Intermediate Financial Reporting 1
Primer
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Intermediate Financial Reporting 1
Primer

INTRODUCTION
Intermediate Financial Reporting 1 introduces a number of fundamental accounting concepts that form the basis of many of the topics discussed in the other financial accounting courses. The subject matter is presented in a way that is consistent with the methodology used in the CPA Canada Handbook – Accounting, which comprises five components that must be determined when accounting for a financial statement element:

- **Recognition** — if and how the transaction is included on the financial statements
- **Initial measurement** — how to measure and assign a dollar value to the financial statement element
- **Subsequent measurement** — how to measure or assign a dollar value to the financial statement element in subsequent periods
- **Derecognition** — when and how to remove the financial statement element from the financial statements
- **Presentation and disclosure** — how the financial statement elements are presented in the statements

PART 1
Accounting standards in Canada
Accounting standards in Canada are established by the Accounting Standards Board (AcSB). Recognizing the differences in accounting strategies, objectives and needs of the users of the financial statements, there are five different parts of the CPA Canada Handbook – Accounting that an entity may follow:

- **International Financial Reporting Standards (IFRSs):** These standards are for publicly accountable enterprises. An example would be a company (such as Rogers Communications Inc.) that has shares trading on the public market (such as the Toronto Stock Exchange).
- **Accounting standards for private enterprises (ASPE):** These standards are for private enterprises where neither the shares nor the debt of the entity are publicly traded. Most
small to medium-sized business are private enterprises. They can choose to prepare their financial statements in accordance with either Part I (IFRSs) or Part II (ASPE).

- **Accounting standards for not-for-profit organizations (ASNPO):** These standards are for non-governmental not-for-profit organizations such as the Canadian Red Cross. Such organizations may choose to apply Part I (IFRSs) or Part III (ASNPO), supplementing with Part II (ASPE).

- **Accounting standards for pension plans:** These standards govern the accounting for assets and liabilities of pension plans. An entity such as the British Columbia’s College Pension Plan would be governed by this standard.

- **Pre-changeover accounting standards:** These standards are for publicly accountable enterprises that have not yet completed the transition to IFRSs. Certain investment companies or rate-regulated entities would follow this standard.

Accounting standards are constantly being reviewed to ensure that they still meet user needs. The updating of accounting standards is an iterative process, and involves key stakeholders, standard setters, and the AcSB.

*Unless stated otherwise, the Financial Reporting courses follow IFRS.*

**The Conceptual Framework for Financial Reporting**

The overall objective of general purpose financial reporting is to serve the interests of two specific users of financial information: investors and creditors. The Conceptual Framework for Financial Reporting outlines the principles that should be followed in the preparation of financial information. These can be separated into two broad characteristics:

- **Fundamental qualitative characteristics:** These characteristics are the foundation in providing financial information to users. The conceptual framework states that for information to be useful, it must be relevant and faithfully represent the nature of the underlying transaction. Relevance is based on the expectation that knowledge of the information will affect the decision being made, with materiality as a factor in assessing the potential relevance of the information. Faithful representation is centred on three elements: completeness of information, neutrality and freedom from material error.

- **Enhancing qualitative characteristics:** These characteristics contribute to the usefulness of financial reports. The conceptual framework states that when financial data is comparable, verifiable, timely and understandable, the usefulness of the information presented is heightened.

Financial statement elements are reported in one of the four principal measurement bases: historical cost, current cost, realizable value or present value. Financial statements can be prepared using a mix of the four bases.

All financial statements are prepared with the underlying assumption that the entity is a going concern, meaning that it will be able to operate in the foreseeable future, normally a time frame of at least 12 months following the statement of financial position date. When there are
concerns about an entity’s ability to continue operations, management will need to consider the impact of this on the presentation of financial information.

