Modern Advanced Accounting In Canada (Canadian) 10th edition Herauf Solutions Manual

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Chapter 1

Conceptual & Case Analysis Frameworks for Financial Reporting

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A brief description of the major points covered in each case and problem.

CASES

Case 1-1

Students are asked to determine the impact of adopting the future tax method on key ratios and to provide supporting arguments for the two different methods of accounting for income taxes.

Case 1-2 (adapted from a case prepared by Peter Secord, Saint Mary's University)

In this real-life case, students are asked to discuss the merits of historical costs vs. replacement costs. Actual note disclosure from a company's financial statements is provided as background material.

Case 1-3 (adapted from a case prepared by Peter Secord, Saint Mary's University)

A Canadian company has just acquired a noncontrolling interest in a U.S. public company. It must decide whether to use IFRS or U.S. GAAP for the U.S. subsidiary. Financial statement information is provided under IFRS and U.S. GAAP. The reasons for some of the differences in numbers must be explained and an opinion provided as to which method best reflects economic reality.

Case 1-4

This case is adapted from a CPA Canada case. A private company is planning to go public. Analysis and recommendations are required for accounting issues related to purchase and installation of new information system, revenue recognition, convertible debentures, and doubtful accounts receivable.

Case 1-5

This case is adapted from a CPA Canada case. A private company is planning to transition from ASPE to IFRS. Analysis and recommendations are required for accounting issues related to convertible debentures, unusual item, revenue recognition, contingency and impairment.

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PROBLEMS

Problem 1-1 **(**15 min.)

A short problem to calculate and interpret three key ratios for two years.

Problem 1-2 **(**20 min.)

A short problem to use horizontal and vertical analysis to identify unusual trends in financial performance over two years.

Problem 1-3 **(**30 min.)

A single asset is acquired. Students are asked to prepare and compare financial statement numbers during the life of the asset using both a historical cost and a current value model.

Problem 1-4 **(**40 min.)

Details of a European company that reports using IFRS are given along with specific details relating to certain account balances. Students are asked to show how these balances should be reported under 1) ASPE and 2) IFRS using the facts provided. Students are also asked to reconcile Net Income and Shareholders` Equity from IFRS to ASPE.

Problem 1-5 (30 min.)

This problem involves horizontal, vertical and ratio analysis to assess performance of an actual public company.

Problem 1-6 (40 min.)

A private company plans to convert from IFRS to ASPE and wants to know the impact on three key ratios if it converts from IFRS to ASPE for impairment losses, convertible bonds, and income taxes.

Problem 1-7 (40 min.)

A private company plans to convert to IFRS. It wants to know the impact on three key ratios if it converts from ASPE to IFRS for impaired loans, capitalization of interest and actuarial gains/losses.

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Problem 1-8 (50 min.)

A private company plans to convert to IFRS and go public within 5 years. It wants to know the impact on net income and shareholders' equity if it converts from ASPE to IFRS for impaired loans, interest costs, actuarial gains, compound financial instrument and income taxes.

Problem 1-9 (50 min.)

While taking the role of a financial analyst, the student uses vertical and horizontal analysis and ratios to analyse and interpret the profitability, solvency, and liquidity of a private company.

SOLUTIONS TO REVIEW QUESTIONS

1. There are times when external users may want financial reports that do not follow GAAP. For example, users may need financial statements using non-GAAP accounting policies required for legislative or regulatory purposes, or for contract compliance. A prospective lender may want to receive a balance sheet with assets reported at fair value rather than historical cost. Accountants have the skills and abilities to provide financial information in a variety of formats or using a variety of accounting policies. When the financial statements use non-GAAP accounting policies, the accounting policies must be disclosed in the notes to the financial statements. The accountant's report would refer to these accounting policies.

2. The three main areas where judgment needs to be applied are as follows:
- Choosing accounting policies that are appropriate for the company's situation
- Making estimates to accurately reflect the company's financial position and results of operations
- Deciding what to disclose and how to disclose it in the notes to the financial statements.

3. The GAAP-based financial statements are prepared primarily for the benefit of external users. The financial statements provide a summary of the financial position and results of operations for the company. Management has access to the detailed information available within the company. Therefore, the formal financial statements should give priority to the needs of the external users.

4. The main reason the Accounting Standards Board decided to create a separate section of the CPA Canada Handbook for private enterprises was to address the cost/benefit discrepancy with respect to smaller private companies' ability to comply with GAAP. GAAP has become increasingly complex and for smaller private enterprises this often means that the cost of

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complying with such requirements outweighs the benefit received from compliance. In 2002, the AcSB adopted differential reporting, which allowed private enterprises choices with the respect to certain complex accounting standards (e.g. the option to use the cost method for investments that would otherwise require the equity method). In 2009, the AcSB decided to create a self-contained set of standards for private enterprises. These standards were effective for fiscal periods beginning on or after January 1, 2011.

5. There are a few reasons why a private company would want to comply with IFRS even though it is not required to do so. It may have plans to become publicly listed at some point in the future and will then be required to comply with IFRS. In this case it would make sense to prepare IFRS compliant statements in anticipation of the public transaction since the company would have to provide multiple years of comparative financial statements that comply with IFRS. A private company may have users of their financial statements that find IFRS statements more useful for their purposes (e.g. creditors, customers, partners, and other stakeholders that may receive the company's financial statements). Given the global economy and the increased number of countries that have converted to IFRS, this is more likely than it once might have been.

6. The following financial statement items could have different account balances under ASPE as compared to IFRS: impaired loans, property, plant, & equipment, development costs, post-employment benefits, income taxes, compound financial instruments, preferred shares, and convertible bonds

7. For the item listed in Exhibit 1.1, all items except for disclosure would likely change when a company switched from ASPE to IFRS.

8. The return on assets or return on equity is typically used to assess profitability. The current ratio is typically used to assess liquidity. The debt-to-equity ratio is typically used to assess solvency.

9. If XZY Co. had capitalized rather than expenses the development costs in Year 1, the company's key ratios would change as follows:

- the current ratio would increase if the development costs were classified as a current asset because current assets would increase, and current liabilities would remain the same; the current ratio would not change if the development costs were classified as a noncurrent asset because both current assets and current liabilities would remain the same;
- the debt-to-equity ratio would decrease because debt would remain the same and equity would increase;

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- the return on equity would increase because net income and equity would increase by the same dollar amount, but net income would be a higher percentage of equity after the change.

10. The six steps of the case framework are as follows:

- Determine Your Role and Requirements
- Identify Users & Their Needs
- Identify & Rank Issues
- Identify Viable Alternatives for Each Major Issue
- Analyze Alternatives Using Criteria for Resolving
- Communicate Practical Recommendations/Conclusions

11. The report recipient is the direct recipient of your report or memo e.g. the partner who asked you to prepare the memo. The primary users are the users who will be affected by the actions taken as a result of your recommendations e.g. bankers and shareholders who will receive the financial statements. The primary users should be given priority in financial reporting because they are primary recipients of the financial statements; they are directly affected by the financial statements. If they did not want to receive the financial statements, we would not be preparing them and would not have to write a memo to the partner with respect to the financial statements.

