

Solutions Manual

to accompany

Applying IFRS[®] Standards 4e

Ruth Picker, Kerry Clark, John Dunn, David Koltz, Gilad
Livne, Janice Loftus, Leo van der Tas

Prepared by Nila Latimer and revised for
this edition by John Dunn

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Chapter 1 The IASB and its Conceptual Framework

Discussion Questions

1. Describe the standard-setting process of the IASB.

The standard setting process of the IASB for issuing IFRSs has six stages. The six stages are:

1. Setting the agenda.

The IASB considers the relevance and reliability of the information that could be provided, the existing guidance (if any), the potential for enhanced convergence of accounting practice and the quality of the standard to be developed and any resource constraints.

2. Planning the project.

The IASB decides whether it should undertake the project by itself or jointly with another standard setter such as the Financial Accounting Standards Board (FASB).

3. Developing and publishing the discussion paper.

The IASB may issue a discussion paper; however, this is not mandatory.

4. Developing and publishing the exposure draft (ED).

The IASB must issue an ED. This is a mandatory step.

5. Developing and publishing the standard.

The IASB may re-expose an ED, particularly where there are major changes since the ED was first released in stage 4.

6. Procedures involving consultation and evaluation after an IFRS has been issued.

The IASB may hold regular meetings with interested parties, including other standard-setting bodies, to help understand unanticipated issues related to the practical implementation and potential impact of the IFRS. They also carry out post-implementation reviews of each new IFRS.

The IASB has full discretion over its technical agenda and over the assignment of projects, potentially to national standard setters. In preparing the IFRSs, the IASB has complete responsibility for all technical matters including the preparation and issuance of standards and exposure drafts, including any dissenting opinions on these, as well as final approval of interpretations developed by the IFRS Interpretations Committee.

IASB meetings are normally held every month and last between three and five days. The meetings are open to the public. Interested parties can attend the meetings in person, or may listen and view the meeting via the IASB webcast. Subsequent to each meeting, the decisions are summarised in the form of a publication called IASB Update which is available on the IASB website.

2. Identify the potential benefits of a globally accepted set of accounting standards.

Potential benefits of a globally accepted set of accounting standards include:

Using a principles based approach which allows more scope for the use of professional judgement when the principles are applied to specific situations.

Greater comparability between financial reports of different entities and countries if they are prepared using an internationally recognized and accepted basis of accounting.

Reduction in the cost of financial statement preparation if restatement of financial statements for other jurisdictions is no longer required

Greater mobility of staff as staff trained in IFRS will be more readily able to move between foreign subsidiaries without the need for retraining in financial statement preparation.

3. Outline the fundamental qualitative characteristics of financial reporting information to be considered when preparing general-purpose financial statements.

This requires a discussion of the qualitative characteristics mentioned in figure 1.2 in learning objective 4, namely relevance, reliability, comparability and understandability.

4. Discuss the importance of the going concern assumption to the practice of accounting.

The *going concern assumption* is important in that all measures of performance and financial position, and all classifications in a statement of financial position (current and non-current) implicitly assume that the entity is going to continue. Furthermore, valuation of assets on the basis of cost is sometimes justified on the grounds of the going concern assumption.

The *accrual basis assumption* is made in the preparation of general-purpose financial reports. Under this assumption, the effects of all transactions and other events are recognised in the accounting records when they occur, rather than when cash or its equivalent is received or paid. Financial reports prepared on the accrual basis inform readers not only of past transactions involving the receipt and payment of cash but also of obligations to pay cash in the future and of amounts owing to the entity in the form of receivables. It is argued that the accrual basis therefore provides better information for users in their decision-making processes.

5. Discuss the essential characteristics of an asset as described in the *Conceptual Framework*.

Discussion of essential characteristics of asset:

- resource must contain future economic benefits
- control, requiring a capacity to benefit from the asset in the pursuit of the entity's objectives, and an ability to deny or regulate the access of others to those benefits.
- past event, giving rise to the entity's control over future economic benefits

Non-essential characteristics:

- purchased at a cost
- tangibility
- exchangeability

With the proposed definition of an asset, namely “An asset of an entity is a present economic resource to which, through an enforceable right or other means, the entity has access or can limit the access of others,” there will be less focus on “future economic benefits” and more on “present resource”; and less on “control”, with more on the existence of enforceable rights to limit access of others.

