CHAPTER 3

Accrual Accounting

In the late 16th century, the Dutch were at the forefront of trade with the rest of the known world, sailing as far as modern-day Indonesia to bring back spices that were in high demand in Europe. The large profits from this lucrative trade overcame the significant risks involved in traversing the oceans to the other side of the globe.

These voyages were also very expensive, requiring significant investment upfront to fund the construction and purchase of ships, as well as the hiring of crews for the long journeys, which lasted anywhere from several months up to more than a year. At the time, it was common for a company to be set up for each individual voyage then dissolved when the ship returned to port (or sank) and the goods were sold. There was little in the way of financial accounting, other than to record the amount of funds initially invested and the amount at the end of the voyage for disbursement to the investors.

In 1602, the Dutch government sponsored the creation of the Dutch East India Company (Verenigde Oost-Indische Compagnie). The new company had monopoly powers to trade with Asia as far as the Dutch were concerned (although other European countries had their own ideas about the monopoly). For this company, accounting no longer centred on each voyage as was previously the case. Rather, the company reported its accounts periodically, which resulted in the development of accrual accounting.

Why did the Dutch companies before 1602 not report on a periodic basis, and why did the formation of the Dutch East India Company change that practice? What is accrual accounting and why is it a consequence of periodic reporting?

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

L.O. 3-1. Explain the source of demand for periodic reporting and how accrual accounting satisfies that demand.

L.O. 3-2. Explain why accrual accounting is fundamentally inexact, why estimates are central to accrual accounting, and why there is no "true" income for typical situations; evaluate the "quality of earnings."

L.O. 3-3. Apply accrual accounting in relation to issues of timing: periodicity, cut-off, and subsequent events.

L.O. 3-4. Evaluate whether an accounting change is an error, a change in accounting policy, or a change in estimate, and apply the retrospective and prospective treatments appropriate to that type of accounting change.

L.O. 3-5. Integrate the structure and connections among the four financial statements and explain how this structure relates to accrual accounting.

In modern times, we take for granted that companies produce financial statements every year, or even more frequently. While much of this practice is due to regulation, the regulations themselves reflect the economic demands for periodic reporting. This chapter will first discuss the demand for and supply of periodic reporting. We will also see why periodic reporting naturally leads away from cash accounting toward accrual accounting (i.e., the way we currently present accounting reports; a formal definition of accrual accounting will follow). The chapter will then revisit the concept of uncertainty from Chapter 1 and how it

impacts the preparation of accrual accounting reports through the use of estimates. This conceptual background will help explain the structure of the income statement (the main report measuring periodic performance) and the idea of "quality of earnings," a concept that is used frequently in the press but often poorly understood.

After showing that periodic reports using accrual accounting are necessary to satisfy users' information needs, this chapter proceeds to explore several issues that surface as a consequence. First, what kinds of financial statements (balance sheet, income statement, etc.) are necessary under an accrual accounting regime? How do we define the reporting periods, and which events should be included in a particular period? Given the need to make accounting estimates and the need to change accounting policies from time to time, how do we deal with changes in these estimates and policies? How do we address errors in accounting reports that were previously issued?

While this range of issues may seem diverse, they all are addressed in this chapter because they all are connected by the idea of timing: when do events, transactions, and accounting occur relative to each other. In accrual accounting, as you will see, *timing is everything*.

A. DEMAND FOR PERIODIC REPORTING AND THE NEED FOR ACCRUAL ACCOUNTING

L.O. 3-1. Explain the source of demand for periodic reporting and how accrual accounting satisfies that demand.

Recall from Chapter 1 that a ccounting involves the production and transmission of information about an enterprise from those who have it to those who need it. In the context of financial reporting to external users, accounting can be very simple for businesses like the Dutch trading ships before 1602. Accountants needed only to record how much each investor contributed to the voyage; then, when the ship returned, the accountant tallied up how much the ship's goods fetched on the market and disbursed the funds to the investors according to their share of investment. In other words, the accounting was on a *cash basis*: track how much money comes into the enterprise at the beginning and how much goes back to each investor. This approach was efficient and practical because the cash cycles had all been completed.

TYPES OF CASH CYCLES

A **cash cycle** is a set of transactions that converts a cash inflow to a cash outflow or vice versa. We can categorize cash cycles into three types: financing, investing, and operating. A **financing cash cycle** is the receipt of funding from investors, using those funds to generate returns from investments and operations, and returning the funds to investors. An **investing cash cycle** begins with the use of funds to purchase property that has long-term future benefits for the enterprise (e.g., equipment), using that property to obtain economic benefits that ultimately result in cash inflows, and disposing of the property. An **operating cash cycle** involves the purchase of items such as inventory; production, sales, and delivery of goods or provision of services; and receipts from customers. The distinction between financing and the other two cycles is quite clear because of the *direction* of cash flows: financing involves inflows to the enterprise followed by outflows, while investment/operations involve outflows then inflows. The distinction between the investing and

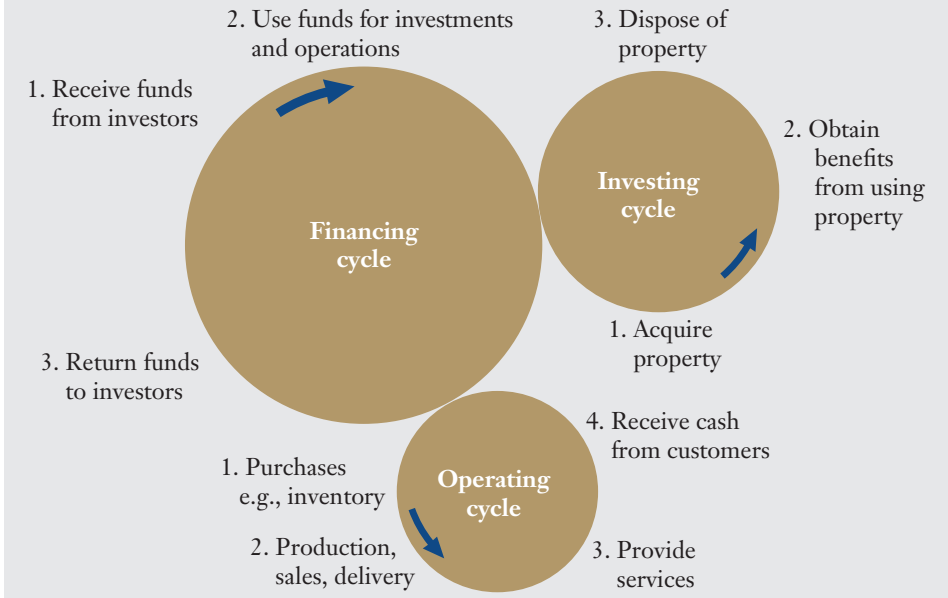
(*Continued*)

cash cycle: A set of transactions that converts a cash inflow to a cash outflow, or vice versa. A **financing cash cycle** is the receipt of funding from investors, using those funds to generate returns from investments and operations, and returning the funds to investors. An **investing cash cycle** is the purchase of property that has long-term future benefits for the enterprise, using that property to obtain economic benefits that ultimately result in cash inflows, and disposing of the property. An **operating cash cycle** involves the purchase of items such as inventory; production, sales, and delivery of goods or provision of services; and receipts from customers.

operating cash cycles is less clear as it requires subjective judgments about long versus short term: investing cycles tend to be longer than operating cash cycles.

Exhibit 3-1 summarizes each of these three cash cycles as well as their tendency to be nested: financing provides cash flows for investment and operations, investment provides benefits for operations, and operations generates cash flows to fund more investments and payments to investors.

Exhibit 3-1 Conceptual depictions of cash cycles



Why was there no reporting in between departure and return of the ships? The reason is simple: there were no credible and timely ways to obtain information about a voyage until the ship returned to port. (Credibility is important here, as there could be unverifiable rumours from other ships that happen to cross paths with the ship of interest.) Without such information, no one was in any mood to buy or sell investments in the voyage once the ship had started its journey. It was only practical to wait until each ship returned to port. In other words, there was an *inability to supply* the information during the voyage, even if people demanded it. Given the limited duration of each company/voyage, investors were willing to wait for the ship's return.

The formation of corporations like the Dutch East India Company changed all that. These corporations, and other types of entities, had indefinite lives. They were intended to continue operating until the owners at a future date collectively decided to dissolve the entity. With the uncertain length of time until dissolution, which could be a very long time in the future, it is clearly not practical for investors to wait until the dissolution of the company to find out if they made any money!

The rise of entities with indefinite lives meant that investors in such entities needed to sell their investments at some point before the dissolution of the entity. These sellers and any potential buyers needed information to help them value the investment. Given a multitude of investors, it only made sense that enterprises report at pre-specified intervals rather than respond to information requests coming from each investor or potential investor. In the case of the

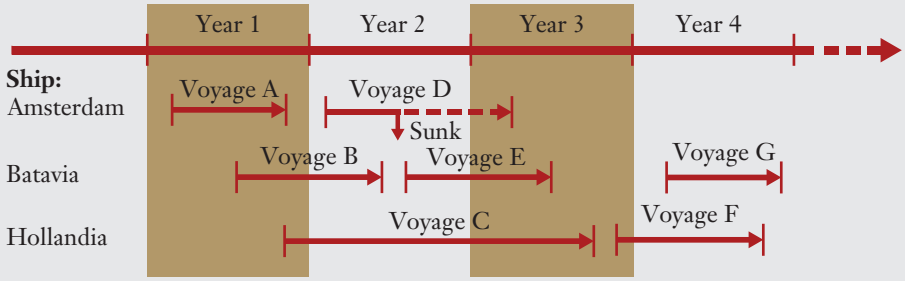
STILL WAITING...

In 1670, an incorporation under the British royal charter created "The Governor and Company of Adventurers of England trading into Hudson's Bay." The charter gave the company exclusive rights to the fur trade in the watershed flowing into Hudson Bay. The company continues to operate today as The Hudson's Bay Company. It was publicly traded until January 2006, when it was purchased by private equity firm NRDC Equity Partners. If investors had to wait until dissolution to find out what happened to their investments, they would have been waiting for almost three and a half centuries—and counting!

Dutch East India Company, this interval was 10 years.[1] Today the interval is typically a year or a quarter according to incorporation laws, securities regulations, and securities exchange rules.

Except for coincidental occasions, the end of a reporting period such as a year will not correspond with the completion of transactions. For instance, consider the hypothetical series of trading voyages for Tradewinds Company shown in Exhibit 3-2.

Exhibit 3-2 Timeline with voyages for Tradewinds Company



At the end of the first year, Voyage A will have been completed. However, Voyages B and C also began in Year 1, but the ships had not returned by the end of the year. Should Tradewinds Company report only the results of Voyage A? What should Tradewinds report regarding the investments it made for Voyages B and C?

As you can gather from this example, reporting only information for completed voyages using cash basis accounting provides incomplete information to investors. (Recall the concept of completeness in the conceptual frameworks of Chapter 2.) Investors need to know that Tradewinds has invested in other voyages that are in progress at the end of the year—and, if the information is available, the status of those voyages. The accrual basis of accounting would try to capture the voyages in progress.

Formally, **accrual accounting** is a basis of accounting that reflects economic events when they happen rather than only when cash exchanges occur. For instance, for Year 1 accrual accounting would include information relating to

accrual accounting A basis of accounting that records economic events when they happen rather than only when cash exchanges occur; contrast with **cash accounting**.

1. The reports were required every 10 years. While this seems like a long time in current times, bear in mind that each voyage could last for more than a year. Given the nature of the Dutch East India Company's operations, 10 years is perhaps not such an unreasonable reporting period.

the one completed voyage (A) as well as the two that are in progress at year-end (voyages B and C). Investors would find all of this information useful. Indeed, the financial report would be misleading were it to omit information about the two unfinished voyages. As you can see, accrual accounting arises naturally when enterprises report periodically.

CHECKPOINT **CP3-1**

Explain the historical and logical reasons why we prepare periodic financial reports.

B. ACCRUAL VERSUS CASH ACCOUNTING

cash accounting A method of accounting that records only cash exchanges; contrast with **accrual accounting**.

We can use Exhibit 3-2 to illustrate the differences between accrual and **cash accounting** by applying some simple numbers to the voyages.[2]

- Investors provide $20 million in financing to start up the company.
- Each ship costs $5 million and on average can complete 10 voyages, unless it is sunk by storms, hazards, or pirates.
- Operating costs for each voyage are $1 million to pay for the crew's wages and to stock the ship with inventories and supplies. The company must pay these costs in advance because the goods and the crew may perish at sea.
- A successful voyage usually returns within a year (sometimes longer, depending on weather conditions) with goods that can be sold for $5 million.

The cash basis accounting report for Years 1 and 2 would look as shown in Exhibit 3-3 (Years 3 and 4 will be left as an exercise).

Exhibit 3-3 Cash basis financial report for Tradewinds Company

	Year 1		Year 2	
	Voyages	$m	Voyages	$m
Operations				
Inflow from sale of goods ($5m/arrival)	A	$ 5	B	$ 5
Outflow for operating costs ($1m/departure)	A, B, C	(3)	D, E	(2)
Cash flow from operations		2		3
Cash flow from investing activities ($5m/ship)		(15)		0
Cash flow from financing activities		20		0
Net cash flow for the year		7		3
Cash at beginning of year		0		7
Cash at end of year		$ 7		$10

Note that the cash financial report is a statement of flows, with the balance of cash reported at the bottom. We can also produce a balance sheet, but it would be very short and redundant: it would show only cash of $7 million and $10 million for Year 1 and 2, respectively, and equity equal to those amounts. *The cash basis balance sheet has only cash and equity in equal amounts; there are no other items because all non-cash items are accruals.*

accrual An accounting entry that reflects events or transactions in a period different from its corresponding cash flow.

Accruals are accounting entries that record events in a period different from the corresponding cash flows. Accruals encompass both instances where the accounting

2. We use "dollars" and "$" for convenience. The actual Dutch currency since the 13th century had been the guilder, until the Netherlands adopted the euro.

record reflects (i) events before cash flows and (ii) events after cash flows. Sometimes accountants will refer to the latter more specifically as **deferrals**. For example, recognizing sales revenue after the receipt of cash is a deferral of revenue.

deferral An accounting entry that reflects events or transactions after the related cash flow.

To prepare the accrual basis financial report, we need to provide some additional guidance on Tradewinds Company's accrual policies:

- Record the cost of products shipped out and traded in exchange for products from Asia when the Asian products are sold at the home port. Similarly, record the cost of supplies and wages as well as depreciation when the ship returns home. This is a reasonable but arbitrary allocation rule that maintains the logical relationship between revenues and related costs (conventionally called "matching" of costs to revenues).
- When the company receives information about the sinking of one of its ships, the company writes off the recorded value of that ship and expenses any inventories, prepaid wages, and prepaid supplies on the books.

Based on the previous information and these two accrual accounting policies, the accrual basis financial report would look like the one shown in Exhibit 3-4:

Exhibit 3-4 Accrual basis financial report for Tradewinds Company

	Year 1		Year 2	
	Voyages	$m	Voyages	$m
Statement of income and retained earnings				
Revenue ($5m/arrival)	A	$ 5.0	B	$ 5.0
Operating expenses ($1m/arrival)	A	(1.0)	B	(1.0)
Depreciation ($0.5m/arrival)	A	(0.5)	B	(0.5)
Write-off of sunken ship		0.0	D	(4.5)*
Write-off of operating costs due to sunken ship ($1m/ship)		0.0	D	(1.0)
Net income (loss)		3.5		(2.0)
Retained earnings at beginning of year		0.0		3.5
Retained earnings at end of year		$ 3.5		$ 1.5
Balance sheet				
Cash (see Exhibit 3-3)		$ 7.0		$10.0
Prepaid expenses ($1m/voyage in progress)	B, C	2.0	C, E	2.0
Ships at cost ($5m/ship)		15.0		10.0
Less: accumulated depreciation	A	(0.5)	B	(0.5)
Total assets		$23.5		$21.5
Contributed capital		20.0		20.0
Retained earnings		3.5		1.5
Total equity		$23.5		$21.5
Cash flow statement (same as cash basis report—see Exhibit 3-3)				

*The *Amsterdam* sank in Voyage D. After depreciation of $0.5m for Voyage A, it had a book value of $4.5m, so this is the amount written off.

Let's compare and contrast the differences in the two sets of reports. What can we say about the complexity of the reports? It is evident that the cash basis report is much simpler. Tradewinds' cash balance increased from $7 million to $10 million, and we can see the sources of that change. In contrast, the accrual reports are more complex; there are many more items in the accrual accounting reports. Observe that all the items other than cash in the balance sheet result from accrual accounting.

Second, which set of reports provides more useful information about performance? The cash basis report shows operating cash flows of $2 million in Year 1, increasing to $3 million in Year 2. The accrual basis report shows $2.5 million income in Year 1, turning into a loss of $2 million in Year 2.

Exhibit 3-5 Summary of performance measures for Tradewinds Company

Reporting basis	Performance measure	Year 1	Year 2
Cash basis	Operating cash flow	$2.0m	$3.0m
Accrual basis	Net income (loss)	$3.5m	($2.0)m

These are quite dramatic differences and trends. To decide which one better reflects the underlying facts known to us (and to insiders, but not necessarily to people outside the company) we can summarize Tradewinds' activities as follows:

Exhibit 3-6 Summary of trading activities for Tradewinds Company

Activity	Year 1	Year 2
Ships departed	3	2
Ships returned	1	1
Ships sunk	0	1

The company did not increase its trading activity in Year 2 and actually lost a ship during the year. Since the value of each voyage is constant year to year, it only makes sense that Year 2's performance should be lower than that in Year 1. From this example, we can say objectively and unambiguously that the accrual basis more closely reflects underlying events. The accrual basis of accounting provides more useful financial information to readers because it permits companies and their management to communicate their expectations of future outcomes.

To summarize these last two sections, we observe from history that a change from (i) single-purpose enterprises with limited life to (ii) enterprises that had indefinite lives created a demand for periodic reporting. In turn, periodic reports are more useful in terms of reflecting the economic conditions of the enterprise if they use an accrual basis rather than a cash basis. The illustration using Tradewinds Company demonstrates the differences in the financial reports that result.

CHECKPOINT **CP3-2**

Explain how accrual accounting better satisfies the demand for information in comparison to cash accounting.

L.O. 3-2. Explain why accrual accounting is fundamentally inexact, why estimates are central to accrual accounting, and why there is no "true" income for typical situations; evaluate the "quality of earnings."

C. UNCERTAINTY AND THE ESSENTIAL ROLE OF ESTIMATES IN ACCRUAL ACCOUNTING

Accrual accounting involves reporting amounts before the completion of some or all of the cash cycles. The inherent uncertainty of the future means that accrual accounting necessarily requires the use of estimates—no one, including the company's management, knows precisely the likelihood and amounts of future cash flows that will occur later in the cash cycles.

Refer to Tradewinds Company from the previous section, for example. The mere act of recording the three ships as assets uses estimates of the future cash flows expected to result from the use of the ships. Sometimes these estimates turn out to be incorrect—the vessel *Amsterdam* sank in Voyage D in Year 2, taking with it the inventories, supplies, and most likely the souls on board.

The need to use estimates means that all accrual accounting reports are imprecise—there is no single "true" accounting report for any set of circumstances. However, this does not mean that any arbitrary accrual accounting report is acceptable. Rather, there is a range of acceptable alternatives. For instance, Tradewinds Company could have used an alternate allocation policy for the ships' cost that recorded the depreciation expense when a ship departed instead of when it returned to port. On the other hand, not recording an expense for the supplies used would not be acceptable.

If we cannot describe financial statements as "true," or even more or less true, what *can* we say? Because of uncertainty and the need for estimates, the appropriate reference point should be "unbiased" financial statements. If we were to ask a sample of accountants (say, a hundred) without vested interests in the company concerned what they would do, we are likely to hear a range of answers. We can think of **unbiased accounting** as some average or consensus from this sample of disinterested accountants. Unbiased accounting is similar to the attribute of neutrality, which contributes to the qualitative characteristic of representational faithfulness in the IFRS Conceptual Framework discussed in Chapter 2.

unbiased accounting A conceptual accounting outcome that would result from taking an average or consensus from a sample of disinterested accountants.

Historically, IFRS has had a concept called the **true and fair** view, which states that accountants and auditors have a duty to evaluate the financial statements as a whole and determine whether those financial statements present a "true and fair" presentation of the company; if the financial statements are not true and fair, then the responsible accountant should amend them such that they are true and fair. This overall assessment can be used to override individual estimates, accounting choices, and even accounting standards if those estimates, choices, or standards produce financial statements that are not "true and fair."

true and fair An overall evaluation of a set of financial statements as being a fair representation of the enterprise's economic conditions and performance.

This is unfortunate wording, however. As we have seen in the above discussion, there can be no "true" financial statements under accrual accounting within the ordinary meaning of the word "true." Thus, we should not interpret "true and fair" literally; instead, we should take it to mean simply "fair." Appropriately, the new IFRS Conceptual Framework makes no mention of this concept. Furthermore, Canadian Auditing Standards note that to present financial statements that are "true and fair" and to "present fairly" have the same meaning.[3]

CHECKPOINT **CP3-3**

Explain why accrual accounting numbers are fundamentally inexact.

