Solutions for Intermediate Accounting Volume 1 8th Edition by Beechy

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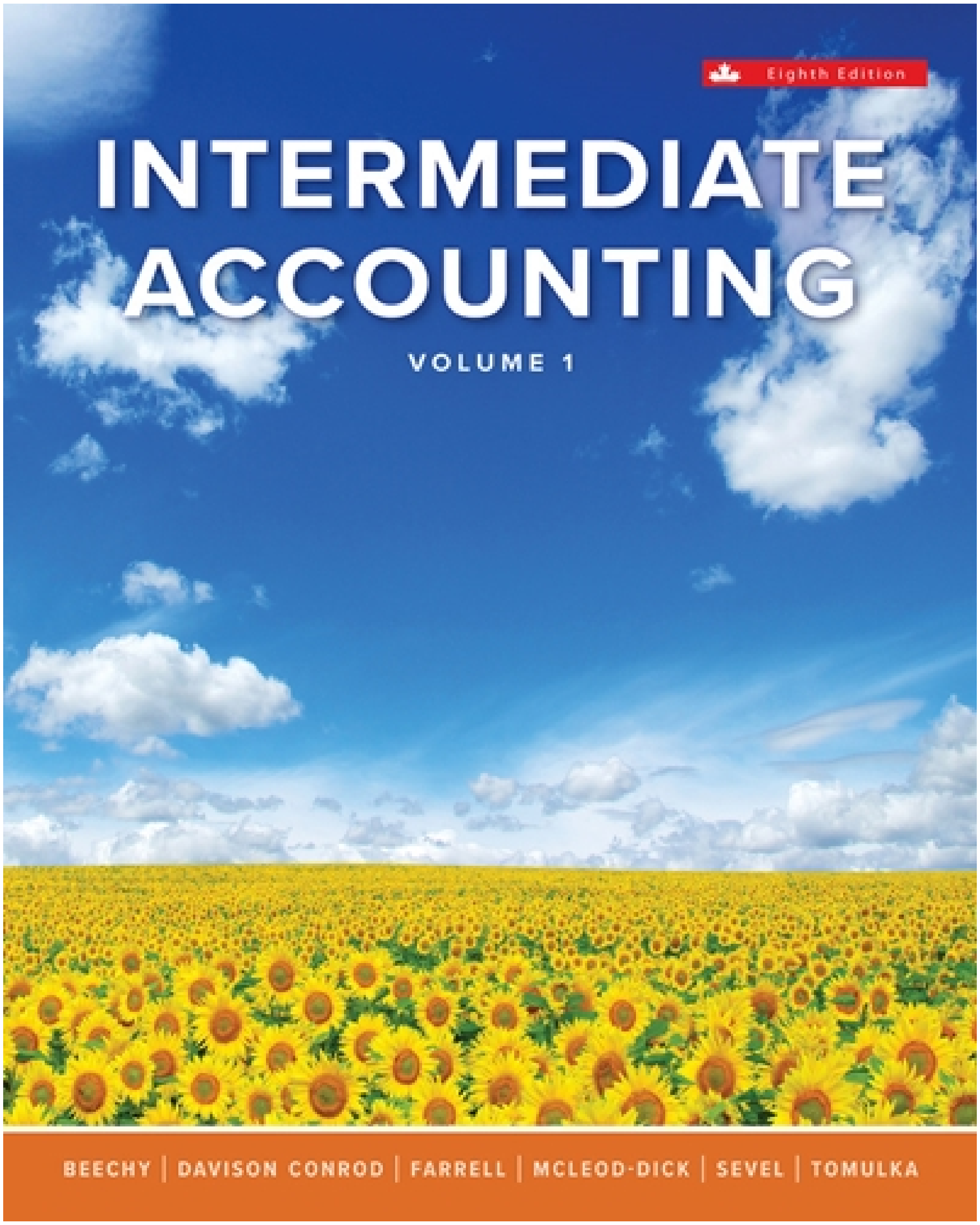

Solutions

Chapter 1: The Framework for Financial Reporting

Case	1-1	Mulla and Yang
	1-2	Richard Wright
	1-3	Taylor Jay

			Suggested Time
Technical	1-1	Chapter overview, true-false	10
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Cases

Case 1-1 (LO1.2, LO1.3, LO1.4, LO1.5)

Notes for Discussion With Elicia:

There is a conflict of interest between the objectives of Elicia and Dabika due to the buyout clause in the shareholder agreement. Elicia will have a motivation to decrease shareholders' equity since this will reduce the amount that she will be required to pay to buy out Dabika. Dabika will be interested in increasing shareholders' equity to increase the amount she will receive. It must be clarified who I am working for since I may have a conflict of interest since I know both parties.