6. Discuss the essential characteristics of a liability as contained in the Conceptual Framework.

A **liability** is defined in the current *Framework* as ‘a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits’. Important aspects of this definition:

- A legal debt constitutes a liability, but a liability is not restricted to being a legal debt. Its essential characteristic is the existence of a present obligation, being a duty or responsibility of the entity to act or perform in a certain way. A present obligation may arise as a legal obligation and also as an obligation imposed by custom or normal business practices (referred to as a ‘constructive’ obligation). For example, an entity may decide as a matter of normal business policy to rectify faults in its products even after the warranty period has expired. Hence, the amounts that are expected to be spent in respect of goods already sold are liabilities.
- A present obligation needs to be distinguished from a future commitment. A decision by management to buy an asset in the future does not give rise to a present obligation.
- A liability must result in the giving up of resources embodying economic benefits which requires settlement in the future. The entity has little, if any, discretion in avoiding this sacrifice. This settlement in the future may be required on demand, at a specified date, or on the occurrence of a specified event.
- A liability is that it must have resulted from a past event. For example, wages to be paid to staff for work they will do in the future is not a liability as there is no past event and no present obligation.

The IASB and FASB have proposed to change the definition of a liability by focusing on a liability as an enforceable “economic obligation” rather than an expected future sacrifice of economic benefits. Furthermore, the reference to past events is to be replaced by a focus on the present. The essential attributes of an enforceable obligation include the involvement of a separate party and the existence of a mechanism that is capable of forcing an entity to take a specified course of action.

7. Discuss the difference, if any, between income, revenue and gains.

The *Framework* defines *income* as “increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.”

This definition of income is linked to the definitions of assets and liabilities. The definition

is wide in its scope, in that income in the form of inflows or enhancements of assets can arise from the provision of goods or services, the investment in or lending to another entity, the holding and disposing of assets, and the receipt of contributions such as grants and donations. To qualify as income, the inflows or enhancements of assets must have the effect of increasing the equity, excluding capital contributions by owners.

Income can exist as well through a reduction in liabilities that increase the entity's equity. An example of a liability reduction is if a liability of the entity is 'forgiven'. Income arises as a result of that forgiveness, unless the forgiveness of the debt constitutes a contribution by equity holders.

Under the current *Framework*, income encompasses both revenue and gains. A more complete definition of *revenue* arises in accounting standard IAS 18 *Revenue* as follows: "the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants."

Revenue therefore represents income which has arisen from 'the ordinary activities of an entity'. On the other hand, *gains* represent income which does not necessarily arise from the ordinary activities of the entity, e.g. gains on the disposal of non-current assets or on the revaluation of marketable securities. Gains are usually disclosed in the income statement net of any related expenses, whereas revenues are reported at a gross amount.

Revenues arise from the "ordinary activities" of the entity and gains may or may not be from ordinary activities. What "ordinary activities" means in any particular context is unclear; hence the distinction between revenues and gains is unclear. Would we be better off abandoning the distinction?

8. Distinguish between the financial and physical concepts of capital and their implications for the measurement of profit.

Under the financial capital concept, capital is synonymous with the net assets or equity of the entity, measured either in terms of the actual amount of dollars by subtracting the total of liabilities from assets, or in terms of the purchasing power of the dollar amount recorded as equity. Profit exists only after the entity has maintained its capital, measured as either the dollar value of equity at the beginning of the period, or the purchasing power of those dollars in the equity at the beginning of the period.

Under the physical capital concept, capital is seen not so much as the equity recorded by the entity but as the operating capability of the entity's assets. Profit exists only after the entity has set aside enough capital to maintain the operating capability of its assets.

Exercises

Exercise 1.1 MEASURING INVENTORIES OF GOLD AND SILVER

IAS 2 Inventories allows producers of gold and silver to measure inventories of those commodities at selling price, even before they have sold it, which means a profit is recognised at production. In nearly all other industries, however, profit is recognised only when the inventories are sold to outside customers. What concept(s) in the *Conceptual Framework* might the IASB have looked to with regard to accounting for gold and silver production?