D. QUALITY OF EARNINGS AND EARNINGS MANAGEMENT

A close relative of fair presentation is the idea of "quality of earnings." While many people have a general idea of what would constitute high-quality or low-quality earnings, there is often confusion over this concept. Some believe that earnings quality should be measured by comparing actual reported profits to

3. See IFRS Framework prior to 2011, paragraph 46, and Canadian Auditing Standard 700, paragraph 35.

what "true" earnings would be. On the other hand, many finance professionals such as stock analysts evaluate the quality of earnings by comparing income to cash flows.

While both of these ideas make some sense, they are both inadequate characterizations of earnings quality in different ways:

- Since a measure of true earnings does not exist, as discussed previously, we cannot evaluate earnings quality relative to true earnings. This applies both at the conceptual level and at a practical level.
- Using cash flow to evaluate the quality of earnings implies that cash flow is a better measure of performance. As the Tradewinds' example demonstrates, cash flow is usually an inferior measure of performance compared with accrual basis earnings.

quality of earnings How closely reported earnings correspond to earnings that would be reported in the absence of management bias.

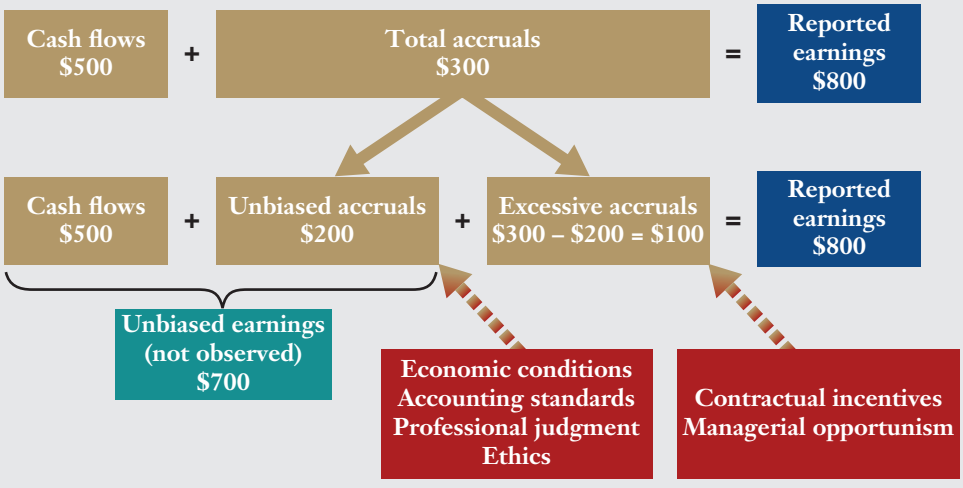
Instead, the **quality of earnings** refers to how closely reported earnings correspond to earnings that would be reported in the absence of managerial bias. To understand this idea, let's take a simple example. Suppose Quantum Company has cash flows equal to $500, and reported earnings are $800. As defined earlier, accruals reflect events and transactions that occur in periods different from their corresponding cash flows. Thus, accruals represent the difference between reported earnings and cash flows, or $300 ($800 – $500).

We can think of separating this $300 of accruals into two components:

- *unbiased accruals* that reflect economic conditions and accounting standards with the application of professional judgment and considering professional ethics
- *excessive accruals* that result from contractual incentives for the firm or management as well as any unethical managerial opportunism to over- or under-accrue

Suppose that Quantum Company has unbiased accruals of $200, meaning that excessive accruals amount to $100 ($300 – $200). Ideally, if we were able to observe the amount of unbiased accruals, then we could determine the amount of unbiased earnings = cash flows + unbiased accruals = $500 + $200 = $700. However, the actual earnings that we observe are $800, which includes both unbiased and excessive accruals. The relationships among cash flows, accruals, and earnings are shown in Exhibit 3-7.

Exhibit 3-7 Relationship among cash flows, accruals, and earnings, including figures for Quantum Company



If it were possible, *we would evaluate the quality of earnings by identifying the excessive component of accruals*. Lower excessive accruals translate into higher-quality earnings. However, we can only observe total accruals. To distinguish the portion of total accruals that is excessive from the portion that is unbiased, users need to make conjectures about the incentives faced by management that would lead them to make more or less excessive accruals. Several of these motivations to manage earnings were discussed in Chapter 1 in relation to positive accounting theory and the economic consequences of different accounting choices.

THRESHOLD CONCEPT

The discussion in this section has focused on the quality of earnings, but the general ideas apply to the other financial statements as well. For instance, we can also think about the quality of the balance sheet: which assets and liabilities are potentially over- or understated relative to unbiased reporting, and by how much? Furthermore, excessive accruals on the income statement will have direct implications for the other financial statements because of the connections among them. For instance, recognition of more revenue on the income statement results in higher accounts receivable on the balance sheet. This and other connections among the financial statements will be explored further later in this chapter.

CHECKPOINT **CP3-4**

Explain what is meant by "quality of earnings." How can financial statement readers evaluate the quality of earnings?

E. PERIODICITY, CUT-OFF, AND SUBSEQUENT EVENTS

L.O. 3-3. Apply accrual accounting in relation to issues of timing: periodicity, cut-off, and subsequent events.

Once in a while, those who are not familiar with accounting (and some who are) will say something to the effect of "It's only a matter of timing" in reference to the accounting of a transaction—and, in so doing, try to play down the importance of an accounting issue. However, as mentioned in the introduction, in accrual accounting *timing is everything*! Accrual accounting exists precisely because users desire to know what events and transactions occurred in a particular period of time. Therefore, it is essential to properly define the reporting period. Related to this issue, how do we deal with events and information that arise near the cut-off date at the end of the period and subsequent to that date?

THRESHOLD CONCEPT

1. Periodicity

The typical reporting period for an enterprise is 12 months. Aside from regulatory and tax reporting requirements, this length of time makes sense in terms of the annual cycles of the seasons and the resultant ebb and flow of economic activity. However, an annual period does not need to match the calendar year of January 1 to December 31. Many businesses choose a year-end that coincides with a time of lower activity. For instance, Canadian retailers will tend to have year-ends at the end of January—after the holiday season when sales peak, inventory is at a low level, and any returns from customers have been processed. In addition, some enterprises will have reporting periods that are close to, but not exactly, 12 months. Again, retailers provide a good example: they have reporting periods of 52 weeks (364 days) and 53 weeks once every several years because doing so provides more comparable information year to year due to sales being significantly higher on some days of the week. In practice, about two-thirds of public enterprises have year-ends on December 31 or within a few days before or after.

2. Cut-off

cut-off The point in time at which one reporting period ends and the next begins.

Cut-off refers to the point in time at which one reporting period ends and the next begins. Defining this point is crucial to financial statements reported on a periodic basis. Because accrual accounting reflects some cash cycles that are not complete, it is necessary to formulate rules regarding which events will be reflected in the reporting period (i.e., prior to the cut-off date) and which others will not. As we proceed through later chapters, we will see this idea again and again. For example, Chapter 4 will discuss whether revenue should be recorded prior to the cut-off date or in a later period.

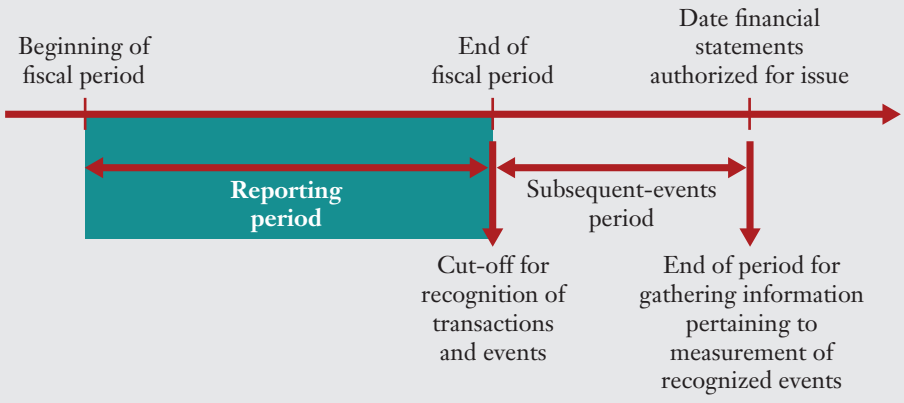
In addition to deciding which events should be reflected in the reporting period, we also need to consider the timing of information relating to these events. While accrual accounting estimates are inherently imprecise, we should use the best information available to maximize the precision as much as possible. This usually means using information that is as up-to-date as possible. However, we cannot wait for all uncertainty to disappear, as that would require all the cash cycles to be complete, which goes against the idea of periodic reporting.

For instance, suppose that a company has inventories of $2 million at year-end. During the preparation of the annual financial statements, the company's management learns that a quarter of the inventories have declined in value because of a technological change that has made the inventory obsolete. This information affects how much the company reports for inventories because these goods need to have future benefits for the company to satisfy the definition of an asset. The subsequent event indicates that the inventories did not have such future benefits, so the company would need to write down or write off the value of the affected inventory. The period between the cut-off date and the date when the company authorizes its financial statements for issuance is called the **subsequent-events period**.

subsequent-events period The period between the cut-off date and the date when the company authorizes its financial statements for issuance.

A common point of confusion involves whether an event is merely a subsequent event and not part of the reporting period. A useful way to distinguish the difference is in terms of recognition and measurement. We *recognize* transactions and events occurring within the reporting period (i.e., up to the cut-off date), but the *measurement* of those transactions can use the best information available whether that information is from the reporting period or the subsequent-events period. The timeline in Exhibit 3-8 illustrates this difference.

Exhibit 3-8 Timeline showing subsequent-events period in relation to recognition and measurement



For the inventories just mentioned, the inventories are on hand at year-end, so they should be recognized on the balance sheet. If some of the inventories become obsolete prior to the cut-off date (i.e., the fiscal year-end), then the obsolescence should be recognized even if the information about the technological change becomes available later during the subsequent-events period. That

information affects the measurement of the financial consequences of the technological change and the value of inventory at year-end.

On the other hand, if the technological change occurs during the subsequent-events period, then there would be no impact on the amounts recognized. If the effect is material, the company should disclose the information about the technological change in the notes to the financial statements.

Another common example to illustrate subsequent events relates to accounts receivable. Enterprises can and should use information in the subsequent period to estimate the amount to record in the allowance for doubtful accounts. Such information includes actual collections and defaults in the subsequent-events period for accounts outstanding at year-end.

In contrast, suppose an accident on January 15, 2012, results in the destruction of a transport truck that had a carrying value of $400,000 on the year-end date of December 31, 2011. The accident occurred after the cut-off date, so the reported value of the truck on December 31, 2011, would not include the effect of the accident. If the amount were material, the reporting entity would provide note disclosure regarding the effect of the accident.

CHECKPOINT **CP3-5**

What key dates define the subsequent-events period? Explain how information obtained in the subsequent-events period should be used.

F. ACCOUNTING CHANGES: ERRORS, CHANGES IN ACCOUNTING POLICY, AND CHANGES IN ESTIMATES

L.O. 3-4. Evaluate whether an accounting change is an error, a change in accounting policy, or a change in estimate, and apply the retrospective and prospective treatments appropriate to that type of accounting change.

As noted previously, accounting is inherently inexact because accruals depend on uncertain future outcomes. Therefore, we should expect changes in circumstances over time. To reflect changed circumstances, management may find it appropriate to change accounting estimates. At other times, a change in accounting policy is more appropriate since, ideally, a company chooses accounting policies that best reflect its economic circumstances. In addition, to err is human, so we need to know how to handle accounting errors. IFRS–IAS 8 and ASPE Section 1506 provide guidance on how to deal with these three types of accounting changes.

1. Correction of errors

An error occurs when a company reports an incorrect amount *given the information available at the time*—hindsight must not be used. For instance, a forecast of useful life for equipment that turns out to be wrong is not an error as long as the forecast was made in good faith based on the available information. However, if management estimates the useful life to be five years but then applies a 10% straight-line depreciation rate, this would be an error. For a **correction of an error**, the appropriate treatment is **retrospective adjustment with restatement**. "With restatement" means that any financial statements from prior years presented for comparative purposes must be restated. The reason for retrospective correction of errors is to restore the previous financial statements to *what they should have been* given the information available at that prior date.

correction of an error An accounting change made necessary by the discovery of an incorrect amount given information available at the time the amount was reported.

retrospective adjustment (also retroactive adjustment) Applying an accounting change to all periods affected in the past, present, and future. Retrospective adjustment **with restatement** shows any comparative figures on the same basis as the current period figures. Retrospective adjustment **without restatement** reflects the accounting change's impact on past periods in the current period.

2. Changes in accounting policy

A **change in accounting policy** is a change in, for example, inventory accounting from weighted average to first-in, first-out (FIFO). Such changes are at the

change in accounting policy An accounting change made at the discretion of management.

discretion of management but should be made to reflect economic circumstances. (Recall that standards allow a range of accounting policies because there are a variety of economic circumstances.) The appropriate treatment for changes in accounting policy is retrospective adjustment with restatement.

Requiring retrospective adjustment with restatement increases comparability of financial statements (i.e., consistency over time). If a switch from weighted average to FIFO increases income for the current year, for example, users need to have financial statements from the prior year to make a meaningful comparison. Retrospective adjustment with restatement also reduces the temptation to change accounting policies to manage earnings, because the effect of the change applies not just to the current year but also to all prior years. If the change were not retrospective, then the cumulative effect of the accounting policy change could significantly impact the current year's income. In fact, US GAAP treats changes in accounting policy retroactively *without* restatement. Comparative financial statements are not adjusted, and the income statement reports the retroactive effect through current-year income as "cumulative effect of accounting change" at the bottom of the income statement.

To illustrate the effect of the different methods, consider a change in depreciation policy that is treated as a change in accounting policy. (As will bee seen in Chapter 8, a change in depreciation can also be considered a change in accounting estimate.) Assume that a company has a single piece of equipment, purchased at the beginning of 2013 for $1 million. The equipment has an estimated useful life of 10 years and zero residual value. The company initially decides to use a declining-balance method of depreciation at double the straight-line rate. The straight-line rate is 10%, so the depreciation in 2013 is 20% of $1 million, or $200,000. Also assume that the company earns income before depreciation of $500,000 in both 2013 and 2014. In 2014, the company chooses to change the depreciation policy from double-declining-balance to straight-line. (For simplicity, ignore income taxes.) This change in depreciation was not due to any change in circumstances or new information; the useful life remains at 10 years and there is no change in usage of the equipment. Exhibit 3-9 shows the effect of this change in accounting policy under different reporting methods.

Exhibit 3-9 Illustration of potential methods to reflect a change in accounting policy

($000's)	As originally reported	Retrospective with restatement (IFRS, CICA)*		Retrospective without restatement (U.S. GAAP)†		Prospective treatment (not permitted for change in policy)‡	
	2013	2013	2014	2013	2014	2013	2014
Equipment—at cost	1,000	1,000	1,000	1,000	1,000	1,000	1,000
Accumulated depreciation	(200)	(100)	(200)	(200)	(200)	(200)	(289)
Equipment—net	800	900	800	800	800	800	711
Income before depreciation	500	500	500	500	500	500	500
Depreciation expense	(200)	(100)	(100)	(200)	(100)	(200)	(89)
Income before the following	300	400	400	300	400	300	411
Cumulative effect of accounting change	—	—	—	—	100	—	—
Net income	300	400	400	300	500	300	411

* Retrospective with restatement: Apply straight-line depreciation from the beginning of the equipment's life, so annual depreciation equals 10% of $1 million cost.

† Retrospective without restatement: Determine how much straight-line depreciation would be had it been used from the beginning of the equipment life, and reflect the effect on only the 2014 financial statements. The 2014 depreciation should be $100,000. Previously, $200,000 had been recorded for depreciation in 2013. Cumulative depreciation is $300,000, but straight-line depreciation over two years would require only $200,000. The excess $100,000 of depreciation is reversed by item "cumulative effect of accounting change."

‡ Prospective treatment: Do not adjust prior year. Apply new depreciation policy beginning in 2014. The undepreciated cost at the beginning of 2014 is $800,000, depreciated over the remaining nine years results in straight-line depreciation of $800,000/9 = $88,889 per year.

With the given assumption of stable operations (constant income before depreciation), we observe that the method of retrospective adjustment with restatement provides the most comparable financial information, particularly net income, which is $400,000 each year. The US approach of retrospective adjustment without restatement shows a pattern of increasing income from $300,000 to $500,000, although the separate reporting of the cumulative effect of accounting change of $100,000 makes evident the source of the increase. However, even backing out this $100,000 results in a pattern of increasing income: $300,000 in 2013 and $400,000 in 2014.

The last two columns show what would be reported under the prospective method, which is not permitted for changes in accounting policy. However, the prospective method is appropriate for changes in accounting estimates, which we discuss next.

3. Changes in accounting estimates

Accounting estimates are, for example, the percentage of bad debts or the number of years of useful life for a piece of equipment. These estimates should be based on the best information available at the time of financial statement preparation. However, as time progresses, new information could suggest that alternate estimates would be more accurate. Since such information was not predictable at the time of the prior estimates, the appropriate treatment is **prospective adjustment**: applying the change only to the current and future reporting periods without any changes to past financial statements. The two columns on the far right of Exhibit 3-9 show how this method would be applied if a change in depreciation method were considered a **change in estimate**. A change from the declining-balance method to the straight-line method can be justified as a change in estimate if the straight-line method more closely resembles the pattern of usage or value derived from the equipment.

prospective adjustment Applying an accounting change only to the current and future reporting periods without any changes to past financial statements.

change in estimate An accounting change made necessary by the arrival of new information.

4. Illustrative example for practice

You have been provided with the following information related to two recent financial years for Random Home Inc. (amounts in $millions):

	2012	2013
Retained earnings—beginning of year	800	920
Accounts receivable—gross	850	900
Revenues	2,500	2,650
Cost of goods sold	1,600	1,650
Selling, general, and administrative expenses	300	320
Depreciation	100	100
Interest expense	260	240
Income before tax	240	340
Income tax expense	72	102
Net income	168	238

Required:

While preparing the 2013 financial statements, you realize that, in anticipation of uncollectible accounts, there needs to be a downward adjustment to end-of-year accounts receivable by 4% of the accounts receivable balance. Using the following table, indicate the impact on the financial statements if this change is due to one of the following reasons (ignore the effect of income tax):

a. An error correction because the company should have known that receivables were overvalued as early as 2012.
b. A change in accounting policy because the company had not previously provided for bad debts as they had been deemed immaterial.
c. A change in estimate due to new information showing a deterioration of economic conditions.

	2012			2013		
Type of accounting change	**Statement of comp. income**	**Accounts receivable**	**Retained earnings**	**Statement of comp. income**	**Accounts receivable**	**Retained earnings**
(a)						
(b)						
(c)						

Suggested solution:

	2012			2013		
($000's) Type of accounting change	**Statement of comp. income**	**Accounts receivable**	**Retained earnings**	**Statement of comp. income**	**Accounts receivable**	**Retained earnings**
(a) Error correction	–34	–34	–34	–2	–36	–36
(b) Change in policy	–34	–34	–34	–2	–36	–36
(c) Change in estimate	0	0	0	–36	–36	–36

The change in estimate in (c) is the simplest as it requires prospective adjustment. In 2013, the current reporting period, the company needs to record an allowance for doubtful accounts (a reduction in net accounts receivable) equal to 4% of the receivable balance of $900,000, which is $36,000. The adjusting journal entry would be:

2013	Dr. Bad debts expense	36,000	
	Cr. Allowance for doubtful accounts		36,000

When the income statement accounts are closed for the period, the bad debts expense also reduces retained earnings.

The error correction and change in accounting policy in (a) and (b) both require retrospective adjustment with restatement. To properly reflect this accounting change, the company needs to consider the effect on current as well as prior reporting periods. Had the company provided for bad debts in 2012, it would have recorded 4% of the receivable balance of $850,000, which is $34,000. After making this provision, the company would then record only an additional $2,000 for bad debts to bring the balance up to $36,000. Thus, the journal entries are:

2012	Dr. Retained earnings (bad debts expense)	34,000	
	Cr. Allowance for doubtful accounts		34,000
2013	Dr. Bad debts expense	2,000	
	Cr. Allowance for doubtful accounts		2,000

Notice that the 2012 entry debits retained earnings. While conceptually the $34,000 adjustment is for bad debts expense, which is denoted in parentheses,

it is not correct to debit the "bad debts expense" account. All income statement accounts, such as bad debts expense, are temporary accounts representing the current fiscal year. To debit "bad debts expense" would record the expense in 2013. The "bad debts expense" account for 2012 had already been closed to retained earnings, so the adjustment goes directly to retained earnings.

For a review of temporary accounts, closing entries, and other aspects of the accounting cycle, see the Appendix at the end of this chapter.

CHECKPOINT **CP3-6**

Which type(s) of accounting changes require retrospective adjustment? Which one(s) require prospective treatment?