The ASPE and IFRS frameworks

The two frameworks used in Canada by profit-oriented companies are IFRS and ASPE. The primary difference between the two frameworks relates to the differences in users of the financial statements. Publicly accountable entities follow IFRS, and the users primarily consist of creditors and shareholders (current and potential). Private entities can have creditors and shareholders as well, and generally these users have a greater ability to access information than users of the financial statements of a publicly accountable entity.

Financial statements

IAS 1 *Presentation of Financial Statements* outlines the requirements with respect to the preparation of a complete set of financial statements. The underlying premise of useful financial information continues to be prevalent throughout this standard. In particular, the format of expenses should be presented either in terms of their nature or their function within the company. The method chosen will be based on professional judgment and should provide the most reliable and relevant information to the users.

The terminology used in the IFRS and ASPE standards is different, as outlined below; however, in Canada, publicly accountable entities can use either set of terms in the preparation of their financial statements.

<table>
<thead>
<tr>
<th>IFRS</th>
<th>ASPE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement of financial position</td>
<td>Balance sheet</td>
</tr>
<tr>
<td>Statement of profit or loss*</td>
<td>Income statement</td>
</tr>
<tr>
<td>Statement of other comprehensive income*</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Statement of changes in equity</td>
<td>Statement of retained earnings</td>
</tr>
<tr>
<td>Statement of cash flows</td>
<td>Cash flow statement</td>
</tr>
<tr>
<td>Notes</td>
<td>Notes to the financial statements</td>
</tr>
</tbody>
</table>

*These two statements may be combined to form the statement of profit or loss and other comprehensive income.*

IAS 1 also outlines several general requirements that pertain to all financial statements, including the following:

- They must be prepared fairly and in accordance with the applicable reporting framework.
- They are to be prepared on a going-concern basis, as explained above.
- They shall be prepared on an accrual basis, except for the statement of cash flows.
- Each class of similar and items of dissimilar nature should be presented separately unless they are immaterial.
Neither assets or liabilities nor income and expenses should be offset unless required or permitted by the standards.

- They must be prepared at least annually.
- They must normally present comparative information.
- They should normally present and classify the items in the financial statements on the same basis from one period to the next.
- They must include on each statement the name of the company (or group of companies), the date of the financial statement or period, and the currency and denomination.

**Accounting information systems and information technology**

Businesses must ensure that they have the appropriate systems and processes in place to properly capture, record and process financial data. As such, businesses will implement an accounting information system that can be manual, computerized or a combination of the two. A business’s accounting information system will comprise elements such as accounting software and IT security. Accounting software packages, such as Sage 50 Accounting or QuickBooks, are used to maintain daily transactions. For larger businesses, the accounting software will be supported by databases and IT security systems to ensure adequate backup of system data in order to prevent loss of important data.

**Ethics**

There are many areas where accountants must make judgments such as appropriate measurement methods, accounting estimates and disclosures in the financial statement notes. It is important that accountants do not allow their personal biases to influence the overall fairness of the reporting process. The fundamental characteristics of relevance and faithful representation in the conceptual framework must always be maintained.

**The accounting cycle**

The process of recording journal entries, posting to the general ledger and using this information to prepare the trial balance and a set of financial statements is discussed. Journalizing closing entries and reversing entries are also examined.

The accounting cycle is completed by a business during each accounting period to record and report business transactions. As each step in the cycle is completed it leads to the next. This also means that no step may be completed until the prior step has been completed:

**Step 1:** Identify and measure transactions and other events.

**Step 2:** Record in the journal.

**Step 3:** Post transactions to the general ledger.

**Step 4:** Prepare an unadjusted trial balance.

**Step 5:** Prepare, journalize and post adjusting entries.
Step 6: Prepare an adjusted trial balance.
Step 7: Prepare financial statements.
Step 8: Prepare, record, and post closing entries.
Step 9: Prepare the post-closing trial balance (optional).
Step 10: Journalize reversing entries (optional).

All businesses must follow accrual accounting rather than cash accounting. Accrual accounting leads to adjusting journal entries as transactions are recorded as soon as there is a financial impact on the business (regardless if cash has been exchanged).

