CHAPTER 1

Setting the Stage

Chapter 1 is intended to set the stage for the application of accounting standards in differing contexts and the exercise of professional judgement. Throughout this text, the need for professional accountants to apply professional judgement in most areas of financial reporting is emphasized, especially in the crucial area of *estimates*. The choice of accounting policies is highly constrained in most of the subject areas of *Advanced Financial Accounting*, but applying the mandated accounting policies still leaves a lot of room for estimates, such as assigning fair values to assets acquired in a business combination. The allocation of the purchase price can have a substantial impact on the reported consolidated financial results.

There are three major topics covered in this chapter: (1) the general approach in Canada to accounting standards for the four different types of economic entities; (2) the comparability of financial statements when prepared in different countries; and (3) accounting standards for private enterprise. The use of a disclosed basis of accounting (DBA) as an alternative to GAAP-based presentation is also presented.

Two additional topics that appeared in the sixth edition of Advanced Financial Accounting have been moved to the Instructor Resource Manual, in case instructors wish to use this material as background material for their own teaching or for providing to the students:

* A more detailed explanation of financial reporting objectives, in case students have not already become fully acquainted with using the different (and usually conflicting) users and preparer reporting objectives in approaching accounting judgements.
* A description of the background of the IASB and development of international standards, including the formal structure of the IASB and its different bodies.

Students will obtain practice in exercising their professional judgement through case analysis. There are several cases at the end of each chapter. These cases highlight the existence of alternative accounting policies and raise the question as to what criteria should be used to make a choice. Students need to consider the importance of financial reporting objectives in arriving at decisions, as well as the specific facts and constraints presented in the case situation.

The extent of will vary from university to university and program to program. For students who lack familiarity with situation-specific objectives, this chapter will contain new material and may require substantial study. For these students, a thorough coverage of the cases at the end of this chapter is strongly recommended. The Chapter 1 cases should not be assigned all at once, but they probably should all be covered over the course of the first few weeks of the course, in order to give the students practice at application. Other students may be quite experienced at case analyses that emphasize financial reporting objectives. For these students, this chapter will constitute a review and an update for the introduction of IFRS in Canada. For case-experienced students, coverage of one or two cases may be sufficient to reinforce prior learning.

Most chapters have at least one multi-competency case. In this chapter, the multi-competency cases are **Case 1-2, Smith & Stewart,** and **Case 1-4, W&K Gardens**. These two cases have much different scenarios, as Smith & Smith is a partnership while W&K Gardens is a private enterprise. These multi-competency cases have been introduced in response to the multi-competency evaluation systems that are now being used in the profession.

When assigning these cases you will need to decide if you want to assign part of the required only, such as by instructing students to ignore certain issues or some aspects of the case (for example, auditing issues or tax issues).

Whether the students are experienced or new to this material, Chapter 1 should not be skipped. It is important material to which reference is made throughout the text.

# SUMMARY OF ASSIGNMENT MATERIAL

Case 1-1: Capricorn Carpet Corporation

In this case, the company is a publicly-held Canadian corporation that is a newly-acquired subsidiary of an overseas parent. The two types of owners lead to conflicting reporting objectives that must be resolved. The case focuses on the acceptability of parent-directed changes in accounting policies for the Canadian subsidiary.

Case 1-2: Smith and Stewart

This is a multi-competency case that requires students to consider the appropriateness of using a disclosed basis of accounting (DBA) for a partnership. The case has some unique valuation issues that must be addressed using market values as a DBA. This case includes assurance issues.

Case 1-3: Renaud Development Corporation

Private companies often have quite specific reporting objectives, objectives that are tied both to the needs of the individual shareholders and to accounting-based measurements that are often specified in the shareholders’ agreement. This case requires the student to discern the reporting objectives of a private company, including the use of share book value to set the selling price of shares. A “dump” of standard reporting objectives will not work in this case. Two different lines of business are described in the case, each requiring accounting policy recommendations.

Case 1-4: W&K Gardens

This is a multi-competency case that includes business advice, accounting policy advice, and advice on how to structure the new entity. The students must consider the objectives of each of the partners in determining the initial set-up of the new business and other alternatives besides GAAP in determining the appropriate accounting policies.

# ANSWERS TO REVIEW QUESTIONS

**Q1-1**: Some nations require that new and/or changed standards issued by the IASB be approved by that nation’s legislators or regulators before they can go into effect in that country. In some places, selected provisions in a standard may be denied acceptance while the rest of the standard may be approved. Even if the new or revised standard is approved in its entirety, its implementation may be delayed to a date following the general date that the standard takes effect.

**Q1-2**: The four general types of organization to which accounting standards apply are (1) publicly-accountable enterprises, (2) private enterprises, (3) not-for-profit organizations, and (4) governments and other public sector entities. The four accounting regimes (or “threads”) that apply to each are (1) the *CICA Handbook, Part I*, (2) the *CICA Handbook, Part II*, (3) *CICA Handbook, Part III*, and (4) the *Public Sector Accounting Handbook*.

**Q1-3**: Governmental accounting standards are the recommendations issued by the Public Sector Accounting Board, which is a unit of the Canadian Institute of Chartered Accountants. The board does not have the authority to impose its recommendations, but governments often voluntarily choose to follow the PSAB’s recommendations, particularly the senior governments – the federal, provincial, and territorial governments. Generally, municipalities and other more local governments are governed by provincial statute and/or regulations.

**Q1-4**: Even when an accounting standard prescribes only one accounting policy, judgement still must be applied in determining if the policy is appropriate, and if it is, then measurement estimates still underlie its application.