5. Summary

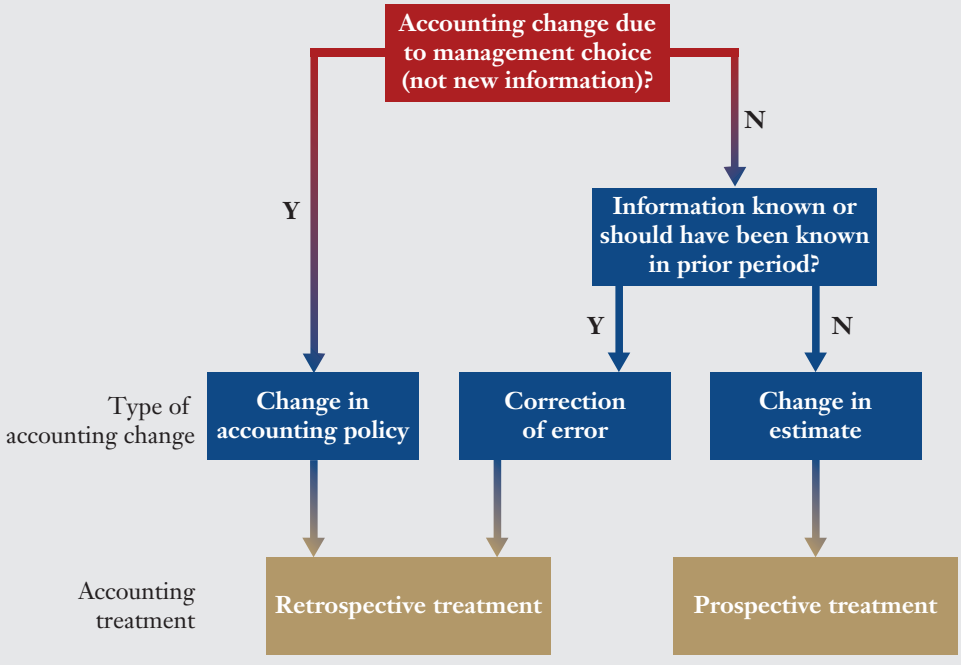
We can summarize the three types of accounting changes and their treatments in IFRS and ASPE as shown in Exhibit 3-10:

Exhibit 3-10 Summary of types of accounting changes and corresponding treatments

Type of accounting change	Treatment under IFRS and ASPE
Correction of errors	Retrospective with restatement
Changes in accounting policy	Retrospective with restatement
Changes in estimates	Prospective

We can distinguish the type of accounting change by answering two questions, as illustrated in the decision tree shown in Exhibit 3-11. First, is the accounting change due to new information or just management choice? If it is just management choice, then it would be a change in accounting policy and treated retrospectively. If the change is due to new information, when was the

Exhibit 3-11 Decision tree for accounting changes



information known or should have been known? If it was known or should have been known in a prior period, then we have an error that needs to be corrected retroactively. If the information could not have been known until the current period, then it is a change in estimate that is treated prospectively.

This section provided the basic tools necessary to deal with accounting changes. Future chapters will show many more applications of these tools. For example, Chapter 4, on revenue recognition, will show an important application of changes in estimates relating to the accounting for long-term contracts, and Chapter 6 will illustrate the effect of errors in inventory accounting.

L.O. 3-5. Integrate the structure and connections among the four financial statements and explain how this structure relates to accrual accounting.

G. THE STRUCTURE OF FINANCIAL REPORTS AND THEIR RELATIONSHIPS

Earlier in this chapter we showed the key differences between cash and accrual accounting. Cash accounting is relatively straightforward, and likewise are the resulting financial statements, which involve a cash flow statement that shows the change is cash from the beginning to the end of the period. Accrual accounting, on the other hand, results in more extensive financial statements. The income statement arises as an alternative to the cash flow statement as a report on performance, while the balance sheet accumulates all of the accruals. In addition, accrual accounting developed when enterprises were no longer short-lived; these enterprises obtained multiple rounds of financing from owners and made periodic payments to them (dividends), creating a need for a report that distinguished such capital transactions with owners from other transactions with everyone else. In comparison, a Dutch trading company before 1602 would simply have had one financing prior to the beginning of the voyage and one set of payments upon dissolution of the company.

In this section, we look at the interrelationship of these four financial statements (cash flow statement, income statement, balance sheet, statement of changes in equity), how they relate to the IFRS Conceptual Framework from Chapter 2, and the requirements for their presentation according to IFRS. The following discussion will be quite general; we will look at many of the specific items in the financial statements in later chapters.

1. Overview of financial statement presentation and interrelationships

Financial statements are the end product of the accounting process, made to meet the information needs of users. As discussed in the last chapter, the objective of financial statements is to provide information useful for investment and lending decisions. These decisions depend on users' assessment of future cash flows in terms of amount, timing, and uncertainty. IFRS then asserts that financial reports help users' make these assessments by providing two main types of information (see IFRS Conceptual Framework, paragraph OB12):

1. information on the entity's resources and claims against those resources; and
2. information on changes in the entity's resources and claims.

Simply stated resources and claims mean what the enterprise has and what it owes, where "owes" refers to both lenders and equity investors. IFRS further considers three categories of information about changes in resources and claims:

1. financial performance according to accrual accounting;
2. financial performance according to cash flows; and

3. changes in the entity's resources and claims that are not due to financial performance.

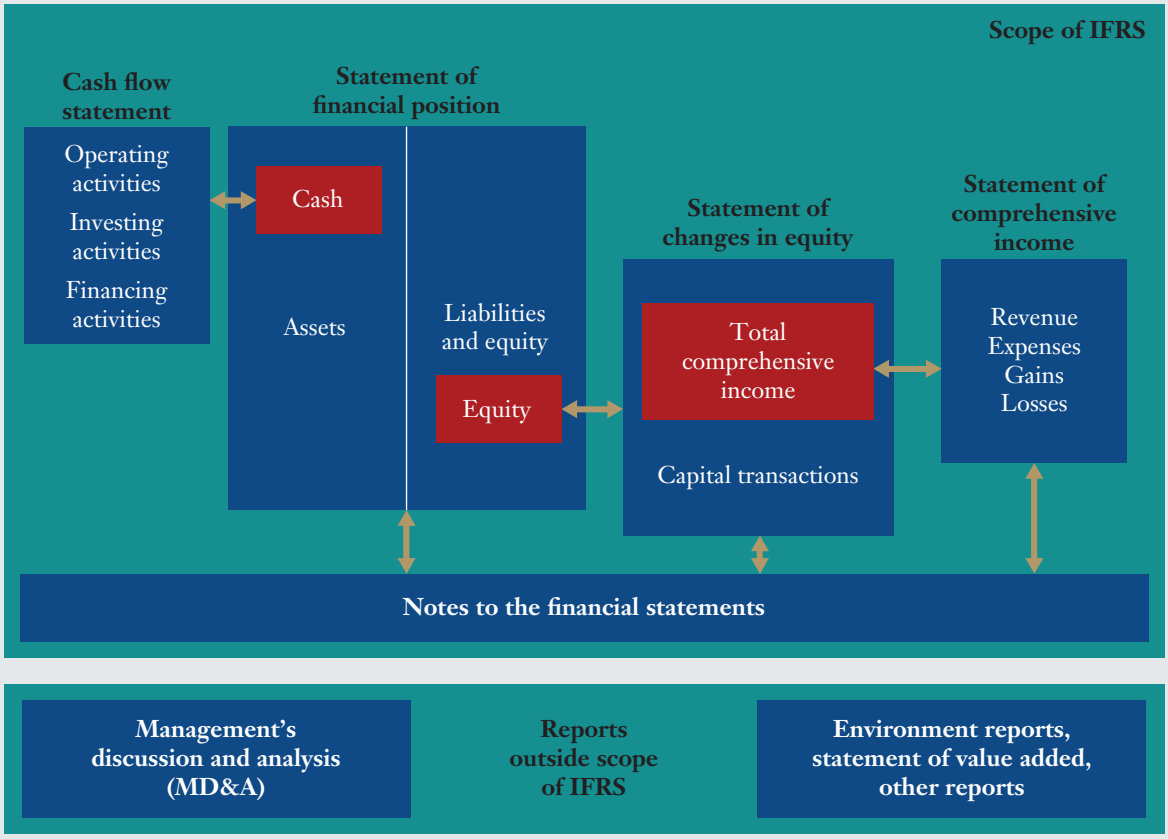
Translating these types of information to financial statements, we have the following relationships:

- resources and claims ⟶ balance sheet (statement of financial position)
- performance on accrual basis ⟶ income statement (statement of comprehensive income)
- performance on cash basis ⟶ cash flow statement
- changes in resources and claims not due to performance ⟶ statement of changes in equity

The diagram in Exhibit 3-12 lays out these four key financial statements and the relationships among them. As well, the diagram shows the scope of IFRS, which covers all of the financial statements as well as note disclosures. IFRS does not cover commentary on financial performance in management's discussion and analysis (MD&A) and other types of reports, such as those on environmental performance, corporate social responsibility, value added, and so on.

Central to the set of financial statements is the statement of financial position (traditionally called the balance sheet), as it records the *stock* or balances of assets, liabilities, and equity; that is, it shows the financial position at a point in time. The other three financial statements track the *flows* of items on the balance sheet. The cash flow statement shows the different activities that explain the change in cash balance over the year. The statement of equity explains changes to equity, differentiating comprehensive income or loss from other changes in equity. The statement of comprehensive income provides further details of items comprising

Exhibit 3-12 Financial statements, relationships, and the scope of IFRS



comprehensive income. The notes to the financial statements provide additional disclosures that improve the understanding of the financial statements.

articulation The connection of financial statements (balance sheet, income statement, cash flow statement, statement of changes in equity) with each other.

The relationships among the four financial statements shown above embed an important concept called **articulation**. In financial accounting, articulation does not have its common meaning relating to communication (e.g., "the articulate speaker delivered a convincing speech"). Rather, articulation refers to the *connection* of the financial statements with each other, similar to the usage in reference to human joints. The accounting system that we use is articulated: the amounts reported on the income statement connect with the balance sheet

DOUBLE-ENTRY ACCOUNTING AND THE BALANCE SHEET

The balance sheet is the centre of the set of financial statements because we use a double-entry accounting system. In this system, the balance sheet is self-contained. To see why this is the case, consider the three types of transactions that are possible:

a. exchange of one asset for another;
b. exchange of one financial claim (i.e., a liability or equity) for another; or
c. increase (or decrease) of an asset and a financial claim.

The first type of transaction involves the left side of the balance sheet, the second involves the right side, and the third involves both sides. One can, of course, construct compound transactions that involve a combination of these three types of transactions.

An example of the first type of transaction is the purchase of $16,000 inventory with cash, which would be recorded as follows:

Dr. Inventories	16,000	
Cr. Cash		16,000

An example of the second type of transaction is the receipt of an invoice for electricity costs incurred over the past month:

Dr. Equity (Utility expense)	2,000	
Cr. Accounts payable		2,000

Finally, the third type of transaction could be the sale of goods for $25,000 on credit:

Dr. Accounts receivable	25,000	
Cr. Equity (Revenue)		25,000

Notice from these examples that the second and third types of transactions can involve accounts you would normally think of as accounts on the income statement, which have been noted in parentheses in the journal entries. As you will recall from introductory accounting, utility expense, revenue, and other income statement accounts are temporary accounts; they exist as a more detailed representation of the changes that affect equity, and at the end of each period they are reset to zero with the net balance transferred to the retained earnings component of equity. Thus, only the balance sheet is a direct result of a double-entry system. All of the other financial statements result from additional information requirements we impose on the accounting system.

through the equity accounts. In other words, what happens on the income statement also impacts the balance sheet. In a different system in which the financial statements are not articulated, the measure of performance on the income statement can be independent from the amount of equity reported on the balance sheet. Such alternatives have been proposed from time to time because they can produce financial statements that better represent financial position and performance; however, these alternatives have not received wide acceptance.

Another issue of practical importance is the degree of aggregation in the financial statements. A large company will have thousands of items in its general ledger, distinguished by the nature of the item (e.g., cash or inventory), the function of the item (manufacturing, administration), geographic location, division within the company, and so on. Clearly it is not useful for financial statements to contain so much detail, which tends to obscure rather than illuminate the overall picture. The concept of materiality comes into play here. IAS 1, Presentation of Financial Statements, indicates the following:

> ¶29 An entity shall present separately each material class of similar items. An entity shall present separately items of a dissimilar nature or function unless they are immaterial.

This means items in the financial statements should be grouped together in a logical fashion. Cash and equipment are dissimilar, so they should not be grouped together as "cash and equipment," but cash in different currencies could be grouped together as "cash." Groupings that are immaterial should be enlarged to include other similar groupings. If the grouping of immaterial items results in a category without a suitably descriptive label, then the group would be called "other."

So far in this section we have looked at the overall presentation and relationships among the different financial statements. Let's now examine each component in more detail.

CHECKPOINT **CP3-7**

What is articulation? How are financial statements articulated?

2. Balance sheet (statement of financial position)

The balance sheet, or statement of financial position, shows the financial position of an enterprise at a point in time. Financial position is the amount and composition of assets and the composition of the claims on those assets. In a double-entry accounting system, total assets equal total financial claims; that is, the two sides of the balance sheet balance, as you know from basic accounting.

Exhibit 3-13 provides a sample balance sheet for a hypothetical company called Illustrator Ltd. In examining this balance sheet and the other financial statements, focus on the overall structure and how the parts connect with each other; it is not important what transactions generated this set of financial statements. Also note that some of the features in this sample balance sheet will be discussed later in this section (e.g., comparative figures, discontinued operations).

There are potentially many different ways to organize the balance sheet to show the composition of assets and liabilities. IFRS generally requires a current/non-current presentation of assets and liabilities (which is the method used in

Exhibit 3-13 Balance sheet (statement of financial position) for Illustrator Ltd.

Illustrator Ltd.
Balance Sheet
As at December 31

In $000's	2011	2010
Current assets		
Cash and cash equivalents	1,215	11,405
Trade and other receivables	15,820	13,600
Inventories	8,180	7,230
	25,215	32,235
Non-current assets		
Available-for-sale investments	3,620	3,200
Investments in associates	5,500	5,000
Grapevines	22,000	20,000
Property, plant, and equipment - net	34,000	30,500
Intangible assets	1	1
Deferred income tax	27	24
	65,148	58,725
Assets held for sale (discontinued operations)	–	2,630
Total assets	90,363	93,590
Current liabilities		
Trade and other payables	10,700	9,450
Provision for warranties	90	80
Taxes payable	280	250
Current portion of finance lease obligation	370	340
Current portion of long-term debt	10,000	8,000
	21,440	18,120
Non-current liabilities		
Finance lease obligation	2,480	2,850
Long-term debt	20,000	30,000
Deferred income tax	3,720	3,190
Employee pension benefits	1,470	1,350
	27,670	37,390
Liabilities of discontinued operations	–	1,440
Total liabilities	49,110	56,950
Equity		
Share capital (1,000,000 issued and outstanding)	15,000	13,000
Reserves	660	240
Retained earnings	25,593	23,400
Total equity	41,253	36,640
Total liabilities and equity	90,363	93,590

Presentation of comparative figures for prior year

Current/ non-current presentation

Minimum categories:
-- cash & equivalents
-- receivables
-- investments (equity method)
-- financial assets not above
-- inventories
-- biological assets
-- property, plant, and equipment
-- investment property
-- intangible assets
-- deferred tax assets

Separate item for discontinued operations

Current/ non-current presentation

Partition of debt into current and long-term portions

Minimum categories:
- payables
- provisions
- financial liabilities not above
- taxes payable
- deferred taxes

Separate item for discontinued operations

Minimum categories:
- contributed capital
- retained earnings
- reserves
- minority interest

Exhibit 3-13), unless ordering the items by liquidity provides more useful information. In particular, IAS 1 indicates the following:

> ¶60 An entity shall present current and non-current assets, and current and non-current liabilities, as separate classifications in its statement of financial position . . . except when a presentation based on liquidity provides information that is reliable and is more relevant . . .

> ¶61 Whichever method of presentation is adopted, an entity shall disclose the amount expected to be recovered or settled after more than twelve months for each asset and liability line item that combines amounts expected to be recovered or settled (a) no more than twelve months after the reporting period and (b) more than twelve months after the reporting period.

In other words, enterprises should separate current (short-term) and non-current (long-term) items, or at least provide disclosures that allow users to make that determination. The definition of what constitutes current assets or liabilities will be discussed below.

With regard to the exception from the current/non-current presentation, IAS 1 specifically identifies financial institutions as an example for which a presentation by liquidity could be more useful. For instance, depositors' confidence in a bank's viability significantly depends on liquidity—its ability to pay depositors when they need funds. Furthermore, banks' cash cycles differ from other enterprises in that it is difficult to distinguish their operating and financing cycles (see Exhibit 3-1 and related discussion on cash cycles).

Other than the current/non-current (or liquidity) presentation, there is a substantial degree of flexibility in the organization of the balance sheet. For example, European companies have a tradition of showing equity before liabilities, non-current items before current items, and items in increasing order of liquidity (e.g., inventory before cash); the implementation guidance that accompanies IAS 1 illustrates this approach. However, North American companies have the opposite tradition. Both approaches are equally acceptable under IFRS.

Let's now examine the three major components of the balance sheet.

a. Assets

Assets and liabilities are fundamental elements in the IFRS Framework, so it is worthwhile to reinforce some of the discussion from Chapter 2. Recall that for an amount to be recorded as an asset, it must meet the definition of an asset as well as the criteria for recognition and measurement. The Conceptual Framework defines an asset as that which gives rise to future inflows of economic benefits, arose from past transactions, and is under the control of the enterprise. For recognition on the balance sheet, the inflow of future economic benefits must be probable, and there must be a reasonable basis of measurement.

After meeting the criteria in the definition, recognition, and measurement of an asset, the fourth step is presentation. In addition to the general concept of materiality that affects the aggregation of assets, IAS 1 paragraph 54 specifically identifies the following asset groups as having a sufficiently different nature or function to warrant separate categories:

1. cash and cash equivalents
2. trade and other receivables
3. investments accounted for using the equity method
4. financial assets other than those shown above in (i), (ii), and (iii)
5. inventories
6. biological assets (such as sheep, cattle, trees, grapevines)
7. property, plant, and equipment
8. investment property
9. intangible assets
10. receivables for current tax
11. deferred tax assets

These are the coarsest groupings under IFRS; finer partitions should be made according to the circumstances to achieve the objective of providing useful information. For example, "property, plant, and equipment" could be split into "land," "buildings," and "equipment," especially if each category uses a different measurement base, such as historical cost or current value.

Enterprises using the current/non-current classification of the balance sheet need to determine which of the above assets are current and which are not. IAS 1 provides the following guidance:

> ¶66 An entity shall classify an asset as current when:
> (a) it expects to realize the asset, or intends to sell or consume it, in its normal operating cycle;
> (b) it holds the asset primarily for the purpose of trading;
> (c) it expects to realize the asset within twelve months after the reporting period; or
> (d) the asset is cash or a cash equivalent (as defined in IAS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.
> An entity shall classify all other assets as non-current.

Criteria (a) and (c) together mean that an asset is current if it will be realized (sold or used) within a year or during the operating cycle, *whichever is longer*.

b. Liabilities

Mirroring the definition of an asset, a liability is a present obligation arising from past transactions that entail future outflows of economic resources. Similar to an asset, if the future outflows are probable and reasonably measurable, the enterprise recognizes the liability on the balance sheet. Similar to assets, once the reporting entity has decided that an item should be reported as a liability, it needs to determine the presentation of the item—the degree of aggregation and where it should appear on the balance sheet.

IFRS requires at a minimum the following categories of liabilities (again, as long as they are material):

1. trade and other payables
2. provisions (e.g., warranty liability, pension benefits, restructuring costs)
3. financial liabilities other than the above
4. liability for taxes payable
5. liability for deferred taxes

If the reporting entity uses the current/non-current classification of the balance sheet, it would classify a liability as current using the following guidance in IAS 1:

> ¶69 An entity shall classify a liability as current when:
> (a) it expects to settle the liability in its normal operating cycle;
> (b) it holds the liability primarily for the purpose of trading;
> (c) the liability is due to be settled within twelve months after the reporting date; or
> (d) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. . . . An entity shall classify all other liabilities as non-current.

Criteria (a) to (c) parallel those for current assets. Criterion (d) applies to, for example, revolving debt such as a line of credit—debt with a short nominal maturity

that is rolled over from one period to another. At a particular date, the debt is non-current if the reporting entity has an agreement in place that gives it discretion to refinance the debt such that the debt need not be settled until more than a year after the balance sheet date.

c. Equity

In the double-entry system, equity is the residual amount after deducting total liabilities from total assets. Aside from its residual nature, equity can be classified into several distinct components that differ significantly in their nature:

1. contributed capital
2. retained earnings
3. reserves
4. non-controlling interest

Reserves can arise from a number of sources such as the revaluation of land, which will be discussed in Chapter 10. The last item relates to subsidiaries that the reporting entity does not own entirely; accounting for parents and subsidiaries is a complex topic covered in advanced financial accounting and will not be not addressed further in this text except for a brief discussion in Chapter 7 on investments. While IAS 1 does not specifically require the first three items to be separated on the balance sheet, in practice companies will list them as separate line items because their natures significantly differ from each other. It should be apparent that profits retained are different from capital contributed by the owners.