There are three categories of adjusting entries: deferrals, accruals and depreciation. These adjustments are completed to ensure that a business entity is recognizing revenue and expenses in appropriate periods. These principles are the cornerstone of accrual accounting.

**Adjusting entry categories**

<table>
<thead>
<tr>
<th>Category</th>
<th>Journal entry</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Deferrals</strong></td>
<td></td>
</tr>
</tbody>
</table>
| Liability: A customer pays for services or goods in advance. Revenue cannot be recognized until the goods or services are delivered to the customer; until such time, a liability to the customer exists. | On receipt of cash:  
DR Cash  
CR Deferred or Unearned revenue  
When goods or services are provided:  
DR Deferred or unearned revenue  
CR Revenue  
**Alternatively:**  
On receipt of cash:  
DR Cash  
CR Revenue  
At financial statement preparation date:  
DR Revenue  
CR Deferred or unearned revenue (for the portion not yet earned) |
| **Prepaid:** The business pays for goods or services in advance of using them to generate revenue. | On purchase:  
DR Prepaid expense  
CR Cash  
Adjustment to record use of prepaid:  
DR Expense  
CR Prepaid expense |
### Accruals

**Receivable:** When revenue is earned in the accounting period and cash has not been received.  
**DR** Accounts receivable  
**CR** Revenue

**Liability:** Expense incurred but not paid for in the accounting period. Examples include wages payable and interest payable.  
**DR** Expense  
**CR** Liability

### Depreciation

**Depreciation:** The allocation of the cost of a capital asset (such as equipment or buildings) over its expected useful life (with useful life defined as the period of time over which the business expects to be able to use the asset to generate revenue).  
**DR** Depreciation expense  
**CR** Accumulated depreciation

### Practice questions

1. Multiple-choice questions:
   i. Which of the following financial statements is **NOT** required under ASPE?

   a) Statement of comprehensive income  
   b) Statement of cash flows  
   c) Statement of profit and loss  
   d) Statement of retained earnings

   **Solution**

   Option a) is **correct.** ASPE does not have comprehensive income; therefore, no statement of comprehensive income is required.
ii. Which of the following is an example of the qualitative characteristic of comparability of financial statements?

a) A new standard of accounting is applied retrospectively in the financial statements.
b) The information provided in the financial statements is at a level of detail appropriate for the users.
c) Users are able to confirm their expectations regarding the outcome of a decision made previously.
d) The transactions included in the financial statements are free from bias.

Solution

Option a) is correct. Applying the standards retrospectively allows for comparability between the current and previous years.

Option b) is incorrect. This is the enhancing characteristic of understandability. Financial statements must be of sufficient quality and clarity to allow reasonably informed users to understand the significance of the information provided in the statements. A contributing factor to understandability is to ensure that the level of detail provided is appropriate for the user.

Option c) is incorrect. This is an example of faithful representation rather than understandability.

Option d) is incorrect. Neutrality, or freedom from bias, is a component of faithful representation.

iii. According to the IFRS framework for the preparation and presentation of financial statements, freedom from error is a component of which fundamental qualitative characteristic of financial statements?

a) Verifiability
b) Relevance
c) Materiality
d) Faithful representation

Solution

Option d) is correct. Faithful representation is a fundamental qualitative characteristic. The framework for the preparation and presentation of financial statements indicates that, to be faithfully represented, financial statements should have three characteristics: completeness, neutrality, and freedom from error.

Option a) is incorrect. Verifiability is an enhancing (not fundamental) qualitative characteristic that helps assure users that information faithfully represents the
economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation.

Option b) is incorrect. To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present, or future events, or by confirming (or correcting) their past evaluations.

Option c) is incorrect. The relevance of information is affected by its nature and materiality. Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

2. Spartacus Sports Ltd. is a small private company that prepares its financial statements in accordance with ASPE.

Spartacus’s unadjusted trial balance is as follows:

<table>
<thead>
<tr>
<th>Unadjusted trial balance — April 30, 20X2</th>
<th>DR</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>27,101</td>
<td></td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td></td>
<td>1,780</td>
</tr>
<tr>
<td>Inventory</td>
<td>24,102</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>49,000</td>
<td></td>
</tr>
<tr>
<td>Buildings</td>
<td>222,736</td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation — buildings</td>
<td></td>
<td>29,328</td>
</tr>
<tr>
<td>Office furniture</td>
<td>72,300</td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation — office furniture</td>
<td></td>
<td>36,150</td>
</tr>
<tr>
<td>Vehicles</td>
<td>47,120</td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation — vehicles</td>
<td></td>
<td>19,325</td>
</tr>
<tr>
<td>Bank indebtedness</td>
<td></td>
<td>45,697</td>
</tr>
<tr>
<td>Accounts payable</td>
<td></td>
<td>12,260</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td></td>
<td>9,333</td>
</tr>
<tr>
<td>Long-term debt</td>
<td></td>
<td>150,000</td>
</tr>
<tr>
<td>Common shares</td>
<td></td>
<td>20,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td></td>
<td>93,429</td>
</tr>
<tr>
<td>Sales</td>
<td></td>
<td>255,300</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>120,820</td>
<td></td>
</tr>
<tr>
<td>Administration expense</td>
<td>22,700</td>
<td></td>
</tr>
<tr>
<td>Salaries and wages expense</td>
<td>74,333</td>
<td></td>
</tr>
<tr>
<td>Insurance expense</td>
<td>6,300</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>16,090</td>
<td></td>
</tr>
<tr>
<td>Miscellaneous expense</td>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td></td>
<td><strong>682,602</strong></td>
<td><strong>682,602</strong></td>
</tr>
</tbody>
</table>
Depreciation rates
5% declining balance — building
20% declining balance — office furniture
25% declining balance — vehicles

Additional information
1. No depreciation expense has been recorded for this year.
2. 10,000 new common shares were issued during the year for $10,000. The proceeds were originally credited to miscellaneous expense.
3. The company purchased a three-year insurance policy on January 1, 20X2, for $6,300.
4. The principal balance on the long-term debt is due on April 30, 20X6. Interest at 5% was last accrued and paid on November 30, 20X1. (For ease of computation, use the number of months to calculate interest expense, rather than the number of days.)
5. Spartacus received a deposit of $4,000 from a customer for equipment that was not delivered until May 15, 20X2. The $4,000 was credited to sales for the April 30, 20X2, fiscal year end.

Required:

a) Journalize the adjusting journal entries.

b) Prepare a worksheet using the following headings.

<table>
<thead>
<tr>
<th>Adjusted trial balance — April 30, 20X2</th>
<th>Unadjusted trial balance</th>
<th>Adjusting entries</th>
<th>Adjusted trial balance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>DR</td>
<td>CR</td>
<td>DR</td>
</tr>
</tbody>
</table>

c) Prepare the income statement and statement of retained earnings for the year ended April 30, 20X2, and the balance sheet at April 30, 20X2.

Solution

a) CPA Way step: Assess the Situation

Adjusting journal entries — April 30, 20X2

1. Depreciation expense 23,849
   - Accumulated depreciation — buildings 9,670
   - Accumulated depreciation — office furniture 7,230
   - Accumulated depreciation — vehicles 6,949

To record depreciation expense for the year.
Calculations:
Buildings ($222,736 – $29,328 = $193,408 \times 5\% = $9,670)
Office furniture ($72,300 – $36,150 = $36,150 \times 20\% = $7,230)
Vehicles ($47,120 – $19,325 = $27,795 \times 25\% = $6,949)

2. Miscellaneous expense
   Common shares 10,000
   To adjust and properly record issuance of common shares.

3. Prepaid insurance
   Insurance expense 5,600
   To record prepaid portion of insurance policy.
   $6,300 / 36 months \times 32 months remaining in policy = $5,600

