

Solutions Manual

to accompany

Applying International Financial Reporting Standards 2e

by

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CHAPTER 1

The IASB and its conceptual Framework



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Chapter 1 – The IASB and its conceptual framework

DISCUSSION QUESTIONS

1. What is meant by “IFRSs”?

The term International Financial Reporting Standards (IFRSs) has both a narrow and a broad meaning. In the narrow sense, IFRSs refers to those new standards issued by the IASB since it was established, as distinct from the International Accounting Standards (IASs) series issued by its predecessor, the IASC. In the broad sense, IFRSs refers to the entire body of IASB pronouncements, including standards and interpretations approved by the IASB, as well as the IASs and SIC interpretations approved by the IASC.

IAS 1 paragraph 11 defines IFRSs as comprising:

- International Financial Reporting Standards;
- International Accounting Standards; and
- Interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

2. Discuss why a company may consider changing to preparing its financial statements under IFRSs.

The case in favour of switching to IFRSs can be made on two bases: **First**, legal or stock exchange requirements to use IFRSs and **second**, benefits to the company from using IFRSs.

- a. **Legal and stock exchange requirements.** The European Union accounting regulation requires all companies domiciled in an EU member state that are listed in an EU public securities market, such as the London Stock Exchange or Euronext, to use IFRSs starting in 2005. Companies from countries outside the EU have until 2007 to switch to IFRSs. The European Commission is studying whether any foreign GAAPs should be regarded as “equivalent” to IFRS so non-European companies can continue to use those GAAPs. So if a company wants to list in London or Paris and it has significant foreign operations, then it has no choice but to use IFRSs.
- b. **Benefits to the company.** From time to time companies need to attract new capital from outside investors. Any company that goes to the public capital markets gives up its privacy – transparency (that is, full financial disclosure) is required by national securities laws and stock exchange regulations to protect investors. The concern about too much disclosure will arise regardless of where the company lists. Furthermore, investors and financial analysts in London or Paris will not know the GAAP of individual countries and starting from 2005 will expect to see IFRS financial statements. The IFRS information will bring

credibility and comparability, which in turn should reduce the company's cost of capital. Even if the law did not require IFRSs, market pressure would.

3. Discuss the due process undertaken by the IASB in preparing IFRSs.

See section 1.4 of Chapter 1.

See the *Due Process Handbook for the IASB* available on www.iasb.org.

4. Distinguish between the roles of the IASCF, the IASB and the SAC.

See Figure 1.1 to show the standard-setting structure of the IASB.

Section 1.4 sets out the objectives of the IASCF, and the duties of the Trustees.

Section 1.5 sets out the role of the IASB

Section 1.7 sets out the role of the SAC.

5. Discuss the changes proposed by the Trustees of the IASCF to the Constitution in 2008.

On 29 January 2009, the IASC Foundation Trustees put out a Press Release announcing amendments to the IASCF Constitution effective 1 February 2009, including formation of a Monitoring Board and expansion of the IASB from 14 to 16 members. The Trustees approved the changes at their meeting on 15/16 January 2009. These changes are the result of the first part of the IASCF Constitution Review 2008-2009. The second part of the review is currently ongoing. The contents of the Press Release are as below:

Trustees enhance public accountability through new Monitoring Board, complete first part of Constitution Review

The Trustees of the IASC Foundation, the oversight body of the International Accounting Standards Board (IASB), today announced important amendments to the organisation's Constitution, as well as a summary of other agreements reached at the Trustees' meeting in New Delhi, India, on 15 and 16 January 2009.

Highlights:

- Significant enhancement to the organisation's public accountability by establishing a link to a Monitoring Board of public authorities
- IASB to be expanded from 14 to 16 members by 2012, with criteria added to ensure geographical diversity
- Enhanced liaison with investor groups
- Constitutional changes directly address G20 recommendations
- Free availability of core standards through the public website.

In 2007 the Trustees conducted a strategic review of the IASC Foundation, which included discussions with relevant public authorities. This review addressed the issue of public accountability and the composition, geographical diversity and the size of the International Accounting Standards Board (IASB). There was extensive public consultation, including round-table discussions on the proposals emerging from the strategic review. These proposals were exposed for public comment in July 2008. Over 70 responses from organisations and individuals were received, and these generally supported the proposal on public accountability.

Establishing a link to public authorities

The constitutional changes represent significant enhancements to existing governance arrangements. Underpinning the organisation's structure is the internationally accepted principle that global accounting standards should be developed by an independent IASB.

The IASB reaches conclusions following a transparent and open due process that considers the views of all stakeholders. An independent and geographically diverse body of Trustees oversees the IASB. Under the constitutional changes, the Trustees themselves will be publically accountable to a Monitoring Board of public authorities.

This basic approach to the architecture of governance is similar to that in place in many national jurisdictions for accounting standard-setters. The consultation process revealed

strong and consistent support among investors and other stakeholders on the need to maintain, within agreed due process, the independence of the IASB's decision-making.

At the same time, stakeholders understood the need to establish a formal linkage to public authorities, where none was previously defined, and strongly encouraged the organisation's efforts to enhance its public accountability. All the Monitoring Board members also supported the independence of the IASB's decision-making within the new governance framework.

The Monitoring Board will comprise the relevant leaders from the Emerging Markets and Technical Committees of the International Organization of Securities Commission (IOSCO), the European Commission, the Japan Financial Services Agency (FSA), and the US Securities and Exchange Commission (SEC). The Basel Committee on Banking Supervision will sit as a formal observer at Monitoring Board meetings.