3. Statement of changes in equity

One of the objectives of financial statements is to provide information on changes in financial position. The statement of changes in equity aims to achieve this objective by identifying the reasons for the change in total equity and its components from the beginning to the end of the period. Exhibit 3-14 shows an example of such a statement.

There are three components of equity, as shown in Exhibit 3-14 that we will consider:[4]

1. *Contributed capital*—the amount of funds provided by owners, net of any repayments to the owners or repurchases of ownership units (shares).
2. *Retained earnings*—the amount of cumulative profits (or losses) recognized through the statement of comprehensive income less dividends (and a few other adjustments discussed in Chapter 13).
3. *Reserves*—amounts accumulated from events or transactions increasing equity that are not transactions with owners and which have not flowed through profit or loss. An example of a reserve is "accumulated other comprehensive income," or AOCI.

There are potentially up to five classes of transactions that explain the change in these three components:

1. *Profit or loss*—income and expenses as recognized on the income statement, other than (2) below
2. *Other comprehensive income* (OCI)
3. *Dividends*

4. A fourth component is non-controlling interest, which, as mentioned above, is beyond the scope of this text.

Exhibit 3-14 Statement of changes in equity for Illustrator Ltd.

Illustrator Ltd.
Statement of Changes in Equity
For the year ended December 31

In $000's	Share capital	Accumulated OCI on AFS securities*	Retained earnings	2011 Total	2010 Total
Profit for the year	–	–	2,393	2,393	1,386
Other comprehensive income					
Net gains on available-for-sale securities	–	420	–	420	240
Total comprehensive income	–	420	2,393	2,813	1,626
Issuance of common shares	2,000	–	–	2,000	–
Dividends declared	–	–	(200)	(200)	(200)
Net change in equity	2,000	420	2,193	4,613	1,426
Balance at January 1	13,000	240	23,400	36,640	35,214
Balance at December 31	15,000	660	25,593	41,253	36,640

Classes of transactions:
1. Profit or loss
2. Other comprehensive income
3. Dividends
4. Capital transactions
5. Effect of changes in accounting policy and correction of errors

Components of equity

*OCI = other comprehensive income
AFS = available-for-sale investments (see Chapter 7)

4. *Capital transactions*—transactions with owners such as share issuances or repurchases
5. *Effect of changes in accounting policy and correction of errors*

Item 2, other comprehensive income or OCI, requires a brief explanation, as it will be unfamiliar to some students. Other comprehensive income is a relatively recent development, being first included in IFRS in 2008. Currently, there are only a few items that qualify as OCI. In general, these items reflect changes in value that have not yet been "realized" via a transaction. An example of OCI arises from investments classified as "available for sale" and the changes in the value of such investments prior to the date of sale. An investment in $25,000 of shares whose value rises to $27,000 by the balance sheet date would result in $2,000 in unrealized gains reported in OCI. The treatment of financial investments will be explored in detail in Chapter 7, and other items of other comprehensive income will be discussed in the appropriate chapters as they arise.

One issue unique to other comprehensive income is commonly referred to as "recycling." As you know, items recorded through net income impact retained earnings in the same period. For example, recording revenue of $100 in 2013 results in an additional $100 of net income and therefore an extra $100 of retained earnings in 2013 (ignoring tax effects). The same does not apply to other comprehensive income. Depending on the type of OCI, some will immediately impact retained earnings while others will be "parked" in a reserve account within equity until a future date when they are recognized through net income and retained earnings. **Recycling** refers to the latter process of recognizing amounts through OCI, accumulating that OCI in reserves, and later recognizing those amounts

recycling (of OCI) The process of recognizing amounts through OCI, accumulating that OCI in reserves, and later recognizing those amounts through net income and retained earnings.

through net income and retained earnings. OCI that is not recycled impacts retained earnings immediately. Consider again the example of the $25,000 share investment just given. When the value of the investment increased to $27,000, the $2,000 of unrealized gains are shown in the equity section of the balance sheet as part of "accumulated other comprehensive income." In the following year, if the company sold the investment for proceeds of $28,000, it would record a gain of $3,000 through net income. Of that amount, $2,000 is recycled while the remaining $1,000 comes from the additional increase in value from $27,000 to $28,000. "Recycling" is somewhat descriptive in that the $2,000 is recognized twice: first through OCI and a second time through net income.

Exhibit 3-15 summarizes the typical relationship between the five classes of transactions and the three components of equity, along with the two presentation options.

Exhibit 3-15 Content and alternative presentations of the statement of changes in equity

Class of transaction	Component of equity affected
1. Profit or loss (also called net income)	Retained earnings
2. Other comprehensive income	Accumulated other comprehensive income (a component of reserves)
Total comprehensive income (1 + 2)	
3. Dividends*	Retained earnings
4. Capital transactions (e.g., share issuance or repurchase)	Contributed capital and sometimes retained earnings
5. Effect of changes in accounting policy and correction of errors	Contributed capital or retained earnings

*Dividends may be disclosed outside the statement of changes in equity.

It is important to note that there can be several types of contributed capital, such as when a company has more than one class of shares. Also, each type of other comprehensive income needs to be tracked as a separate component of reserves. Due to there being five different classes of transactions and multiple components of equity, it is usually most convenient to use a matrix-style presentation as illustrated in Exhibit 3-14.

CHECKPOINT **CP3-8**

When is other comprehensive income is recycled? What is the effect of recycling on net income?

4. Income statement (statement of comprehensive income)

The statement of changes in equity specifically separates total comprehensive income from other changes in equity (items 1 and 2 in Exhibit 3-15). Comprehensive income for the period is a measure of the return on capital and therefore the statement of comprehensive income provides a measure of performance, which is one of the objectives of the financial statements in the IFRS Framework. Useful measures of performance should distinguish results from operating activities from financing activities because the effect of financial leverage significantly affects performance and risk. In addition, tax costs are only partially under the control of management, so such costs should be separately identified. Likewise,

the reporting entity has limited influence over decisions at associated companies (i.e., companies that they do not control), so income or loss from such associates should be a separate item as well. As noted previously, specific items considered to be other comprehensive income need to be separated. For these reasons, IAS 1 requires reporting, at a minimum, items relating to each of these five components, plus two summary measures of performance: a subtotal for profit or loss and total comprehensive income.

Enterprises have the option to present the seven items in Exhibit 3-16 in one of two ways. The first way is to use a single statement of comprehensive income. The second is to break up the information into two parts: an income statement that includes items 1 to 5, and a statement of comprehensive income that includes items 5 to 7. The title "statement of comprehensive income" can be a little confusing since it can refer to the single statement comprising items 1 through 7 or the separate statement containing only items 5 to 7.

Exhibit 3-16 Minimal line items on the statement of comprehensive income per IAS 1 paragraph 82

1. Revenue
   Operating expenses
2. Finance costs
3. Share of profit or loss of associates
4. Tax expense
5. Profit or loss (net income)
6. Other comprehensive income
7. Total comprehensive income

One line item that is notably absent from the list in Exhibit 3-16 is "extraordinary items." Permitted under Canadian standards prior to 2011, IFRS specifically prohibits the classification of income or expenses as extraordinary. ASPE also follows this prohibition.

IAS 1 does not specifically require the item "operating expenses" as shown in Exhibit 3-16. However, the requirement to show profit or loss implies an amount for operating expenses. Furthermore, IAS 1 paragraph 99 recommends including on the income statement an analysis of expenses, although this information may be presented in the notes. The analysis of expenses should classify expenses according to their nature or function.

nature (of an expense) The source of the expense (depreciation from equipment, costs of employee labour, cost of raw materials, or other means of production); contrast with **function**.

function (of an expense) The use to which the expense has been put (e.g., cost of sales, distribution, administration, or other activities); contrast with **nature**.

- **Nature** relates to the *source* of the expense (depreciation from equipment, labour costs from employees, cost of raw materials, or other means of production).
- **Function** refers to the *use* to which the expense has been put (cost of sales, distribution, administration, or other activities).

Entities choosing the latter option must also provide information on the nature of expenses, disclosing, at a minimum, employee benefits expense, depreciation, and amortization. In other words, *information on the nature of expenses is mandatory*, but information about their function is optional.

Exhibit 3-17 shows an example of an income statement with expenses classified by function. The disclosure by the nature of expenses appears as separate disclosure at the bottom of the exhibit.

This exhibit also illustrates a multi-step financial statement, because Illustrator's income statement includes subtotals such as gross margin and operating

Exhibit 3-17 Income statement for Illustrator Ltd.

Illustrator Ltd.
Statement of Comprehensive Income
For the year ended December 31

In $000's except per share amounts	2011	2010
Revenues	15,800	13,600
Cost of goods sold	(8,000)	(7,000)
Gross margin	7,800	6,600
Delivery expenses	(751)	(649)
Administration	(1,357)	(1,246)
Operating profit	5,692	4,705
Interest expense	(2,850)	(3,450)
Income from associates	500	550
Profit before tax	3,342	1,805
Income tax	(1,003)	(542)
Profit from continuing operations	2,339	1,263
Income from discontinued operations	54	123
Profit for the year	2,393	1,386
Net gains from available-for-sale securities	420	240
Total comprehensive income	2,813	1,626
Basic earnings per share		
Continuing operations	$ 2.34	$ 1.26
Profit for the year	$ 2.39	$ 1.39
Diluted earnings per share		
Continuing operations	$ 2.34	$ 1.26
Profit for the year	$ 2.39	$ 1.39
Operating expenses categorized by nature		
Raw materials consumed	2,630	2,310
Employee benefits	3,458	2,913
Depreciation of property, plant, and equipment	3,400	3,050
Other	620	622
	10,108	8,895

Minimal line items:
1. Revenue
2. Finance costs
3. Share of profit or loss of associates
4. Tax expense
5. Profit or loss
6. Other comprehensive income
7. Total comprehensive income

Earnings per share reported on statement of comprehensive income. EPS for discontinued operations may be shown in footnote.

Presentation of comparative figures

Operating expenses by use (alternative to presentation by nature)

Separate reporting of continuing vs. discontinued operations

Disclosure of operating expenses by their nature (either on statement or in footnote)

profit. These subtotals are optional. Enterprises can choose to use a single-step statement that omits these subtotals; the only required totals are for net income and comprehensive income.

For many reporting entities, the profit for the entire enterprise may not be meaningful to an owner who has 500 shares out of a total of 50 million shares. To help owners gauge the performance of the enterprise, IFRS requires the disclosure of earnings per share (EPS), either on the face of the income statement or in the notes. Chapter 15 explores the details of EPS calculations and the different versions of this measure (basic EPS, diluted EPS). These EPS amounts are displayed in Exhibit 3-17.

5. Statement of cash flows

Similar to the statement of changes in equity, the statement of cash flows helps the reader understand the change in financial position of the enterprise in terms of the most liquid asset available: cash and cash equivalents. **Cash equivalents** are short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value. Different from equity, however, is the fact that equity has a number of distinct

cash equivalents Short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

components (share capital, reserves, retained earnings), for which a matrix-style presentation is effective. Cash is a single category, so a linear format similar to the income statement suffices.

The cash flow statement has three sections corresponding to the three cash cycles discussed at the beginning of this chapter: operating, investing, and financing activities. The amounts in the three categories combined must fully explain the net change in cash from the beginning to the end of the year. Appendix A will discuss in detail what types of items go into which of the three categories of the cash flow statement. At this point, it suffices to make generalizations based on the nature of the three cash flow cycles, which are shown in Exhibit 3-18.

Exhibit 3-18 Categories of cash flows

Cash flow from:	General nature of cash flows	Examples
Operating activities	Changes in current assets and liabilities resulting from day-to-day operations of the enterprise	Cash received from customers Cash paid to suppliers Cash paid to employees
Investing activities	Purchases and sales of non-current assets	Proceeds from sale of land Cash paid for purchase of equipment
Financing activities	Issuances and redemptions of the reporting entity's debt and equity	Proceeds from issuance of common shares Repayment of long-term debt

direct method (cash flow statement) A method of presenting the cash flow statement that shows the amounts attributable to each activity, such as sales to customers; contrast with **indirect method**.

indirect method (cash flow statement) A method of presenting the operating section of the cash flow statement that uses the profit or loss from the income statement as a starting point and then itemizes adjustments to arrive at the net amount of operating cash flows; contrast with **direct method**.

Exhibit 3-18 lists example cash flows in terms of the **direct method**, which shows the amounts attributable to each activity. Doing so satisfies the requirements in IAS 7, Statement of Cash Flows. For operating activities, IAS 7 allows an alternative presentation, called the **indirect method**. This method uses the profit or loss from the income statement as a starting point and then itemizes adjustments to arrive at operating cash flows. In the example of Illustrator Ltd. shown in Exhibit 3-19, the depreciation and amortization total is $3.4 million. This amount is a non-cash expense, so profit is lower than operating cash flow by this amount. Therefore, the indirect method shows an addition of $3.4 million in operating activities. Appendix A will discuss other similar adjustments and the preparation of the entire cash flow statement.

6. Note disclosures

Note disclosures are an important and integral part of the financial statements. For even moderately sized companies, the notes will typically comprise the bulk of the financial statements in terms of the number of pages. IAS 1 provides the general requirements for disclosure, including the following:

- A statement of compliance with IFRS—a reporting entity must provide an unreserved statement as to whether it complies with IFRS in its entirety
- A summary of significant accounting policies, including the bases of measurement used in preparing the financial statements
- Disclosures required by specific standards in IFRS
- Disclosures relevant to understanding the items reported on the face of the four financial statements

IAS 1 also requires cross-referencing of items on the face of the financial statements and the related note disclosures. While this is an obvious and sensible

Exhibit 3-19 Cash flow statement for Illustrator Ltd.

Illustrator Ltd.
Cash Flow Statement
For the year ended December 31

In $000's	2011	2010
Cash flows from operating activities		
Profit before tax from continuing operations	3,342	1,805
Profit before tax from discontinued operations	77	176
Profit before tax	3,419	1,981
Non-cash items		
Depreciation of property, plant, and equipment	3,400	3,050
Income from associates	(500)	(550)
Interest expense	2,850	3,450
Increase in liability for employee pension benefits	120	140
Working capital adjustments		
(Increase) decrease in trade and other receivables	(2,220)	(1,050)
(Increase) decrease in inventories	(950)	(682)
Increase (decrease) in trade and other payables	1,250	470
Increase (decrease) in warranty provision	10	–
Income tax paid	(469)	(244)
Net cash from (used in) operating activities	6,910	6,565
Cash flows from investing activities		
Proceeds from net assets held for sale	1,190	–
Purchase of property,plant, and equipment	(6,900)	–
Investment in grapevines	(2,000)	(1,500)
Net cash from (used in) investing activities	(7,710)	(1,500)
Cash flows from financing activities		
Payment of finance lease obligation	(340)	(320)
Repayment of long-term debt	(8,000)	(6,000)
Proceeds from issuance of common shares	2,000	–
Interest paid	(2,850)	(3,450)
Dividends paid	(200)	(200)
Net cash from (used in) financing activities	(9,390)	(9,970)
Net increase (decrease) in cash and cash equivalents	(10,190)	(4,905)
Cash and cash equivalents, January 1	11,405	16,310
Cash and cash equivalents, December 31	1,215	11,405

Three types of activities:
1. Operating
2. Investing
3. Financing

Presentation of comparative figures

Separate reporting of discontinued operations

Indirect method reconciles profit to operating cash flow

Interest and dividends paid may be shown in operating activities instead

Net cash flow reconciles opening and closing cash balances

requirement to help readers locate relevant information, it is not required in US standards.

7. Discontinued operations and other non-current assets held for sale

As discussed in Chapter 2, one of the important assumptions in accrual accounting in the IFRS Framework is that the reporting entity is a going concern—meaning that the entity will continue to operate, realizing the benefits of assets and discharging liabilities in the ordinary course of business. From time to time, companies will decide to discontinue some part of their operations. For example, a national retail chain could decide to sell its operations in the Atlantic provinces to focus more on other regions, or an integrated oil producer could decide to sell its downstream consumer products division to focus attention on the company's upstream extraction and refining activities. Once management has made the

decision to dispose of these groups of assets and related liabilities, they no longer satisfy the assumption of going concern. Consequently, IFRS requires separate reporting for discontinued operations and other non-current assets held for sale. (We specify "non-current" to distinguish from current assets held for sale, such as inventories.) We will look at this issue in more detail in Chapter 10. At this point, it suffices to understand that the financial statements should segregate discontinued operations using separate line items and disclosures. For example, "profit from discontinued operations" would be a separate line item on the income statement. The financial statements for Illustrator Ltd. (Exhibit 3-13, Exhibit 3-14, Exhibit 3-17, Exhibit 3-19) show how we would present discontinued operations.

8. Comparative figures

As discussed in Chapter 2, comparability is an important qualitative characteristic that enhances the usefulness of financial information. To help users discern trends for a particular company, IAS 1 requires the presentation of comparative information for the relevant prior period. For comparisons to be meaningful, items need to be measured and reported on the same basis over time (i.e., consistently). For instance, a change may involve something as simple as splitting what was one line item in the prior year into two items for the current year because each of the components has become material. When companies make such changes, they need to ensure that they also present comparative figures for past periods on the same basis.

9. Putting it all together: An illustrative example

In this section, we first had an overview of the financial statements as a whole, then we looked at each component separately. Now it is time to bring it all together again. Exhibit 3-20 illustrates the financial statements of Illustrator Ltd. in a condensed fashion, showing the articulation of the items and amounts in the four financial statements.

10. A practical illustration: Thomson Reuters Corporation

So far in this section, we have used a constructed example to show the basic application of the general reporting requirements for financial statements. To see a real-life example, we now turn to the 2010 financial statements for Thomson Reuters Corporation, which begin on page 74 of the company's annual report. These financial statements have been reproduced in Appendix D at the end of this text. The following are some observations about these financial statements:

1. Note that the financial statements begin with a declaration of management's responsibility for the financial statements. While companies hire auditors to verify their books and records, it is not the responsibility of auditors to prepare the financial statements. Rather, financial statement preparation is management's responsibility. (The auditor's report issued by Pricewaterhouse Coopers LLP has been omitted from Appendix D due to copyright limitations.)
2. The second thing to note about these financial statements is the considerable length of the report. Aside from the first page containing the declaration of management's responsibilities, there are a total of 56 pages, of which only the first five are tabular financial statements and the remaining 51 pages are note disclosures. This length underscores the point made previously that disclosures can be very extensive.

Exhibit 3-20 Condensed financial statements for Illustrator Ltd. showing interrelationships

Cash Flow Statement
For the year ended December 31

In $000's	2011	2010
Net cash from operating activities	6,833	6,566
Net cash from investing activities	(7,633)	(1,500)
Net cash from financing activities	(9,390)	(9,970)
Net increase (decrease) in cash	(10,190)	(4,905)
Cash and cash equivalents, Jan. 1	11,405	16,310
Cash and cash equivalents, Dec. 31	1,215	11,405

Balance Sheet
As at December 31

In $000's	2011	2010
Current assets		
Cash and cash equivalents	1,215	11,405
Trade and other receivables	15,820	13,600
Inventories	8,180	7,230
	25,215	32,235
Non-current assets	65,148	58,725
Assets held for sale -	–	2,630
Total assets	90,363	93,590
Current liabilities	21,440	18,120
Non-current liabilities	27,670	37,390
Liabilities of disc. operations	—	1,440
Total liabilities	49,110	56,950
Equity		
Share capital	15,000	13,000
Reserves	660	240
Retained earnings	25,593	23,400
Total equity	41,253	36,640
Total liabilities and equity	90,363	93,590

Statement of Comprehensive Income
For the year ended December 31

In $000's	2011	2010
Revenues	15,800	13,600
Cost of goods sold	(8,000)	(7,000)
Delivery expenses	(751)	(649)
Administration	(1,357)	(1,246)
Interest expense	(2,850)	(3,450)
Income from associates	500	550
Income tax	(1,003)	(542)
Income from discontinued operations	54	123
Profit for the year	2,393	1,386
Other comprehensive income	420	240
Total comprehensive income	2,813	1,626

Statement of Changes in Equity
For the year ended December 31

	2011				
In $000's	Share capital	Accum. OCI on AFS	Retained earnings	Total	2010 Total
Profit for the year	–	–	2,393	2,393	1,386
Other comprehensive income					
Net gains on avail.-for-sale securities	–	420	–	420	240
Total comprehensive income	–	420	2,393	2,813	1,626
Issuance of com. shares	2,000	–	–	2,000	–
Dividends declared	–	–	(200)	(200)	(200)
Net change in equity	2,000	420	2,193	4,613	1,426
Balance at January 1	13,000	240	23,400	36,640	35,214
Balance at December 31	15,000	660	25,593	41,253	36,640

Notes to the financial statements
1. Statement of compliance:
   The financial statements of Illustrator Ltd. have been prepared in accordance with International Financial Reporting Standards (IFRS).
2. Significant accounting policies, estimates, assumptions, and judgments.
3. Specific disclosures cross-referenced to the four financial statements.