It is important that all accounting policies are 'fair' to both sides. What is considered 'fair'? From Dabika's perspective, fair could be accounting policies consistent with prior years. From Elicia's perspective, fair could be if the economic events change the accounting policy would change. Fair could be both sides split the difference where Dabika and Elicia disagree on value. In the future it is important that the shareholders agreement is more specific.

Due to the choices allowed within GAAP a policy could be selected that would be more beneficial to one of the parties. It is assumed since this is a small private company that they are using ASPE. There is no indication that neither Elicia or Dabika would be using IFRS nor that the bank requires it.

Inventory
Elicia wants to write off the inventory value for the garden gnomes and statues and this will decrease the amount of the payment to Dabika. According to ASPE, inventory would be valued at the lower of cost and net realizable value. Even though this inventory has been sitting in the gardening centre there is still a few being sold each year. This indicates there is still some value associated with the inventory and therefore it should not be written down to zero. It should be determined what the net realizable value of this inventory is to determine the amount of the write off. If it is all written off and then sold at a later date this would not be fair to Dabika since Elicia would get the benefit of a reduced shareholders' equity and thus a lower payment required to Dabika. The purchase of this inventory would have been a decision made by both Dabika and Elicia so if the inventory is unsellable they should both bear the impact of this decision.

Warranty
According to ASPE the accounting policy is appropriate and a warranty expense should be included for the guarantee. The impact is that this would decrease shareholders' equity and the amount of the payment to Dabika. This is a new policy that did not exist until this year. The estimate of 5% was only based on sales from the fall. Since it is a new policy that was made by Elicia on her own it may be appropriate that the impact of this is excluded from the calculation of shareholders' equity. At a minimum the estimate should

be reviewed to determine if it is reasonable. Furthermore, the estimate, if included in the shareholders' equity calculation, should be agreed upon by both Elicia and Dabika.

Computer Equipment
ASPE is flexible in the method used to depreciate assets. The declining balance method using 40% would write off the value of the computers in approximately two years. This is very fast especially for a small company that is likely to use a computer for a longer period of time due to limited resources as compared to a larger company. Just because the computer may become obsolete quickly does not mean the business will not continue to derive benefit from the continued use of the computer. The impact of higher depreciation is a reduction in the payment to Dabika. If we look at consistency with other assets it would be appropriate to use the straight line method. We should inquire with Elicia as to her rationale for choosing declining balance instead of the straight-line depreciatoin method used for all other assets and determine the declining method reflects the actual usage of the asset (i.e. more of the asset used earlier on). Since again since this was a decision made only be Elicia maybe it should be excluded from the calculation or maybe the policy should be consistent with their other assets but further information is required.

Case 1-2 (LO1.2, LO1.3, LO1.4, LO1.5)

Dear Richard Wright:

I am happy to respond to your questions regarding the accounting changes that the new banker has requested. It is important that you realize that the needs of the banker are different than your needs. The bank is interested in your ability to make loan payments; therefore, the banker wants to assess future cash flows, collateral and your ability to pay back the loan.

First, there is the issue of moving to the accrual basis. While it's true that, ultimately, what you earn is the net cash in your pocket, the cash basis of accounting doesn't wholly capture all of the cash flows that will happen in the future. Your banker wants to know what liabilities you'll have to pay in the coming months (and years), and what amounts you currently are owed that will be collected in the future weeks or months. The accrual method really gives a clear picture of future "cash flow".

It's for much the same reason that he wishes you to show your cattle at market value. I'm sure he recognizes that both your dairy cattle and your breeders are intended for continued use and are not for sale in the normal course of business.As saleable stock, the cattle represent a potential cash resource in the event of bankruptcy or default. After all, you probably use the cattle as collateral for loans, and he needs to know the value of that collateral.