12. The biggest factor to be used when ranking the importance of issues to be resolved is the materiality of the item. If one problem involves a $10,000 item and another problem involves a $10 million item, then the $10 million item likely is the most important item. After that, issues are typically ranked in the following order of priority:

- controversial or highly contentious items
- items with errors
- complex items

13. The final case report should contain your recommendations along with the analysis and arguments supporting your recommendations. It does not need to discuss the alternatives for each issue unless the issue was very contentious. If in the analysis stage, you determined that there was clearly a right answer for a problem, then your report would provide only the recommendation with the supporting arguments. If two or more alternatives were nearly equal in benefits, then your final report could present the arguments for both alternatives along with your recommendation as to the best option in this contentious situation.

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SOLUTIONS TO CASES

Case 1-1 [IFRS: The conceptual framework for financial reporting: chapter 3]

To: CEO
From: CPA
Re: New Accounting Policy for Income Taxes

As requested, I have analyzed the impact of adopting the future income tax method on the key ratios and used basic principles to provide arguments for each of the two methods of accounting for income taxes.

Exhibit I shows the calculation of the three key ratios for Year 10 under the two methods of accounting for income taxes. The current ratio does not change since the future taxes are all presented as noncurrent items. Although the liquidity position remains unchanged, the ratio of 1.6 is not very strong to begin with. Many investors would like to see a current ratio around 2. The debt-to-equity ratio increases from 2.78 to 3.14. This indicates that the ability of the company to pay its obligations has worsened and is getting to be quite substantial. This will be viewed negatively by potential investors and creditors. The return on shareholders' equity has increased from 16.67 to 17.27 percent when the tax paid to CRA was removed from tax expense because it did not match to the income earned during the year. The higher return is a better reflection of the performance of the entity. This will be viewed positively by potential investors and creditors.

The decision on whether to adopt the future income tax method should be made based on a cost-benefit assessment. The future tax method may better reflect the financial position of the company because it includes taxes that will eventually have to be paid. However, there are many judgements involved with these calculations and the values may not be reliable enough to convince users to take them seriously. The calculations are complex and are not fully understood by preparers and users. Furthermore, the future taxes are not discounted and therefore overstate the true cost of these liabilities in today's dollars. As such, many users do not include these future taxes as part of their assessment of the obligations of the entity. Since private entities do not have to use the future tax method, I recommend that we continue with the taxes payable method until we have decided to go public and would then be required to use the future income tax method.

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Exhibit I

			Current Taxes Method		Future Taxes Method
Current ratio	Current assets	400	1.60	400	1.60
	Current liabilities	250		250	
Debt-to-equity	Debt	250 + 2,250	2.78	250 + 2,250 + 90 - 12	3.14
	Equity	100 + 800		100 + 800 -90 + 12	
Return on equity	Net income	150	16.67%	150 – 20 + 12	17.27%
	Shareholders' equity	100 + 800		100 + 800 – 90 + 12	

Case 1-2 [IFRS: The conceptual framework for financial reporting: chapter 3]

(a) Can any alternative to historical cost provide for fair presentation in financial reports or are the risks too great? Discuss.

When we refer to "present fairly" in the preparation of financial statements, we generally qualify the statement (as the auditors here have): "in accordance with generally accepted accounting principles." That is, fair presentation has a contextual, rather than an absolute, meaning. For any presentation to be fair to the user, the basis of presentation must be known and understood, but does not necessarily have to follow any one particular model.

Financial statements may be considered to "present fairly" whether prepared in accordance with the historical cost convention, replacement cost, general price level adjusted model, or net realized value. The important issue is that the model employed is known, understood, and consistently followed.

Arguably, fair value accounting is the model most likely to provide fair presentation, especially where asset values are volatile, as historical costs become rapidly out of date. For many long-established companies, historical costs for some assets are significantly out of date and of no value in support of managerial decisions. In managerial accounting, we have long recognized that the relevant costs are the current costs. In some European countries, an approach to financial reporting has developed that adopts more of a managerial approach and seeks to

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provide the most relevant information for decision-making. As a result, many companies follow alternatives to historical cost, generally fair values, in the financial statements.

There are risks, however, that arise from the adoption of alternatives to historical cost. Some of these are the same risks that arise from the historical cost model in that the recorded amount may soon be out of date. Prices may go up or down, and even "fair values" of prior periods may display no relationship to fair values at the present date. Cost is always cost in a particular context and a cost determined for a particular context or decision may not be valid for a different context or decision and the user should be aware of this.

The question of objective determination also arises. The reported values in fair value-based financial statements are not directly supportable by arms' length transactions. This introduces the risk of an important (and potentially deliberate) misstatement. This is the principal risk arising from fair value accounting. It leads many countries to have highly detailed rules for the preparation, audit, and publication of financial statement asset values under fair values.

(b) *Discuss the relative merits of historical cost accounting and fair value accounting. Consider the question of the achievement of a balance between relevance and reliability when trying to "present fairly*" the financial position of the reporting entity.

Students will provide a wide range of responses to this question; at this stage (unless they have been provided with supplementary material or have background from other courses) responses will just scratch the surface. The following note may be helpful:

Historical cost accounting has the advantage that it is verifiable, and therefore tends to be more reliable and freer from bias than fair value accounting. Historical cost amounts are based on objective information and are more likely to have the "paper trail" of an actual transaction that provides support. Historical costs, however, are sunk costs and have limited value in support of decisions. They are particularly deficient if a long time has passed since the transaction occurred, or if there have been significant technical developments. These are serious difficulties which the accounting profession has tried to address through a variety of different mechanisms, but no other method has become universally acceptable as an answer to the problem and so historical cost accounting persists, largely because of inertia, and because no better model has emerged.

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Fair value accounting has the advantage of enhanced relevance because the values included have been determined at the current time, rather than at some uncertain past date. These amounts may therefore be better for investment decisions than historical costs. However, fair values may be potentially deficient in that they might not be objectively determined and lack reliability. At the worst, they could contain bias to support a particular management policy or decision. In other cases, they could be guesses or otherwise based on invalid information. Also, the use of fair value in financial statements in no manner makes the financial statements more "accurate," although (if the amounts are carefully and objectively determined) there may be advantages in the fairness of presentation and therefore the relevance of financial statement amounts.

With respect to income measurement, in a period of inflation, historical cost accounting will result in an overstatement of income. Income is overstated, as a portion of the reported profits must be reinvested in the business to maintain the productive capacity and not all profits are available for distribution. If all profits are distributed, the business will not have the capacity to replace the items that have been consumed in the process of earning income. Fair value accounting will alleviate this problem by charging to expense the fair value of all items consumed. With fair value charged to expense, the income remaining is a true income, potentially available for distribution without impairment of the productive capacity of the enterprise.

A further important point is that both the preparer and the user of financial statements should understand the basis of preparation of the statements, and the strengths and weaknesses of the approach employed.

(c) *Financial statements are now beyond the comprehension of the average person. Many of the accounting terms and methods of accounting used are simply too complex to understand just from reading the financial statements. Additional explanations should be provided with, or in, the financial statements, to help investors understand the financial statements. Briefly discuss.*

It is true that financial statements are complicated by accounting methods, such as the method of accounting for deferred income taxes, foreign currency translation, and so on. However, some of these complexities cannot be avoided. The business environment and business transactions are themselves more complex. Since the financial statements try to reflect these

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business events, it is inevitable that the financial statements will be more complex. Thus, it is not accounting methods per se that make financial statements difficult to understand.

Financial statements are not directed at the average person, so they cannot be criticized on the grounds that they are beyond the comprehension of the "average person". Instead, they are intended for users with a reasonable understanding of financial statements. The question then becomes should additional explanations be provided for users who have a reasonable understanding of the financial statements? The answer depends on what type of information the "explanations" will contain.

Additional explanations might be of three types:

- They could provide more detail on information that is already contained in financial statements. For example, certain dollar amounts reported in the financial statements might be broken down into more detail, or the significance of certain amounts might be discussed;
- They could make information that is currently in the financial statements easier to understand by explaining technical accounting terms and concepts used in the statements; or
- They could provide entirely new information not included in financial statements that might help users better understand the significance of the information that appears in the financial statements.

In all three cases, the information provided might concern the future or the past. It is important to note that for publicly accountable enterprises, there is already a considerable amount of supplemental information provided in a company's MD&A. This document provides supplementary discussion of financial results and in many cases explanations of accounting treatments used in a company's financial statements for the period. Further, it is important to note that at some point additional information may "overload" the user. Too much information may achieve the undesired result of making financial statements more difficult to understand. This must be taken into account when considering supplemental information and explanations.

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CASE 1-3

Case Note

Ajax Communications presents the classic case of the conflict among the accounting standards that are in force in different jurisdictions. Each set of requirements can be seen to be correct, although dramatically different amounts may be presented on a variety of dimensions. Certainly, the standard-setters (and, generally, the accounting practitioners) of each jurisdiction believe that the requirements in place locally are the best requirements available, in that they present results that are consistent with the prevailing views on a fair presentation of both financial performance and financial position. Although the conceptual frameworks are very similar under IFRS and U.S. GAAP, the actual requirements in place are quite different in some areas, and there is no guidance in choosing the right set of accounting standards to base decisions upon. Harmonization efforts are ongoing to resolve these differences, yet regardless of the changes in accounting standards, there will remain differences in interpretation of the requirements and differences in the practices that are in place.

Responses to specific questions:

(a) As John McCurdy, outline the initial approach that you will take to determine the reasons for the difference in the numbers.

Items throughout the income statement differ between the two sets of financial statements, as do all the aspects of the balance sheet presented. Although it is not unusual to have some differences between U.S. GAAP and IFRS, the magnitude of the differences would not usually be of the size in the Waqaas case. As a start, McCurdy may be able to determine where some of the difference arises by examining the summary of significant accounting policies included with the financial statements. This source will not identify all the accounting policies in place. More detailed knowledge of the accounting policies in place could come from the specific notes to the financial statements. In addition, he should search for publications or web sites that discuss differences in accounting policies among countries. A website provided by Deloitte (www.iasplus.com) could also provide useful information.

(b) *List some of the obvious items that need resolution and indicate some of the possible causes of the discrepancies.*

- Why are operating income and net income higher under IFRS for the same period?

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- What is the nature of the accounting policy differences that have led to such dramatic differences in asset valuation between the two sets of financial statements? (Two possible reasons: (1) consolidation of some investments under IFRS that would not be consolidated in the U.S. financial statements; this might explain the differences in the investments account, and arises because there are different requirements for the determination of when an investment is classified as a subsidiary and consolidated; and (2) the use of LIFO in the U.S. and FIFO under IFRS might produce different results if there have been major changes in inventory costs during the year.)
- Given the higher asset values under IFRS, the company may be using the revaluation option under IFRS.
- What items, if any, have been deferred and are being amortized under IFRS that are directly expensed in the U.S. statements? (R&D comes to mind) Does this account for the difference in intangibles?
- A variety of other specific points could be raised, including, for example, policies associated with tax allocation.

(c) *In your opinion, which GAAP best reflects economic reality? Briefly explain.*
Without knowing what has caused the difference, it is hard to determine which GAAP best reflects economic reality. Although the differences represent a dilemma to the Board of Directors in this case, neither set of financial statements may be said to be unequivocally superior to the other for the purpose of making investment decisions. This is the general dilemma of international comparisons, and a principal reason why accounting harmonization is so important. [IFRS: The conceptual framework for financial reporting: chapter 3]

CASE 1-4

Memorandum

To: Partner
From: CPA
Re: Roman Systems Inc. Financial Reporting Issues

Roman Systems Inc. (RSI) has been using IFRS over the past few years presumably because it plans to go public within the next year. RSI's bias is to maximize revenue, net income and shareholder's equity to attract potential investors.

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The major financial reporting issues arising from our interim work are:

I. Accounting for the costs of the new accounting system
II. Revenue recognition
    a. Maintenance and contract revenue
    b. Product revenue
    c. ABM revenue
III. Convertible debentures
IV. Receivable from Mountain Bank

Accounting for new accounting system costs [IAS 38]

During fiscal Year 12, RSI implemented a new general ledger package. The new package has been functioning in parallel with the old system since April 1, Year 12, and will no longer be used in parallel effective July 1, Year 12. The new package has been used to generate RSI's financial results since April.

RSI has incurred $720,000 in third-party costs associated with the new general ledger package, together with $70,000 of internal salary costs. These costs have all been capitalized in Year 12.

IAS 38 offers guidance as to the costs that may be capitalized when internally developing intangible assets. In particular:

The cost of an internally generated intangible asset comprises all directly attributable costs necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by management. Examples of directly attributable costs are:

(a) costs of materials and services used or consumed in generating the intangible asset; and
(b) costs of employee benefits arising from the generation of the intangible asset;

The following are not components of the cost of an internally generated intangible asset:

(a) selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to preparing the asset for use;

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(b) identified inefficiencies and initial operating losses incurred before the asset achieves planned performance; and
(c) expenditures on training staff to operate the asset.

Based on the above:

- Costs of $110,000 related to initial review and recommendations would be considered business process re-engineering activities and not directly related to the creation of the new system. These costs should be expensed.
- Costs of $270,000 for new software and implementation costs represent a betterment, as they extend the life of the accounting system and enhance the service capacity. They should be capitalized.
- Training costs of $275,000 should be expensed, as the costs are not directly attributable to the development, betterment, or acquisition of the software.
- The monthly support fee of $25,000 (and all future monthly fees) is an operational cost of the system and should be expensed.
- The other consulting fees of $40,000 should be reviewed in more detail, but they appear to be part of the ongoing costs of the new system with no specific value added and should likely be expensed.
- The salaries of $70,000 could be capitalized if they are directly attributable to the implementation of the new software package. Since only two additional individuals were hired to handle the work previously done by the four employees, it is questionable whether the four employees were 100% dedicated to the task of implementing the new software. Only the costs related to the implementation should be capitalized.

Effective April 1, RSI should start amortizing the new system and effective June 30, Year 12, it should write off the remaining carrying amount of the old system.

Revenue Recognition [IFRS 15]

Product Revenue

Product revenue is recognized at the time of delivery and installation. Customer acceptance is evidenced by customer sign-off once installation is complete. It is RSI's standard practice to

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obtain such evidence of acceptance. It would therefore be inappropriate to recognize revenue without such evidence of customer acceptance.

In performing the interim work, we determined that revenue of $640,000 was recorded prior to obtaining customer sign-off. This has not been an issue in the past and may be an isolated case related to new employees who may be unfamiliar with RSI's standard procedures. We need to ensure that Marge communicated the policy to all staff members and ensure that customer sign-off is obtained for all installations prior to year-end. Since it is early June, Marge would have a month to ensure that there are no issues at year-end.

Maintenance contracts

During the year, the company changed its revenue recognition policy on maintenance contracts. If the company previously recognized maintenance revenue on a straight-line basis over the course of the contract, the new method will recognize a greater proportion of the revenue earlier in the contract life. This new method recognizes 25% of the revenue in each of the first two months and may not be appropriate. Maintenance services must be provided over the full life of the contract. The preventive maintenance is entirely at the discretion of the company. It may not be continued in the future and may not consistently reduce future service calls. As well, the study serving as a basis for the policy is two years old and may no longer be an accurate reflection of the pattern of maintenance calls. Revenue recognition for service contracts should be based on the service obligation over the term of the contract.

ABM business

RSI began selling ABMs in fiscal Year 12. The machines are purchased from an electronic manufacturer and resold at margins of 5%. It is important to consider whether RSI is recording revenue on a gross or net basis.

Recognizing revenue on a gross basis is appropriate if RSI bears the risk of selling the product. Recognizing revenue on a net basis is more appropriate if RSI is simply fulfilling orders obtained by the manufacturer, for a fee. It is important to better understand the relationship between RSI, the manufacturer, and the end-party customer to recommend an appropriate revenue recognition policy.

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Transaction fee revenue

The company has begun a new line of business related to transaction fee revenue generated from the sale of ABM machines. A total of 3,230,000 ABM transactions were processed at a fee of $1.50 per transaction, for a total of $4,845,000. RSI's share of this fee is 40%. RSI is currently recording the transaction fee revenue on a gross basis, with an associated expense for the 60% attributable to other parties.

The following factors suggest that the ABM transaction fee revenue should be recorded on a net basis:

- RSI has no ownership of the ABM machines;
- RSI has no responsibility for stocking or emptying the machines;
- RSI has no responsibility for cash collection;
- RSI is being paid on a net basis;
- RSI does not have responsibility for maintenance of the ABMs, and
- RSI cannot set the transaction fee amount.

On this basis, it would be appropriate for the ABM transaction fee revenue to be recorded on a net basis i.e. record revenue of $1,938,000 (40% x $4,845,000) and no expenses. This will reduce revenue and expenses by $2,907,000 but will have no impact of net income or shareholders' equity.

Convertible debentures [IAS 32.28]

The debentures are currently classified as long-term debt. Since they are convertible into common shares, RSI should consider the reclassification of a portion of the debentures based on the fair value of the conversion feature. This reclassification will result in higher charges to the income statement through the addition of the debt discount. The reclassification is currently not required since RSI is not a public company. Marge Roman should be made aware that if RSI is going public, a detailed analysis should be done related to the split between debt and equity. The financial statements in an offering document would have to be modified to split the debenture between debt and equity. The debt is repayable on demand should RSI not go public by June 30, Year 13. The debt may therefore have to be reclassified as a short-term item in the current financial statements. While there are plans to go public and negotiations have begun (which supports a long-term classification), there is no document such as terms of agreement or

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a memorandum of understanding providing evidence that this will likely occur. Also, the ability to issue the IPO is beyond the strict control of the company. Reclassifying the debentures as short-term appears to be the more appropriate form of presentation.

Receivable from Mountain Bank [IFRS 15 and IFRS 9]

In reviewing the aged accounts received on April 30, Year 12 we determined that there was a balance of $835,000 from Mountain Bank, which was overdue by more than 120 days. On June 1, $450,000 was received from the customer and the balance remains outstanding. There are between five and ten sites where the Bank is not completely satisfied with the way the cameras were installed.

Two issues arise which must be analyzed in succession. First, is it appropriate to recognize revenue upon delivery, installation, and sign off by the customer? And second, if revenue recognition is appropriate, is collection of the remaining accounts receivable doubtful?

On the issue of revenue recognition, IFRS 15.31 says that revenue shall be recognized when (or as) the entity satisfied a performance obligation by transferring a promised good or service (i.e. an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.

In this case, the above conditions were met upon delivery and installation of the cameras. Revenue may be held back, however, to the extent that a customer acceptance term exists in the arrangement. Although no terms exist in the contract with Mountain that requires the client to come back and adjust the installation of the cameras, it could be argued that such a term exists implicitly since the client has been willing to do so and has accommodated the customer. The question then becomes whether this implicit acceptance is material such that it could be argued that the delivery criterion has not been met. In this case I believe the answer is no. The work required to complete the adjustments is minimal and within the control of RSI and has nothing to do with the quality of the product. On this basis, it appears that revenue recognition was appropriate.

IFRS 9. 5.5.15 states that an entity should measure the loss allowance at an amount equal to lifetime expected credit losses. In this case, there is evidence that the customer is willing to pay once the minor fixes are complete given the $450,000 payment that was made in June. It

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appears unlikely that the customer will not pay. We should examine Mountain's payment history a little closer to determine whether amounts were unpaid regarding prior work/product sold and whether any amounts were written off/forgiven. In the absence of either, it would appear supportable that the accounts receivable related to this sale are collectible and do not need to be written down/off.

Overall Impact

Based on the recommendations above, RSI's revenue, net income and shareholder's equity will decrease. RSI will not like these adjustments because they worsen the key financial metrics. The adjustments are appropriate as they better reflect the results of operations and financial position of RSI in accordance with GAAP.

CASE 1-5

Comments regarding July 1 to September 30, Year 9 (Q1) Financial Statements

On review of the draft first quarter interim financial statements, I have noted several items that require corrections because they are not currently compliant with ASPE, or that require further investigation before we decide whether they are compliant.

I have noted four issues that require corrections.

1. Long-Term Debt Arrangement

   During the first quarter, GPL entered a long-term debt arrangement of $1 million at a rate of 5% (compared to a market rate of 9%) for 10 years. In obtaining the debt, $70,000 in transaction costs were incurred. Currently, GPL has recorded a loan at the face amount and the issue costs have been capitalized under other assets on the balance sheet. However, there is a conversion option related to the debt. The principal of the debt can be converted, at the option of the lender, into 200,000 common shares of GPL at any time prior to maturity. The treatment of the long-term debt arrangement raises some accounting issues. First, the conversion option does not appear to have been considered in accounting for the transaction. Second, the treatment of the transaction costs is incorrect.

   a) Accounting for the conversion feature

   Section 3856 of Part II of the *CPA Canada Handbook* states the following:

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.20 states, "…, *the issuer of a financial instrument shall classify the instrument, or its component parts, as a liability or as equity in accordance with the substance of the contractual arrangement on initial recognition and the definitions of a financial liability and an equity instrument.*

.21 states, "*The issuer of a financial instrument that contains both a liability and an equity element, including warrants or options issued with and detachable from a financial liability, shall classify the instrument's component parts separately in accordance with paragraph 3856.20.*

It appears that GPL has an arrangement in which there is both a debt and an equity element to the transaction. Normally the debt would have to have been financed at a market rate of 9%. In this arrangement, the loan rate was reduced by 4% in return for issuing a conversion option to the debt holder. It appears that the lender has "paid" for the option of converting the debt principal repayments into shares of GPL in an amount equivalent to the extra 4% interest they could have collected on the debt had they charged the market rate.

Based on the above *Handbook* description, GPL needs to allocate a portion of the proceeds from the financing to the equity component. The easiest way to do so is to first determine the carrying amount of the financial liability by discounting the stream of future payments of interest and principal at the prevailing market rate for a similar liability that does not have an associated equity component; in other words, by using the 9% market rate. The carrying amount of the equity instrument, represented by the option to convert the instrument into common shares, is then determined by deducting the carrying amount of the financial liability from the amount of the compound instrument as a whole. This is also the method required by IAS 32. Under a second approach, the equity component could be measured as zero. If so, the entire proceeds of the issue would be allocated to the liability component.

Since the company plans to adopt IFRS in the future, it would be appropriate to report the value of the option as an equity component.

The subsequent measurement of the loan portion of the arrangement is determined by the classification of the financial instrument, which in this case is a financial liability. Financial liabilities are to be measured at fair value when they are classified as held for trading (or are certain types of derivatives). Other financial liabilities are subsequently measured at

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amortized cost. Since the loan in this case was made to complete future acquisitions, and it is not held for trading, it should be measured at amortized cost.

b) Transaction costs

According to Section 3856.07, *"When a … financial liability is issued or assumed in an arm's length transaction, an entity shall measure it at its fair value adjusted by financing fees and transaction costs that are directly attributable to its origination, acquisition, issuance or assumption.*

Currently GPL has set up a financial asset of $70,000 in other assets and is amortizing it using the effective interest method. Instead, GPL needs to include it in the amount determined for the debt, after allocating a pro-rated portion to the equity conversion feature. It would be treated like a discount on bonds payable. It would be amortized over the life of the debt and incorporated as a component of interest expense using either the effective interest method or straight-line method. Note that when we transition to IFRS, only the effective interest method is allowed for amortizing the transaction costs included in the debt amount.

2. Revenue Recognition

The quarterly highlights mention that title and risk of loss for the special shipment of balls transferred once they were shipped, and that GPL has invoiced the PAC committee for the full amount of this shipment. The committee does not have to pay for the balls until they are sold at the PAC in November, and they can return any unsold balls. But GPL is confident they will sell all the balls. The accounting for this transaction appears to be incorrect.

Although title and risk of loss transferred once the balls were shipped, the customer has a right of return until November, and only has to pay for the balls once they are sold in November. The question is whether we have earned the revenue and therefore whether we should have recorded the $900,000 in revenue in the first quarter.

The general revenue recognition criteria in Section 3400.05 are:

In a transaction involving the sale of goods, performance shall be regarded as having been achieved when the following conditions have been fulfilled:

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(a) *the seller of the goods has transferred to the buyer the significant risks and rewards of ownership, in that all significant acts have been completed and the seller retains no continuing managerial involvement in, or effective control of, the goods transferred to a degree usually associated with ownership; and*

(b) *reasonable assurance exists regarding the measurement of the consideration that will be derived from the sale of goods, and the extent to which goods may be returned.*

The transaction appears to meet the requirements of the first condition; however, the second condition may not have been met. Although we are "confident" that the balls will sell out, there is nothing to guarantee this. The number of balls sold is linked to the success of the tournament, and we have no information on sales at the PAC. In addition, because this was a special shipment for GPL, we likely have no prior history with this customer and event.

Furthermore, the fact that the customer does not have to pay until November and the fact that it can return any unsold balls raises the question as to whether all the risks and rewards have transferred. Section 3400.13 states that:
"Revenue from a transaction involving the sale of goods would be recognized when the seller has transferred to the buyer the significant risks and rewards of ownership of the goods sold. When the seller retains significant risks of ownership, it is normally inappropriate to recognize the transaction as a sale. Examples of a significant risk of ownership being retained by a seller are: when there is a liability for unsatisfactory performance not covered by normal warranty provisions; when the purchaser has the right to rescind the transaction; and when the goods are shipped on consignment."

It appears that the transaction is closer to a consignment arrangement than a normal sales transaction.

Based on the above, GPL should not have recorded the revenue in Q1. It should wait until the risks and rewards have transferred, in November, to record the revenue. GPL may wish to include this information as part of the Summary Highlights, but it would not have to be disclosed as part of the Q1 notes.

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3. Lawsuit Contingency

Minimum interim disclosures require that any changes from year-end regarding the existence, likelihood, or amounts of contingencies are to be disclosed. Section 3290 requires that a contingent loss be accrued when its occurrence is likely, and the loss can be reasonably estimated. If the occurrence is unknown or the estimate not determinable, the loss is only required to be disclosed.

The supplier that is suing us is claiming for damages as well as loss of revenue in the amount of approximately $800,000. Based on the documentation, GPL's legal counsel thinks the chance we will lose is just over 75%. If we lose, legal believes GPL will have to pay the full claim. Since we believe the court proceedings will be resolved by the end of the fiscal year, we have accrued $150,000 (25% of our probability estimate) so that $600,000 is accrued by year-end.

The outcome appears to be likely at this time, since "likely" is often interpreted as greater than 70% by the accounting profession. Because the occurrence is determinable, the entire potential legal claim should be accrued. Therefore, there is an error in the interim financial statement — the full estimate of $800,000 should be accrued, rather than $150,000 or the $600,000 GPL intended to have accrued by year-end. Expenses cannot be smoothed to build up the accrued year-end amount.

4. Unusual Item

Under both ASPE and IFRS, the loss due to fire is correctly shown as a separate line item on the income statement. Paragraph 87 of IAS 1 states: *"An entity shall not present any items of income or expense as extraordinary items, in the statement of comprehensive income or the separate income statement (if presented), or in the notes."* Instead, IFRS encourages companies to adjust the line items of the financial statements to provide readers with the information. IAS 1 Paragraph 85 states: *"An entity shall present additional line items, headings and subtotals in the statement of comprehensive income and the separate income statement (if presented), when such presentation is relevant to an understanding of the entity's financial performance."*

Paragraph 04(m) of Section 1520 *Income Statement* requires that revenue, expenses, gains or losses resulting from transactions or events that are not expected to occur frequently over several years, or do not typify normal business activities of the entity should be shown

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separately on the face of the income statement or disclosed in the notes to the financial statements.

5. Interim Financial Reporting Disclosures

Since there is no Handbook section for Interim Reporting under ASPE, there are no explicit requirements for note disclosure for the quarterly financial statements.

A comparison of ASPE and IFRS for any other GPL policies

Asset Impairment

Let me begin with a discussion of how our quarterly statement would be affected if we applied IAS 36 rather than Section 3063 on Impairment of long-lived assets, which currently applies to us. First, let me explain in very general terms what the requirements are under both sets of standards.

1. Under ASPE, we must test for impairment when there is an indication or "triggering event" that leads us to question the carrying amount of the asset. However, the requirement for when to test is more passive than under IFRS. Section 3063 first compares the carrying value to the recoverable amount, which is undiscounted future cash flows. If the carrying value exceeds the recoverable amount, an impairment loss is computed as the difference between the carrying amount and fair value, and there is no reversal of impairment losses.
2. IFRS requires impairment indicators to be assessed at each reporting date. IAS 36 computes impairment loss as the excess of carrying amount above the recoverable amount (higher of fair value less costs to sell and value in use), and the loss must be reversed if there has been a change in estimates used to determine the recoverable amount since the last impairment loss was recognized.

Essentially, Section 3063 differs from IAS 36 in that IAS 36:

- does not include a separate trigger for recognizing impairment losses based on an assessment of undiscounted cash flows;
- determines an impairment loss as the excess of the carrying amount of an asset or group of assets above the recoverable amount (the higher of fair value less costs to sell and value in use), rather than the difference between carrying amount and fair value; and
- requires the reversal of an impairment loss when there has been a change in estimates used to determine the recoverable amount.

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Since you think you have located the critical part needed to make the manufacturing equipment serviceable again, you might have an opportunity to reverse the impairment loss recorded at year-end (to the extent of the impairment amount less depreciation taken in the year).

Based on the differences between the two sets of standards, our first quarter statement would have required us to assess the recoverable amount associated with the piece of equipment (assuming that it is a cash-generating unit on its own — I won't go into detail on cash-generating units at this point), and to then reverse the impairment loss of $160,000 we recorded (or part of it) to better reflect the estimated value of the equipment. Under Handbook Section 3063, we are not allowed to write an asset up again once it has been written down.

Property, Plant and Equipment (PPE)

Another area in which there are differences between ASPE and IFRS is property, plant and equipment. Because GPL is a manufacturer and has significant value in capital assets, as shown on the balance sheet, this is an area that could have a large impact when the transition to IFRS occurs.

Under ASPE, an entity is required to carry PPE on a cost basis. Revaluation is prohibited under Section 3061. Under IAS 16, GPL could continue to carry PPE at cost, or it could choose to revalue capital assets and carry them at fair value (less depreciation). When revaluation is used, it must be applied to entire classes of assets and it needs to be reassessed regularly. There are also additional disclosure considerations under IFRS that are not required under ASPE, such as a reconciliation of the carrying amount of each class of property for the year; contractual commitments for the purchase of PPE; measurement basis; and restrictions on title to assets. A transition to IFRS (if the revaluation method were chosen) would result in additional work to determine the fair value with sufficient regularity to ensure the carrying amount does not differ materially from the fair value.

Under IFRS, amortization of PPE is calculated on the cost less residual value, over the useful life of the asset, including any idle period. Under ASPE, amortization is based on the greater of this amount or the asset cost less the salvage value, over the life of the asset. This could have an impact on the amortization recorded on the income statement. The capabilities of the capital asset software would have to be examined to determine whether it can handle the additional tracking of components and the related amortization.

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Earnings Per Share (EPS)

Under IFRS, basic and fully diluted EPS would need to be reported for the current period and comparative period. EPS information is not required to be disclosed under ASPE.

Changeover to IFRS

In your email to me, you said that you don't imagine the transition to IFRS will have much of an impact on GPL. Based on my assessment of the control work that is required and my belief that the transition to IFRS is a large project, I think you need to consider how GPL plans to manage the transition to IFRS.

The following discussion points further explain my reasoning.

I believe you have underestimated the impact of adopting IFRS. There are significant implications for the changeover from ASPE to IFRS. Your statement that it should not have a big impact on GPL because we already follow ASPE is not true. The changeover to IFRS involves more than just changes in accounting policies and the composition of the financial statements.

What you seem to have failed to consider is that the changeover to IFRS will affect more than GPL's accounting policies and the composition of financial statements. Converting to IFRS will not merely be a technical accounting exercise, but a widespread change that will affect many areas of the business. Any business function required to prepare financial information or affected by financial information will potentially need to change.

The conversion will likely affect other aspects of operations, such as

- income tax calculations (taxation);
- internal controls and processes (finance and other areas);
- information and data systems (IT);
- executive and employee compensation plans (human resources); and
- training and resource needs (all departments).

I mentioned that internal controls and processes may be affected by the change to IFRS. Changes to, and re-documentation of, internal controls may need to be made, especially relating to areas that are likely to be different. For example, taxation, financial instruments, balance sheet item valuations, and property, plant and equipment are areas that often need to

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be looked at closely. Revisions to disclosure controls and procedures manuals due to enhanced disclosures under IFRS may also be required.

SOLUTIONS TO PROBLEMS

Problem 1-1

(a)

		Year 6 (in $000s)	*Year 7 (in $000s)*
Current ratio	Current assets / Current liabilities	560 / 390 = 1.44	595 / 450 = 1.32
Debt-to-equity	Total liabilities / Equity	1,090 / 215 = 5.07	1,310 / 240 = 5.46
Return on average assets	Income before interest & taxes / Average assets	111 / (1,460 + 1,305) / 2 = 8.0%	130 / (1,305 +1,550) / 2 = 9.1%
Return on average equity	Net income / Average equity	45 / (410 + 215) / 2 = 14.4%	65 / (215 + 240) / 2 = 28.6%

(b)

Gravelbourg's liquidity looks worse because the current ratio went down. Its solvency also looks worse because its debt-to-equity ratio went up. Its profitability looks better because the return on average assets and return on average equity both increased from Year 6 to Year 7.

Problem 1-2

(a) (i)

	Year 6	**Year 7**
Sales revenue	100	100
Cost of goods sold	58	59
Other expenses	25	20
Net income	17	22
Current assets	27	28

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Total assets	100	100
Total liabilities	72	61
Shareholders' equity	28	39

(ii)

	Year 6	Year 7
Sales revenue	100	108
Cost of goods sold	100	109
Other expenses	100	85
Net income	100	140
Current assets	100	110
Total assets	100	106
Total liabilities	100	91
Shareholders' equity	100	144

(b)

The three financial statement items that seem most peculiar relative to expectations are:

1. Other expenses declined when revenue increased and now represent only 20% of sales compared to 25% of sales in Year 6.
2. Total liabilities declined by 9% even though sales increased by 8% and now represent only 61% of total assets compared to 72% in Year 6.
3. Shareholders' equity increased by 44% even though sales only increased by 8% and now represent 39% of total assets compared to only 28% in Year 6.

Problem 1-3

		Historical Cost (ASPE)	Current Value (IAS 16)
Jan 1 /1	Asset cost	10,000,000	10,000,000
Year 1	Depreciation	500,000	500,000
Dec 31/1	Balance	9,500,000	9,500,000
Year 2	Depreciation	500,000	500,000
Dec 31/2	Balance	9,000,000	9,000,000
Jan 2/3	Appraisal		12,000,000

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Year 3	Depreciation	500,000	666,667
Dec 31/3	Balance	8,500,000	11,333,333
Year 4	Depreciation	500,000	666,667
Dec 31/4	Balance	8,000,000	10,666,666

(a)

	Year 2	Year 3	Year 4
1. IAS 16	500,000	666,667	666,667
2. ASPE	500,000	500,000	500,000

(b)

	Jan 2/3	Dec 31/3	Dec 31/4
1. IAS 16	12,000,000	11,333,333	10,666,666
2. ASPE	9,000,000	8,500,000	8,000,000

(c)

IAS 16	Total depreciation over 20 years		
	Years 1 & 2	1,000,000	
	Next 18 years	12,000,000	13,000,000
ASPE	Total depreciation over 20 years		10,000,000
Profit	ASPE > IAS 16		3,000,000

There would be no difference in shareholders' equity at the end of 20 years.

During the first two years the reduction in shareholders' equity is the same under the two alternatives (2 x 500,000 = 1,000,000)

During the last 18 years

depreciation IAS 16 > ASPE	(18 x 166,667)	3,000,000
Offset by appraisal surplus through OCI		3,000,000
Difference in shareholders' equity		0

Problem 1-4

(a)

(i)

	IFRS[1]	ASPE[2]
Development costs @ Dec 31, Yr 2	$135,000	$0

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[1] $500,000*.30 - ($500,000*.30)/10 = $135,000 – only development costs are capitalized. (IAS 38.57)

[2] R&D costs are expensed in Year 1 under ASPE to minimize net income.

(ii)	IFRS[3]	ASPE[4]
Equipment @ Dec 31, Yr 2	$56,250	$60,000

[3] Under IFRS (IAS 36), an asset is impaired at the end of Year 1 if the carrying amount of $80,000 ($100,000 – $100,000/5 years) exceeds the higher of assets value in use (discounted cash flows = $75,000 at Dec 31, Yr 1) and its FV less costs to dispose ($72,000). If impaired, the asset is written down to its value in use. The balance at Dec 31, Yr 2 is therefore determined using the $75,000 value in use at Dec 31, Yr 1 less one year of depreciation ($75,000/4 = $18,750).

[4] Under ASPE, there is no indicator of impairment if the undiscounted cash flows from its use ($85,000) are greater than the carrying amount, $80,000, at Dec 31, Yr 1. The balance under ASPE at Dec 31, Yr 2 is therefore $100,000 less two years of depreciation ($20,000 per year).

(b)

Net Income Year 2 under IFRS	$200,000
Less: additional depreciation under ASPE (20,000 - 18,750)	(1,250)
Add: development cost amortization, not recognized under ASPE	15,000
Net Income Year 2 under ASPE	$213,750

S/E Dec 31 Year 2 under IFRS	$1,800,000
Less: development cost not capitalized under ASPE	(135,000)
additional depreciation under ASPE (20,000 - 18,750)	(1,250)
Add: impairment on equipment not recognized in Year 1 under ASPE	5,000
S/E @ Dec 31, Year 2 under ASPE	$1,668,750

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Problem 1-5

(a) The two accounts on the income statement that had the most unusual change from 2019 to 2020 were:

	2020	2019
2019 is used as the base		
Depreciation and amortization	50.7 / 18 = 282	100
Income tax expense	12 / 38.9 = 31	100

(b) The two accounts on the balance sheet that had the most unusual change from 2019 to 2020 were:

	2020	2019
Total assets is used as the base	100	100
Right of use assets	211.8 / 1,112.7 = 19	0
Lease liability	192.0 / 1,112.7 = 17	0

(c)

Current ratio	524.2 / 201.3 = 2.60	413.2 / 136.6 = 3.02
Debt-to-equity ratio	592.5 / 520.2 = 1.14	326.3 / 399.1 = 0.82
Return on total equity	151.7 / 520.2 = 29.2%	143.6 / 399.1 = 36.0%

(d)

The profitability worsened in 2020 because the return on total equity decreased. The solvency worsened in 2020 because the debt-to-equity ratio increased. The liquidity worsened in 2020 because the current ratio decreased.

Problem 1-6

(a) Maurice Ltd. Reconciliation from IFRS to ASPE:

Description	*Net Income*	*Current Assets*	*Current Liabilities*	*Debt*	*Equity*
Per IFRS	$3,000	$13,600	$10,700	$25,200	$21,500
Depreciation expense	230[1a]				230[1b]
Impairment loss & Recovery	(300)[1c]				(1,500)[1d]
Convertible bonds	56[2a]			789[2b]	(789)[2c]

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Income taxes	210	0	0	(3,710)	3,710
Per ASPE	$3,196	$13,600	$10,700	$22,279	$23,151

		IFRS	*ASPE*
Current ratio	Current assets	13,600 = 1.27	13,600 = 1.27
	Current liabilities	10,700	10,700
Debt-to-equity	Debt	25,200 = 1.17	22,279 = 0.96
	Equity	21,500	23,151
Return on total equity	Net income	3,000 = 13.95%	3,196 = 13.81%
	Total equity	21,500	23,151

Notes:

1. The recoverable amount under IFRS is the higher of value in use and fair value, which are $18,900 at the end of Year 5 and $17,200 at the end of Year 6. Under ASPE, the equipment is written down to fair value if the undiscounted cash flows are less than the carrying amount. An impairment loss can be reversed under IFRS but not under ASPE.

	IFRS		ASPE	
	YR5	YR6	YR5	YR6
Cost of equipment	$25,000	$25,000	$25,000	$25,000
Accum depreciation	(5,000)	(7,000)	(5,000)	(6,770)
Accum impairment losses	(1,100)	(800)	(2,300)	(2,300)
Carrying amount on SCFP	$18,900	$17,200	$17,700	$15,930
Depreciation expense	2,000	2,000	2,000	1,770*
Impairment loss (recovery)	1,100	(300)	2,300	

* 17,700 / 10 Years = 1,770

(a) Difference in depreciation expense for Year 6 (2,000 – 1,770) 230

(b) Difference in accumulated depreciation at end of Year 6 (7,000 – 6,770) 230

(c) Impairment loss recovery for Year 6 under IFRS (1,100 – 800) 300

(d) Difference in accumulated impairment loss at end of Year 6 (2,300 – 800) 1,500

2. Under ASPE, you can assign the entire proceeds from the convertible bonds to bonds payable or can split the total proceeds between bonds payable and conversion option, which

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is a component of shareholders' equity. Maurice wants to use the simplest method, which would be assigning the entire amount to bonds payable.

	IFRS		ASPE	
	Liability	Equity	Liability	Equity
Issuance of bonds	$12,100	$900	$13,000	$0
Amort of discount – Year 5	55			
Amort of discount – Year 6	56	0	0	0
Carrying amount on SCFP	$12,211	$900	$13,000	$0

(a) Difference in amortization of bond discount for Year 6 (56 - 0)	56
(b) Difference in bond liability at end of Year 6 (13,000 – 12,211)	789
(c) Difference in shareholders' equity at end of Year 6 (900 – 0 – 55 - 56)	789

3. Under ASPE, Maurice would choose the taxes payable method because it is much simpler than the future taxes payable method. Therefore, all the future tax amounts would be eliminated when converting from IFRS to ASPE.

(b) The current ratio did not change, which means that liquidity remains the same under ASPE. The debt-to-equity ratio decreased, which means that solvency looks better under ASPE. The return on total equity decreased, which makes profitability look worse under ASPE.

Problem 1-7

(a) Becker Ltd. Reconciliation from ASPE to IFRS (in 000s):

Description	*Net Income*	*Current Assets*	*Current Liabilities*	*Debt*	*Equity*
Per ASPE	$1,500	$6,800	$5,400	$12,600	$10,900
Impaired loans	(12)[1]				(12)[1]
Interest capitalization	30[2]				45[3]
Actuarial loss	115[4]				0[5]
Per IFRS	$1,633	$6,800	$5,400	$12,600	$10,933

		ASPE	*IFRS*

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Current ratio	Current assets	6,800 = 1.26	6,800 = 1.26
	Current liabilities	5,400	5,400
Debt-to-equity	Debt	12,600 = 1.16	12,600 = 1.15
	Equity	10,900	10,933
Return on total equity	Net income	1,500 = 13.76%	1,633 = 14.94%
	Total equity	10,900	10,933

Notes:

1. The loan receivable is $452 under ASPE and should be $440 under IFRS.
2. The interest cost was expensed under ASPE and should be capitalized under IFRS. (500 x 6% = 30)
3. The interest cost was expensed under ASPE and should be capitalized under IFRS. (500 x 6% x 1.5 years = 45)
4. The actuarial loss is reported in net income under ASPE and should be reported in OCI under IFRS.
5. Since net income and OCI both end up in shareholders' equity, there is no change to shareholders' equity when converting from ASPE to IFRS.

(b) The current ratio did not change, which means that liquidity remains the same under IFRS. The debt-to-equity ratio decreased, which means that solvency looks better under IFRS. The return on total equity increased, which makes profitability look better under IFRS.

Problem 1-8

	Net income		Shareholders' equity	
Description	**ASPE**	**IFRS**	**ASPE**	**IFRS**
Preliminary financial statements	$409,000	$409,000	$3,590,000	$3,590,000
Loan impairment (#1)	(6,307)	(13,165)	(6,307)	(13,165)
Accrued interest payable (#2)	(28,665)		(28,665)	
Actuarial gains (#3)	98,100		98,100	98,100
Equity portion of compound instrument (#4)			68,000	68,000
Future tax liability (#5)	(49,000)	(49,000)	(358,000)	(358,000)
Revised values	$423,128	$346,835	$3,363,128	$3,384,935

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Notes:

1. Impaired loans – Must determine present value of future cash flows. Must use market interest rate of 9% under ASPE and original interest rate of 11% under IFRS.
2. Interest costs – Can capitalize or expense under ASPE; would expense to minimize ROE. Must capitalize under IFRS.
3. Actuarial gains – Must recognize immediately in net income under ASPE. Must recognize immediately in OCI under IFRS.
4. Compound financial instrument – Can recognize the $68,000 value of the conversion option as debt or equity under ASPE; would recognize as equity to increase denominator for ROE calculation and thereby reduce ROE. Must recognize as equity under IFRS.
5. Income Tax –Can use taxes payable or future income tax method under ASPE; would use future income tax to reduce net income. Must use future income tax method under IFRS.

Calculations:	**ASPE**	**IFRS**
1. Loan receivable		
Carrying amount	$240,000	$240,000
Present value of future cash flows at		
9%	229,489	
11%		218,058
Impairment loss before tax	10,511	21,942
Impairment loss after tax (x 0.6)	6,307	13,165
2. Interest costs		
March to September (490,000 x 9% x 7/12)	25,725	25,725
October to December (980,000 x 9% x 3/12)	22,050	22,050
Accrued interest expensed	47,775	
Accrued interest capitalized		47,775
After tax expense (x 0.6)	28,665	
3. Actuarial gains		
Recognized immediately in net income	163,500	
Recognized immediately in OCI		163,500
After tax gain (x 0.6)	98,100	98,100
4. Compound financial instrument		
Value of conversion option (1,180,000 – 1,112,000)	68,000	68,000
Not taxable since it does not affect net income		

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5. Income tax

Future income tax expense for Year 5 (358,000 – 309,000)	49,000	49,000
Future income tax expense for all years	358,000	358,000

Problem 1-9

(a) i)

BALANCE SHEETS

	Year 7	*Year 6*
Assets		
Cash	2	5
Accounts receivable	25	24
Inventory	38	39
Property, plant & equipment	35	32
	100	100
Liabilities and Shareholders' Equity		
Accounts payable	24	26
Other accrued liabilities	8	7
Bonds payable	23	24
Common shares	20	22
Retained earnings	25	21
	100	100

INCOME STATEMENT

	Year 7	*Year 6*
Sales	100	100
Cost of goods sold	69	66
Gross margin	31	34
Depreciation expense	2	2
Other expenses	21	22
Income tax expense	3	4
Net income	5	6

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ii)

BALANCE SHEETS

	Year 7	*Year 6*
Assets		
Cash	39	100
Accounts receivable	106	100
Inventory	103	100
Property, plant & equipment	115	100
	105	100
Liabilities and Shareholders' Equity		
Accounts payable	97	100
Other accrued liabilities	121	100
Bonds payable	100	100
Common shares	97	100
Retained earnings	123	100
	105	100

INCOME STATEMENT

	Year 7	*Year 6*
Sales	103	100
Cost of goods sold	106	100
Gross margin	95	100
Depreciation expense	114	100
Other expenses	96	100
Income tax expense	86	100
Net income	94	100

(b)

Since sales increased by 3%, the items directly related to sales would be expected to increase by 3%. However, the horizontal analysis indicates that cost of sales increased by 6%, accounts payable decreased by 3% and other accrued liabilities increased by 21%. Since equipment

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increased by 15%, an increase of 14% for depreciation expense appears reasonable. The change in income tax expense is fairly consistent with the change in net income.

(c)		Year 7		Year 6	
Current ratio	Current assets	560	2.00	560	2.04
	Current liabilities	280		275	
Debt-to-equity	Debt	480	1.23	475	1.34
	Equity	390		355	
Return on assets	EBIT	176	.20	193	.23
	Assets	870		830	
Return on equity	Net income	100	.26	106	.30
	Shareholders' equity	390		355	

(d)

Since the current ratio decreased, liquidity deteriorated. Since the debt-to-equity ratio went down, the solvency improved. Since both the return on assets and return on equity went down, the profitability deteriorated.

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