personal assets. The owner may extend loans to the corporation that are, in substance, equity

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infusions. In recognition of this, a bank may require personal guarantees from the owner the corporation's debts.

2. The continuity assumption may not be valid in two instances. First, if the business is a limited life venture intended only to exist for a limited period of time. Second, when a business is in financial difficulty and is expected to be shut down and liquidated.

3. An alternative to the proprietary concept is the entity concept. The entity concept considers that the owners (shareholders) are but one of many participants in the enterprise and that the net value added by the enterprise is distributed to the various factors of production. Factors of production include the providers of capital and labour, and the government; the residual represents reinvestment in the enterprise (the entity).

4. In a country with triple digit annual inflation, the stable currency assumption is no longer valid. In particular, the nominal dollar capital maintenance assumption is not appropriate. In such countries a business is deemed to have earned a profit only if it has generated enough earnings to maintain the purchasing power of the owners' equity. Due to high inflation, capital assets and income measured in nominal dollars may materially misrepresent financial performance, as their purchasing power may be severely eroded from period to period.

Page

1. The concept of relevance is the most important qualitative characteristic of financial information. If the accounting information is to be of any use, it must be relevant for its intended use.

2. The criterion of understandability does not imply that all information must be reduced to the lowest common level or simplified so that the least sophisticated investor would understand it. Rather, it is presumed that users have a reasonable understanding of business and economic activities, as well as some understanding of accounting.

3. The enhancing qualities of accounting information are comparability (consistency and uniformity), verifiability (independent observers can measure an economic event and arrive at the same result), timeliness and understandability.

4. There are often trade-offs between different qualitative criteria, as a given qualitative criterion may be satisfied only at the expense of another. For example, while information may become more verifiable by delaying publication of the statements until all future events came to pass and uncertain facts were confirmed, such information, however, may be more relevant now, when the decision must be made.

Page

1. Realization is the process of converting an asset, liability, or commitment into a cash flow (transactional event). Recognition is the process of measuring and including an item in the financial statements (accounting event). Recognition may precede realization (e.g., in accrual accounting);

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however, once realization has occurred, recognition must occur because there has been a cash flow impact that cannot be ignored in the accounts.

2. Accrual accounting means that assets and liabilities are recognized in the period in which the rights and obligations pertaining to them are established. Interperiod allocation is the recognition as expenses of those amounts that were originally recognized as assets, or the recognition of income for an item previously recognized as a liability. Interperiod allocation follows accrual accounting, bringing into income (or expense) assets or liabilities recognized in the accrual accounting entry (in a previous period).

3. The three criteria that must be met to justify recognition of an item in the financial statements are:

1. It must meet the definition of an element.

2. It must have an appropriate basis of reliable measurement (measurability).

3. For assets and liabilities, realization must be probable (probability).

Page

1. An entry value is the price to be paid to acquire an asset. Exit value for an asset is the value that can be recovered when as asset is disposed of. Exit value or settlement value for a liability is the amount to be paid to pay off the liability.

2. The qualitative criteria of relevance and faithful representation underlie accounting standards use of fair value measurements for some assets and liabilities.

3. The three levels of fair value hierarchy are:

Level 1 - quoted prices in active markets for identical assets;

Level 2 - prices for similar assets or that can be derived from observable market data; and

Level 3 - values derived by indirect valuation techniques, and not verifiable by direct observation of market data.

4. Highest and best use - represents the valuation of an asset based on the its most advantageous use, in cases where the asset may have several uses.

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Page

1. Three possible measurement bases for inventory are: historical cost, net realizable value or fair value.

2. Period costs are only indirectly related to specific revenue-generating activities. They do not lend themselves easily to matching to specific revenues. Therefore, the concept of matching is usually applied to period costs as a matching of costs to time, as opposed to a matching of costs to revenues. Therefore, period costs may be recognized as expenses in the period incurred.

3. No, full disclosure means that the financial statements should report all *relevant* information bearing on the economic affairs of a business enterprise. The aim of full disclosure is to provide external users with the accounting information they need to make informed investment and credit decisions. Full disclosure requires, among other things, that the chosen accounting policies be explained in the disclosure notes. Although the common expression is "full disclosure," perhaps a more realistic expression is "adequate disclosure." Obviously, not all information that may be relevant to a financial statement user can be disclosed. Instead, the objective is to disclose enough supplemental information to keep from misleading the users of the statements who are likely to be using the statements to predict cash flows or to evaluate the earnings ability of the company. A useful guide to deciding what to disclose is as follows:

- Disclose accounting policy choice information.
- Disclose further detail about recognized items that have been summarized or are unusual.
- Disclose items that have not been recognized because they have failed one of the recognition criteria but are still potentially relevant.
- Disclose information about future cash flow.
- Disclose alternate measurement bases.
- Disclose information to assist investors in calculating return on investment.

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CHAPTER 2

Accounting Judgements

Learning Objectives:

After you have studied this chapter, you should:

1	Understand the concepts involved in constructing financial statements.
2	Explain the role of ethical professional judgement in accounting.
3	Apply the universal and entity specific assumptions underlying the foundation of GAAP.
4	Apply the fundamental and enhancing qualities and pervasive constraints of financial reporting.
5	Describe the measurement methods available within GAAP.
6	Discuss the criteria for recognizing business events and transactions in the financial records.
7	Describe the measurement methods used in the accounting standards for private enterprises.

Lecture Notes

Accounting is often a matter of making choices among possible alternatives. This chapter discusses the financial statement concepts and principles that guide standard setters and that accountants use to make those choices. These concepts and principles are the basis for professional judgement. Chapters 6 to 11 illustrate how those concepts and principles are applied to specific accounting issues.

1. CATEGORIES OF ACCOUNTING CONCEPTS

The generally accepted body of accounting principles consists of three different types of concepts. The types of concepts are:

1. **Underlying assumptions,** which form the basic foundation for which accounting measurement rests. The accounting principle of continuity (going concern) is an underlying assumption.

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2. **Qualitative criteria,** which in conjunction with the organization's reporting objectives, facts and constraints, are used to evaluate the possible measurement options and select the most appropriate measurement methods for a given situation. The principles of comparability and understandability are examples of qualitative criteria.

3. **Measurement methods**, which are the various ways in which financial position and the results of operations can be reported. These methods are how transactions and events are measured and reported. The accounting principles of fair value and realizable value are examples of measurement methods, and are both based on the underlying continuity assumption.

Limitations of the Concepts

There are limitations to the use of accounting concepts. They focus on generalities because they determine policies for a wide application and on producing general purpose financial statements. Therefore, there are exceptions to the applicability of the concepts and conclusions.