- a. Unlike other ordinary goods, there is a ready liquid market with quoted prices, minimal transaction costs, minimal selling effort, minimal after-costs, and immediate cash settlement.
- b. Under the *Conceptual Framework*, an item that meets the definition of an asset, liability, income, or expense should be recognised if:
 - it is probable that any future economic benefit associated with the item will flow to or from the entity; and
 - the item has a cost or value that can be measured with reliability.
- c. The IASB concluded that because of the nature of the market in which gold and silver are bought and sold, the conditions for income recognition are met at the time of production.

Exercise 1.2 RECOGNISING A LOSS FROM A LAWSUIT

The law in your community requires store owners to shovel snow and ice from the pavement (sidewalk) in front of their shops. You failed to do that. A pedestrian slipped and fell, resulting in serious and costly injury. The pedestrian has sued you. Your attorney says that while he will vigorously defend you in the lawsuit, you should expect to lose \$25 000 to cover the injured party's costs. A court decision, however, is not expected for at least a year. What aspects of the *Conceptual Framework* might help you in deciding the appropriate accounting for this situation?

- a. The definition of liability can help decide the accounting treatment of the situation. Under the *Conceptual Framework* a liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. In this case, the past event is the fall and injury to the pedestrian.
- b. Present obligation depends on the probability of payment. The attorney has advised that a \$25 000 loss is probable. Therefore appropriate accounting involves recognising a liability for the probable payment. An expense would also be recognised.
- c. Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities. In this case, the expense arises at the time the pedestrian is injured because a liability has also arisen at that time.

Exercise 1.3 **NEED FOR THE *CONCEPTUAL FRAMEWORK* VS. INTERPRETATIONS**

Applying the *Conceptual Framework* is subjective and requires judgement. Would the IASB be better off to abandon the *Conceptual Framework* entirely and, instead, rely on a very active interpretations committee that develops detailed guidance in response to requests from constituents?

- a. No. The fact that the *Conceptual Framework* involves judgement does not mean that it should be abandoned.
- b. The guidance developed by the interpretations committee would be ad hoc – that is, developed case by case without the foundation of the *Conceptual Framework* to look to. The standards themselves would suffer from the same problem if there were no *Conceptual Framework*.
- c. The *Conceptual Framework* provides guidance and direction to the standard setters, and therefore will lead to consistency among the standards.
- d. But it is a set of concepts. It provides a boundary for the exercise of judgement by the standard setter and the interpretive body.

Exercise 1.4 **ASSESSING PROBABILITIES IN ACCOUNTING RECOGNITION**

The *Conceptual Framework* defines an asset as a resource from which future economic benefits are expected to flow. Expected is something less than a sure thing – it involves some degree of probability. At the same time, the *Conceptual Framework* establishes, as a criterion for recognising an asset that “it is probable that any future economic benefit associated with the item will flow to or from the enterprise.” Again, an assessment of probability is required. Is there a redundancy, or possibly some type of inconsistency, in including the notion of probability in both the asset definition and recognition criteria?

It is not an inconsistency to include the notion of probability both in the definition of an asset and in the recognition criteria. However, it may be a redundancy.

Exercise 1.5 PURCHASE ORDERS

An airline places a non-cancellable order for a new airplane with one of the major commercial aircraft manufacturers at a fixed price, delivery in 30 months, payment in full to be made at delivery.

- (a) Under the *Conceptual Framework*, do you think the airline should recognise any asset or liability at the time it places the order?
- (b) One year later, the price of this airplane model has risen by 5%, but our airline had locked in a fixed, lower price. Under the *Conceptual Framework*, do you think the airline should recognise any asset (and gain) at the time when the price of the airplane rises? If the price fell by 5%, instead of rising, do you think the airline should recognise a liability (and loss) under the *Conceptual Framework*?

(a) Under the *Conceptual Framework*, the airline should not recognise any asset or liability at the time it place the order, because the transaction has not taken place. Accounting recognises purchase transactions when delivery takes place, and title passes. At this point the airline, and not the manufacturer, has assumed the risks and rewards of owning the airplane.

Nonetheless, the airline has made an important and irrevocable commitment. Generally, major capital spending commitments are disclosed in the notes to the financial statements.

(b) The airline is better off for having locked in the price than if it had not done so. Conversely, if the price had fallen, it would be worse off for having signed the non-cancellable fixed price order. Nonetheless, under current accounting standards, such gains and losses are not recognised.