You should not try to estimate the value of your stock by yourself. For credibility, you should obtain an independent estimate. The valuation will require a professional evaluation (and the cost thereof), but will be necessary in order to satisfy the bank.

Sincerely,
Andriana

Case 1-3 *(LO1.1, LO1.2, LO1.3, LO1.4, LO1.5)*

Overview

This case is intended to get students to focus on the differences between companies and the various factors that have a bearing on their financial reporting objectives. Students are asked to prioritize the factors or characteristics that are most likely to affect each company's financial reporting.

Company Characterics

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

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

Prioritization

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

Breeze Inc.	Saturn Software	Intern'l Auto Parts
Major foreign investor must be kept happy—ASPE may not be understood so IFRS may be more appropriate	Liquidity requirements—cash flow prediction primary objective	IPO likely in near future—compliance with IFRS will be necessary (ASPE not appropriate)
Important Japanese partner (Telyu) – there may be a bias to decrease revenue to decrease payment to Telyu	Bank covenants—protect lines of credit to be able to pay preferred dividends	Reflect good management performance to help attract new auto companies as customers
Need for major capital investment, major competitors are public	Complex reporting not necessary; ASPE probably best, plus disclosure of salary information	Satisfy investment funds' reporting expections (e.g., re covenants)
Clear reporting of revenues on which 2% fee is based	Continuously profitable—minimize income taxes to conserve cash	Exhibit success in attracting new customers
CRTC requirements	Employee profit sharing plan	Show strong profitability to attract high stock price on IPO

Assignments

Technical Review

TR 1-1 (LO1.1, LO1.2, LO1.3, LO1.4, LO1.5, LO1.6, LO1.7)
The question statement has been repeated below followed by the correct statement in instances where the question statement is false.

F 1. The International Accounting Standards Board has authority for setting Canadian accounting standards. Canadian standards are set and or endorsed the Accounting Standards Board in Canada.

F 2. All Canadian corporations must comply with international accounting standards. This only applies for publicly accountable enterprises. Private enterprises have a choice between ASPE and IFRS.

T 3. Most public Canadian corporations are listed on the Toronto Stock Exchange.

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

T 5. The objective of general purpose financial reporting is to serve the information needs of a wide variety of users, including lenders, shareholders, employees and regulators.

T 6. The primary objective of financial accounting is to reveal information about an enterprise's financial performance.

T 7. If a corporation has a restrictive bond covenant that specifies a minimum times-interest-earned ratio, the corporation's management will be motivated to pick discretionary accounting policies that maximize income. (Note: Times-interest-earned is calculated as income before interest and taxes, divided by interest.)

F 8. Income tax law has no impact on the accounting choices made by management. There are certain sections of the tax act that are based on GAAP so certain accounting policies will impact taxes paid.

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

F 10. Any Canadian company that uses U.S. GAAP must prepare its statements in U.S. dollars. No the currency a company uses for reporting on their financial statements is not specified (in ASPE) or dependent on the functional currency for reporting (IFRS).

TR 1-2 (LO1.1, LO1.2, LO1.3, LO1.4, LO1.5, LO1.6, LO1.7)

The question statement has been repeated below followed by the correct statement in instances where the question statement is false.

F 1. IFRS and the *CPA Canada Handbook, Part II* have equal status in Canada for financial reporting. In Canada Canadian companies must follow CPA Canada Handbook. *CPA Canada Handbook, Part I* is based on IFRS and must be used by publicly accountable enterprises. *CPA Canada Handbook, Part II* is an option for private enterprises.

F 2. In a private corporation, the needs of external users have no impact on the company's financial reporting objectives. External users' objectives are always considered in the selection of accounting policies especially where GAAP allows a choice. They will also impact on whether a private corporation will decide to use ASPE or IFRS.

F 3. Canadian companies must always prepare their annual financial statements in Canadian dollars. No the currency a company using for reporting on their financial statements is not specified.

F 4. Canadian accounting standards are set by the Canada Business Corporations Act. Canadian accounting standards are governed by the Accounting Standards Board.

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

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

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

F 8. When an enterprise's primary reporting objective is cash flow assessment, the enterprise will use a cash basis of reporting rather than an accrual basis. Accrual accounting e.g. recording accounts receivables and accounts payable will help predict future cash flows.

T 9. Any Canadian company may use IFRS.

T 10. The IASB cannot require transnational corporations to use IFRS.**TR1-3** (LO1.1)

1.	J	IASB
2.	F	ASPE
3.	A	AcSB
4.	E	IFRS
5.	I	TSX
6.	D	OSC
7.	C	CPA
8.	B	SEC
9.	G	FASB
10.	H	DBA

TR1-4 (LO1.1)

1. Bank – IFRS required since publicly accountable enterprise
2. Private company two shareholders – ASPE required for small group of shareholders; likely do not need to incur cost of IFRS.
3. Public company - IFRS required since publicly accountable enterprise
4. Mutual fund - IFRS required since publicly accountable enterprise
5. Private company wholly owned subsidiary of public company – IFRS likely requested by parent company to allow ease of consolidation

TR1-5 (LO1.1)

1. Private bank - IFRS required since it holds assets in a fiduciary capacity as one of its primary businesses.
2. Private company many shareholders – ASPE since less costly unless shareholders request IFRS
3. Private company major competitor public company – IFRS more likely since would be more comparable to their competitor
4. Government business enterprise - IFRS required since publicly accountable enterprise
5. Private company intends to go public – IFRS more likely since will be required when go public

TR1-6 (LO1.1)

The question statement has been repeated below followed by the correct statement in instances where the question statement is false.

F 1. A disclosed basis of accounting is GAAP. DBA is an alternative to GAAP financial statements. DBA is not considered to be GAAP.

T 2. An audit opinion can be provided on a disclosed basis of accounting.

T 3. A disclosed basis of accounting is used to provide more useful information for the users.

T 4. Note disclosure is required if a disclosed basis of accounting is used.

F 5. A public company can use a disclosed basis of accounting. A public company is required to use IFRS. They cannot use DBA.

TR 1-7 (LO1.1, LO1.3, LO1.4)

1. **F** A private company based in Canada must follow the recommendations of the *CPA Canada* Handbook. Most private Canadian companies report on the basis of either IFRS or ASPE, both of which are contained in the *CPA Canada Handbook*. However, private companies may also choose to use a disclosed basis of accounting, one in which the company's accounting standards differ in one or more respects from the recommendations in the *CPA Canada Handbook*, either Part I or Part II.
2. **F** A company that reports in U.S. dollars must use U.S. accounting standards. There is no requirement that a company's presentation currency be that of the country on which its accounting standards are based.
3. **F** A company cannot report under Canadian accounting standards unless it uses Canadian dollars as the unit of presentation in its financial statements. Same as above–the company's presentation currency is not tied to its accounting standards.
4. **T** A Canadian company that is listed on the TSX may use U.S. accounting standards if they also file their financial statements in the U.S.
5. **F** All companies listed on the NYSE must use U.S. accounting standards. A reporting entity that is based outside the U.S. may use either U.S. standards or IFRS.

TR1-8 (LO1.1, LO1.3, LO1.4)

1. **F** The U.S. SEC will accept financial statements from U.S.-listed foreign companies in their home-country accounting standards. The U.S. SEC permits IFRS to be used when a foreign-listed company requires IFRS. Therefore U.S.-listed foreign companies can use either U.S. GAAP or IFRS.
2. **F** Each country that accepts IFRS commits to using the full set of standards. An individual country can choose to review each IFRS standard and accept it, reject it, or modify it to suit the national reporting environment.
3. **F** A Canadian private enterprise does not have access to outside investors if it uses Canadian ASPE. A private company can obtain "outside" capital from anywhere in the world from private equity investors or from debt issues.
4. **F** Under Canadian ASPE, a company must report in its functional currency. In ASPE the term functional currency is not used in the standards. The currency used for reporting on the financial statements is usually the same as the currency the company deals with on a daily basis. A company may report in any currency for the convenience of its users.
5. F A private Canadian company that is a subsidiary of a U.K. parent company may not report in British pound sterling unless the pound also is its functional currency. As far as terminology it depends on if the company is using ASPE or IFRS. The presentation currency does not need to be the same as the functional currency; the subsidiary can report in British pound sterling to be compatible with the parent's presentation currency.

TR 1-9 (LO1.2, LO1.3, LO1.4)

1. **C** - Bank –cash flow prediction to determine if their loan can be repaid.
2. **B -** Small private company - income tax deferral since they would want to minimize the amount of income taxes they need to pay
3. **A** – Not for profit organization – stewardship since they want to ensure assets are used for the correct purposes.
4. **E** – Management – performance evaluation to see how will company is performing
5. **D** – Shareholders with agreement – contract compliance to see if agreement is adhered to or not

TR1-10 (LO1.6, LO1.7)

	IFRS	ASPE	Both
1. Statement Financial Position			X
2. Statement of Comprehensive Income	X		
3. Income Statement		X	
4. Statement of Retained Earnings		X	
5. Cash Flow Statement			X
6. Statement of Changes in Shareholders' Equity	X		

Assignment 1-1 (LO1.1)

The IASB website indicates six stages of IFRS development:

1. Agenda consultation
2. Research programme
3. Standard-setting programme
4. Maintenance programme

The last stage can properly be viewed by students as not being a part of developing the standard, therefore the standard setting process involves three steps.

The below is taken directly from the IASB website:
https://www.ifrs.org/about-us/how-we-set-ifrs-standards/

Agenda Consultation

Every five years, the Board conducts a comprehensive review and consultation to define international standard-setting priorities and develop its project work plan.

The Board can also add topics to its work plan if necessary between agenda consultations. This can include topics following Post-implementation Reviews of Standards; the IFRS Interpretations Committee may also request the Board review an issue.

Research programme

We begin most projects with research—explore the issues, identify possible solutions and decide whether standard-setting is required. Often, we set out our ideas in a discussion paper and seek public comment.

If we find sufficient evidence that an accounting problem exists, the problem is sufficiently important to warrant changing a Standard or issuing a new one and a practical solution can be found, we begin standard-setting.

Standard-setting programme

If the Board decides to amend a Standard or issue a new one, we generally review the research, including comments on the discussion paper, and propose amendments or Standards to resolve issues identified through research and consultation.

Proposals for a new Standard or an amendment to a Standard are published in an exposure draft for public consultation. To gather additional evidence, members of the Board and IFRS Foundation technical staff consult with a range of stakeholders from all over the world.

The Board analyses feedback and refines proposals before the new Standard, or an amendment to a Standard, is issued.

Maintenance programme

Our work doesn't stop once a Standard is issued. We also support consistent application of the Standards and we make sure we maintain them.

This process includes consulting on the implementation of a new or amended Standard to identify any implementation problems that may need to be addressed. If issues arise, the IFRS Interpretations Committee may decide to create an IFRIC Interpretation of the Standard or recommend a narrow-scope amendment. Such amendments follow the Board's normal due process."

Assignment 1-2 (LO1.1, LO1.3)

Memo to: Manager
Subject: Viewpoint of conference speaker

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

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

To complicate matters some countries that adopt IFRS do not fully adopt the entire set of standards. They follow country guidance for some of the standards.

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

Assignment 1-3 (LO1.3, LO1.4)

The following accounting policy choices or accounting estimates are necessary:

1. The company must consider whether to:
   a. provide for possibly returning at least part of the inventory to the supplier if the agreement allows for returns, and
   b. write down the remaining inventory to lower of cost and net realizable value, which requires the company to estimate its net realizable value.
2. The company must make an estimate of the amount of recovery that is probable and write off the rest of the receivable. Note disclosure will be required for the circumstances and the court action.
3. The company must estimate the probability that the legal judgement will be upheld on appeal, and if the probability is greater than not, the company must estimate the actual amount of the final financial judgement. If the probability is >50%, and if the amount is reasonably estimable, the company must recognize the liability. If the amount is not reasonably estimable the company must prepare a disclosure note. (If not probable, Sukkor would do nothing).
4. The company must provide certain estimates to determine if the criteria are met to capitalize the development costs. The company must estimate:
   a. the completion date of the project,
   b. potential market,
   c. future benefits through sales of the product,
   d. ability to raise financing to finish the project due to financial difficulty,
   e. if capitalized, the period of amortization
5. The company must estimate:
   a. whether the full production cost can be recovered over the next 3 years, and
   b. how the production cost should be amortized (i.e., on the basis of revenues or on a time-basis)

Assignment 1-4 (Solution) (LO1.3)

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

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

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

Assignment 1-5 (LO1.1, LO1.2, LO1.3, LO1.4, LO1.5)

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

Assignment 1-6 (LO1.1, LO1.2, LO1.3, LO1.4, LO1.5)

Dear Manager:

You have many factors to consider in making your decision. Since your company is privately-held, you have some options. The bank requires GAAP-Compliant financial statements. Canadian private companies can use either:
Canadian accounting standards for private enterprises (ASPE), as contained in Part II of the *CPA Canada Handbook* or,
International Financial Reporting Standards as contained in Part I of the *CPA Canada Handbook.*

The differences are mainly in some measurement and disclosure requirements. IFRS contains guidance that is generally more appropriate for public companies than for the more limited user group of private company statements. ASPE is also generally more cost-effective to prepare.

The following are factors to consider in making your decision. To support the use of ASPE you have no desire to go public and you are dealing with a Canadian bank that is familiar with ASPE. On the other hand your major competitors are public companies and using IFRS would make your financial statements more comparable and you may look stronger for selling your company since a prospective buyer may want to adopt IFRS. Alternatively, it will be costly to convert to IFRS so that should be considered as there would be additional resources consumed by the business that could make it appear less attractive.

Overall, in making your decision you will need to trade off the costs associated with adopting IFRS compared to the benefits of IFRS over ASPE.

Assignment 1-7 (LO1.1, LO1.2, LO1.3, LO1.4, LO1.5)

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

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

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

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

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

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

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

private-company GAAP, with possible variations based on industry practice (which effectively turns it into DBA).

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

Assignment 1-8 (LO1.1, LO1.2, LO1.3, LO1.4, LO1.5)

1. Since the company is searching for funds internationally, Canadian GAAP statements will be unfamiliar to potential investors. It might be preferable to raise financing to move to IFRS. The company should also use US dollars as presentation currency.

2. FI should continue to use Canadian private enteprise accounting standards (ASPE) as prescribed in the *CPA Canada Handbook Part II* to continue to obtain financing from the Class B shareholders. If the Class A shareholders who have control wish reporting on a near-cash basis, FI should prepare special-purpose reports for the fund by backing out accruals and interperiod allocations other than those "permitted" by the fund. FI can continue to have its regular financial statements audited; the auditor can then review the special purpose reports and give some assurance on them to the Class A shareholders.

Assignment 1-9 (LO1.1, LO1.2, LO1.3, LO1.4, LO1.5)

The *CPA Canada Handbook* cites the objectives of general purpose financial statements as:

> ... to provide financial information ... that is useful to present and potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers. Information that is decision-useful to capital providers may also be useful to other users of financial reporting who are not capital providers.

These objectives are very broad and applications of accounting standards can still be affected by the entity-specific objectives of financial reporting. The objectives of a private and public company can be different since private companies may have a more limited group of users and may be more interested in minimizing income taxes. However a large private company may have the same objectives as a public company. A summary follows:

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

	Spread out revenues and expenses to reduce profit variation (smoothing).
8. Minimum compliance	Minimize bookkeeping costs by minimizing disclosures.

Assignment 1-10 (LO1.5)

Scenario	User 1	User 2	Conflicts
1	Bank –Ensure repayment of principal and interest	Management of a public company - Performance evaluation is likely evaluated based on share price, and therefore income smoothing may be an objective. Earnings maximization to ensure bonus payment.	Bank looking for revenues and expenses to be as close to the related cash flows where as management wants to likely both smooth and maximize income.
2	Bank –Ensure repayment of principal and interest	Owners of a private company that are facing cash flow issues – Minimize taxes due to cash flow issues, maximize income to ensure loan qualification	Bank looking for revenues and expenses to be as close to the related cash flows whereas the owners are currently cash strapped and would like to both 1) qualify for the loan so would want to ensure financial statements are attractive to the bank and 2) also likely looking to minimize income tax to help with cash flow issues.
3	Union – Maximize earnings to allow for more bargaining power	Management – minimize income as evaluated based on overall reduction of operating expenses.	Union is looking to maximize income in order to have strength in collective bargaining (i.e. increase wages / benefits etc). This conflicts with management as they are evaluated

			based on a reduction of expenses and therefore will be trying to minimize income and specifically expenses relating to wages / benefits.

Assignment 1-11(LO1.2, LO1.3, LO1.4, LO1.5)

Issue	Earnings maximization	Cash flow prediction	Earnings minimization
1	Average cost[1] with LCM	FIFO with LCM	FIFO[1] with LCM
2	Capitalize if meets development criteria[2] and S.L. amortization	Expense, or if policy to capitalize, then amortize by unit-of-sale	Expense or if policy to capitalized then amortize using accelerated deprec.
3	Straight line depreciation	SL or accelerated depreciation	Accelerated depreciation
4	Defer and amortize[3]	Expense	Expense

1 With declining inventory costs, FIFO gives higher CGS than average cost. (If inventory costs rise, average cost gives higher CGS than FIFO). LCM is necessary under GAAP. LCM is defined as lower of cost and net realizable value.

2 Assuming following ASPE and has policy choice to capitalize or expense.

3 Assuming that software development costs are eligible for capitalization. However, the capitalization of training costs is not permitted.

Assignment 1-12 (LO1.2, LO1.3, LO1.4, LO1.5)

Dear Ms. Raisa,

After conducting the research that you requested, I've come to the conclusion that both IFRS and Canadian ASPE require research costs to be expensed. In contrast, development costs should be capitalized and amortized, if certain criteria are met in IFRS. In ASPE there is the option to choose to expense development costs even though they meet the criteria to capitalize.

In the past, the company has expensed all research and development costs. I understand that this practice was followed because, until this year, the costs were relatively minor and could be construed as immaterial.

Accounting standards define a set of criteria to differentiate between research and development costs. If all criteria are satisfied, then there is no choice—they are defined as development costs and must be deferred and amortized in IFRS. The catch is that the criteria all involve estimates about the future, such as the availability of resources to complete the project and the ability of the company to actually sell it. The estimates are about future events and are made by management.

In light of the fact that the new copying machine has been brought to a marketable stage, it would seem that most of the criteria have already been met. Only the saleability is really open to question at this stage. If the long-run viability of this project is still open to reasonable question, it may be possible to continue to expense the costs. Management has some discretion, but should not act **unethically**.

You are concerned about the reaction of the bank to burdening future revenues with past costs and the fact that the bank is primarily interested in the company's cash flows. If you wish, this issue can easily be solved by preparing a special-purpose report that treats development costs as expenses, but this must be exclusively for the bank's use. In practice, however, the bank is a sophisticated user and will most likely analyse our company's cash flows by use of their own techniques.

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

Faithfully yours,

Assignment 1-13 (LO1.2, LO1.3, LO1.4, LO1.5)

1. C and D
2. A and D
3. C and D
4. B

Assignment 1-14 (LO1.3, LO1.4)

Note: The objective of this assignment is to stress the different ways in which circumstances can affect the way in which management may look at an accounting issue.

Chapter 3 will discuss the difference between an *idle* asset (which continues to be depreciated) and an *abandoned* asset (which is written down to NRV and thereafter not depreciated). The assets described in this assignment are idle, as they are being converted to a different use. However, students probably will not be familiar with this distinction nor with the relevant treatment for each.

Policy	Rationale
1. Do not depreciate	Match depreciation with revenue earned once units are rented; this avoids increasing current loss due to vacant properties.
2. Do not depreciate	Managers will prefer to maximize income.
3. Defer depreciation	Net income will be higher. This effect will partially be offset by higher assets, but depreciation expense will have a proportionately greater effect on net income that on the amount of total assets, thereby improving the NI:TA ratio.
4. Indifferent	Accounting depreciation policy does not affect income tax policy; CCA is an independent calculation for income tax purposes.
5. Could go either way	(a) Depreciate, as idle properties are still getting older and increasingly obsolete, for stewardship; or (b) Delay depreciation to achieve better matching with future rental revenues, for performance appraisal. (don't depreciate)
6. Depreciate	An increased loss for the current period will not affect managers' compensation for the year. However, depreciating the assets in the current period will reduce the amount of depreciation for future periods in which management may be able to earn a bonus. Managers may try for a 'big bath'.