Structure of Accounting Policy Choice

In constructing the financial statements for an enterprise, you must determine the **objectives** of the financial reporting, make sure the underlying assumptions are valid, measure the elements of financial statements for the situation that satisfy the qualitative criteria and finally prepare the financial statements. This process is illustrated in Exhibit 2-1 of the textbook and follows this order of consideration:

1. Underlying assumptions
2. Qualitative criteria
3. Accounting choices
    a. Financial statement elements
    b. Recognition and realization
    c. Measurement methods

WATCH!

In selecting accounting policies, an accountant must first evaluate the facts in the situation including reporting constraints. If the facts allow a choice, then the users and objectives are considered in selecting the appropriate accounting policy. Decisions cannot be made strictly according to which policy is best for the users and objectives while ignoring the facts in the situation.

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2. ETHICAL PROFESSIONAL JUDGEMENT – PART 1

The process of making choices in accounting is the process of exercising **professional judgement.** An accountant exercises professional judgement to be fair to all stakeholders. Judgement is used in many aspects of accounting that are not specifically dealt with in the accounting standards. This is done by taking into account several factors:

- The users of financial statements and their specific information needs;
- The motivations of managers;
- The nature of the organization's operations; and
- The organization's reporting constraints.

Accounting policy choices and estimates must be made taking these factors in to account.

3. UNDERLYING ASSUMPTIONS

Underlying assumptions provide the foundation of GAAP for for-profit enterprises, but only the going-concern assumption is discussed specifically in the IFRS conceptual framework. There are six basic assumptions affect the recording, measuring, and reporting of accounting information. These are divided into 2 general categories (1) universal assumptions and (2) entity-specific assumptions.

Universal assumptions:

1. Time-period.
2. Separate entity.
3. Unit of measure.

Entity-specific assumptions (depend on an individual entity's reporting circumstances):

1. Proprietary.
2. Continuity.
3. Stable currency.

GAAP changes in response to changes in the environment but the underlying assumptions are assumed to be constant. If any of these assumptions are not valid, then GAAP is not appropriate.

Universal Assumptions

The **time-period assumption** recognizes that information needs to be provided to users for a time period less than the enterprise's life span and states that it is feasible to provide useful information in shorter periods while the enterprise is in operation.

The standard reporting period is one year; however, some companies use a calendar year-end that coincides with the low point in business activity over a 12-month period. Other companies report summarized information on an interim basis (quarterly for public

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companies, monthly for internal purposes). Although the reporting period varies, one year is the standard.

The **separate entity assumption** considers an accounting unit or identifiable business enterprise as separate and apart from its owners and from other entities.

This concept does not necessarily correspond with legal and tax status of an entity.
A corporation is an entity that is legally distinct. Partnerships and proprietorships are not legally distinct but the separate entity assumption still applies; for accounting purposes they are considered separate from their owners. All accounting records and reports are developed from the point of view of a single entity with the assumption that an individual's transactions are distinguishable from those of the business.

The **unit-of-measure assumption** refers to the results of the business's economic activities. The assumption is that these can be reported in terms of a single standard monetary unit and, further, that everything of relevance can be measured using the dollar as the unit of measure. Thus, something that can't be measured can't be reported. Therefore, information that may be relevant to decision makers may not be reported, such as:

- The value of in-house intellectual capital.
- The impact of the company's operations.
- The value of customer goodwill and "human capital" (i.e. employees).

Entity-Specific Assumptions

The **proprietary concept** considers that the results of an enterprise's operations should be reported from the *point of view* of the owners. This concept is applied to all types of business enterprises and has nothing to do with the form of the enterprise (i.e., proprietorship, partnership, or corporation). This concept follows the accounting equation with assets discharging liabilities and residual wealth to the owners.

The **continuity assumption** is also known as the **going-concern assumption.** The assumption is that the enterprise will continue operating for the foreseeable future and not be liquidated. It assumes that the business will continue long enough to recover the assets and repay its outstanding liabilities. This assumption provides the conceptual basis for measuring and classifying assets and liabilities in current and non-current classifications.

There are two instances where this assumption is not valid - a limited life venture, and a business in financial difficulty that is expected to be shut down. If this assumption is in doubt because of financial difficulty, the historical costs of assets are not relevant and liquidation accounting is appropriate.

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A common problem is the misuse of the term *going concern*. A company that is considered to be a going concern is expected to continue in operation. If there is a going concern issue or going concern problem, then this assumption is no longer valid. An example would be where the company is undergoing financial restructuring.

WATCH!

The **stable currency assumption** assumes constant purchasing power and that the value of the dollar does not change significantly from year to year. The reason for this assumption is that inflation in most developed countries has been relatively modest. It also assumes the dollar is constant in relation to the value of other currencies (its exchange rate).

Two other concepts are related to the stable currency assumption. The concept of **capital maintenance** explains that to keep operating successfully, an entity must preserve its capital investment**.** This assumption also includes the use of a **nominal dollar**, which is not adjusted for inflation. The nominal dollar assumption is still dominant universally, due to the reliance on historical cost methods in the measurement of assets. As we move more to fair value accounting, alternative perspectives are gaining strength.

Alternative Capital Maintenance Approaches

Financial capital maintenance is measured in nominal monetary units or in units of constant purchasing power.

Constant dollar capital maintenance says that not all dollars are created equally. Therefore, if prices are rising then the enterprise needs to keep more nominal dollars invested in capital to stay even.

Physical capital maintenance concept recognizes that the prices of different goods and services change at different rates. The key is the company needs to maintain the same level of productive capacity in its assets. This is the perspective that supports the use of fair-value reporting.

4. QUALITATIVE CRITERIA

Qualitative criteria are criteria that, in conjunction with the organization's reporting objectives, are used to evaluate possible measurement options and to choose the most appropriate accounting policies. The qualitative criteria are summarized in a table on the next page.