Accounting treats commitments to purchase financial assets differently from commitments to purchase property. If the airline had agreed to purchase a foreign currency at a fixed price for delivery at a future date, and the exchange rate goes up or down, it is required to recognise a gain or loss.

Exercise 1.6 DEFINITIONS OF ELEMENTS AND RECOGNITION CRITERIA

Explain how you would account for the following items, justifying your answer by reference to the *Conceptual Framework's* definitions and recognition criteria:

- (a) A trinket of sentimental value only.
- (b) You are guarantor for your friend's bank loan:
- (i) You have no reason to believe your friend will default on the loan.
- (ii) As your friend is in serious financial difficulties, you think it likely that he will default on the loan.
- (c) You receive 1000 shares in X Ltd, trading at \$4 each, as a gift from a grateful client.
- (d) The panoramic view of the coast from your café's windows, which you are convinced attracts customers to your café.
- (e) The court has ordered your firm to repair the environmental damage it caused to the local river system. You have no idea how much this repair work will cost.
- (a) *Trinket of sentimental value*
- Fails the para 49(a) asset definition as it does not constitute future economic benefits, defined in para 53 as the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity.
 - Recognition criteria are irrelevant, as there is no asset to recognise.

(b) Guarantor for friend's loan**(i) Friend unlikely to default on his loan**

- Meets the para 49(b) liability definition: (1) present obligation – legal obligation via the guarantor contract; (2) past event – signing the guarantor contract; (3) settlement involving outflow of economic benefits – payment of the guarantee.
- Fails probability recognition criterion, as it is not likely that you will be required to pay on the guarantee. Hence, no liability can be recognised. However, note disclosure of the guarantee may be warranted (para 88).

(ii) Friend likely to default on his loan

- Again, meets the liability definition as per (i) above.
- Meets both recognition criteria – probable that outflow of economic benefits will be required, and settlement amount can be reliably measured (amount owing). Hence, a liability should be recognised.
- Also meets the expense definition and recognition criteria. Definition: (1) decrease in economic benefits in the form of a liability increase – you now owe the amount of your friend's loan; (2) during period – the liability increase arose during period; (3) results in equity decrease – if liabilities increase and assets do not change, equity decreases. Recognition criteria: The decrease in future economic benefits has arisen, as you now owe the amount of your friend's loan. The bank can advise exactly how much your friend owes and so it can be reliably measured.

(c) Receipt of 1000 shares in X Ltd, trading at \$4 each, as a gift from a grateful client.

- The receipt of the shares meets the asset definition: (1) represent FEBs (via future sales or dividend stream); (2) controlled by you (only you can benefit from either selling them or receiving dividends); (3) past event (their receipt).
- They also meet the asset recognition criteria: probable that FEBs will eventuate (via sale or dividend stream); and the shares have a value (they are trading at \$4 each) that can be reliably measured (this value can be verified via stock exchange etc.).
- The shares also meet the income definition and recognition criteria. Definition: (1) increase in EBs in the form of an asset increase – you now own the shares; (2) during period – the shares were received during period; (3) results in equity increase – if assets increase and liabilities do not change, equity increases. Recognition criteria: The increase in FEBs has arisen, as you now own the shares (asset). The shares' value is known and so can be reliably measured.

(d) Café's panoramic view

- The view fails the definition as the entity does not control the FEBs that are expected to flow from the view – the entity cannot deny or regulate access by others to the view.
- Recognition criteria are irrelevant, as there is no asset to recognise.

(e) Court order to repair environmental damage caused to the local river system. You have no idea how much this repair work will cost.

- The court order meets the liability definition: (1) present obligation – legal obligation; (2) past event – order has been made; (3) settlement will involve outflow of EBs – future payment for repair of damage.
- Fails reliable measurement recognition criterion, as you have no idea as yet how much the repair work will cost. Hence, no liability can be recognised. However, note disclosure of the court order may be warranted (para 88).
- However, if you know a minimum amount that you will have to pay, then the reliable measurement criterion is met for this amount. The probability criterion is met as it is certain (given that you have been ordered by the court) that you will have to pay the repair cost. Again, note disclosure may still be warranted advising that the cost may be well in excess of this amount.