3. The company has chosen the two-statement presentation of comprehensive income: an income statement and a separate statement of comprehensive income. The other three financial statements are the statement of financial position (balance sheet), the statement of cash flow, and the statement of changes in equity. All are denoted as "consolidated" because these financial statements present information not only for the legal entity of Thomson Reuters Corporation, but also for all of the subsidiaries that are owned by Thomson Reuters.
4. Exhibit 3-21 (next page) shows condensed versions of the five financial statements shown on pages D3 to D8. This summary makes clear the articulation among the financial statements. Due to the complex corporate structure of Thomson Reuters, which involves many parent–subsidiary relationships, there are several items relating to "non-controlling interests" about which you do not need to be concerned.
5. Now, look more carefully at each of the five financial statements. The first one is the income statement, displayed in Exhibit 3-22. Following IFRS requirements, Thomson Reuters has separately presented line items for expenses by their nature (not by function). Furthermore, this income statement separately shows line items for each of the following: interest expense, income from associates, tax expense, and income from discontinued operations. The bottom of the income statement shows earnings per share.
6. Exhibit 3-23 shows the statement of comprehensive income. The statement is relatively short—as noted previously, there are only a few possible items of OCI. In the case of Thomson Reuters, there are just five items of OCI.
7. The statement of financial position (balance sheet) is in Exhibit 3-24. We can see that Thomson Reuters is a large company, with total assets of over $35 billion. Notice that the amounts are reported as millions of US dollars, even though this is a Canadian company. This practice is common when a Canadian company derives most of its revenues and incurs most of its expenses in a foreign currency such as the US dollar. Consistent with IFRS requirements, the statement separates current from non-current assets, and likewise for liabilities. Equity is separated into four components, as required by IFRS.
8. Next, the cash flow statement in Exhibit 3-25 explains the change in the cash balance from $1,111 million at the beginning of 2010 to $864 million at the end of the year. The cash flows appear in three categories matching the three cash cycles: operating, investing, and financing. Thomson Reuters chose the indirect method to present cash flows from operating activities; this method begins with net income and adjusts for deviations of accrual numbers from cash flows.
9. The fifth and final financial statement is the statement of changes in equity, shown in Exhibit 3-26. This financial statement is relatively complex compared to the other four. The presentation is in a matrix format, with a separate matrix for 2010 and the comparative year 2009. The columns represent the four components of equity, with additional columns showing sub-components of these four. The rows contain the different types of transactions that caused the changes in the different components of equity.
10. Following the five financial statements are 51 pages of note disclosure. (Refer to pages D8 to D58 in Appendix D.) The first note is particularly long, taking up almost 10 pages. However, this is important information, because Note 1 summarizes the significant accounting policies used in the preparation of the financial statements; for example, pages D10–D11 describe the company's revenue recognition policies. Note 2 identifies the "critical accounting estimates

Exhibit 3-21 Condensed financial statements for Thomson Reuters Corporation showing interrelationships

Consolidated Statement of Cash Flow
For the year ended December 31

(millions of U.S. dollars)	2010	2009
Net cash provided by operating activities	2,655	2,666
Net cash used in investing activities	(1,675)	(1,365)
Net cash used in financing activities	(1,219)	(1,051)
Translation adjustment	(8)	20
Net increase (decrease) in cash	(247)	270
Cash and cash equivalents at beg. of period	1,111	841
Cash and cash equivalents at end of period	864	1,111

Consolidated Statement of Financial Position
As at December 31

(millions of U.S. dollars)	2010	2009
Assets		
Cash and cash equivalents	864	1,111
Non-cash assets	34,667	33,462
Total assets	35,531	34,573
Liabilities	15,856	15,238
Equity		
Capital	10,284	10,177
Retained earnings	10,518	10,561
Accumulated OCI	(1,480)	(1,471)
Total shareholders' equity	19,322	19,267
Non-controlling interests	353	68
Total equity	19,675	19,335
Total liabilities and equity	35,531	34,573

Consolidated Income Statement
For the year ended December 31

(millions of U.S. dollars)	2010	2009
Revenues	13,070	12,997
Expenses	(12,006)	(12,459)
Income before tax and equity method investees	1,064	538
Share of post tax earnings in equity method investees	8	7
Tax expense (benefit)	(139)	299
Earnings from continuing operations	933	844
Earnings from discontinued operations, net of tax	--	23
Net earnings	933	867
Earnings attributable to:		
Common shareholders	909	844
Non-controlling interests	24	23

Consolidated Statement of Comprehensive income
For the year ended December 31

(millions of U.S. dollars)	2010	2009
Net earnings	933	867
OCI items going to reserves	(9)	797
OCI items going to retained earnings	(108)	(4)
Total comprehensive income	816	1,660
Comprehensive income attributable to:		
Common shareholders	792	1,637
Non-controlling interests	24	23

Consolidated Statement of Changes in Equity
For the year ended December 31

(millions of U.S. dollars)	Capital	Retained earnings	Accum-ulated OCI	Non-control-ling interests	Total
Balance, December 31, 2009	10,177	10,561	(1,471)	68	19,335
Net earnings		909		24	933
OCI		(108)	(9)		(117)
Other transactions	107	(844)	--	261	(476)
Balance, December 31, 2010	10,284	10,518	(1,480)	353	19,675

OCI = other comprehensive income

Exhibit 3-22 Income statement for Thomson Reuters

THOMSON REUTERS CORPORATION
CONSOLIDATED INCOME STATEMENT

(millions of U.S. dollars, except per share amounts)	Notes	Year ended December 31, 2010	2009
Revenues		13,070	12,997
Operating expenses	5	(10,061)	(9,875)
Depreciation		(457)	(509)
Amortization of computer software		(572)	(548)
Amortization of other identifiable intangible assets		(545)	(499)
Other operating (losses) gains, net	6	(16)	9
Operating profit		1,419	1,575
Finance costs, net:			
Net interest expense	7	(383)	(410)
Other finance income (costs)	7	28	(242)
Other non-operating charge	8	-	(385)
Income before tax and equity method investees		1,064	538
Share of post tax earnings in equity method investees		8	7
Tax (expense) benefit	9	(139)	299
Earnings from continuing operations		933	844
Earning from discontinued operations, net of tax	10	-	23
Net earnings		933	867
Earnings attributable to:			
Common shareholders		909	844
Non-controlling interests	28	24	23
Earnings per share:	11		
Basic earnings per share:			
From continuing operations		$1.09	$0.99
From discontinued operations		-	0.02
Basic earnings per share		$1.09	$1.01
Diluted earnings per share:			
From continuing operations		$1.08	$0.99
From discontinued operations		-	0.02
Diluted earnings per share		$1.08	$1.01

The related notes form an integral part of these consolidated financial statements.

Expenses itemized by nature of expenses. Note 5 provides additional details about operating expenses. Expenses by function not required.

Interest expense separately identified.

Income from associated separately identified.

Tax expense separately identified.

After-tax effect of discontinued operations separately identified.

Earnings per share reported on income statement

Exhibit 3-23 Statement of comprehensive income for Thomson Reuters Corporation

THOMSON REUTERS CORPORATION
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

		Year ended December 31,	
(millions of U.S. dollars)	Notes	2010	2009
Net earnings		933	867
Other comprehensive (loss) income:			
Net gain on cash flow hedges		113	296
Net (gain) on cash flow hedges transferred to earnings	19	(123	(350)
Foreign currency translation adjustments to equity		9	678
Foreign currency translation adjustments to earnings		(8)	173
Net actuarial losses on defined benefit pension plans, net of tax[1]	26	(108)	(4)
Other comprehensive (loss) income		(117)	793
Total comprehensive income		816	1,660
Comprehensive income for the period attributable to:			
Common shareholders		792	1,637
Non-controlling interests	28	24	23

(1) The related tax benefit was $58 million and $7 million for the years ended December 31, 2010 and 2009, respectively.

The related notes for an integral part of these consolidated financial statements.

Begin with net income from the income statement.

Each source of other comprehensive income (OCI) identified.

Exhibit 3-24 Statement of financial position (balance sheet) for Thomson Reuters

THOMSON REUTERS CORPORATION
CONSOLIDATED STATEMENT OF FINANCIAL POSITION

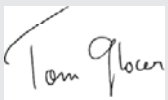
(*millions of U.S. dollars*)	Notes	December 31, 2010	2009
ASSETS			
Cash and cash equivalents	12	864	1,111
Trade and other receivables	13	1,809	1,742
Other financial assets	19	74	76
Prepaid expenses and other current assets	14	912	734
Current assets		3,659	3,663
Computer hardware and other property, net	15	1,567	1,546
Computer software, net	16	1,613	1,495
Other identifiable intangible assets, net	17	8,714	8,694
Goodwill	18	18,892	18,130
Other financial assets	19	460	383
Other non-current assets	20	558	649
Deferred tax	23	68	13
Total assets		35,531	34,573
LIABILITIES AND EQUITY			
Liabilities			
Current indebtedness	19	645	782
Payables, accruals and provisions	21	2,924	2,651
Deferred revenue		1,300	1,187
Other financial liabilities	19	142	92
Current liabilities		5,011	4,712
Long-term indebtedness	19	6,873	6,821
Provisions and other non-current liabilities	22	2,217	1,878
Other financial liabilities	19	71	42
Deferred tax	23	1,684	1,785
Total liabilities		15,856	15,238
Equity			
Capital	24	10,284	10,177
Retained earnings		10,518	10,561
Accumulated other comprehensive loss		(1,480)	(1,471)
Total shareholders' equity		19,322	19,267
Non-controlling interests	28	353	68
Total equity		19,675	19,335
Total liabilities and equity		35,531	34,573

Contingencies (note 29)

The related notes form an integral part of these consolidated financial statements.

These financial statements were approved by the Company's board of directors on March 2, 2011.

David Thomson
Director



Thomas H. Glocer
Director

Current assets separated from non-current assets.

Current portion of debt separated from long-term protion

Current liabilities separated from non-current liabilities.

Equity separated into the four required categories.

Exhibit 3-25 Cash flow statement for Thomson Reuters

THOMSON REUTERS CORPORATION
CONSOLIDATED STATEMENT OF CASH FLOW

(millions of U.S. dollars)	Notes	Year ended December 31, **2010**	2009
Cash provided by (used in):			
OPERATING ACTIVITIES			
Net earnings		**933**	867
Adjustments for:			
Depreciation		**457**	509
Amortization of computer software		**572**	548
Amortization of other identifiable intangible assets		**545**	499
Deferred tax	23	**(205)**	(544)
Embedded derivatives fair value adjustments	19	**72**	147
Net (gains) losses on foreign exchange and derivative financial instruments		**(91)**	182
Other non-operating charge	8	**-**	385
Other	27	**433**	290
Changes in working capital and other items	27	**(55)**	(219)
Operating cash flows from continuing operations		**2,661**	2,664
Operating cash flows from discontinued operations	10	**(6)**	2
Net cash provided by operating activities		**2,655**	2,666
INVESTING ACTIVITIES			
Acquisitions, less cash acquired	28	**(612)**	(349)
Proceeds from other disposals, net of taxes paid		**26**	56
Capital expenditures, less proceeds from disposals		**(1,097)**	(1,097)
Other investing activities		**8**	3
Investing cash flows from continuing operations		**(1,675)**	(1,387)
Investing cash flows from discontinued operations	10	**-**	22
Net cash used in investing activities		**(1,675)**	(1,365)
FINANCING ACTIVITIES			
Proceeds from debt	19	**1,367**	1,107
Repayments of debt	19	**(1,683)**	(1,249)
Net borrowings under short-term loan facilities		**5**	4
Dividends paid on preference shares		**(3)**	(2)
Dividends paid on common shares	24	**(898)**	(905)
Other financing activities		**(7)**	(6)
Net cash used in financing activities		**(1,219)**	(1,051)
Translation adjustments on cash and cash equivalents		**(8)**	20
(Decrease) increase in cash and cash equivalents		**(247)**	270
Cash and cash equivalents at beginning of period	12	**1,111**	841
Cash and cash equivalents at end of period	12	**864**	1,111

Supplemental cash flow information is provided in note 27.

Interest paid	**(393)**	(425)
Interest received	**7**	8
Income taxes paid	**(243)**	(200)

Amounts paid and received for interest are reflected as operating cash flows. Interest paid is net of debt related hedges.

Amounts paid for income taxes are reflected as either operating cash flows or investing cash flows depending upon the nature of the underlying transaction.

The related notes form an integral part of these consolidated financial statements.

Indirect method reconciles net income to operating cash flow.

Effect of discontinued operations separately identified.

Net cash flow reconciles opening and closing cash balances.

Disclosure of choice in classification of interest.

Exhibit 3-26 Statement of changes in equity for Thomson Reuters

THOMSON REUTERS CORPORATION
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

(millions of U.S. dollars)	Stated share capital	Contributed surplus	Total capital	Retained earnings	Unrecognized (loss) gain on cash flow hedges	Foreign currency translation adjustments	other comprehensive (loss) income ("AOCI")	Non-controlling interests	Total
Balance, December 31, 2009	9,957	220	10,177	10,561	(33)	(1,438)	(1,471)	68	19,335
Comprehensive income (loss)[1]	-	-	-	801	(10)	1	(9)	24	816
Change in ownership interest of subsidiary[2]	-	-	-	125	-	-	-	291	416
Distributions to non-controlling interest	-	-	-	-	-	-	-	(30)	(30)
Dividends declared on preference shares	-	-	-	(3)	-	-	-	-	(3)
Dividends declared on common shares	-	-	-	(966)	-	-	-	-	(966)
Shares issued under Dividend Reinvestment Plan ("DRIP")	68	-	68	-	-	-	-	-	68
Effect of stock compensation plans[3]	52	(13)	39	-	-	-	-	-	39
Balance, December 31, 2010	10,077	207	10,284	10,518	(43)	(1,437)	(1,480)	353	19,675

(millions of U.S. dollars)	Stated share capital[4]	Contributed surplus	Total capital	Retained earnings	Unrecognized gain (loss) on cash flow hedges	Foreign currency translation adjustments	AOCI	Non-controlling interests	Total
Balance, December 31, 2008	3,050	6,984	10,034	10,650	21	(2,289)	(2,268)	72	18,488
Comprehensive income (loss)[1]	-	-	-	840	(54)	851	797	23	1,660
Distributions to non-controlling interest	-	-	-	-	-	-	-	(27)	(27)
DLC unification(4)	6,828	(6,828)	-	-	-	-	-	-	-
Dividends declared on preference shares	-	-	-	(2)	-	-	-	-	(2)
Dividends declared on common shares	-	-	-	(927)	-	-	-	-	(927)
Shares issued under DRIP	22	-	22	-	-	-	-	-	22
Effect of stock compensation plans	57	64	121	-	-	-	-	-	121
Balance, December 31, 2010	9,957	220	10,177	10,561	(33)	(1,438)	(1,471)	68	19,335

(1) Retained earnings for the year ended December 31, 2010 includes actuarial losses of $108 million, net of tax, (2009 - $4 million).

(2) Comprised of amounts relating to Tradeweb. See note 28.

(3) Includes a reduction of $89 million relating to cash-settled awards. See note 1.

(4) On September 10, 2009 all Thomson Reuters PLC ordinary shares were exchanged for an equivalent number of Thomson Reuters Corporation common shares in connection with unification of the dual listed company structure. Following unification, stated share capital includes common and preference share capital. See note 24.

The related notes form an integral part of these consolidated financial statements.

The four components of equity are capital, retained earnings, AOCI (reserves), and non-controlling interest. Other columns shown are sub-components.

Changes in equity identified by type of transaction:
1. Profit or loss
2. OCI
3. Dividends,
4. Capital transactions
5. Effect of retrospective changes in accounting.

The company has combined the first two in one row without loss of information because the amounts appear in different columns.

Comparative information for prior year.

and judgments" management has made, underscoring the subjectivity inherent in the accounting process. The remainder of the notes provide additional details relating to certain items appearing in the five financial statements discussed above, ranging from the company's operations in different geographic areas to the computation of earnings per share. Cross-referencing of the line items in the five financial statements with the notes is useful to help readers understand the connections among the different pieces of information.

H. SUBSTANTIVE DIFFERENCES BETWEEN RELEVANT IFRS AND ASPE

Issue	IFRS requirements	ASPE requirements
Comprehensive income	An enterprise distinguishes items of other comprehensive income from items included in net income (profit or loss).	There is no concept of "other comprehensive income" in ASPE. Therefore, there is also no concept of comprehensive income.
Financial statement for performance measurement	An enterprise presents either: (i) a statement of comprehensive income; or (ii) an income statement plus a statement of comprehensive income that details the items of other comprehensive income.	An enterprise presents an income statement.
Statement of compliance	IAS 1 ¶16 requires an enterprise to make an "explicit and unreserved statement of compliance" with IFRS.	Section 1400 ¶16 requires an enterprise to state that it has prepared its financial statements in accordance with ASPE.

I. APPENDIX: REVIEW OF THE ACCOUNTING CYCLE

This appendix provides a brief review of the accounting cycle that you studied in introductory accounting. A more thorough review is available through an interactive online module in MyAccountingLab.

The accounting cycle involves the practical procedures that companies and individuals go through to record financial data and to transform that data into financial statements. It is a cycle because financial statements are prepared on a periodic basis, so the end of one accounting period/cycle is the beginning of the next period/cycle. Exhibit 3-27 summarizes the steps in this cycle and the documents associated with each step (note that "documents" is often in the form of an electronic database).

As Exhibit 3-27 shows, there are six steps in the accounting cycle, consisting of the following processes:

1. Journalizing
2. Posting
3. Adjustments
4. Preparing the financial statements
5. Journalizing closing entries
6. Posting of closing entries

Exhibit 3-27 The accounting cycle

The remainder of this appendix will discuss these six steps in more detail using the data inputs provided in Exhibit 3-28.

Exhibit 3-28 Data inputs for example to illustrate accounting cycle

i. Red and White Ltd. (RWL) provides wine consulting services. The company prepares financial statements on a monthly basis. At the beginning of June 2013, the company had the following account balances:

Cash	$2,800	Dr.	Taxes payable	$1,500	Cr.
Accounts receivable	4,600	Dr.	Common shares	100	Cr.
Equipment—cost	3,600	Dr.	Retained earnings	8,100	Cr.
Accumulated depreciation	1,300	Cr.			

ii. On June 15, the company paid the $1,500 taxes owing.

iii. On June 22, the company collected $3,500 on accounts receivable.

iv. On June 25, RWL billed a client for $5,000 plus $600 HST (harmonized sales tax) for services provided in the month of June. (Note: The $600 is collected on behalf of the government, so the amount becomes a tax payable.)

v. The equipment relates to computer hardware and software, which is being depreciated over 36 months on a straight-line basis.

1. Journalizing

This step involves recording all the transactions that RWL engages in. For the month of June, RWL had three transactions: the payment of taxes, collection of receivables, and billing a client for services rendered. These would be recorded in the journal as follows:

#1, June 15	Dr. Taxes payable	1,500	
	Cr. Cash		1,500
#2, June 22	Dr. Cash	3,500	
	Cr. Accounts receivable		3,500
#3, June 25	Dr. Accounts receivable	5,600	
	Cr. Sales revenue		5,000
	Cr. Taxes payable		600

The first two transactions are purely balance sheet transactions in which the journal entries involve only balance sheet accounts. On the balance sheet, assets have debit balances while liabilities and equities have credit balances (assuming they have positive balances). Assets = liabilities + equities, so debits = credits.

For entry #1, taxes payable is a liability account, so the debit to that account reduces the liability. This reduction in liability comes from a reduction in cash, which is an asset account, so we credit cash. Entry #2 records a receipt of cash for an amount owing from a customer, so we debit cash for the $3,500 received, and credit accounts receivable to reduce the amount owing from customers.

Entry #3 is a compound transaction that involves both the balance sheet and the income statement. Income statement accounts are in essence components of equity. Equity accounts have a credit balance, so increases in equity are credits while decreases in equity are debits. Earning revenue increases equity, so entry #3 credits revenue for $5,000. Including taxes, RWL is expecting to collect $5,600 from the customer, so we debit accounts receivable for that amount. The difference of $600 is payable to the government, which is recorded as a credit to taxes payable.

Note that the journal is a chronological record of transactions affecting a company's financial position. Next we look at posting, which involves the general ledger, which organizes information according to the general ledger account (such as cash, accounts receivable, etc.).