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CRITERIA	COMPONENTS	DESCRIPTION
FUNDAMENTAL QUALITIES (both qualitative characteristics must be present to represent an economic event and cannot be traded of)		
1. Relevance		Capacity of accounting information to make a difference to the external decision-makers who use financial reports. Theoretically, relevance is the most important qualitative characteristic.
	• Predictive value • Confirmatory or Feedback value	Accounting information should be helpful to external decision makers by increasing their ability to make decisions about the outcome of future events (predictive value). Accounting information should be helpful to external decision makers who are confirming or adjusting past predictions.
2. Faithful representation		The information is a sufficiently accurate measure of what it is intended to measure. Although currently not a specific component of faithful representation, substance over form, represents the economic rather than legal impact of a transaction, is included as an element of faithfully portraying a transaction. Faithful representation is closely related to reliability.
	• Completeness	Information must give a faithful picture of the economic events or financial elements. The information must not mislead or deceive.
	• Neutrality	Financial reports are neutral if they do not influence a user's decisions. It is also known as *free from bias*.
	• Freedom from material error	If the statements are free from bias, overstatements and understatements must not exist. Faithful representation does not imply "accuracy" in that it is completely free from error, but rather free from material error.
ENHANCING QUALITIES (the order of these qualities is not a hierarchy, as these characteristics are traded off as needed in support of the fundamental qualities)		
3. Comparability		Enables users to identify similarities and differences between two sets of financial statements.
	• Consistency	Entails using the same accounting policies from period to period within the firm. If consistency is carried too far, it adversely affects relevance, so a change of policy is permitted if applied appropriately.
	• Uniformity	Companies with similar transactions and similar circumstances use the same accounting treatments.
4. Verifiability		The accounting measure is a reasonable measure of the economic event, without material error or bias; and

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CRITERIA	COMPONENTS	DESCRIPTION
		If knowledgeable and independent observers using the same measurement methods can measure an economic event and arrive at generally the same result, the measurement is verifiable.
5. Timeliness		Accounting information should be reported soon enough for it to be useful for decision making (within economic context). Lack of timeliness reduces relevance.
6. Understandability		Based on the assumption that investors and creditors have a reasonable understanding of business and economic activities—and of accounting. Information must be understandable to be useful.
PERVASIVE CONSTRAINTS		
7. Materiality		Materiality is used to describe the significance of an item. Information is material if its omission or misstatement would be likely to change or impact the user's decision. Materiality is related to both relevance and faithful representation.
8. Cost/benefit tradeoff		Any accounting measurement or disclosure should result in greater benefits to the users than its cost to prepare and present. Benefits should exceed costs. It is for this reason the AcSB provides for a somewhat simpler version of GAAP called Accounting Standards for Private Enterprises (ASPE) which enables private companies to follow simpler accounting policies in some areas.

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5. ELEMENTS OF FINNCIAL STATEMENTS AND RECOGNITION

Elements are the classes of items that financial statements should contain. Exhibit 2-4 in your textbook outlines six elements defined by the IASB's conceptual framework. The first three elements (assets, liabilities, owners' equity/net assets) relate to the statement of financial position; the next three (revenues/gains, expenses/losses, and other comprehensive income) relate to the statement of comprehensive income.

Elements of the Statement of Financial Position

Assets and liabilities are central to the element definitions as all other definitions are derived from these meanings.

Assets have three essential characteristics that embody three time frames:

1. They embody a *future* benefit;
2. The entity has a clear *present right* to the asset*;*
3. The asset arose as the result of a *past* transaction or event.

Liabilities also have three characteristics embodying the same time frames:

1. They involve a *future* sacrifice (payment or performance of service);
2. The entity has a clear *present obligation*; and
3. The liability arose as the result of a *past* transaction or event.

Owner's Equity

Owner's or Shareholders' Equity is a residual of assets minus liabilities. It includes several individual categories:
Share ownership; Retained earnings and Items of other comprehensive income.

Items of other comprehensive income reflect changes in net assets that cannot be recognized as components of revenue or expenses

Elements of the Statement of Comprehensive Income

The IASB uses the term income to mean increases in net assets as a result of operating activities and does not distinguish between "revenues" and "gains" or "expenses" or losses". So although these definitions are fairly common usage, companies have reporting choices.

- *Revenues* are normally the increase in net assets arising from ordinary activities of an entity; and
- *Expenses* are normally decreases in net assets resulting from ordinary activities.
- *Gains* are generally increases in net assets from peripheral transactions and re-measurement of assets and liabilities; and
- *Losses* are generally decreases in net assets from peripheral activities and downward re-measurements.

Items of other comprehensive income (OCI) include only certain specific changes in net assets as prescribed by individual IFRS standards.

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Recognition is the process of measuring an item and including it in the financial statements with a title and numerical value. In order for any element to be recognized in financial statements:

1. The item must meet the element's criteria;
   Recognition:
2. The item's cost or value can be measured reliably; and
3. The future benefit will flow to (or from) the reporting entity, either in the current or future reporting period.

If an item meets some, but not all of the above criteria, note disclosure may be appropriate even if the item is not recognized as an element of financial statements. For example, there is a distinction between assets and liabilities and commitments or executory contracts. It is important to note that there is judgement involved in application of these definitions.

Recognition versus Realization
Realization is the process of converting an asset, liability, or commitment into a cash flow. Once realization has occurred, recognition must occur. Recognition often occurs *prior* to realization.

Accruals are recognized events and transaction in periods that they occur rather than when the cash is received or paid. When cash outflow or inflow precedes recognition we use **deferrals**.

Interperiod allocation amounts originally recognized as assets are transferred (or recognized) as on the statement of income as expenses. Amounts recorded as liabilities are transferred to the statement of income as revenue (or reduced expenses).

Expense Recognition and "Matching"
Matching refers to the timing of recognition of revenues and expenses in the statement of income when the recognition is simultaneous. Interperiod allocation such as depreciation is a prime example of matching. Depreciation matches the cost of long-lived assets to the revenue generated by their use in productive activity.

Net asset principle of revenue/expense recognition is an alternative approach to recognition of revenues and expenses. The generation of revenue is seen as an increase in assets (such as cash or accounts receivable increases). But to fulfill the obligation we must use assets (cash, inventory and long-lived assets). So the increase in assets is supported by a decrease in assets (net asset change). Thus matching is achieved, but the rationale is based on changes in assets and liabilities rather than the concept of matching.

Professional judgement. The measurement, including estimations, of cost and the timing of expense recognition are matters that require professional judgement.

Cash Flow Accounting cannot recognize financial statement elements that are not based on actual or predicted cash flow.

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6. MEASUREMENT

Measurement is the process of determining the *amount* at which an item is recognized in the financial statements. The primary measurement methods used in IFRS are:

1. Historical cost;
2. Current cost;
3. Present value; and
4. Fair value.

Historical cost specifies that the actual acquisition cost be used for accounting recognition purposes. The assumption is that assets are acquired at arm's length. The cost principle provides guidance for the initial recording at the time of acquisition. The cost of the asset is based on the value of the consideration (cash or other assets) given up.

Current cost is what it would cost to replace an asset or to replace its productive capacity. There are several ways of measuring current cost, such as:

1. Cost of acquiring a similar asset of similar remaining productivity;
2. Cost of acquiring a similar asset less an estimated amount for depreciation (depreciated replacement cost); and
3. Applying a price index to a class of assets.

Realizable Value
Historical cost and current cost are entry values while net realizable value is an exit value A settlement value is what can be recovered for an asset, or what is settled to pay off a liability.

Present Value is the value of a future asset or liability with its interest component removed, also known as its discounted value. Present value is the normal measurement method used for financial assets and liabilities with a maturity of more than one year after the SFP date.