Exercise 1.7 ASSETS

Lampeter Cosmetics has spent \$220 000 this year on a project to develop a new range of chemical-free cosmetics. As yet it is too early for Lampeter Cosmetics' management to be able to predict whether this project will prove to be commercially successful.

Explain whether Lampeter Cosmetics should recognise this expenditure as an asset, justifying your answer by reference to the *Conceptual Framework* asset definition and recognition criteria.

- The *Conceptual Framework* defines an asset as a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
- The expenditure of developing a new line of chemical-free cosmetics meets this definition as: (1) it represents future economic benefits via sale of the new line of cosmetics; (2) the benefits are controlled, as Lampeter Cosmetics will enjoy the economic benefits flowing from the new line; and (3) there is a past event, as Lampeter Cosmetics has already spent the \$220 000.
- Under the *Conceptual Framework* an asset is recognised only when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be reliably measured.
- The expenditure fails the probability criterion, as it is not yet possible to predict whether the project will prove to be commercially relevant.
- Accordingly, Lampeter Cosmetics cannot (yet) recognise the expenditure as an asset.

Exercise 1.8 ASSET DEFINITION AND RECOGNITION

On 28 May 2013 \$20 000 cash was stolen from Ming Lee Ltd's night safe. Explain how Ming Lee should account for this event, justifying your answer by reference to relevant *Conceptual Framework* definitions and recognition criteria.

- The *Conceptual Framework* defines expenses as decreases in economic benefits during the period in the form of asset decreases or liability increases that result in decreases in equity, other than those relating to distributions to owners.
- The theft of the \$20 000 cash satisfies the expense definition as:
 - It is a decrease in economic benefits during the period, as cash (economic benefits) has decreased;
 - The decrease in economic benefits is in the form of an asset decrease, as cash (an asset) has decreased; and
 - It has resulted in a decrease in equity, as assets have decreased and liabilities have not changed.
- In accordance with the *Conceptual Framework* an expense must be recognised when:
 - A decrease in economic benefits related to an asset increase or a liability decrease has arisen; and
 - The decrease can be reliably measured.

- The theft of the cash satisfies both recognition criteria as:
 - The decrease in economic benefits related to an asset decrease (a decrease in cash) has occurred; and
 - The decrease can be reliably measured, as the amount of cash lost is known (i.e. \$20 000).
- Accordingly, an expense (Dr) and asset decrease (Cr) of \$20 000 must be recognised.

Exercise 1.9 RELEVANT INFORMATION FOR AN INVESTMENT COMPANY

A year ago you bought shares of stock in an investment company. The investment company, in turn, buys, holds, and sells shares of business enterprises. You want to use the financial statements of the investment company to assess its performance over the past year.

- a. **What financial information about the investment company's holdings would be most relevant to you?**
- b. **The investment company earns profits from appreciation of its investment securities and from dividends received. How would the concepts of recognition in the *Conceptual Framework* apply here?**
 - a. The performance of an investment company results from income earned on its investments (dividends and interest) and changes in the fair values of its investments while they are held. I would like to know:
 - Fair values of the securities that the investment company holds
 - How those fair values changed during the year. It would not matter much to me whether the investment company actually sold the investments (in which case they would have to replace them with other investments) or held on to the investments. Either way, the fair value changes represent gains and losses to the investment company and, therefore, to me as an investor in the investment company.
 - How the fair value changes of investments managed by this investment company compared to changes in similar investments in the market as a whole.
 - Turnover of the portfolio, and related transaction costs such as commissions.
 - Interest and dividends earned.
 - Information about risks in the portfolio.
 - Income taxes are usually based on only those fair value changes that have been "confirmed" by a sale transaction. If that is the case with this investment company, I might want to know how the fair value changes were split between "realised" (relating to investments that have been sold) and "unrealised" (relating to investments that are still held). In many countries, investment companies that distribute their earnings rapidly to the investors do not themselves pay taxes – only the investors pay the taxes on realised gains and dividend and interest income.
 - b. Under the *Framework*, an item that meets the definition of an asset, liability, income, or expense should be recognised if:
 - (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and
 - (b) the item has a cost or value that can be measured with reliability.