The Monitoring Board's main responsibilities are to ensure that the Trustees continue to discharge their duties as defined by the IASC Foundation Constitution, as well as approving the appointment or reappointment of Trustees. It is envisaged that the Monitoring Board will meet the Trustees at least once a year, or more often if appropriate.

The relationship and responsibilities of the participating organisations are described in the Memorandum of Understanding (MoU) developed by the members of the Monitoring Board and the Trustees. The Trustees formally approved the MoU in New Delhi. The formal process of signing the MoU is now under way and should be completed shortly. ...

New guidelines in IASB membership

The Trustees also approved a constitutional change that will expand the IASB to 16 members and provides guidelines regarding geographical diversity. The criteria for IASB membership remains that the 'main qualifications shall be professional competence and practical experience'. At the same time, in order to ensure a broad international basis by July 2012, there will normally be four members from the Asia/Oceania region; four members from Europe; four members from North America; one member from Africa; one member from South America; and two members appointed from any area, subject to maintaining overall geographical balance.

Concerted effort to liaise more closely with investor groups

The Trustees recognise that the investor community is a key stakeholder in the organisation, but that standard-setting bodies have commonly experienced difficulty in achieving a sufficiently close engagement with investors. To complement the existing contact with investors, there will be regular liaison with the wide range of investor groups now to be represented in the reconstituted Standards Advisory Council (SAC). The IASC Foundation will announce the membership of the reconstituted SAC shortly.

Constitutional changes directly address G20 recommendations

The constitutional changes—the link to public authorities and the new guidelines for IASB membership—directly address the recommendations made by the G20 last November on public accountability and membership of the standard-setting board. The other recommendations related to the standards have all now been separately actioned by the IASB. A comprehensive summary and a recent Trustees' letter discussing the organisation's response to the G20 conclusions are available from the public website.

Free availability of standards through the public website

Separately from the constitutional issues, the Trustees, responding to many public requests, agreed that the IASB's standards, but not the accompanying documents such as the basis for conclusions or implementation guidance, should become available free of charge through the IASB's website.

Commenting on the constitutional amendments, Gerrit Zalm, Chairman of the Trustees and former deputy prime minister and finance minister of the Netherlands, said:

The Trustees have responded positively on the questions of public accountability and IASB membership. We recognise the need for change in the emerging global framework of standard-setting. The IASB as an independent standard-setter and the Trustees as the oversight body are strengthened by the enhanced governance provided by the link to public authorities through the Monitoring Board. The new arrangements ensure the independence of the IASB within a broader oversight and monitoring system.

6. Discuss the proposals in the IASB/FASB Discussion Paper *Preliminary Views on an Improved Conceptual Framework for Financial Reporting The Reporting Entity*.

In 2007, proposals were put forward to do away with the reporting entity concept in favour of using a size and public accountability test for determining which entities should prepare a general purpose financial report. If an entity is publicly accountable and satisfies the size test, it must prepare general purpose financial reports which comply with the full IFRSs. If an entity is not publicly accountable and does not satisfy a size test, then it should use merely the IFRS for small and medium entities (SMEs).

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

The *Framework* specifies the objectives of general-purpose external financial reporting as being financial reports which are intended to meet the information needs common to a range of users who are unable to command the preparation of reports tailored to satisfy their own particular needs.

The main objective of general-purpose external financial reporting is to provide information useful to users for making and evaluating decisions on the allocation of scarce resources. A second objective is that the reports should be presented by management and governing bodies in such a manner as to discharge their accountability for the resources entrusted to them. The current *Framework* refers to this objective as one of reporting on the results of 'stewardship'. In so doing, general-purpose financial reports should disclose adequate information relevant to assessing the entity's performance, financial position, cash flows from financing and investing activities, and compliance with statutory regulations and rules.

The IASB and FASB joint project to change the conceptual framework has proposed, in the IASB ED of May 2008, to amend the objectives of general-purpose financial reporting in the conceptual framework. The ED of May 2008 argues that the objective of general-purpose financial reporting is "to provide financial information about the reporting entity that is useful to present and potential investors, lenders and other creditors in making decisions in their capacity as capital providers".

The Boards propose to adopt the "entity perspective", i.e. it is the entity, not its owners and others having an interest in it, which is the object of general-purpose financial reporting. In other words, the focus is placed on reporting the entity's resources (assets), the claims to the entity's resources (liabilities and equity) and the changes in them. Shareholders are seen not so much as owners of the entity but merely as providers of resources to the entity, in much the same way as liabilities. Both present and potential equity investors, lenders and other creditors are seen as constituting a single primary user group. This group makes decisions about the allocation of resources as well as decisions relating to protecting or enhancing their claim on the entity's resources. Other potential user groups eg. government and other regulatory bodies, customers, employees and their representatives, are not the focus of the objective.

Hence, it seems that the proposed objective for the revised conceptual framework is going to be more narrowly focussed on the needs of the primary user group than is the objective contained the current *Framework*. Furthermore, the existing objective of accountability and/or stewardship the current *Framework* and the IASB's Discussion Paper issued in July 2006, appears to be deemphasized in the IASB ED of May 2008.

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

8. Discuss the changes to the objectives of financial reporting as contained in the IASB/FASB Exposure Draft (2008) *An improved Conceptual Framework for Financial Reporting: Chapter 1: The Objective of Financial Reporting*.