Fair Value is a current measurement of the value of an asset or liability at the reporting date. It can either be an entry value or an exit value so it could be measured at cost, present value or realizable (settlement) value.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. The IASB established three levels of measuring fair value:
Level 1 Quoted prices in active markets for identical markets (direct observation),
Level 2 Prices for similar assets (indirect observation); and
Level 3 Values derived by indirect valuation techniques (unobservable values).

An asset should be valued in its principal or most advantageous market and at its highest and best use.

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The Crucial Importance of Estimates

Almost all items on the SFP contains estimates. Estimates are required as every asset or liability involves future benefit or future sacrifice. Even a fairly minor change in estimate may have a significant (material) impact on earnings, which can raise concerns about earnings manipulation.

7. ETHICAL PROFESSIONAL JUDGEMENT – PART 2

The Problem of Earnings Management

There are two main sources of earnings targets.

1. The company's own projected earnings for the current fiscal period; and
2. Financial analysts' independent projections which are often cited in financial news.

The market will react strongly to missed earnings expectations, particularly the company's own predictions, which puts great pressure on management to achieve these numbers. Management is often tempted therefore to use relatively small adjustments to meet expectations through:

1. Changes in measurement; or
2. Adjustments to reserves

Measurement variability

As there are several ways to measure items, particularly in fair value measurement, management must be ethical in both the choice of measure (such as using the revaluation method for property, plant and equipment) and in the use of fair value.

Reserves variability

In common practice this term is used for estimated liabilities and allowances that offset assets (such as allowance for doubtful accounts). Small adjustments to these accounts can be used to improve earnings and therefore ethical caution must be exercised when adjusting such reserves.

Exercising Professional Judgment

Ethical professional judgement is the ability to make appropriate choices in accounting. In exercising professional judgement, the accountant considers:

- The objectives of financial reporting in each particular situation.
- The facts of the business environment and operations.
- The organization's reporting constraints (if any).

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Steps required to exercise professional judgement

1. Identify and prioritize the objectives.
   a. Determine the facts relating to the organization's operation and economic environment.
   b. Determine the reporting constraints.
2. Test the underlying assumptions.
3. Consider the accounting policy or measurement choices.
4. Ensure that the measurement choices are consistent with the objectives, and the facts and constraints, and consider qualitative criteria.
5. Identify the financial statement elements and appropriately classify them. Produce the financial statements and ensure that they meet the financial reporting objectives.
6. Ensure that the ethical requirements are met, in that the financial statements result in fair presentation of the underlying business activity.

8. LOOKING FORWARD

Accounting terminology has changed as the standards have evolved. For example, the definitions of assets and liabilities have evolved over the years and continue to be currently considered by the IASB. Exposure drafts in 2015 and 2016 also address proposed changes to the Conceptual Framework including the re-introduction of "prudence" or conservatism removed in 2010.

PowerPoint Slides

The PowerPoint slides can be used in part or in their entirety in computer adapted classrooms.

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Chapter 2 Issues

Your meeting with the Pass's went well they now have a better understanding of the broad frame work of both IFRS and ASPE. They appreciate more fully the impact of consistent application appropriate accounting principles. They have determined that they need to formalize the accounting policies of the company, they have asked you help in formulating accounting policies with respect to the recording of Inventory and its related impact on the cost of sales and revenue recognition. Details of the current practice are provided as an appendix to this question. To better appreciate the choice between ASPE and IFRS they have asked if you can expand more fully on the principals involved in each and how this would impact their company. They are after all a small to medium size private company and not some large international publically listed company.

Required

Provide a brief memo outlining your proposal for the requested accounting principles and how this might be affected by the fundamental principles employed in both IFRS and ASPE. You are encouraged to use CICA and other sources to supplement the information contained in your accounting text.

Appendix

Inventory is currently measured at an estimated of replacement cost based on actual quantities on hand at the yearend date. Revenue is recorded when an invoice is generated and this occurs when the order is completed and not necessarily when it is shipped. A working trial balance is provided as additional information.

Chapter 2 Solutions

Memo

To Canco Ltd.

Subject: Accounting Policies - ASPE and IFRS impact the company and its reporting.

1. **Frame work**

Both ASPE and IFRS provide a frame work for the application of the more detailed accounting principles. The principles are identified in ASPE by subject and handbook section (specific recommendations) and in IFRS by subject and specific recommendations in the pronouncements (IAS – international accounting standard, IFRS – international financial reporting standard).

The exercise of judgment, subject to the principles outlined below, can and does have a significant impact on the recording and reporting function carried out by Canco to reflect the economic results of its operating activities.

ASPE principals are outlined at section 1000 – Financial Statement Concepts

IFRS principals are outlined in the Conceptual framework for financial reporting.

There are both **qualitative and quantitative characteristics** to be considered and applied to the recording of the company's transactions. Understanding what these characteristics are will facilitate the choices that must be made by the company and its management.

2. **Qualitative Characteristics**

IFRS refers to **the qualitative characteristics** that govern the recording and reporting process, the principal characteristics being

- Relevance
- Materiality
- Faithful representation and
- Application of fundamental characteristics

These characteristics influence how the entity will apply **recognition and measurement (quantitative measurements)** to the following key financial statement elements

- Assets
- Liabilities
- Revenues
- Expenses

ASPE at section 1000 defines these **qualitative characteristics** (excerpts) as follows:

Relevance is achieved through information that has predictive value or feedback value and by its timeliness.

Materiality is the term used to describe the significance of financial statement information to Decision makers. An item of information, or an aggregate of items, is material if it is probable That its omission or misstatement would influence or change a decision. Materiality is a matter of professional judgment in the particular circumstances.

Representational faithfulness is achieved when transactions and events affecting the entity are presented in financial statements in a manner that is in agreement with the actual underlying transactions and events. Thus, transactions and events are accounted for and presented in a manner that conveys their substance rather than necessarily their legal or other form.

These characteristics are applied to the recognition and measurement of the key financial statement elements being: assets, liabilities, revenues and expenses.

IFRS indicates that information must be both relevant and faithfully represented if it is to be useful.

3. Accounting Principles for Recording and Measurement (quantitative)

Bearing in mind the qualitative and quantitative characteristics noted above, Canco needs to implement accounting policies for the recording of Inventory and the recognition and recording of revenues.

ASPE provides the following guidance on the recognition of key financial element and the characteristics that are attached to each.

Assets are economic resources controlled by an entity as a result of past transactions or events and from which future economic benefits may be obtained. They have three essential Characteristics:

(a) they embody a future benefit
(b) the entity can control access to the benefit; and
(c) the transaction or event giving rise to the benefit has already occurred.