2. Posting

Posting is the process of transferring the amounts recorded in journal entries into the general ledger. The amounts entered in the general ledger (G/L), together with the opening balances, determine the ending balance of each account in the G/L. In June 2013, the G/L for Red and White Ltd. would be as follows:

Account	Date	Source	Debit	Credit
Cash	June 1	Opening balance	2,800	
	June 15	Entry #1		1,500
	June 22	Entry #2	3,500	
	June 30	Ending balance	4,800	
Accounts receivable	June 1	Opening balance	4,600	
	June 22	Entry #2		3,500
	June 25	Entry #3	5,600	
	June 30	Ending balance	6,700	
Equipment—cost	June 1	Opening balance	3,600	
		Ending balance	3,600	
Accumulated depreciation	June 1	Opening balance		1,300
		Ending balance		1,300
Taxes payable	June 1	Opening balance		1,500
	June 15	Entry #1	1,500	
	June 25	Entry #3		600
	June 30	Ending balance		600

Common shares	June 1	Opening balance	100
		Ending balance	100
Retained earnings	June 1	Opening balance	8,100
		Ending balance	8,100
Sales revenue	June 1	Opening balance	0
	June 25	Entry #3	5,000
	June 30	Ending balance	5,000

Recall from introductory accounting that the income statement accounts show how much activity there is over an accounting period, so they start with a balance of zero at the beginning of each period. The sales revenue account begins the period with a zero balance; the ending balance of $5,000 represents how much revenue RWL recorded during the month.

The tabular presentation just shown is what would be used in practice. For pedagogical purposes, many textbooks (including this one) use T-accounts to show the same information. T-accounts show debits on the left side and credits on the right side of a T. The bottom of each T-account shows the balance in the account. The T-account representation of RWL's general ledger is as follows (with #1, #2, and #3 denoting the three transactions described above):

Cash		Accounts receivable		Equipment		Accum. depreciation	
(Bal) 2,800		(Bal) 4,600		3,600	Balance	Balance	1,300
	1,500 (#1)						
(#2) 3,500			3,500 (#2)				
		(#3) 5,600					
4,800		6,700		3,600			1,300

Taxes payable		Common shares		Retained earnings		Sales revenue	
Balance	1,500	Balance	100	Balance	8,100		
(#1) 1,500							
	600 (#3)						5,000 (#3)
	600		100		8,100		5,000

In manual records, as shown above, there are two separate steps for recording journal entries and posting them to the general ledger. In computerized systems, only one step will be required—after recording the journal entry, the posting step will be done automatically.

So far, we have looked at the process for recording and posting journal entries that reflect transactions with other entities (customers, suppliers, employees, government, etc.). Next, we look at entries that do not involve transactions.

3. Adjustments

In addition to transactions with other entities, enterprises also need to record non-transactional events that affect the company's financial position. Common examples of adjustments include depreciation expense, interest income or expense, and insurance expense. A common element in such adjustments is that they result from the passage of time (and hence there are no explicit transactions with outside parties).

For RWL, we need to record depreciation on its equipment. Straight-line depreciation of $3,600 over 36 months is $100/month. Therefore, we record the following journal entry:

#4, June 30	Dr. Depreciation expense	100	
	Cr. Accumulated depreciation		100

After posting this entry, the general ledger is as follows:

Cash		Accounts receivable		Equipment		Accum. depreciation	
(Bal) 2,800		(Bal) 4,600		3,600	Balance	Balance	1,300
	1,500 (#1)						
(#2) 3,500			3,500 (#2)				
		(#3) 5,600					
							100 (#4)
4,800		6,700		3,600			**1,400**

Taxes payable		Common shares		Retained earnings		Sales revenue	
Balance	1,500	Balance	100	Balance	8,100		
(#1) 1,500							
	600 (#3)						5,000 (#3)
	600		100		8,100		5,000

Depreciation expense	
(#4) 100	
100	

After all transactions and adjustments have been recorded, we would prepare a trial balance. A trial balance simply lists all of the G/L accounts with their corresponding balances. The total of all the debit balances must equal the total of all credit balances. The trial balance for RWL at the end of June 2013 is shown in Exhibit 3-29.

Exhibit 3-29 Trial balance for RWL at the end of June 2013

Account	Debit	Credit
Cash	4,800	
Accounts receivable	6,700	
Equipment	3,600	
Accumulated depreciation		1,400
Taxes payable		600
Common shares		100
Retained earnings		8,100
Sales revenue		5,000
Depreciation expense	100	
Total	15,200	15,200

4. Preparing the financial statements

At this point, the financial statements can be prepared based on the trial balance. A small private company would most likely follow ASPE, which requires a balance sheet, income statement, a statement of retained earnings, and a cash flow statement. For RWL, the financial statements are fairly straightforward, as shown in Exhibit 3-30, with the income statement and statement of retained earnings combined into one.

Exhibit 3-30 Financial statements for RWL for the month ending June 30, 2013

Red and White Ltd.
Balance Sheet As at June 30, 2013

Cash	$ 4,800
Accounts receivable	6,700
Current assets	$11,500
Equipment	3,600
Less: Accum. depreciation	(1,400)
Total assets	$13,700
Taxes payable	$ 600
Common shares	100
Retained earnings	13,000
Total equity	13,100
Total liabilities and equity	$13,700

Red and White Ltd.
Statement of Income and Retained Earnings For the month ended June 30, 2013

Sales revenue	$ 5,000
Depreciation expense	100
Net income	$ 4,900
Retained earnings, June 1	8,100
Retained earnings, June 30	$13,000

Red and White Ltd.
Cash Flow Statement
For the month ended June 30, 2013

Cash received from customers	$3,500
Cash paid for taxes	(1,500)
Cash flow from operations	$2,000
Cash flow from investing	0
Cash flow from financing	0
Net cash flow	$2,000
Cash, June 1	2,800
Cash, June 30	$4,800

5. Journalizing closing entries

After preparing the financial statements, the next step is to close the temporary accounts so that they have zero balances and are ready for the beginning of the next fiscal period. To close a temporary account, we determine the balance of that account and record an entry for the opposite amount; that is, if the temporary account has a debit balance, we record a credit in that account for the same amount; the other side of the closing entry goes to retained earnings.

To determine the balance in the temporary accounts, refer to the trial balance shown in Exhibit 3-29, which shows a credit balance of $5,000 for sales revenue and a debit balance of $100 for depreciation expense. For RWL, the closing entry is as follows:

#5, June 30	Dr. Sales Revenue	5,000	
	Cr. Depreciation expense		100
	Cr. Retained earnings		4,900

6. Posting of closing entries

The closing entry then needs to be posted to the general ledger. After posting, RWL's G/L would be as follows:

Cash		Accounts receivable		Equipment		Accum. depreciation	
(Bal) 2,800		(Bal) 4,600		3,600	Balance	Balance	1,300
	1,500 (#1)						
(#2) 3,500			3,500 (#2)				
		(#3) 5,600					
							100 (#4)
4,800		6,700		3,600			1,400

Taxes payable		Common shares		Retained earnings		Sales revenue	
Balance	1,500	Balance	100	Balance	8,100		
(#1) 1,500							
	600 (#3)						5,000 (#3)
				4,900 (#5)		**(#5) 5,000**	
	600		100	13,000			0

Depreciation expense	
(#4) 100	
	100 (#5)
	0

After closing, the temporary accounts for the income statement have zero balances. Balances for permanent accounts (i.e., balance sheet accounts) carry forward as the opening balances for the next period (July 1, 2013, for RWL).

7. Summary

The accounting cycle is the set of procedures that captures financial data and transforms that data into financial statements. This appendix used a simple example to review the accounting cycle that you learned in introductory accounting. Computerization reduces the need for some of the steps, but it is still important to understand the underlying procedures. For additional review, access the Accounting Cycle Tutorial on MyAccountingLab.

J. SUMMARY

L.O. 3-1. Explain the source of demand for periodic reporting and how accrual accounting satisfies that demand.

- Cash accounting sufficiently meets information demands when enterprises have finite and short lives because all cash cycles close when the entity dissolves.
- The demand for periodic reporting arises from the creation of enterprises with indefinite lives and the consequent need for information prior to the dissolution of the enterprise, so that investors, creditors, and others can ascertain the enterprise's financial position and performance.
- Accrual accounting better satisfies the demand for information because it provides additional information on cash cycles that are not yet complete at the reporting date.

L.O. 3-2. Explain why accrual accounting is fundamentally inexact, why estimates are central to accrual accounting, and why there is no "true" income for typical situations; evaluate the "quality of earnings."

- Since accrual accounting includes information about cash cycles that are not yet complete, management/accountants need to estimate the cycles' outcomes, which are inherently uncertain. There are better or worse estimates based on available information, but since the future is unknowable, none of the predictions about the future can be considered to be true; therefore, "true" income does not exist.
- While no true income exists for any particular circumstance, we can think of unbiased accounting—that is, the average or consensus among a sample of disinterested accountants or managers. Real people, however, have vested interests in the accounting numbers reported, so actual financial numbers reflect the biases that result from those incentives. Quality of earnings conceptually refers to how close the reported earnings are to the unbiased amount. Since we cannot observe unbiased earnings, quality of earnings is difficult to measure in practice.

L.O. 3-3. Apply accrual accounting in relation to issues of timing: periodicity, cut-off, and subsequent events.

- In accrual accounting, it is essential to properly define the reporting period. The cut-off date is the end of the period for the recognition of events. Subsequent events, while not recognized in the reporting period, may provide relevant information for the measurement of items recognized before the cut-off date.

L.O. 3-4. Evaluate whether an accounting change is an error, a change in accounting policy, or a change in estimate, and apply the retrospective and prospective treatments appropriate to that type of accounting change.

- Correction of errors and changes in accounting policies require retrospective adjustment of financial statements. Changes in estimates due to new information require prospective treatment.

L.O. 3-5. Integrate the structure and connections among the four financial statements and explain how this structure relates to accrual accounting.

- To meet the information needs of users, a complete set of financial statements consists of four statements plus note disclosures. The balance sheet (statement of financial position) shows an entity's financial position at a point in time. The statement of changes in equity and the cash flow statement show changes in financial position. The income statement reports financial performance for the period. Notes provide information about the accounting policies used, additional information relevant to items displayed on the four financial statements, and other disclosures pertinent to

help users understand the reporting entity's financial position, performance, and changes in financial position.

- The balance sheet is at the centre of the financial reports. The cash flow statement explains the changes in the cash account, while the statement of changes in equity explains changes in share capital, reserves, and retained earnings. The income statement further analyzes the components of profit/loss and other comprehensive income that contribute to the change in retained earnings.

K. Answers to Checkpoint Questions

CP3-1: The need for periodic financial reports arose from the creation of indefinite life enterprises. Investors in such enterprises could not and did not want to wait until the dissolution/liquidation of these enterprises. These investors needed information to help them value the investment so that they would know what would be a fair price to buy or sell an enterprise or a portion of the enterprise for. Instead of drafting financial reports each and every time such information needs arose, it was more practical to publish financial reports at fixed intervals.

CP3-2: Accrual accounting information better satisfies the demand for information than cash accounting does because accrual accounting information includes information on partially complete cash cycles that cash accounting omits. As a result, the information is more timely, more complete, and more faithfully representational of the transactions and events affecting the enterprise.

CP3-3: Accrual accounting numbers are fundamentally inexact because accruals involve incomplete cash cycles and therefore management needs to make forecasts of future outcomes to estimate the amounts for the accruals.

CP3-4: Quality of earnings refers to how closely reported accounting numbers resemble those that would be reported without managerial bias. Readers cannot directly observe the quality of earnings, but it is possible to make indirect assessments of this quality by evaluating the degree to which management is motivated to make excessive accruals to bias the financial information.

CP3-5: The subsequent-events period is the interval between the cut-off date (the end of the fiscal period) and the date when the company authorizes the financial statements for issuance. Information obtained in the subsequent-events period can be used to improve the *measurement* of transactions and events occurring prior to the cut-off date. However, information on transactions and events after the cut-off date cannot be *recognized*.

CP3-6: Both corrections of errors and changes in accounting policy require retrospective adjustment. In contrast, changes in estimates due to the arrival of new information or changed circumstances requires prospective treatment.

CP3-7: Articulation refers to the connections among the financial statements. The cash flow statement connects with the cash balances shown in the balance sheet. Comprehensive income flows into retained earnings and reserves in the statement of changes in equity. The equity account balances in the statement of changes in equity connect with the equity portion of the balance sheet.

CP3-8: Recycling of other comprehensive income (OCI) results in the recognition of previously recorded OCI in net income (and therefore retained earnings as well). OCI that is *not* recycled does not pass through net income.

L. References

Authoritative standards:

IFRS	ASPE Section
The Conceptual Framework for Financial Reporting	1000—Financial Statement Concepts
IAS 1—Presentation of Financial Statements	1400—General Standards of Financial Statement Presentation
	1505—Disclosure of Accounting Policies
	1520—Income Statement
	1521—Balance Sheet
IAS 7—Statement of Cash Flows	1540—Cash Flow Statement
IAS 8—Accounting Policies, Changes in Accounting Estimates, and Errors	1506—Accounting Changes
IFRS 5—Non-current Assets Held for Sale and Discontinued Operations	3475—Disposal of Long-Lived Assets and Discontinued Operations

Other readings:

Lo, Kin. "Earnings Quality and Earnings Management." *Journal of Accounting and Economics* 45 (2008): 350–357.

M. Glossary

accrual: An accounting entry that reflects events or transactions in a period different from its corresponding cash flow.

accrual accounting: A method of accounting that records economic events when they happen rather than only when cash exchanges occur; contrast with **cash accounting**.

articulation: The connection of financial statements (balance sheet, income statement, cash flow statement, statement of changes in equity) with each other.

cash accounting: A method of accounting that records only cash exchanges; contrast with **accrual accounting**.

cash cycle: A set of transactions that converts a cash inflow to a cash outflow, or vice versa. A **financing cash cycle** is the receipt of funding from investors, using those funds to generate returns from investments and operations, and returning the funds to investors. An **investing cash cycle** is the purchase of property that has long-term future benefits for the enterprise, using that property to obtain economic benefits that ultimately result in cash inflows, and disposing of the property. An **operating cash cycle** involves the purchase of items such as inventory; production, sales, and delivery of goods or provision of services; and receipts from customers.

cash equivalents: Short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

change in accounting policy: An accounting change made at the discretion of management.

change in estimate: An accounting change made necessary by the arrival of new information.

correction of an error: An accounting change made necessary by the discovery of an incorrect amount given information available at the time the amount was reported.

cut-off: The point in time at which one reporting period ends and the next begins.

deferral: An accounting entry that reflects events or transactions after the related cash flow.

direct method (cash flow statement): A method of presenting the cash flow statement that shows the amounts attributable to each activity such as sales to customers; contrast with **indirect method**.

function (of an expense): The use to which the expense has been put (e.g., cost of sales, distribution, administration, or other activities); contrast with **nature**.

indirect method (cash flow statement): A method of presenting the operating section of the cash flow statement that uses the profit or loss from the income statement as a starting point and then itemizes adjustments to arrive at the net amount of operating cash flows; contrast with **direct method**.

nature (of an expense): The source of the expense (depreciation from equipment, costs of employee labour, cost of raw materials, or other means of production); contrast with **function**.

prospective adjustment: Applying an accounting change only to the current and future reporting periods without any changes to past financial statements.

quality of earnings: How closely reported earnings correspond to earnings that would be reported in the absence of management bias.

recycling (of OCI): The process of recognizing amounts through OCI, accumulating that OCI in reserves, and later recognizing those amount through net income and retained earnings.

retrospective adjustment (also retroactive adjustment): Applying an accounting change to all periods affected in the past, present, and future. Retrospective adjustment **with restatement** shows any comparative figures on the same basis as the current period figures. Retrospective adjustment **without restatement** reflects the accounting change's impact on past periods in the current period.

subsequent-events period: The period between the cut-off date and the date when the company authorizes its financial statements for issuance.

true and fair: An overall evaluation of a set of financial statements as being a fair representation of the enterprise's economic conditions and performance.

unbiased accounting: A conceptual accounting outcome that would result from taking an average or consensus from a sample of disinterested accountants.

N. PROBLEMS

P3-1. The nature of accrual accounting (**L.O. 3-1**) (Easy – 5 minutes)

For the factors listed below, indicate whether each significantly contributes to the practice of reporting financial statements periodically (annually or quarterly).

Factor	Significant contributor	Not a significant contributor
a. Improved technological capability (computers, Internet)		
b. A diffuse investor base comprising many people		
c. Increased pace of business transactions		
d. Invention of the printing press		
e. Establishment of regulators such as the Ontario Securities Commission		
f. Creation of indefinite-life entities like corporations		
g. Establishment of professional accounting organizations		

P3-2. The nature of accrual accounting (L.O. 3-1) (Easy – 10 minutes)

For the factors listed below, indicate whether each significantly contributes to the use of accrual accounting for financial reports (rather than using the cash basis).

Factor	Significant contributor contributor	Not a significant contributor
a. Establishment of accounting standard setters such as the International Accounting Standards Board		
b. Invention of the double-entry system of bookkeeping		
c. Creation of indefinite-life entities like corporations		
d. Development of credit cards and other substitutes for cash		
e. Preparation of periodic financial reports		
f. Incomplete transactions at reporting dates		
g. The going concern assumption		
h. Accounting standards such as IFRS requiring accrual accounting		
i. Financial reports using accrual accounting are simpler to understand compared to those prepared using cash accounting		

P3-3. The nature of accrual accounting (L.O. 3-1) (Medium – 10 minutes)

Explain why companies prepare and present financial statements annually.

P3-4. The nature of accrual accounting (L.O. 3-1) (Medium – 5 minutes)

The IFRS Framework, paragraph 22, states: "In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognized when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash, but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions."

Required:

Discuss why you would expect accrual accounting numbers to be better predictors of future cash flows in comparison to cash basis accounting.

P3-5. The nature of accrual accounting (L.O. 3-1) (Medium – 10 minutes)

In finance, the calculation of net present value involves cash flows rather than accrual accounting numbers. Indeed, one often takes accounting reports and adjusts for non-cash items such as depreciation to arrive at cash flows, which are then discounted. Some finance professionals proclaim that "cash is king" and believe accounting accruals should be ignored.

Required:

Do you agree with the above statements? Explain.

P3-6. Role of the going concern assumption in accrual accounting

(L.O. 3-1) (Medium – 20 minutes)

The accrual basis of accounting implicitly assumes that the firm will continue to operate well into the future such that the result of incomplete transactions will be completed or concluded. This assumption is called the "going concern assumption." Because of this assumption we can use the historical cost basis of valuing most of the accounts on the balance sheet. The opposite of the going concern assumption is the notion that the firm is or will soon become bankrupt, and therefore no longer continues to operate.

Required:

a. How does the going concern assumption relate to the valuation of property, plant, and equipment (PPE) on the balance sheet? Why is this assumption essential to the use of depreciation methods for PPE?
b. If the going concern assumption is no longer valid, how should assets be valued?
c. A company purchased a machine for $10,000,000 on January 1, 2013. The machine has a 10-year estimated useful life and an estimated residual value of $1,000,000. The company uses the straight-line depreciation method. During 2014 the company experiences significant and unexpected financial difficulty such that it goes into bankruptcy on December 31, 2014. At this time, the machine has a resale value in an auction for $5,500,000.
    i. How much is depreciation expense for 2013 and 2014?
    ii. Should depreciation expense for 2014 be the same as for 2013? Why?
    iii. What should be the value of the machine on the balance sheet on December 31, 2014?
    iv. What should be the adjustment to the carrying value of the machine in 2014?
d. A company has prepaid rent of $100,000 on December 31, 2014. If the company is a going concern, how should this amount be valued? If the company were *not* a going concern, how should it value the prepaid rent?
e. How should inventory be valued if a company goes into bankruptcy? Can the company use first-in, first-out or average cost?

P3-7. Accrual accounting and need for estimates

(L.O. 3-2) (Easy – 10 minutes)

For each of the following financial statement items, identify an estimate that is required in the measurement of that item on the financial statements.

Item
a. Accounts receivable
b. Inventories
c. Equipment
d. Warranty liability
e. Sales revenue
f. Revenue from long-term contract
g. Cost of goods sold

P3-8. Relation between accrual accounting and cash flows; quality of earnings

(L.O. 3-2) (Medium – 10 minutes)

Finance professionals often evaluate the quality of earnings by looking at the difference between earnings and cash flows. In particular, financial analysts often compute the difference between (i) net income from the income statement and (ii) cash flow from operations from the cash flow statement; the bigger the difference between the two, the lower the level of earnings quality is.

Required:

a. What is the meaning of "quality of earnings"?
b. Evaluate the practice of assessing earnings quality by comparing earnings and cash flows.

P3-9. The relation between accrual accounting and cash flows

(L.O. 3-2, L.O. 3-3) (Medium – 20 minutes)

Refer to the example of Tradewinds Company illustrated by the timeline in Exhibit 3-2 and the facts given at the beginning of Section B, "Accrual versus Cash Accounting." In addition, assume that the remaining ships are sold for $3.5 million each just before the end of Year 4 in preparation for the dissolution of the company.

Required:

a. Complete the financial statements for Years 3 and 4 using the tables below.
b. In the following tables, complete the column for "4-Year Total." Compare the 4-year totals for cash flow and income. Comment on the similarities and differences.