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Hence, it seems that the proposed objective for the revised conceptual framework is going to be more narrowly focussed on the needs of the primary user group than is the objective contained in SAC 2 and the current *Framework*. Furthermore, the existing objective of accountability and/or stewardship, contained in the current *Framework* and the IASB’s Discussion Paper issued in July 2006, appears to be deemphasized in the IASB ED of May 2008.

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

9. From the current *Framework*, outline the qualitative characteristics of financial information to be included in general-purpose financial reports.

This requires a discussion of the qualitative characteristics mentioned in figure 1.2 in learning objective 4, namely relevance, reliability, comparability and understandability.

10. Discuss the proposed changes to the qualitative characteristics of information contained in the IASB/FASB Exposure Draft (2008) *An improved Conceptual Framework for Financial Reporting: Chapter 2: Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information*

The proposals for change put forward by the IASB and the FASB, as discussed in the IASB's ED of May 2008 are shown in figure 1.3. This requires a discussion of relevance and faithful representation (fundamental characteristics) as well as comparability, understandability, verifiability and timeliness (enhancing characteristics)

11. Discuss the importance of the going concern and accrual assumptions to the practice of accounting.

The *going concern assumption* is important in that all measures of performance and financial position, and all classifications in a statement of financial position (current and non-current) implicitly assume that the entity is going to continue. Furthermore, valuation of assets on the basis of cost is sometimes justified on the grounds of the going concern assumption.

The *accrual basis assumption* is made in the preparation of general-purpose financial reports. Under this assumption, the effects of all transactions and other events are recognised in the accounting records when they occur, rather than when cash or its equivalent is received or paid. Financial reports prepared on the accrual basis inform readers not only of past transactions involving the receipt and payment of cash but also of obligations to pay cash in the future and of amounts owing to the entity in the form of receivables. It is argued that the accrual basis therefore provides better information for users in their decision-making processes.

12. Discuss the essential characteristics of an asset as contained in the *Framework* and how these might change as a result of the IASB/FASB discussions.

Discussion of essential characteristics of asset:

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

Non-essential characteristics:

- purchased at a cost
- tangibility
- exchangeability

With the proposed definition of an asset, namely "An asset of an entity is a present economic resource to which, through an enforceable right or other means, the entity has access or can limit the access of others," there will be less focus on "future economic benefits" and more on "present resource"; and less on "control", with more on the existence of enforceable rights to limit access of others.

13. Discuss the essential characteristics of a liability as contained in the Framework and how these might change as a result of the IASB/FASB deliberations.

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

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

The IASB and FASB have proposed to change the definition of a liability by focusing on a liability as an enforceable “economic obligation” rather than an expected future sacrifice of economic benefits. Furthermore, the reference to past events is to be replaced by a focus on the present. The essential attributes of an enforceable obligation include the involvement of a separate party and the existence of a mechanism that is capable of forcing an entity to take a specified course of action.

- 14. A government gives a piece of land to a company at no charge. The company builds a factory on the land and agrees to employ a certain number of people at the factory for a certain period of time. Considering the definition of income in the *Framework*, do you think the fair value of the land is income to the company or is it a direct credit to equity?**

The fair value of the land should be a direct credit to equity.

- a. Under the *Framework*, income is defined as follows:

Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

- b. Arguments for direct credit to equity

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

- c. Arguments for income recognition:

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

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

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

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

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

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

Under the current *Framework*, income encompasses both revenue and gains. A more complete definition of *revenue* arises in accounting standard 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, e.g. gains on the disposal of non-current assets or on the revaluation of marketable securities. Gains are usually disclosed in the income statement net of any related expenses, whereas revenues are reported at a gross amount.

Revenues arise from the “ordinary activities” of the entity and gains may or may not be from ordinary activities. What “ordinary activities” means in any particular context is unclear; hence the distinction between revenues and gains is unclear. Would we be better off abandoning the distinction?

16. Explain what the *Framework* is and how it is used in financial reporting.

A conceptual framework of accounting theory should enable standard setters to develop standards which are consistent and logically formulated, provide guidance to accountants in areas of accounting where standards have not been established, and enable standard users to better understand standards and proposed standards. For further details of anticipated benefits through having a conceptual framework, refer to learning objective 1 in the chapter.

The IASB and FASB are currently undertaking a joint project to amend the conceptual framework. The overall objective of this joint project is to develop a common conceptual framework that is both complete and internally consistent. The Boards want to develop a framework which will provide a sound foundation for developing future accounting standards that are principles-based, internally consistent, internationally converged, and that lead to financial reporting which provides the information needed for investment, credit, and similar decisions. That framework, which will deal with a wide range of issues, will build on the existing IASB and FASB frameworks.

17. (a) Explain what relevance and reliability mean and the role they play in the *Framework*.

(b) Explain why an item must first meet a financial statement's element's definition before we can consider that element's recognition criteria.

See section 1.5.1 for a discussion of relevance and reliability.

Recognition criteria are used to see whether elements should be recognised, that is whether the measurement of the element is sufficiently reliable to record the element. If the measurement is unreliable then the information loses relevance. Hence not all elements are recognised.

18. Define “equity”, and explain why the IASB does not prescribe any recognition criteria for equity.

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

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

Equity = Assets – Liabilities.

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

19. Multiple choice questions:

- (a)** (i) is incorrect. Materiality is not a constraint
- (b)** Only (iii) is correct
- (c)** Only (iv) is correct
- (d)** (ii) is correct.