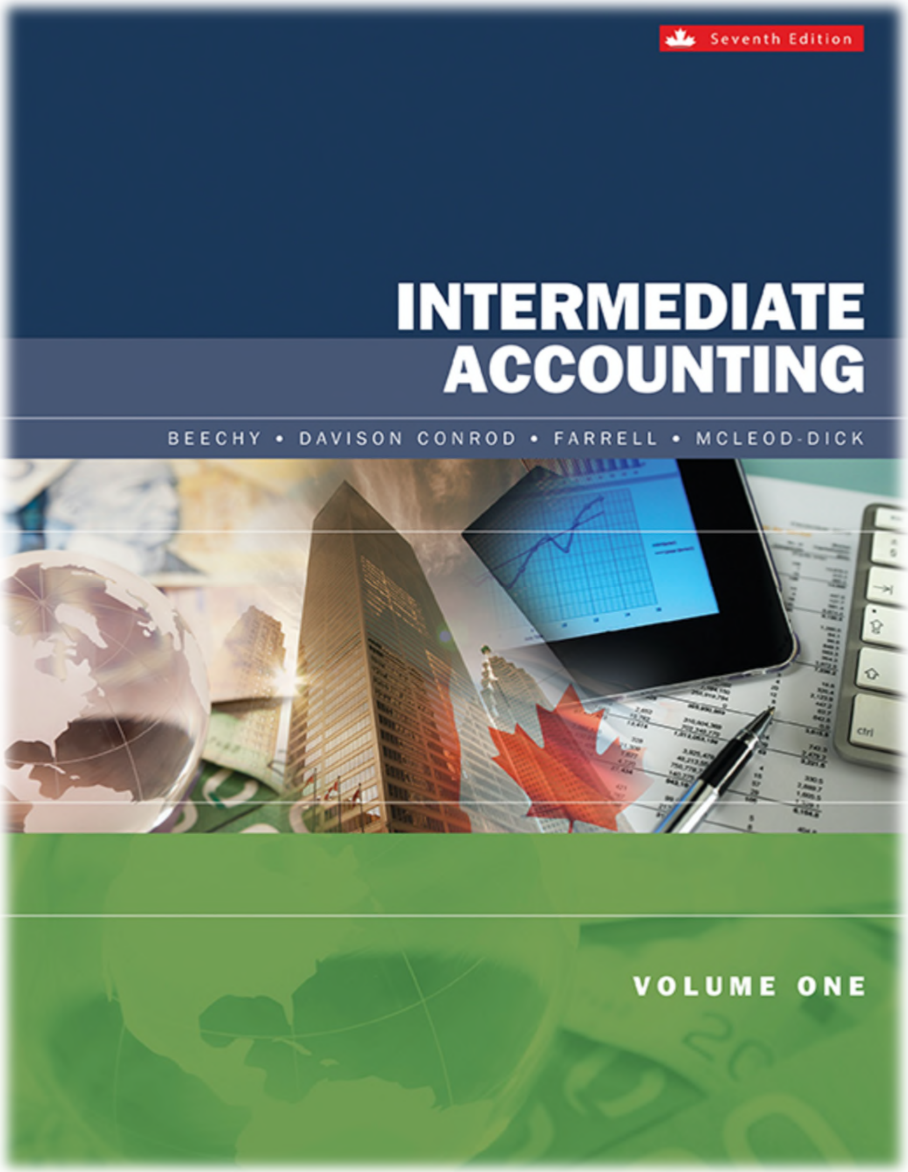
Revenues are increases in economic resources, resulting from the ordinary activities of an entity. Revenues normally arise from the sale of goods or the rendering of services

Inventory, as it is created and as long as it remains the property of Canco, would constitute an economic resource of the company. Consequently it would be recorded as an asset and be reflected on the statement of financial position (balance sheet). At the point of a sale the inventory is no longer the asset of the company, it is replaced by another asset, cash or accounts receivable. The key measurement event is then the recognition of the sale. The accounting policy for Canco must address the point at which Canco would derecognize the inventory asset, record the related cost of sales and recognize the sale. The issues surrounding the recognition of revenues will be examined in greater detail in Chapter 6.

The accounting policies of Canco should also address how the company will measure and record the inventory asset as it is created and then held until derecognized on the sale. There are a number of issues surrounding the recording and measurement of inventory that will be addressed in greater detail at chapter 8.

While there are some differences in the rules for ASPE and IFRS (these will be xplored in the subsequent chapters) regardless of the choice between ASPE and IFRS the objective of the financial reporting process is the same and the fundamental principles that need to be applied are, for the most part, very similar.

The application of those principals, regardless of the choice, will require judgment and that judgment will have a significant impact. In both cases the application of Judgment is a key component, while ASPE states this explicitly and IFRS implicitly, both require it.



CHAPTER 2:

Accounting Judgements

Prepared by
Shannon Butler,
CPA, CA
Carleton

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Introduction

- Accounting estimates are, by definition, approximations.
- Accounting choice is often a matter of professional judgement.
- Accounting estimates play a major role within any accounting model.
- This chapter explains the underlying assumptions of our accounting model.
- GAAP is really a collection of assumptions, objectives, and measurement concepts leading to an accumulation of accounting practices and accounting standards.

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Accounting Concepts

- General body of accounting principles consist of three different categories:
  - **(1) Underlying assumptions**: *the basic foundation upon which accounting measurement rests*
  - e.g. continuity assumption (going concern principle)

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Accounting Concepts (cont'd)

(2) Qualitative characteristics: *in conjunction with the organization's reporting objectives, facts, and constraints, are used to evaluate and choose the most appropriate measurement method*

- e.g. principles of comparability and understandability
  - Answers ***why*** this measurement

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Accounting Concepts (cont'd)

(3) Measurement methods : *the various ways in which financial position and the results of operations can be reported*

- e.g. fair value or historical cost
- Answers ***how*** to measure

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Accounting Concepts (cont'd)

To construct financial statements for a particular enterprise, it is necessary to:

- Consider the facts and constraints for the organization;
- Determine the objectives of financial reporting;
- Make sure underlying assumptions are valid;
- Measure the elements using situation specific measurement methods while satisfying qualitative criteria; and
- Prepare financial statements.

