Financial Reporting 2nd edition Loftus Solutions Manual

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Solutions manual

to accompany

Financial reporting

2nd edition

by

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Chapter 1: Accounting regulation and the conceptual framework

Comprehension questions

1. What are the key sources of regulation in Australia for a listed company?

The key sources of regulation for a listed company in Australia are:

- The Corporations Act, which is administered by the Australian Securities and Investments Commission
- Australian Accounting Standards and the Conceptual Framework, issued by the Australian Accounting Standards Board
- Australian Securities Exchange Listing Rules**.**

2. Describe the standard-setting process of the AASB.

Accounting standards are developed through a consultation process to ensure information is high quality and of value to all users of financial statements. If an item is added to the Board's agenda, it may research the issue, consider solutions, and consult with stakeholders. Then the AASB may proceed with the issue of exposure drafts, invitations to comment, draft interpretations and discussion papers. For standards intended for profit-seeking entities, the exposure drafts issued by the AASB typically incorporate exposure drafts issued by the IASB, along with Australian-specific matters for comment as applicable. The consultation process may involve focus groups and roundtable discussions with stakeholders and responses to exposure drafts. The AASB may also draw on project advisory panels and interpretation advisory panels.

3. Distinguish between the roles of the FRC and the AASB.

Both the FRC and the AASB are involved in standard setting. The AASB is responsible for developing a conceptual framework and issuing accounting standards. Another function of the AASB is to participate in and contribute to the development of a global set of accounting standards. The FRC's role in standard setting is essentially a broad oversight function; it oversees the processes for setting accounting standards. The FRC's oversight function also extends to the auditing standard setting process, including monitoring the effectiveness of auditor independence requirements in Australia.

The FRC appoints members of the AASB and approves its priorities, business plans, budgets and staffing arrangements. The FRC determines the AASB's broad strategic direction (e.g., the FRC directed the AASB to adopt International Financial Reporting Standards, such that compliance with Australian Accounting Standards by profit seeking entities results in compliance with IFRS. The FRC advises the AASB and provides feedback on policy matters.

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4. How does the IASB influence financial reporting in Australia?

Australia has adopted International Financial Reporting Standards since 2005. Hence technical issues on the IASB work program are also included on the AASB work program. The AASB Board members and staff can identify issues requiring consideration. Some of these issues can be referred to the IASB for consideration and some can be addressed domestically. In fact the issue of an accounting standard by the IASB would result in a corresponding and consistent standard being issued by the AASB. The text of the international accounting standard may be modified to the extent necessary to take account of the Australian legal or institutional environment and, in particular, to ensure that any disclosure and transparency provisions in the standard are appropriate to the Australian legal or institutional environment. This is often reflected in modifications to standards for application by not-for-profit entities in Australia.

5. Explain the potential benefits and problems that can result from the adoption of IFRSs in Australia.

The adoption of Australian Accounting Standards that are equivalent of IFRSs may be viewed as implementing development of a global set of accounting standards. It also reflects the view that doing so is, on the whole, in the best interests of the Australian economy. These benefits may manifest in reduce cost of capital and reduced reporting costs for Australian companies that seek finance in global capital markets. It also may make listing in Australia more attractive to multinational corporations because Australian investors' will have greater understanding of financial statements prepared in accordance with IFRSs.

The problem that can result from the adoption of IFRSs in Australia is the 'one size fits all' approach. IFRSs were initially drafted to be used solely by large, for-profit entities. In Australia, however, they have been applied across the board to all entities, including small and medium-sized entities, not-for-profits and governments. The AASB has now recognised this issue and has implemented a differential system — reduced disclosure regime — whereby certain entities may not have to abide by the full requirements of Australian equivalents to IFRSs.

6. What is the difference between Australian Accounting Standards and IFRSs?

While IFRSs are developed for application by profit-seeking entities, Australian Accounting Standards are also applied by not-for-profit entities in the public and private sectors. Accordingly Australian Accounting Standards may include additional or different requirements or exemptions for not-for-profit entities. Australian Accounting Standards also cover additional matters, such as disclosure requirements (typically in a separate standard) on matters not covered by IFRSs. The difference introduced by the AASB can be easily identified in the texts. For example, paragraphs added by the AASB are prefixed with "Aus" while paragraphs deleted by the AASB are indicated as "deleted by the AASB".

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7. Specify the objectives of general purpose financial reporting, the nature of users, and the information to be provided to users to achieve the objectives as provided in the conceptual framework.

The conceptual framework specifies the objectives of general purpose financial reporting as providing financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. It adopts the 'entity perspective'; that is, it is the entity, not its owners and others having an interest in it, which is the object of general purpose financial reporting. In other words, the focus is placed on reporting the entity's resources (assets), the claims to the entity's resources (liabilities and equity) and the changes in them. Shareholders are seen not so much as owners of the entity but merely as providers of resources to the entity, in much the same way as liabilities. Both present and potential equity investors, lenders and other creditors are seen as constituting a single primary user group. This group makes decisions about the allocation of resources as well as decisions relating to protecting or enhancing their claim on the entity's resources. Other potential user groups; for example, government and other regulatory bodies, customers, employees and their representatives, are not the focus of the objective.