$millions	Year 1	Year 2	Year 3	Year 4	4-Year Total
Cash flow statement					
Operations					
Inflow from sale of goods	$ 5	$ 5			
Outflow from operating costs	(3)	(2)			
Cash flow from operations	2	3			
Cash flow from investing activities	(15)	0			
Cash flow from financing activities	20	0			
Net cash flow for the year	7	3			
Cash at beginning of year	0	7			
Cash at end of year	$ 7	$10			

($millions)	Year 1	Year 2	Year 3	Year 4	4-Year Total
Statement of income and retained earnings					
Revenue ($5m/arrival)	5.0	5.0			
Operating expenses ($1m/ arrival)	(1.0)	(1.0)			
Depreciation ($0.5m/ arrival)	(0.5)	(0.5)			
Write-off of sunken ship	0.0	(4.5)			
Write-off of prepaid expenses	0.0	(1.0)			
Net income (loss)	3.5	(2.0)			
Retained earnings at beginning of year	0.0	3.5			
Retained earnings at end of year	$3.5	$1.5			
Balance sheet					
Cash	7.0	10.0			
Prepaid expenses	2.0	2.0			
Ships at cost	15.0	10.0			
Less: accumulated depreciation	(0.5)	(0.5)			
Total assets	23.5	21.5			
Contributed capital	20.5	20.0			
Retained earnings	3.5	1.5			
Total equity	$23.5	$21.5			

P3-10. No "true" net income

(L.O. 3-2) (Medium – 30 minutes)

Computer Consulting Limited was started in early 2009 and continued to operate until early 2012, when it was wound up due to disputes between the two principal owners. When it started, the company considered two sets of accounting policies:

Accounting policy set 1:

a. Use straight-line depreciation method on the firm's only asset. The computer cost $1,000,000 and has an estimated useful life of four years.
b. Estimate warranty expense as 9% of sales.
c. Estimate bad debts expense as 5% of sales.

Accounting policy set 2:

a. Use 50% declining-balance method for depreciation.
b. Estimate warranty expense as 10% of sales.
c. The year-end allowance for doubtful accounts should be 40% of gross accounts receivable.

Actual events, cash flows, and transactions are as follows:

	2009	2010	2011	2012
Sales (all on account)	$3,000,000	$3,500,000	$4,000,000	$500,000
Warranties paid	250,000	275,000	410,000	180,000
Proceeds on disposal of computer	—	—	—	400,000
Accounts receivable collected during the year	2,600,000	2,800,000	3,800,000	1,200,000
Accounts receivable written off during the year	100,000	125,000	200,000	175,000
All other expenses (paid in cash in the year incurred)	2,100,000	2,500,000	2,700,000	350,000

Required:

a. Derive net income for 2009 to 2012 using the first set of accounting policies. For the year-end balance for 2012, assume accounts receivable, allowance for doubtful accounts, and the warranty accrual are $0, as the firm wound itself up during the year and all timing differences have been resolved.
b. Derive net income for 2009 to 2012 using the second set of accounting policies. For the year-end balance for 2012, assume accounts receivable, allowance for doubtful accounts, and the warranty accrual are $0, as the firm wound itself up during the year and all timing differences have been resolved.
c. Derive the annual net cash flows for 2009 to 2012.
d. What is the sum of the net income for the four years for the two sets of accounting policies? What is the sum of the net cash flows for the four years? What does this tell us about net income and accrual accounting?
e. Why were the net incomes different between the two sets of accounting policies?
f. What caused the net income in 2012 to be so high for the second set of accounting policies?

P3-11. Quality of earnings (L.O. 3-2) (Medium – 20 minutes)

Multi-Earnings Company had the following different patterns of net income based on different accounting policies and estimates/assumptions. These differing net incomes were the result of using different depreciation methods and assumptions about asset useful life, different methods of estimating bad debts expenses, different revenue recognition methods, different inventory valuation methods, and different methods of accruing liabilities such as vacation pay and warranties. In all cases, at the end of the fifth year the company had the same retained earnings, total assets and liabilities, and cash.

In $millions	2011	2012	2013	2014	2015	5-Year Total
Net Income A	$30	$30	$30	$30	$30	$150
Net Income B	$22	$25	$29	$34	$40	$150
Net Income C	$39	$35	$30	$25	$21	$150
Net Income D	$35	$27	$30	$34	$24	$150

Required:

a. Assuming that the company is publicly traded, which of these net income streams (A, B, C, or D) would likely result in the highest share price in early 2016? The lowest share price? Justify your conclusion.
b. Imagine you are the president of this company and the company is publicly listed/traded. Which representation of earnings would likely give you the largest aggregate bonus if your compensation was based on net income?
c. If you were the sole owner and chief executive officer of the company, which method of deriving net income would you prefer?
d. Does the selection of accounting policies change the actual achievements of the company? Does it change the future of the company? Does it change what people believe the past, present, or future of the company was, is, or will be? Discuss these differing perceptions and views of the company's financial condition.

P3-12. Evaluating accrual accounting and earnings quality (L.O. 3-2) (Medium – 20 minutes)

In the federal budget delivered on February 18, 2003, Finance Minister John Manley announced that the federal government will use full accrual accounting according to Canadian GAAP, as recommended by the auditor general. Other countries, such as the UK, Australia, and New Zealand, have also made similar changes.

In the past, the method of accounting was a "modified cash basis," which can be roughly summarized as follows:

- revenues = cash received in the fiscal year
- expenses = cash disbursed in the fiscal year
- surplus (or deficit) = revenues – expenses = cash received – cash disbursed

Under this old method of accounting, non-financial assets were not recognized on the balance sheet. For example, spending on the construction of roads or hospitals would be counted as expenses. (Financial assets and liabilities such as cash and bond obligations are recorded.)

Accounting critic Al Rosen, who has a reputation for being blunt, complained that this move by the government was "trading one pile of manure for another even larger, more stinky pile" (*Canadian Business*, May 13, 2003). He argued that GAAP-based rules are "looser," creating "thousands of new ways for the government to engineer the books."[5]

Required:

Discuss the pros and cons of the government adopting GAAP accrual accounting standards.

P3-13. Subsequent events (L.O. 3-3) (Medium – 10 minutes)

The date is February 26, 2015, and you are in the process of making adjusting entries for Bellevue Company for the year ended December 31, 2014. In your analysis of accounts receivable and bad debts, you come across the accounts for two customers that require additional attention:

- Kingston Pen Ltd. owed Bellevue $55,000 as at December 31, 2014. You learned that Kingston Pen filed for bankruptcy on February 14, 2015, due to continuing financial difficulties.
- Trenton Homes owed Bellevue $79,000 as at December 31, 2014. You learned that the owners decided to cease operations on February 22, 2015. An ice dam on the Trent River caused an uninsured flooding incident that damaged most of Trenton Homes' assets. Due to the vastly diminished assets of Trenton Homes, you expect to recover only $15,000 out of the $79,000 from the liquidation of the company's assets.

Required:

Identify and explain the appropriate treatment of the two accounts receivable in the books of Bellevue Company. Assume the amounts are material. Comment on any similarities or differences in treatment.

5. Courtesy of Al Rosen.

P3-14. Subsequent events (L.O. 3-3) (Medium – 15 minutes)

You and your team of auditors are examining the financial statements of Capilano Water Company (CWC) for the fiscal year ended June 30, 2013. It is October 11, 2013. During the audit, you identified the following issues (assume all amounts are material):

a. CWC's draft financial statements show $100,000 of inventory of bottled water as of June 30, 2013. On August 17, 2013, it was discovered that the spring from which the company sources its water had been contaminated. Samples from the year-end inventory show that a quarter of it had been contaminated and is not suitable for sale.
b. On September 7, 2013, one of CWC's water delivery trucks was destroyed in an accident. This truck had a value of $80,000 on the books of CWC as of June 30, 2013.
c. In February 2013, CWC purchased 1,000 shares of Royal Bank Corporation (RBC) at $60 per share. These shares are widely traded on the Toronto Stock Exchange and share prices are available on a daily basis. The share price on June 30, 2013, was $55, and as of October 11, 2013, the share price has further declined to $48.
d. You noted that the closing cash balance on the bank statement dated September 30, 2013, was $3,000, much lower than the $67,000 shown on the draft financial statements that you are auditing.

Required:

Using the table below, identify the accounting treatment that would be most appropriate for each of the four issues described above, and explain why that is the appropriate treatment.

Item	Balance sheet amount after adjustment (if any), June 30, 2013	Explanation
a. Inventory—bottled water		
b. Equipment—truck		
c. Investment—RBC shares		
d. Cash		

P3-15. Subsequent events (L.O. 3-3) (Medium – 15 minutes)

Below are several events that occur after your company's year-end but before the completion of the audit:

a. There is a fire at the company's only warehouse; the company has insufficient fire insurance to replace the warehouse and contents such that a material loss will result and operations will be curtailed for six months.
b. There is a significant fall in the market price of a major portion of inventory due to new technology making the existing items obsolete. The market price is lower than the current carrying value.
c. A new competitor enters the marketplace, which will result in serious price competition and, likely, reduced income next year.
d. New technology makes a major capital asset redundant or causes it to lose significant fair market and salvage value.
e. A major client unexpectedly goes bankrupt and it is determined that you will get 30% of the value of the accounts receivable as full and final settlement.
f. The company experiences a major labour strike. Workers are still on strike when the audit is finished. Does your answer change if this strike might force the company into bankruptcy?

Required:

For each of the above subsequent events, determine whether the event:
– requires an adjustment to the year-end financial statements,
– requires note disclosure, or
– requires neither adjustment to recognized amounts nor disclosure.
Justify your recommendation.

P3-16. Accrual accounting and incomplete transactions (L.O. 3-3) (Medium – 30 minutes)

Incomplete Transactions Company was started on January 1, 2012. During its first year of operations, the company had a choice of accounting policies. The chief financial officer identified the following as possible alternatives and provided the underlying assumptions/estimates for each:

	Accounting policy set A	Accounting policy set B
Inventory valuation	FIFO	Average cost
Bad debts	6% of sales	Allowance: 10% of closing gross accounts receivable
Warranties	4% of sales	Allowance: An analysis of sales and repairs

The following are the actual transactions for the first three years of operations:

	2012	2013	2014
Sales (all on accounts)	$11,000,000	$12,000,000	$12,800,000
Inventory purchases (paid immediately)	5,000,000	3,500,000	3,700,000
Ending inventory value, FIFO	2,000,000	2,300,000	2,500,000
Ending inventory value, average cost	1,800,000	2,000,000	2,500,000
Collections	9,000,000	10,500,000	13,270,000
Amounts actually written off	600,000	650,000	800,000
Warranties actually paid	300,000	460,000	502,000
Estimated warranties payable ending balance based on aging analysis of sales	150,000	180,000	170,000
Depreciation expense	1,000,000	1,000,000	1,000,000
All other operating expenses (paid immediately)	3,000,000	3,300,000	3,900,000

Required:

a. Derive net income for 2012, 2013, and 2014. Ignore income taxes.
b. What is the cumulative income for the three years for the two sets of accounting policies? What does this tell us about the closing balance sheet at the end of the third year?
c. What are the cumulative operating cash flows for the three years for either set of accounting policies? Why are these cumulative cash flows the same for the two sets of policies?
d. Carefully explain why the net incomes for each of the three years under review are not the same. What does this tell us about accruals and allocation methods?

P3-17. Accounting changes (L.O. 3-4) (Easy – 3 minutes)

For the following types of accounting changes, identify the appropriate treatment under IFRS.

Type of accounting change	Accounting treatment
a. Change in estimate	
b. Change in accounting policy	
c. Correction of an error	

P3-18. Accounting changes (L.O. 3-4) (Easy – 3 minutes)

For the following types of accounting changes, identify the relevant criteria for each accounting change by selecting "yes," "no," or "n/a" (not applicable).

Type of accounting change	Accounting change due to management choice?	Information known (or should have been known) in prior period?
a. Change in estimate	Yes No n/a	Yes No n/a
b. Change in accounting policy	Yes No n/a	Yes No n/a
c. Correction of an error	Yes No n/a	Yes No n/a

P3-19. Accounting changes (L.O. 3-4) (Medium – 15 minutes)

Evaluate each of the following independent situations to determine the type of accounting change (correction of error, change in accounting policy, or change in estimate) and the appropriate accounting treatment (retrospective or prospective).

Required:

a. A furniture maker decreases bad debts expense from 3% to 2% of credit sales.
b. A manufacturer determines that credit losses are becoming material due to deteriorating economic conditions. As a result, it decides to set up an allowance for doubtful accounts at 5% of amounts over 90 days.
c. A parking service estimates bad debts to be 10% of the value of parking violations issued. In the current year, it changes to estimating the allowance for bad debts to be equal to 20% of accounts 30 to 90 days and 50% of accounts over 90 days.
d. A shipbuilder changes its revenue recognition policy from the point of receipt by the customer to when the ship leaves the factory shipyard. This change results from a change in shipping policy from F.O.B. destination to F.O.B. shipping point. (Recall from introductory accounting that F.O.B. means "free on board," and it refers to the point at which custody transfers from seller to buyer.)
e. An electronics retailer has never accrued for warranties or product guarantees. A new consumer protection law comes into effect, giving buyers of electronic products a guarantee against defects for 180 days after purchase and the ability to return defective products to the retailer.
f. A clothing company that has been operating for 20 years decides to obtain an external audit for the first time to meet the bank's demands. The audit firm recommends that management report inventories at the lower of cost and net realizable value, whereas the company has previously only tracked and reported inventory figures at cost.

P3-20. Accounting changes (L.O. 3-4) (Easy – 10 minutes)

Explain why a change in accounting policy requires the adjustment of both prior and future periods, whereas a change in estimate requires only adjustment of future periods.

P3-21. Accounting changes (L.O. 3-4) (Medium – 15 minutes)

Accrual accounting necessarily involves professional judgment, because accruals depend on decisions about uncertain future events. These judgments and decisions include the choices of accounting policies that management determines to be most appropriate for the circumstances.

Required:

Using the Conceptual Framework and other ideas, discuss whether a change in accounting policy should be treated prospectively or retrospectively.

P3-22. Accounting changes (L.O. 3-4) (Medium – 10 minutes)

For each of the following scenarios, determine the effects (if any) of the accounting change (correction of error, change in accounting policy, or change in estimate) on the relevant asset or liability, equity, and comprehensive income in the year of change and the prior year. Use the following table for your response.

Type of accounting change	Treatment	Year prior to change: Asset or liability	Year prior to change: Equity	Year prior to change: Income	Year of accounting change: Asset or liability	Year of accounting change: Equity	Year of accounting change: Income
a.							
b.							
c.							

a. Company A increases the allowance for doubtful accounts (ADA). Using the old estimate, ADA would have been $40,000. The new estimate is $45,000.
b. Company B omitted to record an invoice for an $8,000 sale made on credit at the end of the previous year and incorrectly recorded the sale in the current year. The related inventory sold has been accounted for.
c. Company C changes its revenue recognition to a more conservative policy. The result is a decrease in prior-year revenue by $3,000 and a decrease in current-year revenue by $4,000 relative to the amounts under the old policy.

P3-23. Accounting changes (L.O. 3-4) (Medium – 10 minutes)

During the audit of Keats Island Brewery for the fiscal year ended June 30, 2013, the auditors identified the following issues:

a. The company sells beer for $1 each, plus $0.10 deposit on each bottle. The deposit collected is payable to the provincial recycling agency. During 2013, the company recorded $8,000 of deposits as revenue. The auditors believe this amount should have been recorded as a liability.
b. The company had been using the first-in-first-out cost flow assumption for its inventories. In fiscal 2013, management decided to switch to the weighted-average method. This change reduced inventory by $20,000 at June 30, 2012, and $35,000 at June 30, 2013.
c. The company has equipment costing $5,000,000 that it has been depreciating over 10 years on a straight-line basis. The depreciation for fiscal 2012 was $500,000 and accumulated depreciation on June 30, 2012, was $1,000,000. During 2013, management revises the estimate of useful life to 12 years, reducing the amount of depreciation to $400,000 per year.

Required:

For each of the three issues described above, using the following table, identify
(i) the type of accounting change;
(ii) the treatment required; and
(iii) the effect of the accounting change on the financial statements of June 30, 2013.

For (iii), identify both the direction (increase or decrease) and the amount of the effect relative to the amount without the accounting change.

Type of accounting change	Treatment	Effect of accounting change on the financial statements of June 30, 2013 (indicate both direction and amount): Assets	Liabilities	Equity	Income
a.					
b.					
c.					

P3-24. Accounting changes (L.O. 3-4) (Difficult – 30 minutes)

Cross Company Limited, a private company, was started on January 1, 2014. For the first year, the chief accountant prepared the financial statements and a local accountant completed

the necessary review of these statements. However, for the year ended December 31, 2010, an external auditor was appointed. The income statement for 2014 and the preliminary amounts for 2015 are as follows:

	2014	2015
Long-term contract income	$3,000,000	$4,000,000
Other income (loss)	(800,000)	(900,000)
Bad debts expense	(400,000)	(500,000)
Depreciation expense—machine	(500,000)	(500,000)
Depreciation expense—building	(300,000)	(270,000)
Warranty expense	(200,000)	(320,000)
Income before taxes	800,000	1,510,000
Income taxes (at 30%)	(240,000)	(453,000)
Net income	$560,000	$1,057,000

In the process of examining the accounting records the auditor noted the following issues:

i. **Long-term contracts:** Cross Company used the completed contract method for revenue recognition in 2014. Management now believes that the percentage of completion method would be better. Income under the completed contract method for 2014 was $3,000,000 and for 2015 it was $4,000,000. If the percentage of completion method had been used, the incomes would have been $4,200,000 (2014) and $3,700,000 (2015).

ii. **Accounts receivable:** The accounts receivable on December 31, 2014, included a $100,000 account that was not provided for but subsequently was written off during 2015 as the customer went bankrupt after the issuance of the financial statements. Cross Company would like to adjust 2014 for this oversight as it sees this as an error.

iii. **Machine depreciation:** Cross Company has one huge machine that cost $5,000,000 and was depreciated over an estimated useful life of 10 years. Upon reviewing the manufacturer's reports in 2015, management now firmly believes the machine will last a total of 15 years from the date of purchase. They would like to change last year's depreciation charge based on this analysis. Depreciation expense of $500,000 has been recorded for 2015.

iv. **Building depreciation:** The company's building (cost $3,000,000, estimated salvage value $0, useful life 20 years) was depreciated last year using the 10% declining-balance method. The company and auditor now agree that the straight-line method would be more appropriate. A depreciation provision of $270,000 has been made for 2015.

v. **Inventories:** The accountant last year failed to apply the lower of cost and net realizable value test to ending inventory. Upon review, the inventory balance for last year should have been reduced by $200,000. The closing inventory allowance for this year-end should be $300,000. No entry has been made for this matter.

vi. **Warranties:** Cross Company does not accrue for warranties; rather it records the warranty expense when amounts are paid. Cross provides a one-year warranty for defective goods. Payments to satisfy warranty claims in 2014 were $200,000 and $320,000 in 2015. Out of the $320,000 paid in 2015, $150,000 related to 2014 sales. A reasonable estimate of warranties payable at the end of 2015 is $275,000.

Required:

a. As the audit senior on this engagement, what is your recommended treatment for each of these matters in terms of whether they are errors, changes in accounting policy, or changes in estimate? Explain your answers.
b. Assume that management of Cross Company agrees with your recommendations. Prepare the corrected statements of comprehensive income for 2014 and 2015.

P3-25. Current and non-current assets (L.O. 3-5) (Easy – 5 minutes)

IFRS identifies a number of criteria to determine whether an asset can be classified as current. Satisfying *any one* of these criteria is sufficient. For the following list of criteria,

identify whether each one is relevant for the classification of an asset as current instead of non-current.

Criteria	Relevant for classification as current? (Yes/No)
a. The asset is expected to be sold in the entity's normal operating cycle.	
b. The asset is traded in an active market.	
c. The asset is expected to be realized within 12 months after the balance sheet date.	
d. The asset is held primarily for the purpose of being traded.	
e. The asset is expected to be consumed in the entity's normal operating cycle.	
f. The asset is an item of inventory.	
g. The asset is cash or cash equivalent.	
h. The asset is a receivable from another company.	

P3-26. Current and non-current liabilities (L.O. 3-5) (Easy – 5 minutes)

IFRS identifies a number of criteria to determine whether a liability should be classified as current. A liability that satisfies *any one* of these criteria must be classified as current. For the following list of criteria, identify whether each one is relevant for the classification of a liability as current instead of non-current.

Criteria	Relevant for classification as current? (Yes/No)
a. The liability is expected to be settled in the entity's normal operating cycle.	
b. The liability requires settlement in cash.	
c. The liability is expected to be realized within 12 months after the balance sheet date.	
d. The liability is held primarily for the purpose of being traded.	
e. The entity does not have an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date.	
f. The liability is a line of credit owing to a financial institution.	
g. The liability is unavoidable.	

P3-27. Presentation of income statement (L.O. 3-5) (Easy – 5 minutes)

IFRS requires certain line items to be presented in the income statement (rather than just disclosed in the notes). Identify whether the following items are required in the income statement.