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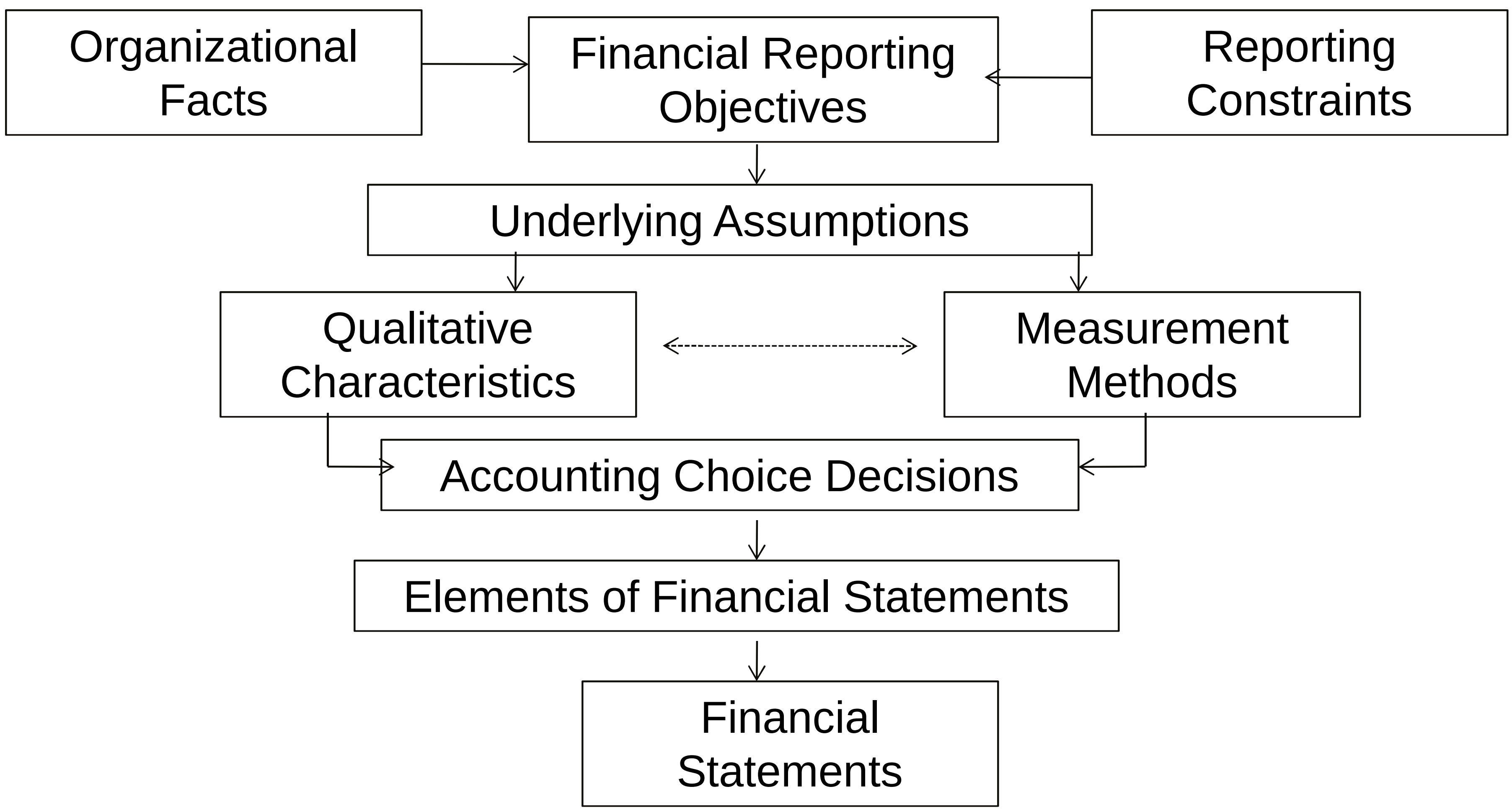
Structure of the Accounting Choice Process



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Ethical Professional Judgement In Accounting

- Exercise ethical professional judgment in making choices by keeping in mind the following:
  - users and their specific information needs
  - motivations of managers
  - the nature of the organization’s operations
  - The organizations reporting constraints, such as audit requirements, reporting to securities regulators, etc.

Underlying Assumptions

- Six basic assumptions significantly affect the recording, measuring, and reporting of accounting information. They can be grouped into the following two categories:
- Universal assumptions:
  - time-period
  - separate entity
  - unit of measure
- Entity-specific assumptions:
  - proprietary approach
  - continuity
  - stable currency

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Time Period Assumption

Time period assumption: states that it is feasible to provide useful information in shorter periods while the enterprise is still functioning instead of only at the end.

- One year is the standard for a reporting period
- In addition, companies also report summarized financial information on an interim basis.
- Usually quarterly for public reporting or monthly for internal purposes

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Separate Entity Assumption

Separate entity assumption: means each specific, identifiable business entity is considered an accounting unit separate and apart from its owners and from other entities.

All accounting records and reports are developed from the viewpoint of a single entity, whether it is a proprietorship, a partnership, or a corporation.

- Corporations are separate for legal and tax purposes
- Sole proprietorships and partnerships may not be separate for legal and tax purposes

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Unit of Measure Assumption

Unit of measure assumption: results of a business's economic activities can be reported in terms of a standard monetary unit throughout the financial statements.

- i.e. dollar, euro
- If it cannot be measured, it cannot be reported and cannot be used for decision making → because of this, many important aspects of a modern business's operations are not included in the financial statements.

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Proprietary Concept

The proprietary concept: an organization's financial condition and results of operations are reported from the point of view of the owners, or proprietors

- i.e. payments to owners are capital transactions and not expenses

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Continuity Assumption

Continuity assumption (going-concern assumption): the business entity is expected to continue operations into the foreseeable future

- Does not assume perpetual life but at least long enough to recover or use up assets and repay its outstanding liabilities.
- Two instances in which the continuity assumption is not valid are:

  (1) when a business is a limited - life venture

  (2) when a business is in financial difficulty and is expected to be shut down or liquidated

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Stable Currency Assumption

Stable currency assumption: the reporting currency is stable over time

- Not entirely correct due to inflation

Accounting is performed under the assumption that every dollar of revenue and expense has the same value regardless of the year it occurred

- Not adjusted for purchasing power (inflation) over time

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Alternative Capital Maintenance Approaches

- There are two approaches to capital maintenance:
- Financial capital maintenance
  - Measured in nominal monetary units
  - Measured in units of constant purchasing power; and
- Physical capital maintenance
- IFRS accepts both nominal dollar and physical/productive capacity capital maintenance concepts.

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EXHIBIT 2-3

QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION

Fundamental Characteristics	**Enhancing Characteristics**
Relevance (*the primary characteristic*)	Comparability (*the goal*)
Predictive value	Consistency (*the means*)
Confirmatory (*or* feedback) value	Verifiability, as:
Faithful representation	Representation of economic phenomena
Completeness	Application of a measurement method
Neutrality	Timeliness
Freedom from material error	Understandability

Pervasive constraints

Materiality

Cost/benefit

Based on Chapter 3 of the IASB *Conceptual Framework for Financial Reporting*, "Qualitative Characteristics of Useful Financial Information."