It appears odd that in times when environmental and social issues are of great importance to society, and the desire for triple-bottom line reporting is growing, that these issues are ignored in the revised conceptual framework.

8. One of the functions of the FRC is to ensure that the Australian Accounting Standards are 'in the best interests of both the private and public sectors in the Australian economy'. How might the FRC assess this?

The FRC is required under the ASIC Act to promote the adoption international best practice, provided doing so would be in the best interests of both the private and public sectors in the Australian economy. The success of this mandate may be assessed by considering the reduction in the cost of capital and reporting costs for Australian companies that seek finance in global capital markets, the attractiveness to multinational corporations of listing in Australia. Feedback obtained via various stakeholder mechanisms may also be assessed. For example, stakeholder groups represented on the FRC will be consulted regularly by the FRC member they have nominated, and stakeholder views will be brought to FRC meetings, as appropriate.

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9. Outline the fundamental qualitative characteristics of financial reporting information to be included in general purpose financial statements.

The fundamental qualitative characteristics of financial information are relevance and faithful representation.

Paragraphs QC6 to QC11 of the *Conceptual Framework* elaborate on the qualitative characteristic of relevance. Information is relevant if:

- it is capable of making a difference in the decisions made by the capital providers as users of financial information
- it has predictive value, confirmatory value or both. Predictive value occurs where the information is useful as an input into the users' decision models and affects their expectations about the future. Confirmatory value arises where the information provides feedback that confirms or changes past or present expectations based on previous evaluations.
- it is capable of making a difference whether the users use it or not. It is not necessary that the information has actually made a difference in the past or will make a difference in the future.

Paragraphs QC12 to QC16 of the *Conceptual Framework* elaborate on the fundamental qualitative characteristic of faithful representation. Information is faithfully represented if:

- complete. A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. (QC13)
- neutral A neutral depiction is without bias in the selection or presentation of financial information. (QC14)
- free from error. Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. (QC15)

10. Discuss the importance of the going concern assumptions to the practice of accounting.

Financial statements are prepared under the assumption that an entity will continue to operate in the foreseeable future. This going concern assumption is important as it may be used to justify the use of historical costs in accounting for liabilities and assets and, in the case of non-current assets, for the systematic allocation of their costs to depreciation expense over their useful lives. As such the assumption is made that current market values of assets are sometimes of little importance. It also ensures that the financial statements are not prepared on the basis of expected liquidation or forced sale values.

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11. Discuss the essential characteristics of an asset as described in the conceptual framework.

Discussion of essential characteristics of asset:

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

Physical form and the right of ownership are not essential to the existence of an asset. For example, property held on a lease is an asset if the entity controls the benefits that are expected to flow to the entity even though there is no legal ownership.

12. Discuss the essential characteristics of a liability as described in the conceptual framework.

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

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

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13. A government gives a parcel of land to a company at no charge. The company builds a factory on the land and employs people at the factory to produce jam that is sold in local and interstate markets. Considering the definition of income in the conceptual framework, do you think the receipt of the land is income to the company? Would your answer depend on how the land is measured?

(a) Under the conceptual framework, income is defined as follows:
Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

(b) Arguments for direct credit to equity
- Those who would argue that the government's contribution of land to the company is not income say that the government is not an equity participant in the business – that is, the government does not own shares of stock and is not entitled to dividends or other return on its contribution of the land.
- They also argue that the grant is not earned in the same way as income from the sales of goods and services is earned. Rather, it is simply an incentive provided by the government without any related costs.
- Therefore the land should be recognised as a direct credit to equity. It would be reported in the statement of financial position as a capital contribution from government. Sometimes this is described as 'donated capital'.

(c) Arguments for income recognition:
- On the other hand, some accountants argue that it is income because the land is owned by the company, that it increases the assets attributable to the shareholders of the company, and that after the company meets its obligations to employ the specified number of people for the specified period of time, the company can sell the land and distribute the proceeds to shareholders.
- Also, while the land is held, it helps to generate profits (benefits) for the company, and those profits benefit the shareholders in the form of increased dividends and/or share value.
- Additionally, grants come with 'strings attached' — in this case the company must employ a certain number of people for a specified time. This involves a cost. The grant is income to be matched against that cost.
- Also, government grants are like a 'reverse income tax' — where the government gives something to the taxpayer rather than the taxpayer giving something to the government. Grants, like taxes, are determined based on a country's fiscal and social policies. When a company pays taxes, it recognises tax expense. When a company receives a grant, it should recognise grant income.

(d) Under AASB 120 Accounting for Government Grants and Disclosure of Government Assistance:

7. Government grants, including non-monetary grants at fair value, shall not be recognised until there is reasonable assurance that:
   (a) the entity will comply with the conditions attaching to them; and
   (b) the grants will be received.

12. Government grants shall be recognised as income over the periods necessary to match them with the related costs, which they are intended to compensate, on a systematic basis. They shall not be credited directly to shareholders' interests.

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

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

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

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

Under the current conceptual framework, income encompasses both revenue and gains. A more complete definition of *revenue* arises in accounting standard IAS 18/AASB 118 *Revenue* as follows: 'the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.'

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

Revenues arise from the does not necessarily arise from the ordinary activities of the entity; for example, gains on the disposal of non-current assets or on the revaluation of market; hence the distinction between revenues and gains is unclear. Would we be better off abandoning the distinction?

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15. Describe the qualitative characteristics of financial information according to the conceptual framework, distinguishing between fundamental and enhancing characteristics.

Chapter 3 of the *Conceptual Framework for Financial Reporting* (the conceptual framework) discusses the qualitative characteristics of useful financial information. For financial information to be useful (e.g. to existing and potential investors, lenders and other creditors for making decisions about the reporting entity on the basis of information in its financial report), it must be relevant and faithfully represent what it purports to represent. Therefore, the fundamental qualitative characteristics are relevance and faithful representation.

Paragraphs QC6 to QC11 of the conceptual framework elaborate on the qualitative characteristic of relevance. Information is relevant if:

- it is capable of making a difference in the decisions made by the capital providers as users of financial information
- it has predictive value, confirmatory value or both. Predictive value occurs where the information is useful as an input into the users' decision models and affects their expectations about the future. Confirmatory value arises where the information provides feedback that confirms or changes past or present expectations based on previous evaluations.
- it is capable of making a difference whether the users use it or not. It is not necessary that the information has actually made a difference in the past or will make a difference in the future.

Paragraphs QC12 to QC16 of the conceptual framework elaborate on the fundamental qualitative characteristic of faithful representation. Information is faithfully represented if:

- complete. A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. (QC13)
- neutral A neutral depiction is without bias in the selection or presentation of financial information. (QC14)
- free from error. Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. (QC15)

The usefulness of financial information is enhanced by *comparability*, *verifiability*, *timeliness* and *understandability*. These are the enhancing characteristics.

Comparability (QC20–QC25)
Financial information is comparable if it:

- can be compared with similar information about other entities or the same entity across for another period or another date.
- enables users to identify and understand similarities in, and differences among, items.

Verifiability (QC26–QC28)
Financial information is verifiable if:

- different knowledgeable and independent observers could reach consensus different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation.
- can be directly or indirectly verified. Direct verification means verifying an amount or

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other representation through direct observation, for example, by counting cash. Indirect verification means checking the inputs to a model, formula or other technique and recalculating the outputs using the same methodology.

Timeliness (QC29)
Timeliness means having information available to decision-makers in time to be capable of influencing their decisions.

Understandability (QC30–QC32)
Financial information is understandable if it is classified, characterised and presented clearly.

16. Define 'equity', and explain why the conceptual framework does not prescribe any recognition criteria for equity.

The *conceptual framework* defines *equity* as 'the residual interest in the assets of the entity after deducting all its liabilities'. Equity cannot be identified independently of the other elements in the statement of financial position/balance sheet.

The characteristics of equity are that equity is a residual, i.e. something left over after the entity has determined its assets and liabilities. In other words:
Equity = Assets –Liabilities.

There is no need for recognition criteria for equity as it is a residual, determined after recognition criteria are applied to the other elements.

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17. In relation to the following multiple choice questions, discuss your choice of correct answer:

(a) Which of the following statements about the conceptual framework is incorrect?

(i) The conceptual framework considers timeliness and materiality to be constraints on relevant and reliable information.

(ii) The conceptual framework states that the elements directly related to the measurement of financial position are assets, liabilities and equity.

(iii) The conceptual framework applies to the financial statements of all commercial, industrial and business reporting entities.

(iv) In accordance with the conceptual framework, income is recognised when an increase in future economic benefits related to an increase in an asset or a decrease in a liability has arisen that can be measured reliably.

(b) The conceptual framework's enhancing qualitative characteristics include:

(i) Understandability, timeliness, verifiability and comparability.

(ii) Faithful representation, relevance, understandability and verifiability.

(iii) Comparability and reliability.

(iv)Substance over form and relevance.

(c) Which of the following statements about the conceptual framework's definition of expenses is correct?

(i) Expenses include distributions to owners.

(ii) Expenses are always in the form of outflows or depletions of assets.

(iii) Expenses exclude losses.

(iv) Expenses are always decreases in economic benefits.

(d) In accordance with the conceptual framework, a lender should recognise the forgiveness of its $20 000 interest-free loan as:

(i) An increase in income and a decrease in a liability.

(ii) An increase in an expense and a decrease in an asset.

(iii) An increase in an asset and an increase in income.

(iv) An increase in an expense and a decrease in a liability.

(a) (i)
(b) (i)
(c) (iv)
(d) (ii)

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Case studies

Case study 1.1

The AASB

Visit the AASB website (www.aasb.gov.au) and answer the following:

1. **Who is the Chair of the AASB?**
2. **Who are the members, and which organisations do they represent?**
3. **Which accounting standards have been issued in the past year?**
4. **Why are there differences in the numbering systems for current accounting standards (e.g. AASB x, AASB xxx and AASB xxxx)?**
5. **What current projects (if any) is the AASB working on in cooperation with the IASB?**

Assuming that you already have access to the AASB website:

1. Chairman of the AASB:

   Go to AASB Board, then Current Board Members. Locate current Chair.

2. Members of the AASB and organisations represented:

   Stay in the same location, as the names and organisations represented on the AASB are all shown. Don't forget to include the observers as well. Comment: Any academics on the board?

3. Accounting standards issued in the past year:

   On the AASB website, go to Quick Links and select Table of Standards. Read from Table 1 all of the standards issued in the last year.

4. Different numbering systems for standards:

   See Pronouncements for information, plus section 1.7.4 in the text.

   - AASB x represent those standards adopted by the AASB from the IFRSs of the IASB.
   - AASB xxx represent those standards adopted by the AASB from the IASs of the IASB and its predecessor the IASC.
   - AASB xxxx represent those standards issued exclusively by the AASB for companies in the Australian context.

   In addition, the AAS standards consist of standards issued by the AASB for special organisations e.g. superannuation plans, government.

   (The numbering system is also set out in tabular format at the For Students link; go to About, then AASB and select For Students).

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5. Current projects:

   On the AASB website, go to Work in Progress, then Project Summaries. It would appear that there are no specific projects at the moment being worked on by the AASB in cooperation with the IASB. The AASB is one of several standard setting boards that liaise with the IASB and merely provide submissions to the IASB on various topics. See also AASB Submissions to the IASB on the website. Also check the News section and Latest News on the website.

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Case study 1.2

The IASB and convergence

Visit the website of the International Accounting Standards Board (www.ifrs.org). Report on:

1. **the most recent stage of the conceptual framework revision**
2. **the accounting standards being changed as a result of moves towards international convergence**
3. **the membership of the IASB and which countries the members come from**
4. **the goals of the IASB.**

1. Since the Norwalk IASB/FASB joint meeting in 2004, the Boards decided to undertake a joint project to develop a common conceptual framework for both Boards. It has gone through various stages from agenda decision to discussion paper, receiving comment letters, special groups consultation and developing exposure draft. It is now in the analysis phase and plan to publish the conceptual framework after six months.

2. Which accounting standards have or are being changed as a result of international convergence moves:

   The list of recently issued IFRS Standards and corresponding effective dates are classified in to two tables – completed IFRS standards and narrow-scope amendments – as follows:
   (see the attached document – IASB-work-plan-January-2017 – for the table)
3. Membership of IASB and member countries:

   Go to the IASB website and see, About us. Click on About the organisation and there you will find the link to the document *Who we are and what we do: The IFRS Foundation and the International Accounting Standards Board*. Page 5 of this document provides information about the Chairman, the Vice-Chairman and all members of the IASB, and the countries from which they came by reading each person's information sheet.

4. Goals of the IASB:

   Go to the IASB website and see About us. Click on About the organisation and there you will find the IASB objectives. On this page you can also access a 8 page guide 'Who we are and what we do' from the Related Information link.

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Case study 1.3

ASIC

Visit the website of the Australian Securities and Investments Commission (www.asic.gov.au). Report on:

1. **what ASIC is and its role**
2. **the tips given to prospective shareholders regarding the reading of a company's prospectus**
3. **the policy statements and practice notes issued by ASIC.**

1. ASIC and its role

   On the ASIC website, go to About ASIC and look up Our Role

2. Tips to prospective shareholders re prospectuses

   From within the For Consumers menu, go to MoneySmart, then Investing, and How to buy & sell shares, then Prospectuses. The ASIC has information about prospectuses which changes quite regularly. See what tips you can find about prospectuses, assuming that you are a prospective investor.

3. Regulatory guides issued

   From ASIC's home page, go to Regulatory Resources then to Regulatory Guides. The regulatory guides are accessible here.

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Case study 1.4

The FRC

Visit the website of the Financial Reporting Council (www.frc.gov.au). Locate its strategic plan and report on:

1. **the key purpose of the strategic plan 2017-20.**
2. **the four sources of complexity in financial reporting that the Managing Complexity in Financial Reporting Task Force outlined in its report to the FRC in May 2012.**

1. The key purpose of the strategic plan:

   There is a separate link on the FRC homepage to information about the strategic plan. Click on this and open the strategic plan for 2017-20.

   As this document notes, the FRC's objectives are to facilitate the development of high quality accounting standards, auditing and assurance standards, and related guidance. The FRC aims to achieve these objectives by developing task forces for specific areas of interest.

2. On the FRC website, go to Documents then Publications, and within the list of 2012 publications select FRC – Managing Complexity in Financial Reporting. The four sources of complexity in financial reporting that the Managing Complexity in Financial Reporting Task Force outlined in its report to the FRC in May 2012 are:
   (a) Increasingly complex business operations.
   (b) Complexities in the regulatory framework.
   (c) Changing attitudes of businesses and stakeholders.
   (d) Developments in Integrated Reporting.

   You should also outline the nature of and purpose of the project, any recommendations or progress made.

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Application and analysis exercises

Exercise 1.1

Relevant information

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

1. **What financial information about the investment company's holdings would be most relevant to you?**
2. **The investment company earns profits from appreciation of its investment securities and from dividends received. How would the concepts of recognition in the conceptual framework apply here?**

(LO5 and LO8)

1. The performance of an investment company results from income earned on its investments (dividends and interest) and changes in the fair values of its investments while they are held. I would like to know:
   - Fair values of the securities that the investment company holds.
   - How those fair values changed during the year. It would not matter much to me whether the investment company actually sold the investments (in which case they would have to replace them with other investments) or held on to the investments. Either way, the fair value changes represent gains and losses to the investment company and, therefore, to me as an investor in the investment company.
   - How the fair value changes of investments managed by this investment company compared to changes in similar investments in the market as a whole.
   - Turnover of the portfolio and related transaction costs such as commissions.
   - Interest and dividends earned.
   - Information about risks in the portfolio.
   - Income taxes are usually only based on those fair value changes that have been 'confirmed' by a sale transaction. If that is the case with this investment company, I might want to know how the fair value changes were split between 'realised' (relating to investments that have been sold) and 'unrealised' (relating to investments that are still held). In many countries, investment companies that distribute their earnings rapidly to the investors do not themselves pay taxes — only the investors pay the taxes on realised gains and dividend and interest income.

2. Under the conceptual framework, an item that meets the definition of an asset, liability, income, or expense should be recognised if:
   (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and
   (b) the item has a cost or value that can be measured with reliability.

With respect to income, the conceptual framework states that income is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease of a liability that results in increases in equity, other than those relating to contributions from equity participants. Appreciation of the fair value of investment securities does represent an increase in an asset. The appreciation of its investment securities means it is probable that future economic benefit will flow to the entity and the fair value can be

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measured with reliability. Hence, it fulfils both of the definition of income and the recognition criteria. As to dividends, when the investment company's right to receive payment is established, it can recognise dividends as revenue. Because fair value changes and dividends are different in nature, they would be reported separately.

Exercise 1.2

Measuring inventories

AASB 102/IAS 2 *Inventories* allows producers of gold and silver to measure inventories of these commodities at selling price even before they have sold them, which means income is recognised at production. In nearly all other industries, however, income is recognised only when the inventories are sold to outside customers. What concepts in the conceptual framework might the standard setters have considered with regard to accounting for gold and silver production?
(LO8)

Unlike other ordinary goods, there is a ready liquid market with quoted prices, minimal transaction costs, minimal selling effort, minimal after-costs, and immediate cash settlement.

Under the conceptual framework, an item that meets the definition of an asset, liability, income, or expense should be recognised if:

(a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and
(b) the item has a cost or value that can be measured with reliability.

The AASB concluded that because of the nature of the market in which gold and silver are bought and sold, the conditions for income recognition are met at the time of production.

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Exercise 1.3

Recognising a loss

The law in your community requires store owners to shovel snow and ice from the footpath in front of their shops. You failed to do that, and a pedestrian slipped and fell, resulting in serious and costly injury. The pedestrian has sued you. Your lawyers say that while they will vigorously defend you in the lawsuit, you should expect to lose $25 000 to cover the injured party's costs. A court decision, however, is not expected for at least a year. What aspects of the conceptual framework might help you in deciding the appropriate accounting for this situation? (LO8)

The definition of liability can help decide the accounting treatment of the situation. Under the conceptual framework a liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. In this case, the past event is the fall and injury to the pedestrian.

Present obligation depends on the probability of payment. The attorney has advised that a $25 000 loss is probable. Therefore appropriate accounting involves recognising a liability for the probable payment. An expense would also be recognised.

Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities. In this case, the expense arises at the time the pedestrian is injured because a liability has also arisen at that time.

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Exercise 1.4

Financial statements

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

1. **What are the relevance and faithful representation accounting considerations in deciding how to measure the building in the entity's financial statements?**
2. **Does the conceptual framework lead to measuring the building at $15 000 000? Or at $9 800 000? Or at some other amount?**

(LO5 and LO9)

1. Is the fair value relevant to stakeholders' decisions? Whether the stakeholders care about the fair value of the building should be considered.

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

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

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Analysis:

- The fair value of the property is relevant to the investors in the enterprise. The enterprise — and therefore its owners — are better off because the value of the property has gone up. Better off means that their wealth increased.
- Is the fair value reported by the appraiser reliable? Certainly, appraisals involve judgements, and different valuation methods and different assumptions can generate different valuations. The objectivity and other qualifications of the appraiser should be considered. The conceptual framework acknowledges that accounting information can be reliable even if it is not precise. The appraiser acknowledged that there is a potential for error of plus or minus 10%. That does not mean that the value information is not reliable.

2. The conceptual framework does not include concepts or principles for selecting which measurement basis should be used for particular elements of financial statements or in particular circumstances. The qualitative characteristics do provide some guidance, particularly the characteristics of relevance and faithful representation.

Exercise 1.5

The conceptual framework versus interpretations

Applying the conceptual framework is subjective and requires judgement. Would the IASB be better off to abandon the conceptual framework entirely and instead rely on a very active interpretations committee that develops detailed guidance in response to requests from constituents? (LO4, LO8 and LO9)

No. The fact that the conceptual framework involves judgement does not mean that it should be abandoned.

The guidance developed by the interpretations committee would be ad hoc – that is, developed case by case without the foundation of the framework to look to. The standards themselves would suffer from the same problem if there were no framework.

The conceptual framework provides guidance and direction to the standard setters, and therefore will lead to consistency among the standards.

But it is a set of concepts. It provides a boundary for the exercise of judgement by the standard setter and the interpretive body.

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Exercise 1.6

Meaning of 'decision useful'

What is meant by saying that accounting information should be 'decision useful'? Provide examples. (LO5)

The conceptual framework identifies the principal classes of users of general purpose financial statements as the existing and potential investors, lenders and other creditors.

All of these categories of users rely on financial statements to help them in making various kinds of economic and public policy decisions. Investors need to decide whether to buy, sell, or hold shares. Lenders need to decide whether to lend and at what price. Suppliers need to decide whether to extend credit. Information is decision-useful if it helps these people make their decisions.

Existing and potential investors, lenders and other creditors have the most critical and immediate need for the information in financial reports and many cannot require the entity to provide the information to them directly.

The general purpose financial statements shall focus on the needs of participants in capital markets, which include not only existing investors but also potential investors and existing and potential lenders and other creditors.

Information that meets the needs of the specified primary users is likely to meet the needs of users both in jurisdictions with a corporate governance model defined in the context of shareholders and those with a corporate governance model defined in the context of all types of stakeholders.

Individual primary users have different, and possibly conflicting, information needs and desires. Reporting entities shall seek to provide the information set that will meet the needs of the maximum number of primary users. However, focusing on common information needs does not prevent the reporting entity from including additional information that is most useful to a particular subset of primary users.

The conceptual framework notes that financial statements cannot provide all the information that users may need to make economic decisions. In developing financial reporting requirements that meet the objective of financial reporting, reporting entities shall rely on the qualitative characteristics of, and the cost constraint on, useful financial information to avoid providing too much information.

While the concepts in the conceptual framework are likely to lead to information that is useful to the management of a business enterprise in running the business, the conceptual framework does not purport to address their information needs. The same can be said for the regulators and fiscal-policy decision makers.

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Exercise 1.7

Performance of a business entity

A financial analyst said:

> **I advise my clients to invest for the long term. Buy good shares and hang onto them. Therefore, I am interested in a company's long-term earning power. Accounting standards that result in earnings volatility obscure long-term earning power. Accounting should report earning power by deferring and amortising costs and revenues.**

Is this analyst's view consistent with the fundamental characteristics of financial information established in the conceptual framework? (LO5)

Accounting standards should help provide relevant and faithfully represented financial information.

Companies that operate in risky business environments or that enter into risky kinds of transactions are likely to experience real ups and downs in their performance. In such cases, volatility of reported earnings results from the real transactions and activities of the company.

In other words, the statement of profit or loss and other comprehensive income reflects the underlying risks. It is not the role of financial accounting and reporting to try to smooth the company's earnings by, say, deferring profits in good years and deferring expenses in bad years. The amounts reported in the financial statements would not be faithfully represented because they do not reflect real phenomena.

Exercise 1.8

Going concern

What measurement principles might be most appropriate for a company that has ceased to be a going concern (e.g. creditors have appointed a receiver who is seeking buyers for the company's assets)? (LO6 and LO9)

Net realisable value is an asset's selling price or a liability's settlement amount less disposal or settlement costs. If a company ceases to be a going concern, that means it is either being wound up or sold.

Either way, the relevant measurements to users of financial statements would be the net realisable value of the company's net assets.

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Exercise 1.9

Assessing probabilities in accounting recognition

The conceptual framework defines an asset as a resource from which future economic benefits are expected to flow. 'Expected' means it is not certain, and involves some degree of probability. At the same time the conceptual framework establishes, as a criterion for recognising an asset, that 'it is probable that any future economic benefit associated with the item will flow to or from the entity.' Again, an assessment of probability is required. Is there a redundancy, or possibly some type of inconsistency, in including the notion of probability in both the asset definition and recognition criteria? (LO7 and LO8)

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

Exercise 1.10

Purchase orders

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

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

(LO8)

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

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

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

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

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recognise a gain or loss.

Exercise 1.11

Definition of elements

Explain how Q Ltd should account for the following items/situations, justifying your answer by reference to the conceptual framework's definitions and recognition criteria:

1. **Receipt of artwork of sentimental value only.**
2. **Q Ltd is the guarantor for an employee's bank loan:**
   (a) You have no reason to believe the employee will default on the loan.
   (b) As the employee is in serious financial difficulties, you think it likely that he will default on the loan.
3. **Q Ltd receives 1000 shares in X Ltd, trading at $4 each, as a gift from a grateful client.**
4. **The panoramic view of the coast from Q Ltd's café windows, which you are convinced attracts customers to the café.**
5. **The court has ordered Q Ltd to repair the environmental damage it caused to the local river system. You have no idea how much this repair work will cost.**

(LO7 and LO8)

1. Trinket of sentimental value:
   - Fails the para. 49(a) asset definition as it does not constitute future economic benefits, defined in para. 53 as the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity.
   - Recognition criteria are irrelevant, as there is no asset to recognise.

2. Guarantor for an employee's loan.
   (i) Employee unlikely to default on his/her loan
   - Meets the para. 49(b) liability definition: (1) present obligation — legal obligation via the guarantor contract; (2) past event — signing the guarantor contract; (3) settlement involving outflow of economic benefits — payment of the guarantee.
   - Fails probability recognition criterion, as it is not likely that Q Ltd will be required to pay on the guarantee. Hence, no liability can be recognised. However, note disclosure of the guarantee may be warranted (para. 88).

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

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employee owes and so it can be reliably measured.

3. Receipt of 1000 shares in X Ltd, trading at $4 each, as a gift from a grateful client.
    - The receipt of the shares meets the asset definition: (1) represent future economic benefits (via future sales or dividend stream); (2) controlled by Q Ltd (only Q Ltd can benefit from either selling them or receiving dividends); (3) past event (their receipt).
    - They also meet the asset recognition criteria: probable that future economic benefits will eventuate (via sale or dividend stream); and the shares have a value (they are trading at $4 each) that can be reliably measured (this value can be verified via securities exchange and so on).
    - The shares also meet the income definition and recognition criteria. Definition: (1) increase in economic benefits in the form of an asset increase — Q Ltd now owns the shares; (2) during period — the shares were received during period; (3) results in equity increase — if assets increase and liabilities do not change, equity increases. Recognition criteria: The increase in future economic benefits has arisen, as Q Ltd now owns the shares (asset). The shares' value is known and so can be reliably measured.

4. Café's panoramic view.
    - The view fails the definition as the entity does not control the future economic benefits that are expected to flow from the view — the entity cannot deny or regulate access by others to the view.
    - Recognition criteria are irrelevant, as there is no asset to recognise.

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

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Exercise 1.12

Definition and recognition criteria

Explain how T Ltd should account for the following items, justifying your answer by reference to the definitions and recognition criteria in the conceptual framework. Also state, where appropriate, which ledger accounts should be debited and credited.

Required

1. **Photographs of the company's founders, which are of great sentimental and historical value.**
2. **(a) T Ltd has been sued for negligence — likely it will lose the case.**
   (b) T Ltd has been sued for negligence — likely it will win the case.
3. **Obsolete plant now retired from use.**
4. **T Ltd receives a donation of $10 000.**

(LO7 and LO8)

1. Photographs of the company's founders, which are of great sentimental value.
   - The asset definition is failed as the photographs do not represent future economic benefits (para. 49(a)). Future economic benefits constitute the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to an entity (para. 53).
   - Recognition criteria are thus irrelevant, as there is no asset to recognise.

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

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- Therefore, at this stage an expense of $20 000 must also be recognised. If the damages firm up to another amount as the case progresses, the amount must be adjusted accordingly.
- Note that in this case the recognition of a liability has resulted in the simultaneous recognition of an expense (paras. 91 and 98).

2.(b) T Ltd has been sued for negligence — likely it will win the case.

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

3. Obsolete plant now retired from use.

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

4. Donation of $10 000.

- The asset definition (para. 49(a)) is met as all 3 characteristics are present.
  - Past event: The receipt of the donation.
  - Flow of future economic benefits: The donation represents an inflow of $10 000 cash into T Ltd.
  - Control over the future economic benefits: T Ltd will benefit from this $10 000 cash inflow and can deny or regulate the access of others to this cash inflow.
- The asset recognition criteria (para. 89) are met, as it is probable (actually, it is certain) that an inflow of economic benefits (cash) will flow to the entity, and the amount ($10 000) can be reliably measured as it is known.
- Therefore, an asset of $10 000 must be recognised.
- The income definition (para. 70(a)) is met as all 3 characteristics are present.
  - Increase in economic benefits during the period: The inflow of $10 000 cash represents an increase in economic benefits, and T Ltd received and cleared the donation during this period.
  - In the form of an asset increase: See above asset discussion — T Ltd now has additional cash of $10 000.
  - Results in an increase in equity: If assets increase and liabilities remain unchanged, equity increases.
- The income recognition criteria (para. 92) are met, as the increase in economic benefits has arisen (as T Ltd now has additional cash), and the amount ($10 000) is known.
- Therefore, income of $10 000 must also be recognised.
- Note that in this case the recognition of an asset has resulted in the simultaneous recognition of income (paras. 84 and 92).

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Exercise 1.13

Definition and recognition criteria

Glenelg Accounting Services has just invoiced one of its clients $3600 for accounting services provided to the client. Explain how Glenelg Accounting Services should recognise this event, justifying your answer by reference to relevant conceptual framework definitions and recognition criteria. Would your answer be different if the services had not yet been provided; that is, the payment is in advance? (LO7 and LO8)

The conceptual framework defines an asset as a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Invoicing the client gives rise to an asset as all 3 characteristics are present:

- Flow of future economic benefits: The invoice represents a future cash inflow to the firm;
- Control: The firm has control over the economic benefits via its contractual right to the future cash inflow; and
- Past event: The issuing of the invoice or the provision of the services for which the invoice was issued.

Under the conceptual framework an asset must be recognised when it is probable that the future economic benefits will flow to the entity, and the asset has a cost or value that can be reliably measured.

These recognition criteria are met as:

- It is more than 50% likely (probably certain) that the firm will receive the cash (otherwise it would not have provided the services); and
- The value ($3600) can be reliably measured as it is known.

Therefore, an asset (receivable) of $3600 must be recognised.

The conceptual framework defines income as increases in economic benefits during the period in the form of inflows or enhancements of assets or decreases in liabilities that result in increases in equity, other than those relating to owners' contributions.

Invoicing gives rise to income as all 3 characteristics are present:

- Increase in economic benefits during the period: The right to a future cash inflow arose during the period;
- Increase in assets or decrease in liabilities: The increase is in the form of an asset increase as the receivable meets the asset definition and recognition criteria; and
- Increase in equity: As assets have increased and liabilities have not changed, equity has increased.

Under the conceptual framework income must be recognised when an increase in future economic benefits, related to an asset increase or liability decrease, has arisen that can be measured reliably.

These recognition criteria are met as:

- The asset increase has arisen (on issue of the invoice); and

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- The increase ($3600) can be reliably measured as it is known.

Therefore, income (fee revenue) of $3600 must be recognised.

However, if the services had not yet been provided it is not probable that there is an inflow of future economic benefits (the firm will only entitle to the payment once the service is provided). Hence, an asset (receivable) of $3600 cannot be recognised.

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Exercise 1.14

Assets

Glam Cosmetics has spent $220 000 this year on a project to develop a new range of chemical-free cosmetics. As yet, it is too early for Glam Cosmetics' management to be able to predict whether this project will prove to be commercially successful. Explain whether Glam Cosmetics should recognise this expenditure as an asset, justifying your answer by reference to the conceptual framework asset definition and recognition criteria. (LO7 and LO8)

The conceptual framework defines an asset as a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

The expenditure of developing a new line of chemical-free cosmetics meets this definition as: (1) it represents future economic benefits via sale of the new line of cosmetics; (2) the benefits are controlled, as the company will enjoy the economic benefits flowing from the new line; and (3) there is a past event, as the company has already spent the $220 000.

Under the conceptual framework an asset is recognised in the statement of financial position when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be reliably measured.

The expenditure fails the probability criterion, as it is not yet possible to predict whether the project will prove to be commercially relevant.

Accordingly, the company cannot (yet) recognise the expenditure as an asset.

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Exercise 1.15

Asset definition and recognition

Recently, $20 000 cash was stolen from Fremantle Ltd's night safe. Explain how Fremantle should account for this event, justifying your answer by reference to relevant conceptual framework definitions and recognition criteria. (LO7 and LO8)

The conceptual framework defines expenses as decreases in economic benefits during the period in the form of asset decreases or liability increases that result in decreases in equity, other than those relating to distributions to owners.

The theft of the $20 000 cash satisfies the expense definition as:

- It is a decrease in economic benefits during the period, as cash (economic benefits) has decreased;
- The decrease in economic benefits is in the form of an asset decrease, as cash (an asset) has decreased; and
- It has resulted in a decrease in equity, as assets have decreased and liabilities have not changed.

In accordance with the conceptual framework an expense must be recognised when:

- A decrease in economic benefits related to an asset decrease or a liability increase has arisen; and
- The decrease can be reliably measured.

The theft of the cash satisfies both recognition criteria as:

- The decrease in economic benefits related to an asset decrease (a decrease in cash) has occurred; and
- The decrease can be reliably measured, as the amount of cash lost is known (i.e. $20 000).

Accordingly, an expense (Dr) and asset decrease (Cr) of $20 000 must be recognised.

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