Chapter 2: Accounting Judgements

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*W The solution to this assignment is on the text website, Connect. This solution is marked **WEB**.

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Questions

1. Accounting principles include:

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

2. Underlying assumptions include:

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

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

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

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

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

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

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

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

8. Three measures of income:

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

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

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

9. The two fundamental characteristics of accounting information are:

   a. Relevance—accounting measurements must be useful to the needs of financial statement users for making decisions.

   b. Representational faithfulness—accounting measurements must be reasonably accurate measures of what they purport to measure, without bias.

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

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

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

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

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

    a. Economic benefits must be received or given up in the **future**.

    b. The rights (obligations) to (for) economic benefits must be clear in the **present**.

    c. The asset or liability must be the result of a **past** event.

15. IFRS makes no distinction between *revenue* and *gains*; all are simply part of enterprise *income*. Under ASPE, however, *revenue* is derived from ordinary business activities of the enterprise; *gains* arise from peripheral or incidental transactions or events.

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

17. An orderly transaction is one in which neither the buyer nor the seller is under undue pressure to enter the transaction.

18. The fair value hierarchy specifies the correct sequence for estimating fair values. If a direct observation of value is available, that value should be used. If the value of an item cannot be observed directly in the market place, an estimate based on market valuations for comparable items should be used. If that estimate also is not available, only then should an indirect valuation technique be used.

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19. If an asset has several possible valuations, based on differing uses, the chosen valuation should be based on its most advantageous use, either as the asset on its own in the most favourable market on a stand-alone basis, or when combined with other assets in use.

20. Ethical professional judgement is a necessary element in the process of selecting accounting policies. It involves the ability to weigh (1) the objectives of financial reporting in a given situation, (2) the facts of the business environment and operations, and (3) the organization's reporting constraints, blended with appropriate reference to qualitative criteria.

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Cases

Case 2-1 AeroTravel Inc.

Overview

This case gives students an opportunity to look closely at revenue and related cost issues in a fairly complex but realistic business – one that most students will be well familiar with in their role as consumers. There are rather complex interactions, and some important estimations that raise significant potential ethical issues. This case is non-numerical; it requires visualizing the business situation and the flow of revenues and expenses, with concurrent ramifactions for the SFP.

Sample response

Dear Ms. Yang:

As you requested, I have studied the operations of AeroTravel Inc. with a view to 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 seven years; most members' units expire thereafter.

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

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contracts. If billings lag expenses, ATI's net expenses should be shown as inventory 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. Delivery of merchandise occurs when it is shipped.

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

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

Estimation issues

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

Estimation is a signficant issue. The information given 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 expenses.

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 2-2 Dubois Limited

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 an ASPE GAAP constraint on the company for the first time. The company 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.

Note that this response includes reference to the disparity between IFRS and ASPE in the matter of revaluation accounting, which students may not be aware of at this point.

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

Sample response

Dear Ms. Bissau:

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

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

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

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

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

Both Mangle and the bank will be quite interested in cash flow prediction, since the cash flow will provide dividends for Mangle and debt service for the bank. The bank most likely will not object to increasing assets (and credit based on those assets) as long as the

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cash flow remains strong. In addition, Mange will be interested in evaluating the general economic performance of Dubois, with a particular eye on the quality of management in an increasingly competitive international market.

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

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

IFRS are mandatory for Canadian public companies, but that set of standards is much more complex than ASPE. Dubois is still a private company and as such has no requirement to report under IFRS. A major advantage of ASPE is that it 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.

On the other hand, IFRS permits the use of "valuation accounting" for real property while ASPE does not. The company could switch to using IFRS, but this would require substantial cost for restating prior years' financial statements and an increased continuing cost of compliance. In my opinion, gaining the perceived advantage of continuing use of valuation accounting is not worth the additional cost.

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.

Instead, I recommend that Dubois continue to use ASPE and change the building accounting to comply with ASPE's requirements for systematic depreciation.

One further observation; Dubois Limited can always prepare special purpose financial statements for specific users, including the board of directors. In such statements, Dubois could revert to revaluation accounting. Frankly, I can't see any sufficiently strong reason to report on two different bases; I recommend adhering to the requirements of ASPE.

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)

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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 now. 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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Case 2-3 BLX Shipping Limited

Overview

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

Issues – Accounting policy for:

1. Revenue recognition
2. Dry-docking expenditures

Analysis

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

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

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

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

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

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

Impact on revenue and net income

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

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

Dry-docking cost is sporadic, and amortization is a smoother pattern. If dry-docking is expensed as incurred, the overall pattern of net income is less smooth but more indicative of the company's actual expense incurrance.

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

Conclusion

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

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Technical Review

Technical Review 2-1

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

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Technical Review 2-2

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. Independent appraisals are acceptable (preferrably two or three independent appraisals, to establish verifiability), but not an internal appraisal by a company "expert" unless it is subject to external validation. Instead, the shares should be used as the valuation basis despite being lightly traded. The *are* traded, so there is some basis for indendent valuation.
2. Delaying the statements would most likely increase the representational faithfulness 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. Completed contract does require far fewer estimates than percentage-of-completion, and therefore representational faithfulness is increased. On the other hand, the absence of any profitability information prior to completion definitely decreases relevance, giving the earnings information little predictive or confirmatory value. As well, comparability is greatly impaired because other companies in the industry are using the percentage-completion method.
4. It is true that many intangible 'assets' are not shown on the company's balance sheet because they were internally generated. There is no assurance that those assets will produce revenue-generating products, even though the company believes they will. Costs were expenses when incurred due to the impossibility of estimating future revenues; revenues cannot be recognized until earned. The company should attempt to disclose of the nature of the assets rather than try to measure it by a highly biased and unverifiable quantitative measure.
5. In substance, a long-term rental arrangement, or lease, may be the same in substance as buying the asset and borrowing the money to finance the purchase. When this is true, the financial statements show the rented asset as a capital asset, and the future rent payments as a liability. The resulting measurements have high representational faithfulness because the asset and liability reflect the true substance of the long-term leases.

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Technical Review 2-3

Solution:

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.

F/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.

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Technical Review 2-4

Requirement 1

Three measures of income:

a. Nominal dollar financial capital maintenance:

$140,000 – $94,000 = $49.000

b. Constant dollar financial capital maintenance:

$140,000 – ($94,000 × 1.05) = $41,300

c. Physical capital maintenance:

$140,000 – $115,000 = $25,000

Requirement 2

Cash remaining

a. Nominal dollar financial capital maintenance: $140,000 – $49,000 = $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 × 1.045= $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 the USA, but physical capital mainenance is permitted under IFRS. IFRS also permits constant dollar capital maintenance in hyperinflationary economies.

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Technical Review 2-5

1. Nominal dollar capital maintentance

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

2. Physical capital maintenance

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

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Assignments

Assignment 2-1

Relevance is the characteristic of usefulness. Information should be useful for making decisions. *Reliability* includes several characteristics: representational faithfulness, verifiability, and freedom from bias. This investment portfolio can be reported at historical cost or at fair market value.

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

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

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

Venture capital is the most difficult type of investment to report at market value. By definition, venture capital investments involve a high level of risk. Risk leads to volatility in price (or value). Therefore, it would likely be impossible to report market values with any reasonable degree of reliability. A reliable valuation would be based on the equity value of the underlying companies, but this probably would not be very relevant. A relevant measure would be based on the discounted value of future cash flows, which would be speculative and therefore unreliable.

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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

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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. Reliability or representational faithfulness (or conservatism) violated because the estimate chosen was the lowest one.
4. Disagree. Separate entity concept was violated because this is a personal asset carried on the company's books.
5. Disagree. Representational faithfulness is violated because netting is not generally allowed. Financial statement elements are not appropriately stated.
6. Agree. Because the item is not material, it does not need to be corrected.

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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 things that are owned, such as processes and other intangible assets, are not shown as assets. The asset definition involves future benefit (future cash flow) from costs incurred in the past, not ownership.

6. False. Relevance is typically enhanced when market values are used.

7. False. Better accounting policies are always encouraged; retrospective restatement addresses comparability.

8. False. Nominal dollar capital maintenance refers to inflation; Intangible assets often fail the unit of measure or reliability tests.

9. False. Materiality is also based on the nature an item and whether or not it could affect a user's decisions.

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Assignment 2-5 (WEB)

Issue	1 Correctness	2 Principle	3 Comment
a.	Correct	Separate-entity	It is feasible to separate the financial affairs of the business from those of the owner.
b.	Incorrect	Representational faithfulness (Substance over form)	Transactions must be analyzed to see if the recorded elements are true to the nature of the transaction. Does a legalistic presentation of the item convey its economic substance? If not, substance should be reflected in the financial statements rather than the legal form.
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	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 LCM 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.

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i.	Incorrect	Revenue and matching; Representational faithfulness;	Measurement should be free of bias. Revenues are recognized when earned, measurable and realizable. Expenses should reflect the costs of earning revenue to obtain an earnings measure that is a faithful representation of the operating results of the company. Costs that may not generate future benefits should be expensed.

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Assignment 2-6

	*Initial transaction **recognized***	*Element **realized** by cash*
1.	1 August	12 September
2.	13 November	1 February
3.	Warranty liability recognized at time of sale	Upon payment of claim
4.	a. 20 Febuary — cash receipt and unearned revenue recognized	20 February
	b. Revenue recognized	10 March
5.	a. During the year, — expense recognized when bill received	When each bi-monthly bill is paid
	b. At year-end, unbilled expense accrued (if material and estimable)	Not realized by year-end
6.	1 February — product delivery triggers revenue recognition	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 reliability (measurement) problems in determining fair value at registration.

3. Employee training 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. Legal expenses, only for the costs incurred. Potential losses if the suit us succesful are not recognized; the amount of loss (if any) usually cannot be estimated accurately. [Would be disclosed in a note, if material in amount.]

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 used for company business; employee compensation if for her/his personal use.*

    *Assumes short-term lease.

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Assignment 2-8

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

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Assignment 2-9 (WEB)

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

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Assignment 2-10 (WEB)

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:

Representational faithfulness is not achieved. The note receivable is not worth its face value at the time of sale; it is over-valued. The note (and the proceeds received from the sale) must be shown at the note's present value: [($55,000 ÷ 1.21 = $45,455). Using the present value tables: $55,000 × (P/F, 10%, 2) = $55,000 × 0.82645 = $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 be more representationally faithful. The statements are out of date.

Case D:

Revenue recognition is inappropriate. Accrual accounting is usually appropriate.

Case E:

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

Case F:

The separate-entity assumption is violated.

Case G:

Full disclosure is violated; 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. Revenue recognition of two months' interest to reflect the passage of time.
6. Revenue recognition on delivery—a slow-paying customer is still a valid customer; if payment was not probable, the sale would not be made.

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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 increased value of the shares benefits 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 amount of any minimum sales value to be received from (or commited to by) the buyer is recognized as an asset, either cash or receivable, offset by deferred revenue. The deferred revenue will 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. Information should be complete to be helpful in users' decision-making. 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. Reliability, representational faithfulness, neutrality. Accounting information should be reliable; it should be free from error and bias. It should represent what it purports to represent.
2. The company policy is inappropriate. 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, representational faithfulness, 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 either (1) report the amounts of interest expense and interest revenue on the face of the income statement or (2) disclose the amounts in the notes.

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Assignment 2-14

a. This entry violates the cost principle (and representational faithfulness) 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 representational faithfulness. Depreciation meets the definition of an expense. Depreciation expense should be matched with the revenues of the period and reported on the income statement as an expense, 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 representational faithfulness. Repairs do not meet the definition of an asset. Usual and ordinary repairs constitute a current expense, not an increase to the value of capital assets. However, no correction is needed because the amount is not material.

d. The reporting of the storm loss was in violation of representational faithfulness as well as the the recognition principle. The loss occurred in a single period—it should not be deferred and recognized as expense over future years. As well the "deferred" loss does not meet the criteria of an asset because it has no future benefit. 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 principle and the materiality constraint were violated because the loan should have been reported as a non-current asset, as it is not due for three years. Also, the representational faithfulness characteristic was violated because the accounts receivable did not correctly report the amounts due from customers. Because the president is a related party, any such loans should be reported separately as a non-trade receivable. 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

a. This entry violated the revenue principle and representational faithfulness. 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 representational faithfulness. The definition of an expense has been met. The loss should be reported as an expense and not deducted directly from retained earnings. The correct entry is:

Loss from flood damage	97,000	
Cash		97,000

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

The correct entry is:

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

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Assignment 2-16

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 representational faithfulness, since the $100,000 reported is not an accurate reflection of the value of the cash in a Canadian dollar financial statement.

Marketable securities:

Marketable securities should be reported at market value (here, $987,000); as "temporary investments", they are available-for-sale.

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 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 an estimated $75,000 in January 20X7 but has not recorded the liability in the financial statements. The amount should be recorded.

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

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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 can be estimated on the basis of past legal precedent, the amount of the lawsuit, and/or the company's willingness to offer a settlement.
3. The element is only recorded if it is probable that the outflow will happen and the lawsuit will be lost or voluntarily settled.

Disclosure of the lawsuit satisfies the full disclosure requirement.

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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 and realizable because the revenue has already been collected. However, not all significant acts have been fulfilled. Revenue cannot be recognized even though the future costs are measurable because Aeroplan hasn't fulfilled its obligation.

Case C

Reclamation and restoration costs should be estimated and recorded as a liability as the oil sands work progresses and the environmental damage occurs. However, Suncor says that the amount cannot be estimated due to changing legislative obligations and also because the extent and technology of remedial action will continue to change in future years. Suncor acknowledges that the cost will have a significant impact on future earnings.

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Assignment 2-19 (WEB)

Case A

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

Case B

The financial statements are not reliable because they are not free from bias. Management's excessive conservatism, which is not a virtue, is displayed.

Case C

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

Case D

Representational faithfulness is violated by netting current assets with current liabilities. The financial statements do not reveal the full extent of the company's assets and liabilities. Full disclosure is also violated as a one-line balance sheet does not contain enough detail. Netting unrelated amounts 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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