Source: The International Accounting Standards Board, © 2012.

Fundamental Quality – Relevance

Relevance:

- The most important qualitative characteristic
- Capacity of accounting information to make a difference to the external decision makers who use financial reports.

Two qualities that contribute to relevance are:

- Predictive value - increase ability to make predictions
- Confirmatory value (feedback value) – confirming past predictions and making adjustments to new predictions

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Faithful Representation

- **Faithful Representation**:
  - Accounting information should represent a sufficiently accurate measure of what it claims to represent
  - **Substance over form** is the most important aspect of faithful representation
- Three Additional concepts:
  - Completeness – information must not mislead or deceive by omitting items
  - Neutrality (freedom from bias) – does not influence judgments or decisions to achieve a specific intended outcome
    - <u>Bias</u> is consistent overstatement or understatement of items
  - Freedom from material error

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Enhancing Quality – Comparability

Comparability: consider the relationship between two pieces of information

- **Consistency:** using the same accounting principles from year to year within a firm
- **Uniformity -** use same accounting methods for same economic events

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Enhancing Quality – Verifiability

Verifiability –*independent observers can measure the economic event and arrive at the same conclusion*

- Accounting measure is a reasonable measure of the event without material error or bias.
- Measurement methods used are the same

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Enhancing Quality – Timeliness

Timeliness - accounting information should be reported soon enough to be useful.

- Lack of timeliness reduces relevance

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Enhancing Quality – Understandability

Understandability - Information must be understandable to be useful to users in their decision-making

- Assumes sophisticated users studying information with due diligence

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Pervasive Constraints – Materiality

Materiality is used to describe the significance of an item

- item is "**material**" if its omission or misstatement will impact a decision
- **Materiality** may be impacted by the size or nature of an item

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Pervasive Constraints – Cost /Benefit Tradeoff

- **Cost/benefit Tradeoff -** any accounting measurement or disclosure should result in greater benefits to the users than it costs to prepare and present.
  - ASPE standards are designed with cost /benefit threshold kept in mind → Simpler version of GAAP

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Elements of Financial Statements

- **Elements:** *the building blocks of financial statements*
- Statement of Financial Position
  - Assets
  - Liabilities
  - Owners' equity (or net assets)
- Statement of Comprehensive Income
  - Income – revenue and gains
  - Expenses (and losses)
  - Other comprehensive items (for IFRS only)

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Elements of the Statement of Financial Position

- **Assets –** require 3 essential characteristics in order to be recognized:
  - Involves a future benefit;
  - The entity has a clear present right to the asset; and
  - The asset arose as the result of a past event.

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Elements of the Statement of Financial Position

- **Liabilities –** require 3 essential characteristics also in order to be recognized:
  - Involves a <u>future sacrifice</u>;
  - The entity has a clear <u>present obligation</u> to the liability; and
  - The liability arose as the result of a <u>past event</u>.

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Elements of the Statement of Financial Position

- **Owners' Equity –** is the residual of assets less liabilities
  - Includes:
    - All ownership related transactions

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Elements of the Statement of Comprehensive Income

- **Income –** all increases in net assets resulting from operating activities of the company.
- **Gains** are increases in net assets arising from two sources:
  - peripheral and incidental activities; and
  - remeasurement increases of asset or liabilities
- **Expenses** are decreases in net assets resulting from ordinary activities of the company.
- **Losses** are decreases in net assets arising from:
  - peripheral and incidental activities; and
  - remeasurement declines of asset or liabilities

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Elements of the Statement of Comprehensive Income

- **Other Comprehensive Income items** (only relevant under IFRS)
    - Specific changes in net assets as allowed by IFRS

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Recognition

Recognition: the process of measuring and including an item in the financial statements.

- Item is given a title and a numerical value
- Must meet three criteria:
  - Meets definition of an element
  - Has an appropriate basis of a reliable measurement
  - For assets and liabilities – it is probable that economic benefits will flow (i.e. be realized)

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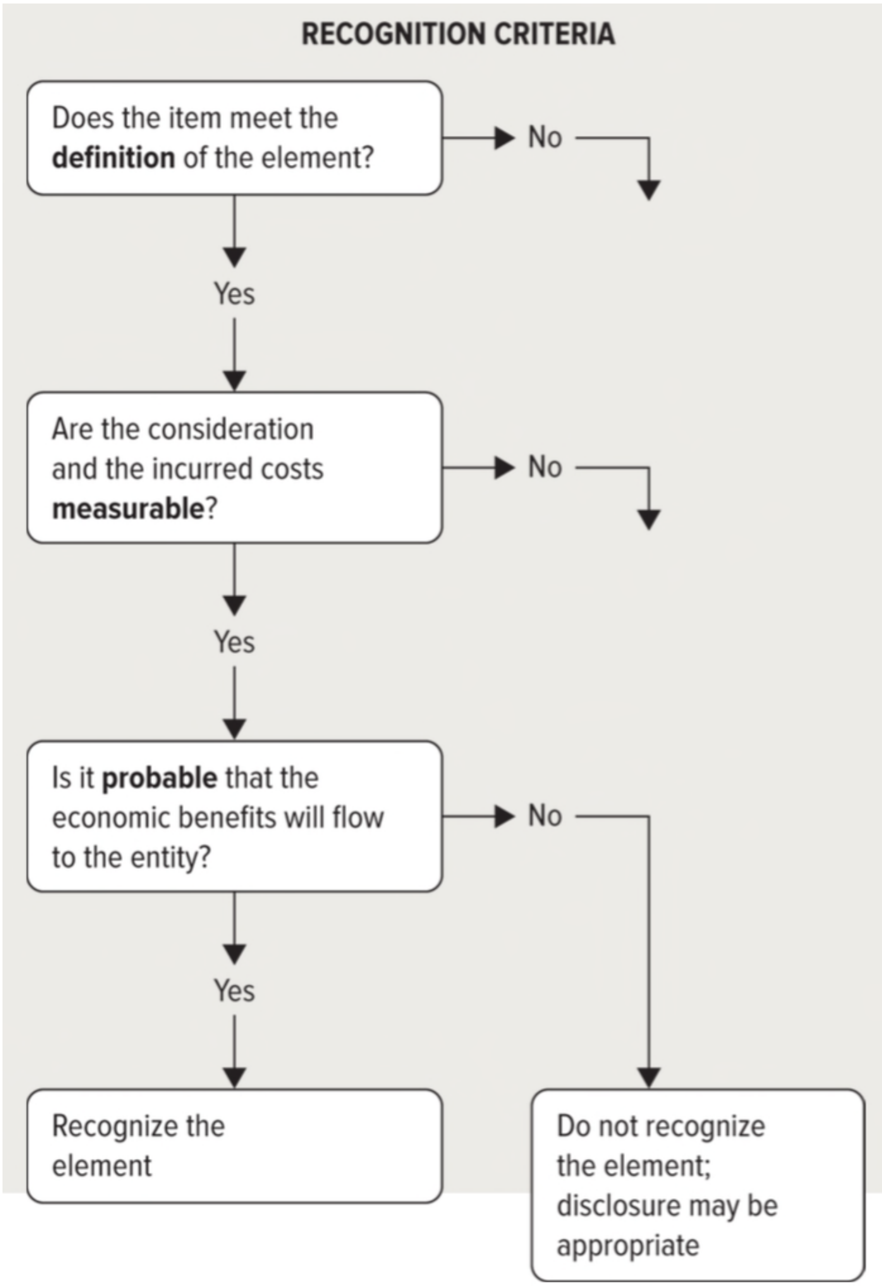
Exhibit 2-5