**Q1-5**: To have quality accounting, a nation must have a strong infrastructure consisting of (1) preparer professionalism, (2) audit quality, and (3) an effective enforcement mechanism. Without these three ingredients, there can be little confidence in financial reports. The preparers (accountants) must be capable of applying accounting standards in an ethical manner, including a good understanding of professional judgement. Secondly, the quality of audit staff and audit overview must be strong in order for a user to have confidence in the auditor’s report. Third, without robust enforcement, there is no penalty for companies that prepare misleading financial statements, either through lack of professionalism or with fraudulent intent.

**Q1-6:** Some factors are as follows (two required; others may apply):

1. Consolidated statements of Japanese companies will not include all of the reporting enterprise’s related “group” companies because the companies operate as interlocking entities instead of operating through parent-subsidiary relationships, as in U.S. and Germany.
2. Banks and employees serve on the boards of German companies. A high level of debt is considered a good thing in Germany because it shows that the banks have confidence in the company. A low level of debt is a bad indicator both in Germany (no bank confidence) and in Japan (no interlocking with major banks), but good in the U.S.
3. In Germany, taxable income is the same as reported earnings. Tax minimization motivations may be pervasive, thereby colouring financial performance as compared with U.S.
4. Exchange rates fluctuate among the dollar, the euro, and the yen. As well, input costs from other countries (e.g., China or Mexico) will be affected by the relative currency changes both between countries and from year-to-year within a country.

**1-7**: A non-PAE may use either IFRS or ASPE. IFRS might be used when a private enterprise is competing with public enterprises in the private capital markets, such as with banks, private equity firms, or investment funds. ASPE would be used when major national and international capital markets are not important to the company, and when the company is reporting to a small group of investors, managers, and banks.

# CASE NOTES

# Case 1-1: Capricorn Carpet Corporation

*Objective of the Case*

This is a case of conflicting objectives. Accounting policy directives are received from an overseas parent corporation, and the student must reconcile the requested changes with the subsidiary’s domestic reporting obligations.

*Reporting Objectives*

Carlisle (CCC) is a private Canadian company. The 60% controlling interest in the company has recently changed hands, from an institutional investor to a U.K. public company. The new controlling shareholder will be required to consolidate CCC in its annual consolidated financial statements. As well, CCC has a reporting responsibility to its 40% minority shareholders, CCC’s original founders.

As a private-company subsidiary of a public company, CCC is not technically constrained by UEL’s public-company reporting requirement for IFRS. Technically, CCC’s board of directors could elect to use Canadian ASPE. If CCC were to continue using ASPE, it would be necessary to restate the company financial results to IFRS for UEL’s consolidation purposes. This is an additional cost that UEL obviously wishes to avoid. Therefore, there is no discussion necessary concerning the choice of GAAP.

A primary reporting objective seems to be stewardship, which is appropriate not only for consolidated public parent-company reporting but also for the minority shareholders. A second objective, particularly from the viewpoint of the new controlling shareholder, may be performance evaluation. However, performance evaluation may be impaired due to the parent’s mandated change in the transfer pricing policy (discussed below).

Income tax deferral may also be an objective, although CCC seems to have been paying little, if any, income taxes in recent years, in view of the marginal profitability of the company. The large capital investments made in recent years would probably provide the company with enough CCA to bring the taxable income to zero. Nevertheless, the company would not want to incur tax losses that could not be used within the carryforward period. Thus, the tax objective is more to maximize the tax benefit position of the company rather than to minimize current income taxes.

The stated reasons for the requested change in accounting policies is to enhance performance evaluation by the parent and to render CCC’s statements compatible to those of the parent for purposes of consolidation. The parent has already declared what they want, and therefore there is no need for the student to evaluate alternative policies in light of performance evaluation objective.

*Discussion of the Proposed Changes*

1. Revaluation accounting was not permitted under ASPE but is acceptable under IFRS and will be discussed in Appendix 2 of Chapter 9. For the purpose of this case analysis, students should only rely on the general idea as presented in the case and not try to research the issue.

Revaluation of land and buildings is not too difficult since appraisals are readily available. However, assignment of fair value is always a matter of some judgement, since different appraisers will assess different values. A range of 10% in valuation by arms-length professional appraisers is normally considered acceptable. Nevertheless, a value must be chosen, and that value will affect comprehensive income immediately and the amount of depreciation expense between revaluations.

UEL may also wish to request that CCC use specific “friendly” advisers. Since UEL wants to “approve” the valuations (at long distance from the UK!), there is some suspicion that UEL managers may want to use valuations (and the resulting depreciation expense) to manipulate net income.

**Ethical considerations** mandate that CCC’s board be aware of this potential and strive to protect the minority shareholders by requesting an agreement from UEL that CCC will choose the appraisers, and the student should make this point. If non-arms-length appraisers are used for major assets, the auditors may take exception and insist on re-revaluation.

1. UEL seems to want to shift gross profits and cash flows from CCC to the parent. The proposed change in the transfer price would be uncontroversial if CCC were wholly-owned by its new parent. However, the 40% minority shareholders will suffer if CCC’s already-thin profits are diminished and cash is shifted to the UK. This can be viewed as “shareholder oppression” and may open UEL to legal challenges. Clearly, **ethical issues** arise.

As well, the change may depress CCC’s profits to an unacceptable level to maintain or obtain debt financing, including the secured debt to PPP and any potential bank line of credit. If the parent insists on the change, then there is nothing CCC can do about it, but a related party note should be provided in CCC’s statements explaining the nature of the relationship between the companies and the extent of the inter-company transactions.

 It is possible that CCC may benefit from the change because the price CCC pays to other companies in the group will also be reduced. The new transfer price may not be acceptable to the Canada Revenue Agency. David Blasé should investigate this possibility before responding to the parent. If duties and taxes are computed on a different price, then it may be too cumbersome and costly to maintain two pricing schemes.

3. The change in depreciation rate is acceptable if it is justified on the basis of shorter productive lives of the assets acquired. This will be a change of accounting estimate and should be recorded prospectively, not retrospectively.

*Presentation Note:*

*The required specifically asks for a report from David Blasé to the financial vice-president of Upper Lip. Students should provide their response in report form, appropriate to the circumstance.*

**Case 1-2: Smith & Stewart**

*Objective of the Case*

This question provides the students with an opportunity to see when a disclosed basis of accounting would be of more value to the users than GAAP. It also provides a chance to review the topic of partnerships since this is not an area typically covered in Intermediate Accounting. Note that there are no accounting standards developed specifically for partnerships. Partnerships are neither public companies nor private corporations. However, the general precepts of GAAP can still be applied to situations such as this case.

*Objectives of Financial Reporting*

There are two major users in this case. First, the bank will be interested in cash flow prediction. It will also be interested in the value of accounts receivables and work in progress on the balance sheet to determine if the line of credit is within the agreed upon limits. The partners have a number of different objectives. They will use the financial statements to evaluate the firm's performance. In addition, they will want to maximize the amount of the bank loan by maximizing the value of accounts receivable and work in progress inventory. Each partner will use the financial statements to determine the amount of income to be included in his or her tax return. The partnership agreement requires an annual valuation of the assets and liabilities of the firm. The partners may want to use the annual financial statements for this purpose.

A critical issue to discuss at this point in time is whether the partnership should use GAAP or a disclosed basis of accounting (DBA). In this case, the basis of accounting would need to be defined in either the lending agreement or the partnership agreement. If the basis of accounting is not defined in one of these agreements, a qualified or adverse audit report would be necessary. A DBA may be especially appropriate here since there is a specific group of users (the partners) who have a specific need (valuation of assets and liabilities). The partners should consider amending the partnership agreement.

*Valuation Basis*

Prior to discussing specific accounting issues, students must decide on the basis of valuation for the partnership. There is strong support for using a DBA with current or market values rather than historical costs. First, stating the accounts receivables and work in progress at market values will increase their value, which in turn will increase the limits for the bank loan. Second, using current values would provide a better basis for determining the amount a partner would pay to enter the partnership or the amount a partner would receive to exit the partnership. If historical cost was used as the basis, the entering partner may contribute too little and the exiting partner may receive not enough.

*Specific Accounting Policies*

(1) Work in Progress (WIP)

Two alternatives exist for WIP. First, it could be recorded at the regular billing rates, as time is accumulated for each client. When the financial statements are prepared, this amount would need to be lowered by any amount that will not be recovered. This method is consistent with a DBA using current market values. This would maximize the amount for the bank loan and be useful for determining the value at the time a partner enters or exits the partnership. Second, it could be recorded at the cost incurred by the firm. There would be no profit component included in WIP. It would be necessary to determine the cost of employee time, administrative costs, etc. for the time worked on the client. This would involve a large number of allocations that may be seen as arbitrary. The increased value would not be included in income until WIP is recognized as revenue. This method is not as useful for the line of credit or the annual valuation.

Note to Instructors:

Students may not have a good understanding of what WIP is for this firm. There may need to be some discussion on how you get WIP.

(2) Revenue Recognition

It must be decided when WIP is recorded as a receivable. This is important because this has an impact on the amount the partnership will receive from the line of credit. The maximum is 75% of accounts receivable and only 40% of WIP. Therefore, to maximize the bank loan, you would want to maximize the amount of accounts receivable by recognizing revenue as early as possible.

Three possible alternatives exist. First, the revenue could be recorded as work proceeds. Under this option, all WIP would be recorded as revenue which would maximize the limits on the bank loan. However, the amount billed to the client may be more or less than the time spent on the client’s file. Therefore, revenues would constantly have to be adjusted for differences which would reduce the credibility of the information. Second, the revenue could be recorded when invoiced. There would be no adjustments required to the financial statements as above. Third, the revenue could be recorded when received. This option delays the recognition of revenue which helps to defer income taxes but does not meet the objective of maximizing the line of credit. This option would only be credible if there was significant doubt concerning collection.

(3) Other Contributed Assets

A value must be assigned to the capital assets transferred from the predecessor firms. These could be recorded at their net book value in the predecessors’ financial statements or at fair market value. Fair market value would assist with the annual valuation of the partnership.

(4) WIP at Merger Date

The partnership agreement requires WIP to be measured at the merger date. It is an asset being contributed by the predecessor firms and presumably has a recoverable value. Goodwill relates to the anticipated earnings power of the firm and is an intangible asset. If goodwill is assigned, this must be above the value of the WIP. It would be offset by an increase to each partner’s capital account.

[CICA, adapted]

Case 1-3: Renaud Development Corporation

*Objective of the Case*

This case asks students to examine the financial reporting objectives of a real estate development company with two divisions that is about to issue a new class of non-voting common shares to private investors. The students are asked to recommend the accounting policies for revenue recognition and valuation of assets that would best serve the company’s reporting objectives.

*Constraints*

Renaud Development Corporation (RDC) is a large private company with three major shareholders. The company has many other stakeholders, especially banks and other sources of debt capital. Audited statements will no doubt be required, and thus RDC will need to comply with IFRS. However, IFRS has several provisions that apply to companies such as this, including (1) reporting for investment property and (2) the revaluation approach for capital assets.

Investment property is property that is held for rental or for capital appreciation, including property under development. Investment property can be accounted for either on the cost basis or on a *fair value basis*, provided that the fair value is measurable. Under the fair value method, gains and losses are taken into income. No depreciation is taken.

Property that is held for use rather than for rental or appreciation can be accounted for either on the cost basis or the *revaluation basis*, provided that the fair value is measurable. Under the revaluation basis, changes in fair value are taken into an equity account (“revaluation surplus”), not into income. However, depreciation expense is based on each period’s revalued amount, not on historical cost.

*Objectives of Financial Reporting*

There is a potential conflict between the interests of the current three voting shareholders and the interests of any new investors in the non-voting shares. The buy-in price for the shares is based on the fair value of RDC’s properties, but the buy-out price is based on the original investment plus a share of the increase in the net book value. As a result, the existing voting shareholders will want to keep the redemption amount low; they will prefer accounting policies which call for later revenue recognition and sooner expense recognition to keep the book value as conservative as possible. New investors, of course, will prefer for gains to flow into earnings as soon as possible.

RDC’s major debt holder, which is also a significant shareholder, is the bank. Bankers are usually interested in financial statements for cash flow prediction to determine the borrower’s ability to repay the debt; however, in this case, the bank would have access to this information as a shareholder. Thus, the banker will prefer accounting policies which minimize income and book value as discussed above.

The controlling shareholders show no indication of a desire to sell their shares, and therefore they will not be concerned about the statements appearing as favourable as possible. The group of potential new shareholders for the non-voting shares is small and they will likely have access to more information than just the financial statements, so again the controlling shareholders will not be concerned about making the statements look favourable. Even if RDC continues to use the cost basis of reporting, IFRS requires companies to report the fair value of their investment properties in the notes.

*Ethical Issue*

The conflict between existing (controlling) shareholders and non-voting shareholders raises an ethical issue. If RDC is able to measure the fair value of its investment property, which is most likely the case, it would seem unethical to keep those increases in value from flowing through to the income statement. Following the cost basis would appear to be an instance of minority shareholder oppression, since it denies exiting non-voting shareholders their share of the accumulated increase in fair-value equity.

*Revenue Recognition*

Residential division

The property is held until values increase sufficiently to be worth developing. At that point, the site is developed and land sales begin.

It is possible to argue that the normal business of this division is land sales, not development. RDC makes no investments in the individual land plots and does not engage in construction. If the land tracts are viewed simply as inventory and not as investment property, one could argue that either the cost basis or the revaluation basis can be used. Either one will result in lower earnings (as compared to the fair value method) until the date of sale because increases in value flow into equity rather than income.

However, this position ignores the reality that RDC makes the land investments with the clear intent of holding the land until its value has increased. Thus, the goal clearly is that of gains through appreciation. The eventual land sales are simply the realization of the increases in value over the years.

Therefore, to be fair to the non-voting shareholders, the land should be reported as investment property on the fair value basis. Even if no new shares are issued, the interest of the three major shareholders are enhanced by using a reporting method that more closely indicates the value of holdings rather than their cost.

There is one development near Calgary that is in difficulty. The fair value of this property seems to have been less than originally estimated. It is possible that the value will increase with time, but meanwhile, the fair value should be written down to a recoverable value based on the low-sales, high-default experience with this property.

Rent received on the model home lots should be recorded as income when received.

Commercial division

This division is clearly operating in the development business. Earnings are recognized mostly through rentals, and occasionally through sales. Either way, the objective is to generate earnings through rental and/or capital appreciation. The commercial division properties should be reported by the fair value method to serve the ethical requirements of not short-changing the potential new minority shareholders.

In this division the company must decide how best to account for its short- and long-term leases. Short-term (i.e., five-year) leases should be reported as operating leases. The initial lump-sum payments should be deferred and amortized over the life of the leases to which they relate. This method best meets user needs since profit on the development is deferred into the future and recognized as the rental revenue is collected.

Some of the long-term leases may be finance leases if, over the lease term, the rental payments return substantially all of RDC’s investment in the lessee’s proportion of the premises under lease.

Expense Recognition

If the fair value method is used, development costs are capitalized since there is future benefit. However, since capitalized development costs increase the carrying value of the properties, the effect is to reduce the gain (or increase a loss) when the fair value is remeasured at each reporting date. Thus, the effect of capitalizing them is the same as simply expensing them in the first place. Since remeasurement may not occur every year (three-year intervals for *each* property on a rotating basis are common), development costs should be expensed. It is industry practice to capitalize interest costs during the development stage of projects. However, it can be argued that where overall cash flow covers financing costs, it is not necessary to relate financing costs to specific projects. This argument should be used for RDC, to allow recognition of interest expense in the period incurred.

In the commercial division, opening and start-up costs should be recognized immediately using the argument that these costs are part of the normal and on-going activities of RDC. These costs will offset the increases in fair value that arise from opening a revenue-producing property.

Case 1-4: W&K Gardens

*Objective of the Case*

This is a multi-competency case that includes business advice, accounting policy advice, and advice on how to structure a new entity. The students must consider the objectives of each of the partners in determining the initial set-up of the new business. The students must consider other alternatives besides GAAP in determining the appropriate accounting policies.

W&K Gardens (W&K) is a new entity, which must select accounting policies for revenue and expense recognition in preparing its financial statements. It is important to determine what objective the preparers of the financial statements are trying to achieve.

It is also necessary to first establish who the users of the financial statements will be and what their information needs will be. Only then can qualitative criteria be applied in deciding which are the most appropriate policies.

The **bank** has stipulated the need for a good asset/debt ratio by the second year. Since W&K has no other alternative sources of financing, maintaining a good ratio is critical to W&K’s success. Therefore, the bank will be an important user of the financial statements. The bank will be interested in financial statements for cash flow prediction to determine W&K’s ability to repay the debt. The bank will prefer accounting policies which will help it predict the actual timing of cash inflows and outflows.

The **government** is also an important user since it is providing a $500,000 forgivable loan. It will be interested in ensuring that the criteria for the loan have been met, including audited financial statements which are in accordance with GAAP.

**Lindsay and Michael** will use the financial statements to decide the future strategies of their new enterprise. They will need information to help them evaluate the performance of each partner and the business as a whole. As a result, they will, similarly to the bank, be interested in financial statements for cash flow prediction and will prefer accounting policies which will help them predict the actual timing of cash inflows and outflows.

The **Canada Revenue Agency** will be interested in ensuring that income from the enterprise is reported in accordance with the *Income Tax Act*. If W&K is structured as a partnership, the partners must include their share of W&K’s income on their personal tax return. Tax minimization is not likely an objective for Lindsay and Michael this year since it is a start-up operation and there will not be significant income. However, this is likely a long-term objective and policies selected at the start-up stage should consider the long-term objectives.

The success of W&K is highly dependent upon the bank financing. The bank is, therefore, the most important user of the financial statements. Therefore, W&K must ensure that its liabilities do not become excessive in order to achieve an acceptable ratio and that the accounting policies chosen help the bank predict future cash flows. The success of W&K is also dependent on not having to repay the $500K loan to the government. It is important that the accounting policies chosen are within GAAP. Since W&K is a private enterprise, GAAP should be considered as compliance with the accounting standards for private enterprises as contained in the *CICA Handbook, Part II*.

*A decision should be made on the most important user and objective. Then, where there are alternatives within GAAP, the objectives must be considered.*

**Revenue Recognition Policies (and matching costs)**

Gardening Centre

W&K will be selling a variety of products and it must be determined when revenue should be recognized. In order to make decisions as to when revenues and associated costs can be recognized, the general revenue recognition criteria under GAAP must be considered. Specifically, Lindsay will have to examine the earnings cycle to determine:

1. When the revenue has been earned (i.e., when has W&K substantially completed everything it has to do with respect to the sale, such as transferring the title to the customers and being able to estimate the associated costs);

2. When the amount earned and the costs associated with it can be measured; and

3. When W&K can be reasonably assured of collecting the amount earned.

Aside from the items sold in the storefront, W&K’s inventory consists mainly of biological assets. ASPE requires biological assets and agricultural produce to be carried at fair value, with gains and losses reported in income. Agricultural costs are expensed when incurred.

##### Storefront

The storefront poses no unusual problems. Like most retail establishments, the most common point at which revenues are recognized is the time of sale or the shipment of goods to customers. Once a customer pays and takes the goods (garden tools, planters, etc.), W&K has completed everything it has to do with respect to the transaction. Unless W&K decides to extend credit to some of its customers, collectibility will be relatively certain. At the time of sale, the cost of the goods sold will be matched to the sale to measure gross profit. This accounting policy meets the revenue recognition criteria and ensures that the income recognized represents the actual cash flows, thereby meeting the objectives of the users of the financial statements.

##### Landscape Designing

There are at least three possible alternatives to recognizing the revenue earned from this service:

(a) recognize the revenue when received,

(b) defer the revenue until the customer purchases the trees, shrubs, and flowers, or

(c) pro-rate the revenue to recognize a portion immediately with the balance deferred until the customer purchases the trees, shrubs, and flowers, etc.

It could be argued that the $500 could be recognized as revenue when received. The amount is non-refundable once the service has been provided, there is no cash value attached to the credit, and Michael’s landscape design service has been performed. This alternative matches the revenue with the actual cash received.

However, the flat fee of $500 for the customized landscape designs does not represent immediate revenue for W&K because the customer is receiving a credit note for the full amount of $500, which can be used for two years to purchase trees, shrubs, and flowers to carry out Michael’s design suggestions. There will be a future outlay of the costs of the goods subsequently purchased with this credit. Hence, W&K has a potential obligation.

Since W&K has promised to deliver products in the future, this would suggest that the $500 design fee should be recorded as unearned revenue. When the customer purchases the plants, the unearned revenue would be transferred to earned revenue since W&K has now fulfilled its part of the contract (i.e., to deliver product). Although the customer has two years to use the credit note, the unearned revenue could be originally recorded as a long-term item. However, it would be difficult to determine what portion would be used in the first year as opposed to the second year. The allocation would be arbitrary since the two-year expiry date for the credit note is the only relevant period. In the event that the customer does not use the full value of the credit note by the end of the second year, the remaining balance in the unearned account would be transferred to earned revenue, since the customer is not entitled to a cash value for any unused credit.

Finally, it could be argued that the revenue should be pro-rated between the service provided at the time of designing the landscape and the delivery of trees, shrubs, and flowers over the next two years. In order to separate the two components, three criteria should be met. The first criterion is that the delivered item has stand-alone value. In this case, the delivered item is the landscape design service and it has stand-alone value as the customer could purchase the necessary plants at another garden centre. The second criterion is whether there is objective evidence of the value of the undelivered item. W&K has allocated $500, 100% of the value, to the undelivered item. The third criterion is whether a general right of return exists. This criterion would also be met here. Therefore, the two revenue streams should be separated. To separate them, we need to allocate the $500 price. The preferred method is to use relative fair values. However, the fair value of the landscape design is not known, so the residual method will be used. Under the residual method, $500 is allocated to the future delivery of trees, etc. and $0 ($500–$500) is allocated to the landscape design. Therefore, the entire amount must be deferred.

In conclusion, the revenue should be deferred to future periods and matched with the cost of goods purchased. The deferral lets the bank and other users know there are future obligations. This alternative does not meet the objective of minimizing liabilities in order to meet the bank covenant and does not represent the actual cash flows; however, it is the only alternative that meets the revenue recognition criteria and is, thus, in accordance with GAAP, which meets the objective.

##### Annual & Perennial Plants

The nature of this part of the business is basically seasonal. The plants are purchased from growing farms each spring and are intended to be sold by the end of the summer. The reporting period will encompass the entire sales season, and thus there is no need for inventory accounting, with one small exception. For these plants, the cost of purchase should be charged to expense when incurred. Revenue is earned at time of sale, the amount can be measured and collectibility should not be a problem. This accounting policy meets the revenue recognition criteria and ensures that the income recognized represents the actual cash flows, thereby balancing the objectives of key users.

A problem could arise if all perennial plants are not sold in the same season as purchased. A small inventory may have to be carried to the next season. If this amount is material, it should remain in inventory at fair value. The value assigned to these plants would be expected retail value in the following year (after additional growth), minus the cost of maintaining the plants over the winter. This net realizable value should be recognized in income, under ASPE. If the future value of these left-over plants is uncertain, they should be assigned a zero value.

Shrubs & Trees

The revenue recognition policy for shrubs and trees should be similar to that of perennial plants. The cost of acquiring all shrubs and trees would be recorded as expense when purchased.

W&K may offer a one-year warranty on all shrubs and trees purchased by customers. This means that customers can return the plants at the beginning of the following season if the plant did not survive the winter, thereby giving rise to three possible alternatives for revenue recognition:

(a) Recognize revenue when payments for shrubs and trees are received and recognize expenses for customer returns if and when goods are returned,

(b) Recognize revenue when payments are received and accrue an estimated liability for customer returns at the same time, or

(c) Defer recognizing revenue until the associated returns take place or the warranty period for returns expires.

The first alternative records cash as received. However, if the return policy is implemented, this alternative does not meet the revenue recognition criteria since the cost of returns have not yet been incurred.

The second alternative allows for proper measurement of both costs and revenues, provided the amount of returns can be properly predicted and measured. Michael and Lindsay can use industry statistics, for example, in order to predict the amount of the necessary accrual. This alternative does not meet the objective of minimizing liabilities in order to meet the bank covenant, but it is the only alternative that allows the revenue to be recognized in accordance with revenue recognition criteria for GAAP purposes, and still meets the cash flows objective of the bank and the partners since the potential cash outflow is estimated.

Since the warranty period for returns will be set for one year, the third alternative essentially defers recognizing the revenue from sales of shrubs and trees until the next fiscal period. This alternative does not meet the cash flow prediction objective and the unearned revenue recorded when cash is actually received will increase the liabilities, which does not meet the objective of satisfying the bank covenant. This alternative should only be considered if the amount of returns is not measurable and is expected to be material or is expected to be volatile.

For the 20% of stock that is expected to be left over, the same accounting policy should be used as described above for left-over perennial plants.

##### Christmas Trees

The outdoor nursery will be used primarily for Christmas trees. The trees will be grown from seedling stock and could remain in the ground for a number of years. Growing and tending costs should be charged to expense when incurred. This biological asset should be recorded as an inventory asset at year-end at the trees’ estimated fair value *at their current height and condition*.

The total number of saleable trees will have to be estimated for each plot in order to determine the NRV per tree. This will be challenging since Christmas trees can be sold at various heights (1.0, 1.5, 1.8, 2.0 metres, etc.). All trees will not grow at the same rate in each plot, which will alter the value per tree. However, a tree that is one metre tall at year-end should be valued on its basis as a one-metre tree, not on its potential value when it grows to two metres.

The gain in value of the trees each period is recognized as revenue. The costs of planting and tending the trees in each period will be recognized as expenses. Actual sales of trees during the year will be the realization of the increase in value—a conversion of one asset to another. To the extent that a tree is sold at a price higher than its previously-recorded fair value, that difference represents both a cash inflow (for the full amount) and a gain (for the difference between cash and recorded value).

###### *Snow Removal*

If Michael is successful in winning the tenders with the town for the snow removal, a revenue recognition policy will need to be determined. For the snow removal, a flat fee of $30,000 would be received each season. If a December 31st year-end was selected then the revenue would be received prior to the service being performed. The snow season is probably November to March (5 months), therefore $12,000 (i.e., 2/5) could be recognized as revenue at the end of the year. If the payment is received prior to each fiscal year-end, the remaining $18,000 would as recorded as unearned revenue. If the payment is received after December 31, the $12,000 would be reported as an account receivable. This approach would match the recognition of the revenue to the proportional period of the snow season.

This policy does not match the cash flow objective of the bank and the partners; however, it does meet the GAAP revenue recognition criteria necessary for the government loan condition since the costs associated with fulfilling the snow removal contract have not yet been incurred and the service not yet provided at the time the cash may have been received.

For the $50,000 for storage of snow, a similar policy could be established. Alternatively, it could be argued that there is no service to be performed since the land is empty and no further work needs to be done. Therefore, the revenue could be recognized in November. This policy meets the cash flow objective but is not in accordance with GAAP revenue recognition criteria since performance has not been completed. Therefore, the $50,000 should be recognized in the same manner as the snow removal.

The snow pile may have contaminants that affect the land and surrounding area. There might need to be an accrual for an asset retirement obligation. The likelihood and measurement of this contingency would need to be assessed and it may be necessary to rely on an environmental report from a specialist. An accrual for this liability could affect the asset to debt ratio.

Recommendations for revenue recognition policies should be tied back to the user and objective that was selected as being most important.

### Inventory Valuation

Merchandise inventories should be carried at fair value, with changes in the fair value recognized in income. The retail store and annual plants inventories should not be a problem since most of the goods will be sold within a few months of being purchased.

A small percentage of perennial plants may be carried over to the next season but this is not expected to be material. Any costs (care and maintenance over the winter months) should be monitored closely because it is not likely that the selling price will increase significantly from one year to the next. The cost of the inventory could, therefore, very quickly surpass the expected NRV. Lindsay and Michael should consider throwing the perennial inventory out at the end of the season since the costs to look after the inventory may be excessive.

Similarly, shrubs and trees will also require close monitoring for costs exceeding expected increases in value. This may be less of an issue for trees, since taller trees probably command higher prices, and they probably don’t take much maintenance over the winter. Shrubs, however, could deteriorate over the winter. Lindsay may want to talk to Michael and consider discounting the shrubs and trees (along with the perennials) at the end of the season rather than keeping them over the winter.

Christmas trees are a slightly different situation. Initially, W&K will buy mature trees to sell. These trees are “agricultural produce” and theoretically should be carried at NRV. However, a cut tree doesn’t last long, and thus any left-over trees must be discarded after the selling season. The cost of purchase is an expense, while the revenue is simply the amount realized by sale. There are no alternatives for the mature trees bought and sold.

The growing trees, as explained above, should be recorded at their fair value, based on their height and condition at the balance sheet date. Changes in fair value from period to period are recognized in income. Cost of planting and tending the trees is an expense.

Lindsay and Michael should consider the practicality of growing the Christmas trees as the lease for the land and the building is only for 5 years. Even though the lease can be renewed after 5 years, since the useful life of the building is estimated to be only 6 years, extending the lease may not be a practical option and the operations may have to be moved.

Recommendations for inventory valuation should be tied back to the user and objective that was selected as being most important.

#### Tangible Capital Assets

All of the tangible capital assets must be recorded at their “laid-down” cost and amortized in a rational and systematic manner over the asset’s useful life.

Lindsay should consider an accelerated amortization method for the small used trucks since this would be the most appropriate method to represent cash outflows, thereby meeting the bank’s and the partners’ own objectives. The trucks may last five years but as they age, the value they contribute to the operations will decline and they will most likely require repair and maintenance on a regular basis to keep them in safe operating condition. Any additions to the trucks for the snowplowing operation (e.g., the blade or plow), should be added to the cost of the capital asset.

The landscaping equipment will probably only last two or three years if used extensively over the summer season. A straight-line method of amortization would be appropriate since the time frame is short and usefulness to the operations would likely be the same each year of use.

The small power tools will likely only last for one season and will have to be replaced the following year. The most convenient method of accounting for these tools would be to expense them in the year of acquisition, as no future benefit to capitalizing them exists. This method would also match the cash outflow and meet the objective of cash flow prediction.

The display shelves could be amortized over several years on a straight-line basis. No repair or maintenance is likely and these assets would contribute the same amount of value to operations for each year of use.

The amortization method and estimates of the life and useful life of all capital assets should be reviewed on a regular basis. The small used trucks, for instance, may not last as long as anticipated and should be monitored.

If the building is recorded as a capital asset, it will be necessary to select an appropriate amortization method over the five-year life of the lease. The straight-line method would best match the cash outflows of the lease agreement, which requires equal annual payments. The estimated renovation cost of $125,000 to the building should be treated as a leasehold improvement and amortized over the lesser of its useful life or the life of the lease. The amortization method should be the same as for the leased building and again the straight-line method would best match the actual cash outflows.

If an event or circumstance occurs which indicates that the carrying amount of a tangible capital asset may not be recoverable, a write-down may be necessary if there is an impairment. If an event or circumstance has occurred, the expected future undiscounted net cash flows (the net recoverable value [NRV]) from the asset are compared to the asset’s carrying amount. If the NRV is less than the carrying value, an impairment is recognized and the asset is written down to its fair value.

Recommendations for tangible capital assets should be tied back to the user and objective that was selected as being most important.

### Accounting for the Lease — Land and Building

In the lease agreement, both land and building are involved. Land normally has an unlimited life span. The only way in which the risks and rewards of ownership of the land can be transferred to the lessee is through an actual transfer of title. The fair value of the land at the inception of the lease is significant in relation to the total fair value of the leased property. The lease does not transfer ownership or contain a bargain purchase option. Therefore, the land and building should be considered separately for classification purposes.

The minimum lease payments should be allocated between the land and building in proportion to their fair values and the portion of the lease applicable to the land should be classified as an operating lease. However, it is still necessary to determine if the lease would be considered a capital lease for the building.

|  |  |  |
| --- | --- | --- |
| Lease payment | $300,000 |  |
| Less: executory costs |  19,506 |  |
| Minimum lease payments | $280,494 |  |
| Fair value of the land | $1,000,000 | × 280,494 = $200,353  |
|  | 1,400,000 |  allocated to land |
| Fair value of building  | $ 400,000 | × 280,494 = $80,141  |
|  |  1,400,000 |  allocated to building |

## *Present Value of Minimum Lease Payments*

Addison has made it known that the interest rate implicit in the lease is 10%. However, Lindsay knows that the new business will be able to borrow at 9% (11% personal rate of borrowing less 2%) and will use this lower rate of 9% to calculate the present value of the minimum lease payments.

Building:

$80,141 × 4.23972 (PV 5 years, 9%) + ($75,000 × 0.64993) = $388,520

Since this amount is greater than 90% of the FMV of $400,000, it is a capital

lease.

Land:

$200,353 × 4.23972 (PV 5 years, 9%) = $849,441

The lease would therefore be accounted for as an operating lease for the land and a finance lease for the building. The finance lease treatment for the building does not meet the objective of minimizing the liabilities in order to meet the bank covenant; however, this policy is in accordance with GAAP in order to meet the conditions for the government loan.

The entries to record the lease when the first payment is made would be:

At the inception of the lease:

 Executory costs 19,506

 Rent expense for land 200,353

 Leased asset 388,520

 Lease obligation 308,379

 Cash 300,000

The leasehold improvements should also be recorded at the inception of the lease (assuming the work is complete and the estimate was accurate):

 Leasehold improvements 125,000

 Cash 125,000

At the end of the first year:

 Interest expense 27,754

 Lease obligation 27,754

 (based on 9% incremental borrowing rate)

 Amortization expense 62,704

 Accumulated amortization-leased asset 62,704

 ($388,520 – $75,000) ÷ 5 = $62,704

 Amortization expense 25,000

 Accumulated amortization–

 leasehold improvements 25,000

The building and the improvements are amortized over the life of the lease since this is shorter than the estimated useful life.

The lease liability could affect the bank covenants needed by the bank. It must not be forgotten, however, that the balancing side of the lease liability is the leased asset that will appear on the balance sheet. At $388K, it represents at inception 1.25 times the value of the lease liability. As the lease payments are made for the second year, this ratio will increase and actually help the assets to liabilities ratio (as long as total assets/total liabilities is the ratio considered). Lindsay will have to review the effect of this lease on the ability to get an operating loan.

If Lindsay determines that it is likely that the covenant will be violated by next year, she will have to disclose the possibility of W&K’s likely failure to satisfy the covenant in the future and the adverse consequences that may result due to such failure. This disclosure is required by GAAP and, therefore, has to be made for the purposes of meeting the conditions for the government loan.

## Forgivable Loan from Government

The intention of the government is to have the loan forgiven. Therefore, it is appropriate to treat the loan as a grant. It appears that Lindsay will use all of the funds for expenses this period and for the purchase of tangible capital assets (purchase of assets, $127K; leasehold improvement, $125K; lease payment for land & building, $300K). The amount used for expenses of this period should be included in net income in this period. If any is being used for future expenses it should be deferred and amortized to income when those future expenses are made.

The amounts related to the purchase of tangible capital assets, e.g., trucks, could be treated in two different ways. First, it could be deducted from the cost of the tangible capital assets (e.g., truck), and amortization would be taken on that reduced amount. Second, it could be deferred and amortized into income on the same basis as the truck. Both methods result in the same impact on net income. There must be a note in the financial statements disclosing the amount of the forgivable loan, the criteria that must be met, and the possibility of repayment.

Recommendations for government grant should be tied back to the user and objective that was selected as being most important.

**Web Design Costs**

The initial costs for developing the web page and designing the graphics in the development stage may be capitalized as an asset if the future benefits are measurable with reasonable assurance. It may be difficult to determine the period of benefit since technology is changing so rapidly. The registration of the Internet domain name could be capitalized and amortized over the legal period the name is registered. Alternatively, if the amount is immaterial, it may be easier to expense the amount immediately. The fee for the Internet service provider should be expensed over the term of the contract.

Recommendations for web design costs should be tied back to the user and objective that was selected as being most important.

## Business Structure

A partnership does not constitute an entity that is legally separate from the owners of the business. Each province has its own *Partnership Act*, which does not vary significantly from province to province. The *Ontario Partnership Act* defines a partnership as follows:

Partnership is the relation that subsists between persons carrying on a business in common with a view to profit, but the relation between the members of a company or association that is incorporated by or under the authority of any special or general Act in force in Ontario or elsewhere, or registered as a corporation under any such Act, is not a partnership within the meaning of this Act.

This definition excludes corporations from having a partnership, and in effect, restricts the legal meaning of the term to partnerships between individuals.

Upon formation of the partnership, it will be necessary to record the assets that have been contributed by the partners. The assets should be recorded at their fair values as at the date the partnership is organized. In this case, the entry to record the startup would be:

 Cash 25,000

 Computer equipment 8,500

 Office furniture 6,500

 Truck 12,000

 Equipment 18,000

Lindsay, Capital 35,000

 Michael, Capital 35,000

This could trigger tax consequences for Lindsay and Michael and the use of a rollover of assets to the partnership should be considered.

If intangibles are valued, Michael’s capital account would have to be credited for more than $35,000. This would reflect the fact that he is bringing something other than identifiable net assets into the partnership. He might also have a favourable reputation in the industry and many business contacts that may enhance the revenue generating capacity of the partnership.

As an alternative, Michael and Lindsay could consider incorporating their business to give them many added benefits, such as limited liability, business continuity, options with respect to the transfer of ownership, and potential tax planning options. However, since this is a start-up business, the bank would likely require a personal guarantee. It is therefore preferable that they start with a partnership, which will allow them to deduct the possible partnership losses against any other income earned personally.

Then, once it is proven that the partnership is successful, Michael and Lindsay could incorporate the business. It could probably be argued that this alternative would be creating a new business entity and it would be necessary to adjust all of the assets and liabilities that are being transferred to the corporation at their current fair values. The transfer could take place with no immediate tax consequences to Lindsay or Michael by electing to transfer the assets of the partnership to a new company at their cost.

For an incorporated company, accounting policies would have to consider the deferred tax liability as a result of the capitalization of the building lease. However, ASPE permits a private enterprise to use either deferred (future) income tax accounting or the taxes payable method. Lindsay and Michael should choose the taxes payable method, which would allow the company to report only its current taxes payable and not any deferred tax assets/liabilities.

#### The Development of the Partnership Agreement

Michael and Lindsay should ensure they establish the boundaries of their partnership before commencing the business and entering into legal contracts. Significant amounts of assets and liabilities will be involved, which infers that the partnership agreement should be established in writing, preferably with professional legal advice.

The content of the partnership agreement becomes the basis upon which the accounting is carried out. It is, therefore, critical that the partnership agreement deals with issues such as:

* the nature of the activities that the partnership will undertake;
* starting date and duration of the agreement;
* the amount and type of asset contributed by each partner;
* the manner in which profits and losses are to be shared;
* provisions for drawings;
* interest on capital accounts;
* interest on loans to and from the partnership;
* insurance on the partners’ lives and beneficiaries;
* procedures for admitting new partners;
* procedures for dealing with disputes; and
* procedures for liquidation.

[ICAO, adapted]