With respect to income, the *Framework* states that income is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. Appreciation of the fair value of investment securities does represent an increase in an asset. For an

investment company, it is an important component of performance. As to dividends, when the investment company's right to receive payment is established, it can recognise dividends as revenue. Because fair value changes and dividends are different in nature, they would be reported separately.

Exercise 1.10 FINANCIAL STATEMENTS OF A REAL ESTATE INVESTOR

An entity purchases a rental property for \$10 000 000 as an investment. The building is fully rented, and is in a prosperous area. At the end of the current year, the enterprise hires an appraiser who reports that the fair value of the building is “\$15 000 000 plus or minus ten per cent”. Depreciating the building over 50 years would reduce the carrying amount to \$9 800 000.

- a. **What are the relevance and reliability accounting considerations in deciding how to measure the building in the entity's financial statements?**
 - b. **Does the *Conceptual Framework* lead clearly to measuring it at \$15 000 000? Or at \$9 800 000? Or at some other amount?**
- a. Is the fair value relevant to stakeholders' decisions? Whether the stakeholders care about the fair value of the building should be considered.

Relevance

- Information in financial statements is relevant when it influences the economic decisions of users. It can do that both by (a) helping them evaluate past, present, or future events relating to an enterprise and by (b) confirming or correcting past evaluations they have made.
- Materiality is a component of relevance. Information is material if its omission or misstatement could influence the economic decisions of users.
- Timeliness is another component of relevance. To be useful, information must be provided to users within the time period in which it is most likely to bear on their decisions.

Reliability

- Information in financial statements is reliable if it is free from material error and bias and can be depended upon by users to represent events and transactions faithfully. Information is not reliable when it is purposely designed to influence users' decisions in a particular direction.
- There is sometimes a trade-off between relevance and reliability - and judgement is required to provide the appropriate balance.
- Reliability is affected by the use of estimates and by uncertainties associated with items recognised and measured in financial statements. These uncertainties are dealt with, in part, by disclosure and, in part, by exercising prudence in preparing financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, prudence can only be exercised within the context of the other qualitative characteristics in the *Conceptual Framework*, particularly relevance and the faithful representation of transactions in financial statements. Prudence does not justify deliberate overstatement of liabilities or expenses or deliberate understatement of assets or income, because the financial statements would not be neutral and, therefore, not have the quality of reliability.

Analysis

- The fair value of the property is relevant to the investors in the enterprise. The enterprise – and therefore its owners – are better off because the value of the property has gone up. Better off means that their wealth increased.
 - Is the fair value reported by the appraiser reliable? Certainly, appraisals involve judgements, and different valuation methods and different assumptions can generate different valuations. The objectivity and other qualifications of the appraiser should be considered. The *Conceptual Framework* acknowledges that accounting information can be reliable even if it is not precise. The appraiser acknowledged that there is a potential for error of plus or minus 10%. That does not mean that the value information is not reliable.
- b. The *Conceptual Framework* does not include concepts or principles for selecting which measurement basis should be used for particular elements of financial statements or in particular circumstances. The qualitative characteristics do provide some guidance, particularly the characteristics of relevance and reliability.

Exercise 1.11 MEANING OF ‘DECISION USEFUL’

What is meant when we say that accounting information should be ‘decision-useful’? Provide examples.

- a. The *Conceptual Framework* identifies the principal classes of users of general purpose financial statements as:
- present and potential investors,
 - lenders,
 - suppliers and other trade creditors,
 - employees,
 - customers,
 - governments and their agencies; and
 - the general public.
- b. All of these categories of users rely on financial statements to help them in making various kinds of economic and public policy decisions. Investors need to decide whether to buy, sell, or hold shares. Lenders need to decide whether to lend and at what price. Suppliers need to decide whether to extend credit. Employees need to make rational career decisions. And so on. Information is decision-useful if it helps these people make their decisions.
- c. Because investors are providers of risk capital to the enterprise, financial statements that meet their needs will also meet most of the general financial information needs of the other classes of users. Common to all of these user groups is their interest in the ability of an enterprise to generate cash and cash equivalents and of the timing and certainty of those future cash flows. Therefore, the *Conceptual Framework* regards investors as the primary, overriding user group.
- d. The *Conceptual Framework* notes that financial statements cannot provide all the information that users may need to make economic decisions. For one thing, financial statements show the financial effects of past events and transactions, whereas the decisions that most users of financial statements have to make relate to the future. Further, financial statements provide only a limited amount of the non-financial information needed by users of financial statements.

- e. Financial statements cannot meet all of the diverse information needs of these user groups. However, there are information needs that are common to all users, and general purpose financial statements focus on meeting those needs.
- f. While the concepts in the *Conceptual Framework* are likely to lead to information that is useful to the management of a business enterprise in running the business, the *Conceptual Framework* does not purport to address their information needs. The same can be said for the Standards and Interpretations themselves.

Exercise 1.12 PERFORMANCE OF A BUSINESS ENTITY

A financial analyst says: “I advise my clients to invest for the long term. Buy good stocks and hang on to them. Therefore I am interested in a company’s long-term earning power. Accounting standards that result in earnings volatility obscure long-term earning power. Accounting should report earning power by deferring and amortising costs and revenues.” How does the *Conceptual Framework* relate to this analyst’s view of financial statements?

- a. Accounting standards should help provide relevant and reliable financial information.
- b. Companies that operate in risky business environments or that enter into risky kinds of transactions are likely to experience real ups and downs in their performance. In such cases, volatility of reported earnings results from the real transactions and activities of the company.
- c. In other words, the statement of comprehensive income reflects the underlying risks. It is not the role of financial accounting and reporting to try to smooth the company’s earnings by, say, deferring profits in good years and deferring expenses in bad years. The amounts reported in the financial statements would not be reliable because they do not reflect real phenomena.

Exercise 1.13 GOING CONCERN

What measurement principles might be most appropriate for a company that has ceased to be a going concern (e.g. it is unable to renew loans and is planning to sell major assets needed for existing operations in order to repay creditors)?

- a. Net realisable value is an asset’s selling price or a liability’s settlement amount less disposal or settlement costs. If a company ceases to be a going concern, that means it is either being wound up or sold.
- b. Either way, the relevant measurements to users of financial statements would be the net realisable value of the company’s net assets.

Exercise 1.14 DEFINITIONS AND RECOGNITION CRITERIA

Explain how you would account for the following items, justifying your answer by reference to the definitions and recognition criteria in the *Conceptual Framework*. Also state, where appropriate, which ledger accounts should be debited and credited.

- (a) (i) Your firm has been sued for negligence – likely you will lose the case.
- (ii) Your firm has been sued for negligence – likely you will win the case.
- (b) Obsolete plant now retired from use.
- (c) Receipt of a donation of \$10 000.

(a) (i) Your firm has been sued for negligence – likely you will lose the case.

- The liability definition (para 49(b)) is met as all 3 characteristics are present.
 - Past event: The act of negligence or the act of being sued.
 - Present obligation: Para 60 states that an obligation is a duty or responsibility to act or perform in a certain way. The key question here is whether there is a present obligation. Does the lawsuit create a present obligation? Or will the obligation only arise when a court decision against you is handed down? The definition requires the existence of a present, not a future, obligation (para 61). I believe that the lawsuit (arising from being sued) gives rise to a present obligation.
 - Settlement involves the outflow of economic benefits: If a present obligation is accepted as existing, its settlement will involve the outflow of economic benefits, namely cash.
- The liability recognition criteria (para 91) are met, as it is probable that an outflow of economic benefits (cash) will result from settling the liability, and the amount (\$20 000 minimum) can be reliably measured.
- Therefore, at this stage a liability of \$20 000 must be recognised. If the damages firm up to another amount as the case progresses, the amount must be adjusted.
- The expense definition (para 70(b)) is met as all 3 characteristics are present.
 - Decrease in economic benefits during the period: The loss of at least \$20 000 represents a decrease in economic benefits and you were sued during the period.
 - In the form of a liability increase: See above liability discussion – you now owe \$20 000 minimum.
 - Results in a decrease in equity: If liabilities increase and assets remain unchanged, equity decreases.
- The expense recognition criteria (para 94) are met, as the decrease in economic benefits has arisen, as you now owe \$20 000 minimum, and the amount (\$20 000 minimum) can be reliably measured.
- Therefore, at this stage an expense of \$20 000 must also be recognised. If the damages firm up to another amount as the case progresses, the amount must be adjusted accordingly.
- Note that in this case the recognition of a liability has resulted in the simultaneous recognition of an expense (paras 91 and 98).

(a)(ii) Your firm has been sued for negligence – likely you will win the case.

- The liability definition (para 49(b)) is met as all 3 characteristics are present. See discussion in (b) (i) above.
- However, the liability probability recognition criterion (para 91) is failed, as it is not probable that an outflow of economic benefits will result from settling the liability. As you are likely to win the case, it is unlikely that you will have to pay damages.
- Therefore, the liability cannot be recognised. However, if material, the lawsuit should be disclosed in the notes.

(b) Obsolete plant now retired from use.

- The asset definition is failed as the plant no longer represents future economic benefits (para 49(a)).
- The plant must now be written off from the accounts.
- Recognition criteria are thus irrelevant, as there is no asset to recognise.

(c) Donation of \$10 000 cheque.

- The asset definition (para 49(a)) is met as all 3 characteristics are present.
 - Past event: The receipt or clearance of the cheque.
 - Flow of future economic benefits: The cheque represents an inflow of \$10 000 cash into your firm.
 - Control over the future economic benefits: Your firm will benefit from this \$10 000 cash inflow and can deny or regulate the access of others to this cash inflow.

- The asset recognition criteria (para 89) are met, as it is probable (actually, it is certain) that an inflow of economic benefits (cash) will flow to the entity, and the amount (\$10 000) can be reliably measured as it is known.
- Therefore, an asset of \$10 000 must be recognised.
- The income definition (para 70(a)) is met as all 3 characteristics are present.
 - Increase in economic benefits during the period: The inflow of \$10 000 cash represents an increase in economic benefits, and you received and cleared the cheque during this period.
 - In the form of an asset increase: See above asset discussion – you now have additional cash of \$10 000.
 - Results in an increase in equity: If assets increase and liabilities remain unchanged, equity increases.
- The income recognition criteria (para 92) are met, as the increase in economic benefits has arisen (as you now have additional cash), and the amount (\$10 000) is known.
- Therefore, income of \$10 000 must also be recognised.
- Note that in this case the recognition of an asset has resulted in the simultaneous recognition of income (paras 84 and 92).

Exercise 1.15 DEFINITIONS AND RECOGNITION CRITERIA

Glasgow Accounting Services has just invoiced one of its clients \$3600 for accounting services provided to the client. Explain how Glasgow Accounting Services should recognise this event, justifying your answer by reference to relevant *Conceptual Framework* definitions and recognition criteria

- The *Conceptual Framework* defines an asset as a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
- Invoicing the client gives rise to an asset as all 3 characteristics are present:
 - Flow of future economic benefits: The invoice represents a future cash inflow to the firm;
 - Control: The firm has control over the economic benefits via its contractual right to the future cash inflow; and
 - Past event: The issuing of the invoice or the provision of the services for which the invoice was issued.
- Under the *Conceptual Framework* an asset must be recognised when it is probable that the future economic benefits will flow to the entity, and the asset has a cost or value that can be reliably measured.
- These recognition criteria are met as:
 - It is more than 50% likely (probably certain) that the firm will receive the cash (otherwise it would not have provided the services); and
 - The value (\$3600) can be reliably measured as it is known.
- Therefore, an asset (receivable) of \$3600 must be recognised.
- The *Conceptual Framework* defines income as increases in economic benefits during the period in the form of inflows or enhancements of assets or decreases in liabilities that result in increases in equity, other than those relating to owners' contributions.
- Invoicing gives rise to income as all 3 characteristics are present:
 - Increase in economic benefits during the period: The right to a future cash inflow arose during the period;
 - Increase in assets or decrease in liabilities: The increase is in the form of an asset increase as the receivable meets the asset definition and recognition criteria; and

- Increase in equity: As assets have increased and liabilities have not changed, equity has increased.
- Under the *Conceptual Framework* income must be recognised when an increase in future economic benefits, related to an asset increase or liability decrease, has arisen that can be measured reliably.
- These recognition criteria are met as:
 - The asset increase has arisen (on issue of the invoice); and
 - The increase (\$3600) can be reliably measured as it is known.
- Therefore, income (fee revenue) of \$3600 must be recognised.