Line item	Required? (Yes/No)
a. Revenue	
b. Profit or loss (net income)	
c. Cost of goods sold	
d. General and administrative expenses	
e. Comprehensive income	
f. Labour costs	
g. Income tax expense	
h. Other comprehensive income	
i. Finance costs (interest expense)	

P3-28. Presentation of income statement (L.O. 3-5) (Easy – 5 minutes)

Identify whether each of the following items of operating expense is described according to its *nature* or *function*.

Type of operating expense	Nature	Function
a. Cost of goods sold		
b. Delivery		
c. Wages and benefits		
d. Administration		
e. Building depreciation		
f. Utilities (electricity, heating, etc.)		
g. Marketing and advertising		
h. Sales commissions		
i. Raw materials consumed		
j. Insurance		

P3-29. Preparation and presentation of financial statements with current/non-current classifications (L.O. 3-5) (Easy – 20 minutes)

Below is an adjusted trial balance for Wan Industries Limited as at December 31, 2013.

Account (in alphabetical order)	Debit	Credit
Accounts payable		$142,000
Accounts receivable	$95,000	
Accumulated depreciation		50,000
Advertising expense	16,000	
Cash	334,000	
Common shares		200,000
Cost of goods sold	410,000	
Current portion of long-term loan payable		40,000
Depreciation expense	12,000	
Dividends	21,000	
Equipment	500,000	
Income tax expense	35,000	
Interest expense	41,000	
Interest payable		10,000
Inventory	51,000	
Long-term loan receivable	300,000	
Non-current portion of long-term loan payable		360,000
Prepaid rent	25,000	
Rent expense	75,000	
Retained earnings		385,000
Sales revenue		800,000
Stationery	5,000	
Stationery expense	14,000	
Unearned revenue		23,000
Wages expense	91,000	
Wages payable		15,000
Total	$2,025,000	$2,025,000

Required:

Prepare a balance sheet for Wan Industries Limited as at December 31, 2013 with items classified as current or non-current.

P3-30. Articulation of financial statements (L.O. 3-5) (Easy – 10 minutes)

Required:

Complete the missing numbers in the following table.

	Company A	Company B	Company C	Company D	Company E
Assets	?	$800	?	?	$4,000
Liabilities	?	425	1,100	1,800	?
Common Stock	20	175	?	100	500
Retained Earnings	130	?	275	?	700
Liabilities + Equity	$500	?	$1,500	$2,500	$4,000
Opening Retained Earnings	$100	$140	?	$500	$750
+ Net Income (Loss)	70	?	160	?	?
– Dividends	?	(10)	(85)	(60)	(10)
Closing Retained Earnings	130	?	?	?	$700

P3-31. Components of the Conceptual Framework and the articulation of financial statements (L.O. 3-5) (Medium – 20 minutes)[6]

A business earns income by converting assets and resources into other assets and resources. For example, through the efforts of its workforce and other resources, a business converts inventories of raw materials into receivables and cash. The value of the new assets generated may be termed "revenue," that of the assets and resources consumed may be termed "expense," and the increased value may be termed "income." Therefore, it can be argued that asset valuation, revenue recognition, and matching of expenses to revenues are interrelated. Some of these relationships are as follows:

a. The choice of asset valuation method affects revenue recognition.
b. The theory on which revenue generation is based affects the valuation of the related assets.
c. When the objectives of asset valuation and income recognition conflict, it becomes necessary to choose either the desired asset valuation method or the desired income recognition method.

Required:

Discuss each of the three relationships described above and provide examples where appropriate.

P3-32. Preparation of articulated financial statements (L.O. 3-5) (Easy – 15 minutes)

The following is a pre-closing trial balance for Axo Inc., a manufacturer of metal tubing, as at December 31, 2013:

6. Adapted from the Uniform Final Examination (1982) with permission from The Canadian Institute of Chartered Accountants, Toronto, Canada. Any changes to the original material are the sole responsibility of the author and have not been reviewed or endorsed by the CICA.

	Debit	Credit
Accounts payable		$ 525,000
Accounts receivable	$ 1,360,000	
Accumulated depreciation		6,555,000
Cash	69,300	
Common shares		700,000
Depreciation	1,475,000	
Income from discontinued operations		25,000
Income tax expense	154,200	
Income tax on income from discontinued operations	7,500	
Interest expense	355,000	
Inventories	645,000	
Long-term debt		5,400,000
Plant and equipment	12,300,000	
Raw materials used	1,670,000	
Retained earnings		817,000
Salaries and wages	5,210,000	
Sales		9,224,000
Total	$23,246,000	$23,246,000

Required:

Prepare, in good form, the following:

a. A multi-step income statement that includes relevant subtotals, with operating expenses listed by their nature, for the year ended December 31, 2013.
b. A statement of changes in equity for the year ended December 31, 2013.

P3-33. Preparation of articulated financial statements

(L.O. 3-4, L.O. 3-5) (Medium – 15 minutes)[7]

The following is a partial listing of the accounts for Boot Company for the year ended December 31, 2014, in alphabetical order:

	Dr. (Cr.)
Common shares	$(2,000,000)
Cost of goods sold	3,775,000
Depreciation expense	84,000
Dividends declared	150,000
Employee wages and benefits	957,000
Loss from discontinued operations before tax	107,000
Marketing and advertising expenses	642,000
Retained earnings, January 1, 2014	(443,000)
Sales	(4,661,000)
Utilities expense	315,000

During the year, the company issued shares for proceeds of $400,000. In addition, the company had a change in depreciation policy that required a retroactive adjustment that increased the prior year's depreciation expense by $62,000. Boot pays income tax at the rate of 40%. Assume that all of the above items except for retained earnings are before tax.

7. Adapted from CGA-Canada FA2 examination, June 2008.

Required:

Using the information above, prepare, in good form, the following:

a. A multi-step income statement that includes relevant subtotals, with operating expenses listed by their function, for the year ended December 31, 2014.
b. A statement of changes in equity for the year ended December 31, 2014.

P3-34. Preparation of articulated financial statements (L.O. 3-5) (Medium – 20 minutes)

The following is a pre-closing trial balance for Kalico Kats, as at December 31, 2015:

	Debit	Credit
Accounts payable		$ 1,235,000
Accounts receivable	$ 2,860,000	
Accumulated depreciation—equipment		1,740,000
Accumulated depreciation—plant		1,500,000
Cash	1,009,800	
Common shares		15,000,000
Depreciation—equipment	580,000	
Depreciation—plant	500,000	
Equipment	5,800,000	
Income tax expense	537,200	
Income tax on income from discontinued operations		200,000
Interest expense	165,000	
Inventories	645,000	
Land—cost	5,000,000	
Land—revaluation adjustment	3,000,000	
Long-term debt		3,500,000
Loss from discontinued operations	500,000	
Other comprehensive income—gain on land revaluation		3,000,000
Plant	10,000,000	
Raw materials used	4,670,000	
Retained earnings		1,834,000
Salaries and wages	7,210,000	
Sales		15,344,000
Utilities expense	876,000	
Total	$43,353,000	$43,353,000

During the year, the company declared and paid $500,000 of dividends and issued shares for proceeds of $5,000,000.

Required:

Prepare, in good form, the following:

a. A statement of comprehensive income that includes net income and comprehensive income in one schedule,
b. A statement of changes in equity.

P3-35. Preparation of articulated financial statements (L.O. 3-5) (Easy – 15 minutes)

The following is a partial list of accounts and their balances for Davidson Company as at December 31, 2013:

	Debit	Credit
Accounts payable		$1,357,000
Accounts receivable	$3,035,000	
Accumulated depreciation—equipment		3,450,000
Accumulated depreciation—plant		2,500,000
Accumulated other comprehensive income—gain on available-for-sale investments		140,000
Cash	457,000	
Common shares		20,000,000
Depreciation—equipment	690,000	
Depreciation—plant	500,000	
Equipment	5,520,000	
Income tax expense	850,000	
Income tax payable		125,000
Intangible assets	1,750,000	
Inventories	820,000	
Land	12,000,000	
Long-term debt		30,000,000
Plant	50,000,000	
Preferred shares		10,000,000
Retained earnings, December 31, 2013		7,650,000
Available-for-sale investments—cost	1,500,000	
Available-for-sale investments—valuation adjustment	140,000	

Net income for the year was $838,000 and the company declared $400,000 in dividends during the year. There were items of other comprehensive income in the year. The investments are not expected to be sold in the next 12 months. The long-term debt is repayable over five years, with 20% of the balance due on June 30, 2014.

Required:

Prepare, in good form, the following:

a. A statement of changes in equity.
b. A balance sheet using the current/non-current presentation. When possible, group related items into one line to obtain the minimum number of line items to satisfy presentation requirements in IFRS.

P3-36. Preparation of articulated financial statements (L.O. 3-5) (Medium – 15 minutes)[8]

The following is a partial trial balance for Pluto, a public company, for the year ended December 31, 2014. Each item has its normal debit or credit balance, but the total does not equal to zero as it is a partial trial balance.

Accounts receivable	$100,000
Sales	250,000
Prepaid expenses	45,000
Equipment, net (note 1)	60,000
Cost of goods sold	150,000
Accounts payable	65,000
Available-for-sale investments (note 2)	90,000

8. Adapted from CGA-Canada FA2 examination, December 2008.

Common shares	80,000
Unearned revenue	12,000
Retained earnings, January 1, 2014	50,000
Discount on bonds payable	8,000
Cash	22,000
Correction of error (note 3)	35,000
Bonds payable, due January 1, 2020	120,000
Loss on discontinued operations	25,000
Net income (note 4)	?

Notes:

1. The machinery is net of accumulated depreciation of $25,000.
2. The balance in the available-for-sale investments represents the original cost at the date of acquisition (January 1, 2014). As of December 31, 2014, none of these investments had been sold and market value was $120,000.
3. During 2013, a patent of Pluto's expired. The related writedown of $35,000 was subsequently recorded in March 2014.
4. Ignore income taxes for this question. Because only a partial trial balance is provided, net income cannot be directly calculated. It should be plugged in to make the financial statements balance.

Required:

Prepare a balance sheet as at December 31, 2014, and a statement of changes in equity for the year then ended in good form and using appropriate terminology.

P3-37. Articulation of financial statements (L.O. 3-5) (Medium – 10 minutes)

The following table presents summarized financial statements for Whiskey Golf Ltd., in $000's.

Balance Sheet, as at December 31					
	2014	**2013**		**2014**	**2013**
Cash	$ 180	$ 250	Accounts payable	$ 740	$1,400
Accounts receivable (net)	2,500	2,000	Current portion of long-term debt	300	300
Inventories	1,800	1,500	Current liabilities	$1,040	$1,700
Prepaid expenses	300	210	Long-term debt	900	1,200
Land	500	500	Preferred shares	800	800
Plant and equipment (net)	3,500	3,820	Common shares	2,000	2,000
Intangible assets	20	20	Retained earnings	4,860	3,400
Goodwill	800	800	Total equity	$8,560	$7,400
Total assets	$9,600	$9,100	Total liabilities and equity	$9,600	$9,100

Income Statement For the year ended December 31		
	2014	**2013**
Revenue	$7,500	$7,000
Cost of goods sold	(4,900)	(4,800)
Interest expense	(400)	(400)
Earnings before tax	2,200	1,800
Income taxes	(660)	(540)
Income before discontinued operations	1,540	1,260
Loss on discontinued operations	(600)	0
Net income	$ 940	$1,260

Cash Flow Statement For the year ended December 31		
	2014	**2013**
Cash flow from operating activities	$ 880	$ 700
Cash flow from discontinued operations	(600)	0
Cash flow from investing activities	100	(400)
Cash flow from financing activities	(380)	(370)
Net change in cash	$ 0	$ (70)

In addition, you also know that the company declared and paid $80,000 of dividends on preferred shares in each of the two years.

Required:

Identify five substantive errors in the above financial statements. There are no arithmetic errors. To save space, the above presentation is necessarily abbreviated, so do not consider omission of detailed line items as errors. Assume that all required disclosures have been made in the notes to the financial statements. The company did not have any transactions involving other comprehensive income.

P3-38. Articulation of financial statements (L.O. 3-5) (Difficult – 30 minutes)

A group of students are preparing for a presentation in their final-year business strategy course. The students have done all their analyses and are now finalizing their report. One of the students wisely suggests that a balance sheet and income statement should be included as part of their visual presentation and written report. As time is running out, one of the students prepares an income statement based on the competitive and market research completed and another student independently makes a comparative balance sheet based on what the financial plan suggests. The group feels proud they were able to complete this task so quickly and get their project in on time. However, during the presentation the instructor detects that the financial statements do not articulate and are unrealistic. Once this major error is uncovered the presentation quickly falls apart (and you can imagine how this story ends).

Required:

Identify three tests that the instructor might have done to determine whether the balance sheet and income statement fit together (articulate) or were developed independent of each other. Also suggest three tests of reasonableness the instructor might do to see whether the analysis is realistic.

P3-39. Preparation of articulated financial statements, error correction, and subsequent events (L.O. 3-3, L.O. 3-4, L.O. 3-5) (Difficult – 40 minutes)[9]

A friend of yours is the president of Maple Imports Ltd. The company sells and services cars imported from Korea. Maple has just completed its first year of operations. The following balance sheet was prepared by the company bookkeeper:

Maple Imports Ltd. Balance Sheet As at December 31, 2015	
Assets	
Cash in current account	$ 4,000
Accounts receivable (note 1)	90,000
Cars and car parts (note 2)	815,000
Accumulated depreciation on cars (note 3)	(87,500)
Equipment (note 4)	170,000
Land held for future development	228,000
	$1,219,500

9. Adapted from CGA-Canada FA2 examination, June 2009.

Equities	
Accounts payable (note 5)	$ 419,000
Bank loan payable (note 6)	320,000
Common shares (40,000 shares authorized and issued)	400,000
Net income	80,500
	$1,219,500

Notes:

1. Accounts receivable is composed of the following:

Debit balances in customer accounts	$145,000
Credit balances in customer accounts	(55,000)
	$ 90,000

2. The cars and car parts account is composed of the following:

Car parts for service department (at cost)	$ 65,000
Cars intended for resale (at retail price)	645,000
Cars used by executives for business purposes	105,000
	$ 815,000

   The purchase price of the cars intended for resale was $530,000. The cars for the executives were purchased on June 30, 2015, at a cost of $105,000.
3. All cars that require depreciation are being depreciated on a straight-line basis with a three-year estimated useful life and a residual value of 30% of original cost.
4. The equipment was purchased for $170,000 on January 2, 2015. The price paid was a bargain because the regular price for this equipment was $218,000. The equipment should last for seven years but will be worthless at that time. However, the company plans to replace it at the end of five years and expects to be able to sell it for $25,000 at that time. The company wants to use the declining-balance method for depreciation with a rate twice the straight-line rate, but has not yet calculated or recorded the depreciation expense for the equipment for the year.
5. Accounts payable is composed of the following balances:

Amounts owing to suppliers	$119,000
Loan received from the majority shareholder	300,000
	$419,000

   The loan was received from the majority shareholder on October 1, 2015. The loan is repayable over four years with annual payments of $50,000 plus accrued interest at 6% per year. The first payment is due on October 1, 2016. No interest has been accrued on the loan.
6. The bank loan is due on demand and is secured by the cars held for resale.

Required:

a. After adjusting for any errors, prepare a balance sheet for Maple Imports as at December 31, 2015, using the current/non-current presentation. Ignore income taxes. (Do not calculate a revised net income; simply plug in a net income figure to balance the balance sheet.)
b. On February 2, 2016, a fire in Maple's warehouse destroys $30,000 worth of car parts. Unfortunately, Maple did not have insurance to cover this loss. The financial statements for 2015 were not finalized until the end of February 2016. Briefly explain how and why this fire loss should be recognized or disclosed in the 2015 financial statements.

P3-40. Analysis of articulated financial statements

(L.O. 3-4, L.O. 3-5) (Medium – 10 minutes)

Obtain the 2011 annual report for Canadian Tire Corporation either from the company's website or from SEDAR (www.sedar.com), then answer the following questions:

a. Where do you find operating expenses listed according to their nature (source)? Which is the company's largest operating expense by nature in 2011?
b. Where do you find operating expenses listed by their function (use)?
c. Why does the company present or disclose operating expenses both by their nature and by their function?
d. Refer to the schedule in Note 44(G) with the title "Consolidated Statement of Income 'Function of Expense' format under previous GAAP" for the year ended January 1, 2011. In which ways does the presentation format under previous GAAP deviate from the requirements under IFRS (specifically IAS 1)?

0. MINI-CASES

CASE 1

Effects of different accrual policies

(30 minutes)

Food Processing Company was started one year ago by three managers who had worked in the food processing industry for many years. They had combined their savings plus borrowed extensively from the bank such that the company was able to invest over $10 million to start the business. Their medium-term goal (next four years) is to get the business up and running successfully and then invite others to invest after the fourth year by taking the company public. One of the three managers is now the president, and the other two are vice-presidents of production and sales, respectively.

One important issue that the owners are struggling with as they prepare their first audited financial statements is setting policies for estimated bad debts and depreciation expense. Based on their years of experience in the food processing industry they agree that the average bad debts as a percentage of credit sales has been 4%, but has varied from a low of 2.5% to a high of 5.5%. Similarly, for the type of equipment they are using in the manufacturing process, the average useful life has been eight years. Half of the firms in the industry use the double-declining-balance method and the other half use the straight-line method to estimate depreciation expense. The company is using very new technology and methods that give them an initial cost-saving advantage. The equipment makers suggest a 10-year useful life may be reasonable, but that the technological competitive advantage may be short lived as other firms adopt this technology.

Bad debts expense and depreciation expense are material and in aggregate will represent upward of 5% (bad debts) and 20% (depreciation) of all expenses for the current year if the most conservative methods of accounting are used. If neutral methods are used the aggregate expense would be 17%, versus 12% if these expenses are estimated generously or liberally.

Required:

You are the vice-president finance and chief financial officer. Write a memo to the executive committee (only the three owners sit on this committee) advising them on your recommendation as to which estimates or methods (neutral, conservative, or liberal) to use to derive bad debts and depreciation expenses.

CASE 2

Grosco's redeemable preferred shares

(45 minutes)

Note: This is a difficult case intended for guided classroom discussion. A good analysis/discussion of this case does not require technical knowledge specific to redeemale perferred shares.

Grosco Corporation (GC), a public company manufacturing farm equipment, was federally incorporated in 1926. Its common shares and bonds are widely held. The company's year-end is December 31.

The bond indentures contain the following covenants:

a. At the end of any quarter, if the debt-to-equity ratio exceeds 2.5:1, dividends may not be declared.
b. At the end of any quarter, if the debt-to-equity ratio exceeds 3:1, the bond principal becomes due and payable.

GC has experienced severe financial difficulties in the past four years and has sought refinancing in an effort to remain solvent. On May 1, 2012, GC issued a new class of preferred shares bearing a cumulative annual dividend of 12% (payable quarterly). The shares are retractable (the shareholders can redeem them for cash) on demand commencing one year from the date of issuance. As a result of the share issuance, the debt-to-equity ratio reported by management decreased from 2.7:1 to 2.2:1. By the end of 2012, the ratio had increased to 2.4:1 because of increased bank borrowings.

It is now April 2013. You are the accountant in charge of the audit of GC. The 2012 financial statements have been drafted and the audit is near completion. The 2013 first-quarter financial statements have just been compiled by the company and reveal a debt-to-equity ratio of 2.8:1.

Required:

Discuss the accounting issues implied in the above fact pattern. Pay particular attention to the timing of events while applying the IFRS Framework.

Note: You do not need to refer to any specific accounting pronouncements relating to retractable preferred shares.

CASE 3

Sleep King Manufacturing Company

(30 minutes)

Sleep King Manufacturing Company (SKMC) is a public manufacturing company specializing in the fabrication of mattresses. The company has been operating from its headquarters in Toronto since 1995. SKMC primarily sells to retailers, who in turn make final sales to customers. In 2011, the company reported net income of $100,000. The company has hired your firm, D & E Auditors, to conduct the year-end audit. As you are going through the financials, you come across a few accounting issues:

a. On December 28, 2011, a large client ordered a shipment worth $20,000 of mattresses. The terms of the sale were F.O.B. destination. The order was shipped on December 30, 2011, and the client received the mattresses on January 2, 2012. Management decided to report the revenue in the fiscal year of 2011 since the inventory left the building in 2011.
b. The company decided to change the useful life of the manufacturing machinery purchased 10 years ago from 15 years to 20 years. Management stated the machinery was still running well.
c. The company decided to reduce the allowance for doubtful accounts (ADA) from 8% of credit sales to 5% of credit sales. Management stated that they believe the new estimate more reliably represents its percentage of uncollectible amounts.
d. The company decided to change its accounting policy for inventory from the moving average-cost method to the FIFO method.

In January 2011, SKMC decided to set the annual management bonus based on net income. The bonus is set to 5% of reported net income at the end of the year.

Required:

a. As the auditor of SKMC, which of the above issues would you be most concerned about and why?
b. Based on the information above, would you say that the quality of earnings of SKMC is of high quality or low quality? Why?
c. What problems do you see arising from the extensive use of estimates in accrual accounting?
d. Between the balance sheet, income statement, and cash flow statement, which financial statement do you believe is least affected by estimates? Explain your reasoning: