Financial Reporting 3rd edition Loftus Solutions Manual

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Solutions manual

to accompany

Financial reporting

3rd 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 that the accounting information prepared and presented in the financial statements following these standards is of high quality and valuable to all users of financial statements. If an accounting issue is added to the AASB's agenda, AASB will start by researching the issue, then will consider solutions and consult with stakeholders. The AASB may then issue 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 accounting 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.

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 members and staff can identify issues requiring consideration. Some of these issues can be

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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 is essentially an example of implementing a global set of accounting standards. It reflects the view that doing so is, on the whole, in the best interests of the Australian economy. These benefits may manifest in reduced cost of capital and reduced reporting costs for Australian companies that seek finance in global capital markets. It also make listing on the stock exchange 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 used in the implementation of IFRSs in Australia. 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-profit and government entities. This resulted in unnecessary costs to the small and medium-sized entities, especially in regards to satisfying the disclosure requirements in IFRSs. The AASB has recently recognised this issue and has implemented a differential system — reduced disclosure regime — whereby certain entities may not have to abide by the full disclosure 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. These differences introduced by the AASB can be easily identified in the text of the standards. For example, paragraphs added by the AASB are prefixed with "Aus" while paragraphs deleted by the AASB are indicated as "deleted by the AASB". Australian Accounting Standards may also cover additional matters, such as disclosure requirements on issues not covered by IFRSs (typically in a separate standard).

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 objective of general purpose financial reporting as providing financial information about the reporting entity that is useful to existing and potential

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investors, lenders and other creditors in making decisions about providing resources to the entity. It adopts the 'entity perspective'; that is, the entity is the object of general purpose financial reporting, not its owners and others having an interest in it. 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 lenders or creditors. Both present and potential shareholders, 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 financial reporting. 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 still ignored in the revised *Conceptual Framework*. However, this omission may not be important as currently shareholders themselves are interested in environmental and social issues and that provides incentives to entities to provide further information related to those issues.

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 of international best practice, provided that 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 whether the Australian Accounting Standards, developed based on IFRSs, contribute to the reduction in the cost of capital and reporting costs for Australian companies that seek finance in global capital markets and improve the attractiveness to multinational corporations of listing on stock exchanges in Australia. In doing so, feedback obtained via various stakeholder mechanisms may 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.

9. Outline the fundamental qualitative characteristics of information that is useful to users of financial statements.

The fundamental qualitative characteristics of financial information are relevance and faithful representation.
Paragraphs 2.6 to 2.10 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.

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Paragraphs 2.12 to 2.19 of the *Conceptual Framework* elaborate on the fundamental qualitative characteristic of faithful representation. Information is faithfully represented if:

- it is complete. A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. (paragraph 2.14)
- it is neutral. A neutral depiction is without bias in the selection or presentation of financial information. (paragraph 2.15)
- it is 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. (paragraph 2.18).

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.

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

An **asset** is defined in paragraph 4.3 of the *Conceptual* Framework as 'a present economic resource controlled by the entity as a result of past events'. Paragraph 4.4 defines an economic resource as 'a right that has the potential to produce economic benefits'.

As such, the essential characteristics of an asset are:

- it is a right – the potential to produce the economic benefits for the entity and to be controlled by the entity (paragraph 4.9)
- it has potential to produce economic benefits – the potential does not need to be certain, or even likely. It is only necessary that the right already exists and that, in at least one circumstance, it would produce for the entity economic benefits beyond those available to all other parties (paragraph 4.14)
- it is controlled by the entity – the entity has the present ability to direct the use of the economic resource and obtain the economic benefits that may flow from it (paragraph 4.20).

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 to transfer an economic resource as a result of past event'.

The important aspects of this definition are:

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- the entity has an obligation – which is a duty or responsibility of the entity to act or perform in a certain way. The entity has little, if any, discretion in avoiding this obligation.
- the obligation is to transfer an economic resource. This transfer is to take place in the future and may be required on demand, at a specified date, or on the occurrence of a specified event.
- the obligation is a present obligation that exists as a result of past events. 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.

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?

Under the *Conceptual Framework*, income is defined in paragraph 4.68 as follows:

‘increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims’.

Some users or preparers of accounting information may argue that the receipt from the government free of change of land may need to be recognised directly as equity, while others argue that it should be treated as an income. A summary of the arguments proposed for those 2 options is listed below.

Argument 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 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’.

Arguments for income recognition:

- On the other hand, some accountants argue that the receipt of land from movement 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.

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Under AASB 120/IAS 20 *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 in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate.

They shall not be credited directly to shareholders' interests.

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

The *Conceptual Framework* defines *income* as '*increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.'*

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 and not be 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 definition of *revenue* arises in accounting standard AASB 118/IAS 18 *Revenue* as follows: 'the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.' Revenue therefore represents income which has arisen from 'the ordinary activities of an entity'. On the other hand, *gains* represent income which does not necessarily arise from the ordinary activities of the entity; 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.

15. Describe the qualitative characteristics of financial information according to the *Conceptual Framework*, distinguishing between fundamental and enhancing characteristics.

Chapter 2 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.

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Paragraphs 2.6 to 2.10 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 2.12 to 2.19 of the *Conceptual Framework* elaborate on the fundamental qualitative characteristic of faithful representation. Information is faithfully represented if:

- it is complete. A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. (paragraph 2.14)
- it is neutral. A neutral depiction is without bias in the selection or presentation of financial information. (paragraph 2.15)
- it is 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. (paragraph 2.18)

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

Paragraphs 2.24 to 2.29 of the *Conceptual Framework* elaborate on the enhancing qualitative characteristic of *comparability.* 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.

Paragraphs 2.30 to 2.32 of the *Conceptual Framework* elaborate on the enhancing qualitative characteristic of *verifiability.* Financial information is verifiable if:

- 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 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.

Paragraphs 2.33 of the *Conceptual Framework* elaborate on the enhancing qualitative characteristic of *timeliness*. Timeliness means having information available to decision-makers in time to be capable of influencing their decisions.

Paragraphs 2.34 to 2.36 of the *Conceptual Framework* elaborate on the enhancing qualitative characteristic of *understandability.* Financial information is understandable if it is classified, characterised and presented clearly.

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16. Define 'equity', and explain why the *Conceptual Framework* does not prescribe any recognition criteria for equity.

The *Conceptual Framework* paragraph 4.2 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.

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* overrides any accounting standard that is in conflict with the International Financial Reporting Standards (IFRS).

(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* determines capital providers as the primary user group of general purpose financial statements.

(iv) In accordance with the *Conceptual Framework*, for financial information to be useful, it must provide users of financial statements with information that is relevant and faithfully represented.

(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*, from the perspective of the lender the forgiveness of its $20 000 interest-free loan results in:

(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?**
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?**

1. On the AASB website, go to "AASB Board", then "Current Board Members". Locate current Chair.

2. Stay in the same location, as the names of the members of the AASB are all shown.

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

4. See "Pronouncements" for information, plus section 1.1.2 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.

5. On the AASB website, go to "Work in Progress", then "Project Summaries". As of the end of 2019, there are 6 projects 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 provide submissions to the IASB on various topics. See also AASB Submissions to the IASB here under "Submissions from AASB". Also check the "News" section on the website.

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Case study 1.2

The IASB

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

1. **the resources that are provided by the IASB for the accounting profession**
2. **the membership of the IASB and which countries the members come from**
3. **the goals of the IASB.**
4. **a current project being undertaken by the IASB.**

1. Go to the IASB website and see "Resources for" and select "Accounting profession".

2. Go to the IASB website and see "About us". Click on "Our structure" and there you will find the link to "International Accounting Standards Board". Click on the "Members" tab and you will find information about the Chair, the Vice-Chair and all members of the IASB, and the countries from which they came by reading each person's information sheet.

3. Go to the IASB website and see "About us". Click on "Who we are" and under the tab "Our constitution" you will find the IFRS Foundation's constitution document. In it, you will be able to find the objectives of the IFRS Foundation. IASB is the standard-setting body of the IFRS Foundation.

4. Go to the IASB website and see "Projects". Click on "Work plan" and you will find the current projects organised under 5 tabs: "All", "Research projects", "Standard-setting projects", "Maintenance projects" and "Other projects". One example of a current project as of December 2019 is the research project on "Financial instruments with characteristics of equity".

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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 types of investigations and enforcement performed by ASIC**
3. **the policy statements and practice notes issued by ASIC.**

1. On the ASIC website, go to "About ASIC" and look up "Our role" under "What we do".

2. On the ASIC website, go to "About ASIC" and look up "ASIC investigations and enforcement".

3. On the ASIC website, go to "Regulatory resources" then to "Regulatory guides" under "Find a document". The regulatory guides that replace the old policy statements and practice notes 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 strategic priorities of the FRC's current strategic plan.**
2. **the key environmental factors that impact the FRC.**

1. On the FRC website under "About the FRC" there is a link information about FRC's strategic plans. As of December 2020, the latest strategic plan is under "Strategic plan 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. The key environmental factors listed in the strategic plan 2017-20 under "Section 2 Environmental scan" are as follows:

General

- Global economic growth and financial market conditions - economic growth is low, financial markets are very cognisant of risk, and in many jurisdictions public sector debt is high.
- The increasing interconnectedness of the global economy, including financial markets.
- The explosion of information available via the internet, and the ease with which stakeholders' views can be disseminated and contested often within a very short period.
- The continuing shift in economic power from western economies to major developing countries (for example, China and India).
- The expected increase in the stock of financial assets in Australia through superannuation savings, placing greater focus on the corporate governance and reporting standards applicable to superannuation funds.
- The constrained resources available to business and government (including the FRC).

The Financial Reporting System

- Australia adopted International Financial Reporting Standards (IFRS) in 2005 and has since been actively promoting IFRS as the preferred global reporting standard as issued by the International Accounting Standards Board. It has also played a leading role in promoting public sector and not-for-profit reporting based on IFRS.
- Australia's auditing standards are based on the international standards issued by the International Auditing and Assurance Standards Board.

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Application and analysis exercises

Exercise 1.1

Requirements to prepare a financial report

Apple Isle Transport Pty Ltd operates tours and transport services throughout Tasmania. The company has 50 employees. Its accounting records show that it has total assets of $30 million, equity of $25 million and revenue of $50 million. The directors of Apple Isle Transport Pty Ltd have not received a request for a financial report from the shareholders or ASIC. Is Apple Isle Transport Pty Ltd required to prepare a financial report? If so, explain whether Apple Isle Transport Pty Ltd needs to apply Tier 1 or Tier 2 reporting requirements. (LO1)

Section 45A of the Corporation Act classifies proprietary companies as small or large, as follows.
A small proprietary company is a proprietary company that satisfies at least two of the following criteria, specified in s. 45A(2).

- The consolidated revenue for the financial year of the company and the entities it controls is less than $50 million.
- The value of the consolidated gross assets at the end of the financial year of the company and the entities it controls is less than $25 million.
- The company and the entities it controls have fewer than 100 employees at the end of the financial year.

A large proprietary company is any proprietary company that does not satisfy the definition of a small proprietary company. As Apple Isle Transport Pty Ltd only satisfies one criteria to be classified as a small proprietary company, it doesn't satisfy the definition of a small proprietary company. As such, it will be classified as a large proprietary company. Therefore, as can be seen in Figure 1.1, Apple Isle Transport Pty Ltd will have to prepare a financial report unless it has received relief from ASIC from that requirement.

AASB 1053 *Application of Tiers of Australian Accounting Standards* was issued in 2010 to apply a two-tier differential reporting system. In terms of Tier 1 reporting requirements, paragraph 11 of AASB 1053 states:

The following types of entities shall prepare general purpose financial statements that comply with Tier 1 reporting requirements:

- *for-profit private sector entities that have public accountability and are required by legislation to comply with Australian Accounting Standards; and*
- *the Australian Government and State, Territory and Local Governments.*

Appendix A of AASB 1053 specifies that an entity has public accountability if:

- its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or
- it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses.

Entities that hold assets in a fiduciary capacity on behalf of others as a primary business include banks, insurance companies, and securities brokers.

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In terms of Tier 2 reporting requirements, paragraph 13 of AASB 1053 states:

Tier 2 reporting requirements shall, as a minimum, apply to the general purpose financial statements of the following types of entities:

- *for-profit private sector entities that do not have public accountability;*
- *not-for-profit private sector entities; and*
- *public sector entities, whether for-profit or not-for-profit, other than the Australian Government and State, Territory and Local Governments.*

There is not enough information provided in the question about Apple Isle Transport Pty Ltd to decide whether it needs to apply Tier 1 or Tier 2 requirements. However, most probably Apple Isle Transport Pty Ltd does not have public accountability as it is highly unlikely that it will have debt or equity instruments traded in a public market. Therefore, it will probably need to comply only with Tier 2 reporting requirements.

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Exercise 1.2

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.

Required

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. You would probably like to know:
   - Fair values of the securities that the investment company holds and how those fair values changed during the year. It would not matter much to you 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 you 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.
   - 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 it provides users of financial statements with useful information that is: (a) relevant; and (b) faithfully represented.

With respect to income, the *Conceptual Framework* states that income is recognised in the income statement when there are increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims. 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 hence it provides relevant information to users. The fair value can be measured with reliability shows faithful representation of the information. 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.

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Exercise 1.3

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 from the sale of goods is recognised only when the inventories are sold to outside customers. What concepts in the *Conceptual Framework* are reflected in accounting for gold and silver production? (LO8)

Under the *Conceptual Framework*, an item that meets the definition of an asset, liability, income, or expense should be recognised if it is:

(a) relevant; and
(b) faithfully represented.

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. Unlike with other ordinary goods, for gold and silver there is a liquid market with quoted prices, minimal transaction costs, minimal selling effort, minimal after-costs, and immediate cash settlement. That means that the information available at the time of production about the gold and silver produced is relevant and faithfully represents the income to be generated.

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Exercise 1.4

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 $30 000 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 to transfer an economic resource as a result of past event. 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 $30 000 loss is probable. As this amount is expected to provide relevant and faithful representation of the liability and of any resulting expenses information to users of financial statements, appropriate accounting involves recognising a liability for the probable payment. An expense would also be recognised.

Expenses are decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims. 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 1.5

Financial statements

An entity purchases a rental property for $5 000 000 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 $7 500 000 plus or minus 15%. Depreciating the building over 40 years would reduce the carrying amount to $4 875 000.

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 $7 500 000? Or at $4 875 000? Or at some other amount?**

(LO5 and LO9)

1. With regards to relevance, the following aspects need to be taken into consideration:

• 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.

With regards to faithful representation, the following aspects need to be taken into consideration:

• 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.

In our case, the following points should be discussed:
• 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,

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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. However, the qualitative characteristics do provide some guidance, particularly the characteristics of relevance and faithful representation. As such, the amount that the building should be measured at should be the amount that is relevant and faithfully represents the value of the building.

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Exercise 1.6

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? (LO3, LO4, LO8 and LO9)

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 1.7

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 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 1.8

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.

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Exercise 1.9

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 1.10

Assessing probabilities in accounting recognition

The *Conceptual Framework* defines an asset as a present economic resource controlled by the entity as a result of past events. At the same time the *Conceptual Framework* establishes that an asset is to be recognised only if it provides information to the users of the financial statements that is relevant and has faithful representation. Discuss the recognition criteria of 'relevance' and 'faithful representation' and provide examples, if any, when an asset may not be recognised in the financial statements. (LO7 and LO8)

With regards to relevance, the following aspects need to be taken into consideration:

• 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.

With regards to faithful representation, the following aspects need to be taken into consideration:

• 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.

An example of assets that may not be recognised in the financial statements are internally generated intangible assets.

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Exercise 1.11

Definition of elements

Explain how Beachside 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. **Beachside 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. **Beachside Ltd receives 5 000 shares in Monty Ltd, trading at $6 each, as a gift from a grateful client.**
4. **The panoramic view of the coast from Beachside Ltd's café windows, which you are convinced attracts customers to the café.**
5. **The court has ordered Beachside 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 paragraph 4.3 asset definition as it does not constitute a present economic resource controlled by the entity. Furthermore, it does constitute a right that has the potential to produce economic benefits (paragraph 4.4).
   - 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 paragraph 4.27 liability definition: (1) present obligation — legal obligation via the guarantor contract; (2) transfer an economic resource — payment of the guarantee; (3) past event — signing the guarantor contract.
   - Fails probability recognition criterion, as it is not likely that Beachside Ltd will be required to pay on the guarantee. No liability can be recognised as it will not result in relevant and faithful represented information. However, note disclosure of the guarantee may be warranted.

   (ii) Employee likely to default on his loan.
   - Again, meets the liability definition as per (i) above.
   - Meets both recognition criteria — relevant and can be faithfully represented. Hence, a liability should be recognised.
   - Also meets the expense definition and recognition criteria. Definition: (1) an increase in a liability — Beachside 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 Beachside Ltd now owes the amount of the employee's loan. The bank can advise exactly how much the employee owes and so it can be reliably measured.

3. Receipt of 5 000 shares in Monty Ltd, trading at $6 each, as a gift from a grateful client.
   - The receipt of the shares meets the asset definition: (1) present economic resource (via future sales or dividend stream); (2) controlled by Beachside Ltd

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(only Beachside Ltd can benefit from either selling them or receiving dividends); (3) past event (their receipt).
- They also meet the asset recognition criteria: relevant and faithfully represented (via sale or dividend stream, trading at $6 each).
- The shares also meet the income definition and recognition criteria. Definition: (1) increase in assets — Beachside 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 assets has arisen, as Beachside Ltd now owns the shares (asset). The shares' value is known and so can be faithfully represented.

4. Café's panoramic view.
   - The view fails the definition as the entity does not control the economic resources that are expected to produce economic benefits — 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) legal obligation; (2) obligation to transfer economic resources — future payment for repair of damage (3) past event — order has been made;
   - 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.
   - However, if you know a minimum amount that Beachside 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 Beachside Ltd has been ordered by the court) that Beachside 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 Simpkins 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) Simpkins Ltd has been sued for negligence — likely it will lose the case.
(b) Simpkins Ltd has been sued for negligence — likely it will win the case.
3. Obsolete machinery now retired from use.
4. Simpkins Ltd receives a donation of $5 000.
(LO7 and LO8)

1. Photographs of the company's founders, which are of great sentimental value.

- The asset definition criteria are not met, as the photographs do not represent future economic benefits (paragraph 4.5). Future economic benefits constitute the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to an entity.
- Recognition criteria are thus irrelevant, as there is no asset to recognise.

2(a) Simpkins Ltd has been sued for negligence — likely it will lose the case. Assume that the amount Simpkins Ltd has to pay is at least $20 000.

- The liability definition (paragraph 4.27) is met as all 3 characteristics are present.
  - Past event: The act of negligence or the act of being sued.
  - An obligation: paragraph 4.29 states that an obligation is a duty or responsibility to act or perform in a certain way and there is no practical ability to avoid the obligation. The key question here is whether there is an obligation. The obligation is a present obligation that exists as a result of a past event i.e. the lawsuit (arising from being sued) gives rise to a present obligation because Simpkins Ltd may have to transfer an economic resource that it would not otherwise have had to transfer.
  - Transfer an economic resource: If a present obligation is accepted as existing, its settlement will involve the outflow of economic benefits, namely cash.
- The liability recognition criteria (paragraph 5.7) are met, as it is relevant (cash will be paid), and the amount can be faithfully represented.
- Therefore, at this stage a liability must be recognised. If the damages firm up to another amount as the case progresses, the amount must be adjusted.
- The expense definition (paragraph 4.69) is met as all 3 characteristics are present.
  - Decrease in economic benefits during the period: The loss represents a decrease in economic benefits and Simpkins Ltd was sued during the period.
  - In the form of a liability increase: See above liability discussion — Simpkins Ltd now owes at least $20 000.
  - Results in a decrease in equity: If liabilities increase and assets remain unchanged, equity decreases.
- The expense recognition criteria (paragraph 5.7) are met. It is relevant, as Simpkins Ltd now owes $20 000 minimum, and the amount ($20 000 minimum) can be faithfully represented.
- Therefore, at this stage an expense of $20 000 must also be recognised. If the damages

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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.

2(b) Simpkins Ltd has been sued for negligence — likely it will win the case.
- The liability definition (paragraph 4.27) is met as all 3 characteristics are present. See discussion in (b)(i) above.
- However, the liability probability recognition criterion (paragraph 5.12) is failed, as it is not probable that an outflow of economic benefits will result from settling the liability. As Simpkins 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 machinery now retired from use.
- The asset definition is failed as the plant no longer represents future economic resources (paragraph 4.3).
- The machinery must now be written off from the accounts.
- Recognition criteria are thus irrelevant, as there is no asset to recognise.

4. Donation of $5 000 received.
- The asset definition (paragraph 4.5) is met as all 3 characteristics are present.
  - Past event: The receipt of the donation.
  - Present economic resource: The donation represents an inflow of $5 000 cash into Simpkins Ltd.
  - Controlled by the entity: Simpkins Ltd will benefit from this $5 000 cash inflow and can deny or regulate the access of others to this cash inflow.
- The asset recognition criteria (paragraph 5.7) 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 ($5 000) can be faithfully represented as it is known.
- Therefore, an asset of $5 000 must be recognised.
- The income definition (paragraph 4.68) is met as all characteristics are present.
  - Increase in assets during the period: The inflow of $5 000 cash represents an increase in economic benefits, and Simpkins Ltd received and cleared the donation during this period.
  - Results in an increase in equity: If assets increase and liabilities remain unchanged, equity increases.
- The income recognition criteria are met, as the increase in economic resources is relevant (as Simpkins Ltd now has additional cash), and the amount ($5 000) is known.
- Therefore, income of $5 000 must also be recognised.
- Note that in this case the recognition of an asset has resulted in the simultaneous recognition of income.

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Exercise 1.13

Definition and recognition criteria

Gunnedah Accounting Services has just invoiced one of its clients $4 800 for accounting services provided to the client. Explain how Gunnedah 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 present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits.

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

- Rights: The issuing of the invoice or the provision of the services for which the invoice was issued.
- Potential to produce 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

Under the *Conceptual Framework* an asset must be recognised when it is relevant and faithfully represented.

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 ($4 800) can be reliably measured as it is known.

Therefore, an asset (receivable) of $4 800 must be recognised.

The *Conceptual Framework* defines income as increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.

Invoicing gives rise to income as all characteristics are present:

- Increase in assets (economic resources) during the period: The right to a future cash inflow arose during the period resulting in 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 economic resources, related to an asset increase or liability decrease, has arisen that can be faithfully represented (measured reliably).

These recognition criteria are met as:

- The asset increase has arisen (on issue of the invoice); and
- The increase ($4 800) can be reliably measured as it is known.

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Therefore, income (fee revenue) of $4 800 must be recognised.

However, if the services had not yet been provided it is not probable that there is an increase of economic resources (the firm will only entitle to the payment once the service is provided). Hence, an asset (receivable) of $4 800 cannot be recognised.

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Exercise 1.14

Recognition and derecognition

The following events occurred in relation to assets and liabilities recognised by Watson Ltd.

(a) Watson Ltd settled (paid) an account payable.
(b) Watson Ltd sold an item of inventory to a customer.
(c) Watson Ltd had been using the fair value measurement base for its plant but estimates of fair value have become unreliable due to changes in market conditions.
(d) A debtor, Holmes Pty Ltd, is facing financial difficulties and has advised that it might be unable to pay the amount owing to Watson Ltd.

Required
For each event, state whether it would be likely to result in derecognition of an asset or liability in accordance with the *Conceptual Framework*. Give reasons for your answer. (LO8)

An entity must remove all or part of a recognised asset or liability from an entity's statement of financial position when the item no longer meets the definition of an asset or a liability. For an asset, derecognition normally occurs when the entity loses control of all or part of the recognised asset or the potential benefits are fully used or expire. For a liability, derecognition normally occurs when the entity no longer has a present obligation for all or part of the recognised liability.

Paragraphs 5.27 and 5.28 of the Conceptual Framework stipulate that derecognition aims to faithfully represent both:

- any assets and liabilities retained after the transaction or other event that led to the derecognition (the control approach)
- the change in the entity's assets and liabilities as a result of that transaction or other event (the risks-and-rewards approach).

This aim can be achieved by:

- derecognising any assets or liabilities that have expired or have been consumed, collected, fulfilled or transferred, and recognising any resulting income and expenses (referred to as the transferred component)
- continuing to recognise the assets or liabilities retained (referred to as the retained component), if any
- including in the financial statement:
    - presentation of any retained component separately in the statement of financial position
    - presentation separately in the statement of financial performance any income and expenses recognised as a result of the derecognition of the transferred component
    - explanatory information.

The event described under (a) is likely to result in derecognition of the asset (cash) and the liability (accounts payable) for the amount paid.

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The event described under (b) is likely to result in derecognition of the asset inventory for the inventory sold.

The event described under (c) is likely to result in a change in measurement base for the plant and not in derecognition of the asset plant unless the new value attached to the plant is $0.

The event described under (d) is likely to result in a recognition of an allowance for doubtful debts for the amount owed by Holmes Pty Ltd and not in derecognition of the asset (accounts receivable) unless Watson Ltd does not expect to be able to collect the amount owed.

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Exercise 1.15

Asset definition and recognition

Recently, $16 000 cash was stolen from Fisher Ltd's night safe. Explain how Fisher 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 assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims. The theft of the $16 000 cash satisfies the expense definition as:

- it is a decrease in assets during the period, as cash (economic benefits) 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 resources related to an asset decrease or a liability increase is relevant (has arisen); and
- the decrease can be faithfully represented (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 faithfully represented, as the amount of cash lost is known (i.e. $16 000).

Accordingly, an expense (Dr) and asset decrease (Cr) of $16 000 must be recognised.

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