PROBLEMS

Problem 1.1 Relevant information for an investment company

A year ago you bought shares of stock 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.

- a. What financial information about the investment company's holdings would be most relevant to you?**
 - b. How would reliability be affected if the investment company only buys shares of listed companies versus if it invests in shares of private high-tech companies?**
 - c. The investment company earns profits from appreciation of its investment securities and from dividends received. How would the concepts of recognition in the *Framework* apply here?**
- a. The performance of an investment company results from income earned on its investments (dividends and interest) and changes in the fair values of its investments while they are held. I would like to know:
- Fair values of the securities that the investment company holds
 - How those fair values changed during the year. It would not matter much to me whether the investment company actually sold the investments (in which case they would have to replace them with other investments) or held on to the investments. Either way, the fair value changes represent gains and losses to the investment company and, therefore, to me as an investor in the investment company.
 - How the fair value changes of investments managed by this investment company compared to changes in similar investments in the market as a whole.
 - Turnover of the portfolio, and related transaction costs such as commissions.
 - Interest and dividends earned.
 - Information about risks in the portfolio.
 - Income taxes are usually based on only those fair value changes that have been “confirmed” by a sale transaction. If that is the case with this investment company, I might want to know how the fair value changes were split between “realised” (relating to investments that have been sold) and “unrealised” (relating to investments that are still held). In many countries, investment companies that distribute their earnings rapidly to the investors do not themselves pay taxes – only the investors pay the taxes on realised gains and dividend and interest income.
- b. Measurements in financial statements must be reliable – that is, they must accurately represent what they purport to represent. In the case of investment securities, a fair value measurement should represent the price that a willing buyer would pay and a willing seller would reasonably charge in an unforced arm's

length transaction. Clearly, it is easier to get fair values for listed securities, because there is a quoted market price. However, if the investment company only invests in shares of private high-tech companies, it is more difficult, and may not be possible, to get a reliable measure of fair value. Recent transactions may provide an indication of fair value in these cases, or valuation models may be appropriate.

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

With respect to income, the *Framework* states that income is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. Appreciation of the fair value of investment securities does represent an increase in an asset. For an investment company, it is an important component of performance. 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.

Problem 1.2 Meaning of 'probable future benefits'

The *Framework* includes "probable future economic benefits" as condition for recognising an element of financial statements. How would you interpret "probable" in this context?

- a. Under IFRSs:
- The word "probable" is defined as "more likely than not", that is, a greater than 50% chance of occurrence.
 - Future economic benefits are "the potential to contribute directly or indirectly to the flow of cash and cash equivalents to the entity."
- b. In the context of probable future economic benefits, the relevant elements of financial statements are assets and income. Recognition of income involves, at the same time, recognising an asset – the entity's right to receive cash or other assets.

Problem 1.3 Measuring inventories of gold and silver

IAS 2 *Inventories* allows producers of gold and silver to measure inventories of those commodities at selling price, even before they have sold it, which means a profit is recognised at production. In nearly all other industries, however, profit is recognised only when the inventories are sold to outside customers. What concept(s) in the *Framework* might the IASB have looked to with regard to accounting for gold and silver production?

- a. Unlike other ordinary goods, there is a ready liquid market with quoted prices, minimal transaction costs, minimal selling effort, minimal after-costs, and immediate cash settlement.
- b. Under the *Framework*, an item that meets the definition of an asset, liability, income, or expense should be recognised if:
 - it is probable that any future economic benefit associated with the item will flow to or from the entity; and
 - the item has a cost or value that can be measured with reliability.
- c. The IASB 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.

Problem 1.4 Recognising a loss from a lawsuit

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

- a. The definition of liability can help decide the accounting treatment of the situation. Under the *Framework* a liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. In this case, the past event is the fall and injury to the pedestrian.
- b. Present obligation depends on the probability of payment. The attorney has advised that a \$25,000 loss is probable. Therefore appropriate accounting involves recognising a liability for the probable payment. An expense would also be recognised.
- c. Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities. In this case, the expense arises at the time the pedestrian is injured because a liability has also arisen at that time.

Problem 1.5 Financial statements of a real estate investor

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

- a. What are the relevance and reliability accounting considerations in deciding how to measure the building in the enterprise’s financial statements?
 - b. Does the *Framework* lead clearly to measuring it at \$15,000,000? \$9,800,000? Some other amount?
- a. Is the fair value relevant to stakeholders’ decisions? Whether the stakeholders care about the fair value of the building should be considered.

Relevance

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

Reliability

- Information in financial statements is reliable if it is free from material error and bias and can be depended upon by users to represent events and transactions faithfully. Information is not reliable when it is purposely designed to influence users' decisions in a particular direction.
- There is sometimes a tradeoff between relevance and reliability - and judgement is required to provide the appropriate balance.
- Reliability 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 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.

Analysis

- The fair value of the property is relevant to the investors in the enterprise. The enterprise – and therefore its owners – are better off because the value of the property has gone up. Better off means that their wealth increased.
 - Is the fair value reported by the appraiser reliable? Certainly, appraisals involve judgements, and different valuation methods and different assumptions can generate different valuations. The objectivity and other qualifications of the appraiser should be considered. The *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.
- b. The *Framework* does not include concepts or principles for selecting which measurement basis should be used for particular elements of financial statements or in particular circumstances. The qualitative characteristics do provide some guidance, particularly the characteristics of relevance and reliability.

Problem 1.6 Need for the *Framework* vs. interpretations

Applying the *Framework* is subjective and requires judgement. Would the IASB be better off to abandon the *Framework* entirely and, instead, rely on a very active interpretations committee that develops detailed guidance in response to requests from constituents?

- a. No. The fact that the *Framework* involves judgement does not mean that it should be abandoned.
- b. 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.
- c. The *Framework* provides guidance and direction to the standard setters, and therefore will lead to consistency among the standards.
- d. But it is a set of concepts. It provides a boundary for the exercise of judgement by the standard setter and the interpretive body.

Problem 1.7 Conservatism

“When I studied accounting, we were taught always to be conservative in recognition or measurement. When in doubt, don’t put the asset on the statement of financial position, or if it’s there, write it down at the first sign of trouble. Never recognise profit until a sale takes place.” How do this person’s comments relate to the *Framework*?

- a. Conservatism is not a concept in the *Framework*.
- b. Conservatism is intentional bias – downward bias in recognising profits and assets and an upward bias in recognising expenses and liabilities.
- c. Amounts reported in financial statements should not be biased. Biased numbers do not help investors and creditors decide whether to put resources into an enterprise and at what price.
- d. Prudence is different from conservatism. 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. Prudence is consistent with the *Framework*, but conservatism is not.

Problem 1.8 Authoritativeness of the *Framework*

Was the IASB wise in amending IAS 8 to make the *Framework* the mandatory source of guidance on an accounting question in the absence of a special standard dealing with the subject? What are the plusses and minuses of doing that?

- a. In the absence of some particular standard, judgement is required in determining an appropriate accounting recognition, measurement, or disclosure policy. The link to the *Framework* provides direction for exercising that judgment. It is simply not possible for IASB to formulate the accounting treatment for every transaction or activity. And it always takes some time for IASB to develop some standard for new or emerging accounting issues. Therefore, it is necessary and proper for IASB to make the *Framework* the mandatory source of guidance on an accounting problem in the absence of a standard.
- b. That does not mean, however, that looking to the framework will always give a clear answer. The *Framework* sets out broad principles. Applying those principles requires judgement, and different judgements and different circumstances may lead to different policies.

Problem 1.9 Meaning of ‘decision useful’

What is meant when we say that accounting information should be “decision-useful”?

- a. The *Framework* identifies the principal classes of users of general purpose financial statements as:
 - present and potential investors,
 - lenders,
 - suppliers and other trade creditors,
 - employees,
 - customers,
 - governments and their agencies; and
 - the general public.
- b. All of these categories of users rely on financial statements to help them in making various kinds of economic and public policy decisions. Investors need to decide whether to buy, sell, or hold shares. Lenders need to decide whether to lend and at what price. Suppliers need to decide whether to extend credit. Employees need to make rational career decisions. And so on. Information is decision-useful if it helps these people make their decisions.
- c. Because investors are providers of risk capital to the enterprise, financial statements that meet their needs will also meet most of the general financial information needs of the other classes of users. Common to all of these user groups is their interest in the ability of an enterprise to generate cash and cash equivalents and of the timing and certainty of those future cash flows. Therefore, the *Framework* regards investors as the primary, overriding user group.
- d. The *Framework* notes that financial statements cannot provide all the information that users may need to make economic decisions. For one thing, financial statements show the financial effects of past events and transactions, whereas the decisions that most users of financial statements have to make relate to the future. Further, financial statements provide only a limited amount of the non-financial information needed by users of financial statements.
- e. Financial statements cannot meet all of the diverse information needs of these user groups. However, there are information needs that are common to all users, and general purpose financial statements focus on meeting those needs.
- f. While the concepts in the *Framework* are likely to lead to information that is useful to the management of a business enterprise in running the business, the *Framework* does not purport to address their information needs. The same can be said for the Standards and Interpretations themselves.

Problem 1.10 Performance of a business entity

A financial analyst says: “I advise my clients to invest for the long term. Buy good stocks and hang on to 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.” How does the *Framework* relate to this analyst’s view of financial statements?

- a. Accounting standards should help provide relevant and reliable financial information.
- b. 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.
- c. In other words, the statement of 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 reliable because they do not reflect real phenomena.

Problem 1.11 Going concern

What measurement principles might be most appropriate for a company that has ceased to be a going concern (for example, it is in bankruptcy and the receiver is seeking buyers for its assets)?

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

Problem 1.12 Economic consequences of accounting standards

After the OPEC oil embargo of 1973, the US government passed a law aimed at encouraging domestic exploration for oil and gas, to make the US less dependent on foreign suppliers. At about the same time, the FASB proposed an accounting standard that would have required oil and gas exploration companies to charge to expense, immediately, all unsuccessful exploration costs (no oil or gas discovered). Some exploration companies had been capitalising and amortising such unsuccessful costs. They said the FASB's proposed new standard would cause them to report losses, their sources of venture capital would disappear, and they would stop their exploration activities, which is contrary to government economic policy. How does the *Framework* relate to the accounting question? Consider, particularly, the issue of neutrality.

- a. The *Framework* is clear that accounting information must be decision-neutral – which means that the information is not designed in a way that intentionally leads the users of that information to make an economic decision that the firm of the information would like them to make.
- b. The definition of an asset in the *Framework* requires that an asset be a source of expected future benefits – benefits in terms of cash flows. Unsuccessful exploration costs provide no future benefits. They do not meet the definition of an asset.
- c. Persons who invest in oil and gas companies understand that these companies often must drill many “dry holes” to get one “gusher”.
- d. Deferring costs that do not meet the definition of an asset violates the *Framework*.
- e. If the national government wants to encourage oil and gas exploration, it can do so through legislation and fiscal policy (for instance, by providing tax incentives). It is not the role of accounting to be a tool of national economic or fiscal policy.

Problem 1.13 Assessing probabilities in accounting recognition

The *Framework* defines an asset as a resource from which future economic benefits are expected to flow. Expected is something less than a sure thing – it involves some degree of probability. At the same time, the *Framework* establishes, as a criterion for recognising an asset that “it is probable that any future economic benefit associated with the item will flow to or from the enterprise.” Again, an assessment of probability is required. Is there a redundancy, or possibly some type of inconsistency, in including the notion of probability in both the asset definition and recognition criteria?

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

Problem 1.14 Purchase orders

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

- a. Under the *Framework*, do you think the airline should recognise any asset or liability at the time it places the order?**
 - b. One year later, the price of this airplane model has risen by 5%, but our airline had locked in a fixed, lower price. Under the *Framework*, do you think the airline should recognise any asset (and gain) at the time when the price of the airplane rises? If the price fell by 5%, instead of rising, do you think the airline should recognise a liability (and loss) under the *Framework*?**
- a. Under current accounting, the airline should not recognise any asset or liability at the time it place the order, because the transaction has not taken place. Accounting recognises purchase transactions when delivery takes place, and title passes. At this point the airline, and not the manufacturer, has assumed the risks and rewards of owning the airplane.
 - b. Nonetheless, the airline has made an important and irrevocable commitment. Generally, major capital spending commitments are disclosed in the notes to the financial statements.
 - c. The airline is better off for having locked in the price than if it had not done so. Conversely, if the price had fallen, it would be worse off for having signed the non-cancellable fixed price order. Nonetheless, under current accounting standards, such gains and losses are not recognised.
 - d. Accounting treats commitments to purchase financial assets differently from commitments to purchase property. If the airline had agreed to purchase a foreign currency at a fixed price for delivery at a future date, and the exchange rate goes up or down, it is required to recognise a gain or loss.

Problem 1.15 Definitions of elements

Explain how you would account for the following items, justifying your answer by reference to the *Framework's* definitions and recognition criteria:

- a. A trinket of sentimental value only.
- b. You are guarantor for your friend's bank loan:
 - (i) You have no reason to believe your friend will default on the loan.
 - (ii) As your friend is in serious financial difficulties, you think it likely that he will default on the loan.
- c. You receive 1 000 shares in X Ltd, trading at \$4 each, as a gift from a grateful client.
- d. The panoramic view of the coast from your café's windows, which you are convinced attracts customers to your café.
- e. The court has ordered your firm to repair the environmental damage it caused to the local river system. You have no idea how much this repair work will cost.

(a) *Trinket of sentimental value*

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

(b) *Guarantor for friend's loan***(i) *Friend unlikely to default on his loan***

- Meets the para 49(b) liability definition: (1) present obligation – legal obligation via the guarantor contract; (2) past event – signing the guarantor contract; (3) settlement involving outflow of economic benefits – payment of the guarantee.
- Fails probability recognition criterion, as it is not likely that you will be required to pay on the guarantee. Hence, no liability can be recognised. However, note disclosure of the guarantee may be warranted (para 88).

(ii) *Friend likely to default on his loan*

- Again, meets the liability definition as per (i) above.
- Meets both recognition criteria – probable that outflow of economic benefits will be required, and settlement amount can be reliably measured (amount owing). Hence, a liability should be recognised.
- Also meets the expense definition and recognition criteria. Definition: (1) decrease in economic benefits in the form of a liability increase – you now owe the amount of your friend'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 you now owe the amount of your friend's loan. The bank can advise exactly how much your friend owes and so it can be reliably measured.

(c) Receipt of 1,000 shares in X Ltd, trading at \$4 each, as a gift from a grateful client.

- The receipt of the shares meets the asset definition: (1) represent FEBs (via future sales or dividend stream); (2) controlled by you (only you can benefit from either selling them or receiving dividends); (3) past event (their receipt).
- They also meet the asset recognition criteria: probable that FEBs will eventuate (via sale or dividend stream); and the shares have a value (they are trading at \$4 each) that can be reliably measured (this value can be verified via stock exchange etc).
- The shares also meet the income definition and recognition criteria. Definition: (1) increase in EBs in the form of an asset increase – you now own 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 FEBs has arisen, as you now own the shares (asset). The shares' value is known and so can be reliably measured.

(d) Café's panoramic view

- The view fails the definition as the entity does not control the FEBs that are expected to flow from the view – the entity cannot deny or regulate access by others to the view.
- Recognition criteria are irrelevant, as there is no asset to recognise.

(e) Court order to repair environmental damage caused to the local river system. You have no idea how much this repair work will cost.

- The court order meets the liability definition: (1) present obligation – legal obligation; (2) past event – order has been made; (3) settlement will involve outflow of EBs – future payment for repair of damage.
- Fails reliable measurement recognition criterion, as you have no idea as yet how much the repair work will cost. Hence, no liability can be recognised. However, note disclosure of the court order may be warranted (para 88).
- However, if you know a minimum amount that you 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 you have been ordered by the court) that you 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.

Problem 1.16 Definitions and recognition criteria

Explain how you would account for the following items, justifying your answer by reference to the definitions and recognition criteria in the *Framework*. Also state, where appropriate, which ledger accounts should be debited and credited.

- (a) Letters from your children, which are of great sentimental value.
 - (b)(i) Your firm has been sued for negligence – likely you will lose the case.
 - (ii) Your firm has been sued for negligence – likely you will win the case.
 - (c) Obsolete plant now retired from use.
 - (d) Donation of \$10 000 cheque.
- The asset definition is failed as the letters do not represent future economic benefits (para 49(a)). Future economic benefits constitute the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to an entity (para 53).
 - Recognition criteria are thus irrelevant, as there is no asset to recognise.
- (b)(i) Your firm has been sued for negligence – likely you will lose the case.**
- The liability definition (para 49(b)) is met as all 3 characteristics are present.
 - Past event: The act of negligence or the act of being sued.
 - Present obligation: Para 60 states that an obligation is a duty or responsibility to act or perform in a certain way. The key question here is whether there is a present obligation. Does the lawsuit create a present obligation? Or will the obligation only arise when a court decision against you is handed down? The definition requires the existence of a present, not a future, obligation (para 61). I believe that the lawsuit (arising from being sued) gives rise to a present obligation.
 - Settlement involves the outflow of economic benefits: If a present obligation is accepted as existing, its settlement will involve the outflow of economic benefits, namely cash.
 - The liability recognition criteria (para 91) are met, as it is probable that an outflow of economic benefits (cash) will result from settling the liability, and the amount (\$20,000 minimum) can be reliably measured.
 - Therefore, at this stage a liability of \$20,000 must be recognised. If the damages firm up to another amount as the case progresses, the amount must be adjusted.
 - The expense definition (para 70(b)) is met as all 3 characteristics are present.
 - Decrease in economic benefits during the period: The loss of at least \$20,000 represents a decrease in economic benefits and you were sued during the period.
 - In the form of a liability increase: See above liability discussion – you now owe \$20,000 minimum.
 - Results in a decrease in equity: If liabilities increase and assets remain unchanged, equity decreases.
 - The expense recognition criteria (para 94) are met, as the decrease in economic benefits has arisen, as you now owe \$20,000 minimum, and the amount (\$20,000 minimum) can be reliably measured.

- Therefore, at this stage an expense of \$20,000 must also be recognised. If the damages firm up to another amount as the case progresses, the amount must be adjusted accordingly.
 - Note that in this case the recognition of a liability has resulted in the simultaneous recognition of an expense (paras 91 and 98).
- (b)(ii) Your firm has been sued for negligence – likely you will win the case.**
- The liability definition (para 49(b)) is met as all 3 characteristics are present. See discussion in (b) (i) above.
 - However, the liability probability recognition criterion (para 91) is failed, as it is not probable that an outflow of economic benefits will result from settling the liability. As you are likely to win the case, it is unlikely that you will have to pay damages.
 - Therefore, the liability cannot be recognised. However, if material, the lawsuit should be disclosed in the notes.
- (c) Obsolete plant now retired from use.**
- The asset definition is failed as the plant no longer represents future economic benefits (para 49(a)).
 - The plant must now be written off from the accounts.
 - Recognition criteria are thus irrelevant, as there is no asset to recognise.
- (d) Donation of \$10,000 cheque.**
- The asset definition (para 49(a)) is met as all 3 characteristics are present.
 - Past event: The receipt or clearance of the cheque.
 - Flow of future economic benefits: The cheque represents an inflow of \$10,000 cash into your firm.
 - Control over the future economic benefits: Your firm will benefit from this \$10,000 cash inflow and can deny or regulate the access of others to this cash inflow.
 - The asset recognition criteria (para 89) are met, as it is probable (actually, it is certain) that an inflow of economic benefits (cash) will flow to the entity, and the amount (\$10,000) can be reliably measured as it is known.
 - Therefore, an asset of \$10,000 must be recognised.
 - The income definition (para 70(a)) is met as all 3 characteristics are present.
 - Increase in economic benefits during the period: The inflow of \$10,000 cash represents an increase in economic benefits, and you received and cleared the cheque during this period.
 - In the form of an asset increase: See above asset discussion – you now have additional cash of \$10,000.
 - Results in an increase in equity: If assets increase and liabilities remain unchanged, equity increases.
 - The income recognition criteria (para 92) are met, as the increase in economic benefits has arisen (as you now have additional cash), and the amount (\$10,000) is known.
 - Therefore, income of \$10,000 must also be recognised.
 - Note that in this case the recognition of an asset has resulted in the simultaneous recognition of income (paras 84 and 92).

Problem 1.17 Definitions and recognition criteria

Glasgow Accounting Services has just invoiced one of its clients \$3,600 for accounting services provided to the client. Explain how Glasgow Accounting Services should recognise this event, justifying your answer by reference to relevant *Framework* definitions and recognition criteria

- The *Framework* defines an asset as a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
- Invoicing the client gives rise to an asset as all 3 characteristics are present:
 - Flow of future economic benefits: The invoice represents a future cash inflow to the firm;
 - Control: The firm has control over the economic benefits via its contractual right to the future cash inflow; and
 - Past event: The issuing of the invoice or the provision of the services for which the invoice was issued.
- Under the *Framework* an asset must be recognised when it is probable that the future economic benefits will flow to the entity, and the asset has a cost or value that can be reliably measured.
- These recognition criteria are met as:
 - It is more than 50% likely (probably certain) that the firm will receive the cash (otherwise it would not have provided the services); and
 - The value (\$3,600) can be reliably measured as it is known.
- Therefore, an asset (receivable) of \$3,600 must be recognised.
- The *Framework* defines income as increases in economic benefits during the period in the form of inflows or enhancements of assets or decreases in liabilities that result in increases in equity, other than those relating to owners' contributions.
- Invoicing gives rise to income as all 3 characteristics are present:
 - Increase in economic benefits during the period: The right to a future cash inflow arose during the period;
 - Increase in assets or decrease in liabilities: The increase is in the form of an asset increase as the receivable meets the asset definition and recognition criteria; and
 - Increase in equity: As assets have increased and liabilities have not changed, equity has increased.
- Under the *Framework* income must be recognised when an increase in future economic benefits, related to an asset increase or liability decrease, has arisen that can be measured reliably.
- These recognition criteria are met as:
 - The asset increase has arisen (on issue of the invoice); and
 - The increase (\$3,600) can be reliably measured as it is known.
- Therefore, income (fee revenue) of \$3,600 must be recognised.

Problem 1.18 Assets

Lampeter Cosmetics has spent \$220,000 this year on a project to develop a new range of chemical-free cosmetics. As yet it is too early for Lampeter Cosmetics' management to be able to predict whether this project will prove to be commercially successful.

Explain whether Lampeter Cosmetics should recognise this expenditure as an asset, justifying your answer by reference to the *Framework* asset definition and recognition criteria.

- The *Framework* defines an asset as a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
- The expenditure of developing a new line of chemical-free cosmetics meets this definition as: (1) it represents future economic benefits via sale of the new line of cosmetics; (2) the benefits are controlled, as Lampeter Cosmetics will enjoy the economic benefits flowing from the new line; and (3) there is a past event, as Lampeter Cosmetics has already spent the \$220,000.
- Under the *Framework* an asset is recognised only when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be reliably measured.
- The expenditure fails the probability criterion, as it is not yet possible to predict whether the project will prove to be commercially relevant.
- Accordingly, Lampeter Cosmetics cannot (yet) recognise the expenditure as an asset.

Problem 1.19 Asset definition and recognition

On 28 May 2009 \$20 000 cash was stolen from Fremantle Ltd's night safe. Explain how Fremantle should account for this event, justifying your answer by reference to relevant *Framework* definitions and recognition criteria.

- The *Framework* defines expenses as decreases in economic benefits during the period in the form of asset decreases or liability increases that result in decreases in equity, other than those relating to distributions to owners.
- The theft of the \$20,000 cash satisfies the expense definition as:
 - It is a decrease in economic benefits during the period, as cash (economic benefits) has decreased;
 - The decrease in economic benefits is in the form of an asset decrease, as cash (an asset) has decreased; and
 - It has resulted in a decrease in equity, as assets have decreased and liabilities have not changed.
- In accordance with the *Framework* an expense must be recognised when:
 - A decrease in economic benefits related to an asset increase or a liability decrease has arisen; and
 - The decrease can be reliably measured.
- The theft of the cash satisfies both recognition criteria as:
 - The decrease in economic benefits related to an asset decrease (a decrease in cash) has occurred; and
 - The decrease can be reliably measured, as the amount of cash lost is known (ie \$20,000).
- Accordingly, an expense (Dr) and asset decrease (Cr) of \$20,000 must be recognised.

Problem 1.20 Revenue recognition

Toucan is a telecommunications provider. One of its products is a mobile phone service, the contract terms of which require the customer to pay 12 months' rental charge in advance at \$120 per month. Toucan's policy is to record the rental as revenue on receipt of the customers' payment. Its financial statements at 30 June 2009 classify the full amount of rental received during the year as revenue.

Toucan's auditor has advised that the rental revenue is overstated and must be adjusted.

Explain how Toucan should adjust the rental revenue recorded at 30 June 2009, justifying your answer by reference to relevant *Framework* definitions and recognition criteria.

- The *Framework* defines income as increases in economic benefits during the period in the form of asset increases or liability decreases that result in increases in equity, other than those relating to owners' contributions.
- The amount of rental prepaid at 30 June 2007 will not give rise to income until Toucan has a claim against its customers for the rental services provided. This claim arises progressively with the passage of time as the customers use the rental service. In respect of the amount prepaid at 30 June 2007, Toucan has an equivalent liability to provide the rental service over the remaining period of the prepayment. As there is an equivalent increase in a liability, there is no increase in equity. As such, the prepaid amount at 30 June 2007 fails the income definition.
- The *Framework* defines a liability as a present obligation arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. The rental prepaid at 30 June 2007 meets this (future outflow of economic benefits: providing the rental service; present obligation: legal obligation under the contract terms; past event: entering into the contract).
- The *Framework* states that a liability can be recognised when it is probable that an outflow of economic benefits will result from the settlement of a present obligation and the settlement amount can be reliably measured. The prepaid amount at 30 June 2007 meets both criteria (under the contract terms the service must be provided, and the amount prepaid can be reliably measured as months unused x rental charge/month).
- Accordingly, the rental prepaid at 30 June 2007 should be recognised as a liability. As such, Toucan should record an adjusting entry at 30 June 2007 (Dr Rental revenue and Cr Unearned revenue) for the amount prepaid.