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Commitments

- **Commitments** – an ***executory*** contract wherein neither party has yet fulfilled the requirements
  - Do not recognize since the first recognition criterion of meeting the definition of an element is <u>not met</u>

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Recognition vs. Realization

Realization – is the process of converting an asset, liability or commitment into a cash flow

Recognition may occur:

- prior to realization – i.e. accounts receivable;
- at the same time as realization i.e. customer makes a cash deposit

Remember: accounting recognition relates to past, present and future cash flows

- i.e. at no time can accounting recognize financial statement elements that are not based on actual or predicted cash flows

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The Accrual Concept

Accrual Concept: the recognition of assets and liabilities that have not yet been realized

- Recognize transactions when they occur

Deferrals: delayed recognition of costs and receipts that have been realized through cash flows but not yet contributed to the earnings process as expenses and revenues

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Expense Recognition and "Matching"

Matching – the simultaneous recognition of revenue and expense that result directly and jointly from the same transaction or other events

- i.e. depreciation, cost of goods sold

Net asset principle of revenue/expense recognition – Revenue (and expenses) are recognized only when net assets increase (decrease).

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Measurement Methods

Measurement: the process of determining the amount at which an item is recognized in the financial statements.

Primary measurement ones used in IFRS are:

- Historical cost
- Current cost
- Present value
- Fair Value

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Historical Cost

- **The historical cost convention:** the actual acquisition cost be used for <u>initial</u> accounting recognition
  - An entry value
- The cost principle assumes that assets are acquired in business transactions conducted at arm's length
  - **Cost** is based on the amount of the consideration given up
  - Provides guidance primarily at the **initial acquisition date**
  - **Subsequent periods -** long-lived assets are amortized and tested for impairment

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Current Cost

- **Current cost –** what it would cost to replace an asset's productive capacity – rarely used for accounting purposes
- Methods used:
  - Cost to acquire an asset of similar age and remaining productivity;
  - Cost of purchasing a new asset and then adjusting for depreciation
  - Applying a price index to a large number of similar/identical assets

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Realizable Value

- **Realizable value –** what can be recovered when an asset is sold or disposed of.
  - An exit value
  - i.e. lower of cost and net realizable value

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Present Value

- **Present value –** the value of a future asset or liability with its interest component removed – its discounted value.
  - Normally used for financial assets and liabilities
  - Entry value uses current interest rate at time of initial transaction date
  - Exit value uses current interest rates at a later date

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Fair Value

- **Fair value –** is a current measurement of the asset or liability at the reporting date. It is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (IASB definition)
  - Valued in its principal or most advantageous market
  - Measured at “highest and best use”
  - Do not adjust for transaction costs

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Fair Value Hierarchy

- **IASB – three measurement levels (IFRS only)**
  - Level 1 – Direct Observation - quoted prices in active markets for identical assets
  - Level 2 – Indirect Observation - prices for similar assets or that can be derived from observable market data
  - Level 3 – Unobservable Values - values derived by indirect valuation techniques, not verifiable by direct observation of market data

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Ethical Professional Judgement

- **The Problems of Earnings Targets** – pressure on management to achieve earnings targets.
- There are two sources of earnings targets:
  - the company’s own projected earnings for the current fiscal period and financial analysts’ independent projections
- Management is often tempted to use relatively small adjustments which fall into two categories:
  - Changes in measurement
  - Adjustments to reserves.

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Ethical Professional Judgement

1. Changes in Measurements - variability of fair value measurements due to inputs used in determination
2. Adjustments to Reserves – “estimated liabilities”
   - i.e. bad debt allowance, the estimated warranty liability, or an allowance for inventory obsolescence
   - Small adjustments in estimates can have large impact on earnings

Applying ethical professional judgment results in fairly presented financial information.

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Ethical Professional Judgement

- Professional judgment permeates the work of a professional accountant and requires the ability to build accounting measurements that take into account:
  - The objectives of financial reporting in each particular situation;
  - The facts of the business environment and operations; and
  - The organization’s reporting constraints (if any).

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Accounting Standards for Private Enterprises

- Conceptual framework is similar to IFRS
- Financial statement objectives: “To communicate information that is useful to investors, creditors and other users” concerning economic resources of an entity, and changes in those resources during the reporting period.
- The arrangement of qualitative characteristics is different from IFRS, but the substance is the same.
- The overall constraints of materiality and cost/benefit also apply within the ASPE framework.
- No other comprehensive income.

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EXHIBIT 2-6

ASPE QUALITATIVE CHARACTERISTICS

Principal Qualitative Characteristics	Pervasive Constraints
Understandability	Cost/benefit
Relevance	Materiality
Predictive value and feedback value	
Timeliness	
Reliability	
Representational faithfulness	
Verifiability	
Neutrality	
Conservatism	
Comparability	

Source: *CPA Canada Handbook, Part II*, Section 1000, © Chartered Professional Accountants of Canada, 2015.

EXHIBIT 2-7

ASPE DEFINITIONS OF ASSETS AND LIABILITIES

Assets	Liabilities
a. An asset is a resource acquired as the result of past events;	a. A liability is a present obligation or responsibility to others that arises from past events;
b. The entity can control access to the benefits; and	b. The duty or responsibility obligates the entity and leaves it little or no discretion to avoid it; and
c. The asset contributes directly or indirectly to future benefits that result in net cash flows.	c. In the future, the entity will be required to transfer or use assets, provide services or yield other economic benefits, at a specified or determinable date, on occurrence of a specified event, or on demand.

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END OF CHAPTER 2: Accounting Judgements

Summary → Accounting is full of choices. Financial statements are constructed from the financial statement elements that have been recognized using measurement methods that optimize the qualitative characteristics and that are based on the appropriate underlying assumptions. The organization's reporting constraints and the facts of its business and environment all impact on the choice of accounting policy. The result is information that best satisfies the objectives of financial reporting in any given situation.

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