4. Interest expense
   Interest payable 3,125
   To record interest expense from December 1 to April 30.
   $150,000 \times 5\% \times 5 / 12 months = $3,125

5. Sales
   Unearned revenue 4,000
   To adjust for customer deposit received by the company on future sales.
### b) CPA Way step: Analyze Major Issues

<table>
<thead>
<tr>
<th>Accounts receivable</th>
<th>Unadjusted trial balance</th>
<th>Adjusting entries</th>
<th>Adjusted trial balance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>DR 27,101</td>
<td>CR</td>
<td>DR 27,101</td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>DR 1,780</td>
<td>CR</td>
<td>DR 1,780</td>
</tr>
<tr>
<td>Inventory</td>
<td>DR 24,102</td>
<td>CR</td>
<td>DR 24,102</td>
</tr>
<tr>
<td>Prepaid insurance</td>
<td>DR 5,600</td>
<td>CR</td>
<td>DR 5,600</td>
</tr>
<tr>
<td>Land</td>
<td>DR 49,000</td>
<td>CR</td>
<td>DR 49,000</td>
</tr>
<tr>
<td>Buildings</td>
<td>DR 222,736</td>
<td>CR</td>
<td>DR 222,736</td>
</tr>
<tr>
<td>Accumulated depreciation — buildings</td>
<td>DR 29,328</td>
<td>CR 9,670</td>
<td>DR 38,998</td>
</tr>
<tr>
<td>Office furniture</td>
<td>DR 72,300</td>
<td>CR</td>
<td>DR 72,300</td>
</tr>
<tr>
<td>Accumulated depreciation — office furniture</td>
<td>DR 36,150</td>
<td>CR 7,230</td>
<td>DR 43,380</td>
</tr>
<tr>
<td>Vehicles</td>
<td>DR 47,120</td>
<td>CR</td>
<td>DR 47,120</td>
</tr>
<tr>
<td>Accumulated depreciation — vehicles</td>
<td>DR 19,325</td>
<td>CR 6,949</td>
<td>DR 26,274</td>
</tr>
<tr>
<td>Bank indebtedness</td>
<td>DR 45,697</td>
<td>CR</td>
<td>DR 45,697</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>DR 12,260</td>
<td>CR</td>
<td>DR 12,260</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>DR 9,333</td>
<td>CR</td>
<td>DR 9,333</td>
</tr>
<tr>
<td>Unearned revenue</td>
<td>DR 4,000</td>
<td>CR</td>
<td>DR 4,000</td>
</tr>
<tr>
<td>Interest payable</td>
<td>DR 3,125</td>
<td>CR</td>
<td>DR 3,125</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>DR 150,000</td>
<td>CR</td>
<td>DR 150,000</td>
</tr>
<tr>
<td>Common shares</td>
<td>DR 20,000</td>
<td>CR 10,000</td>
<td>DR 30,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>DR 93,429</td>
<td>CR</td>
<td>DR 93,429</td>
</tr>
<tr>
<td>Sales</td>
<td>DR 255,300</td>
<td>CR 4,000</td>
<td>DR 251,300</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>DR 120,820</td>
<td>CR</td>
<td>DR 120,820</td>
</tr>
<tr>
<td>Administration expense</td>
<td>DR 22,700</td>
<td>CR</td>
<td>DR 22,700</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>DR —</td>
<td>CR 23,849</td>
<td>DR 23,849</td>
</tr>
<tr>
<td>Salaries and wages expense</td>
<td>DR 74,333</td>
<td>CR</td>
<td>DR 74,333</td>
</tr>
<tr>
<td>Insurance expense</td>
<td>DR 6,300</td>
<td>CR 5,600</td>
<td>DR 700</td>
</tr>
<tr>
<td>Interest expense</td>
<td>DR 16,090</td>
<td>CR 3,125</td>
<td>DR 19,215</td>
</tr>
<tr>
<td>Miscellaneous expense</td>
<td>DR 10,000</td>
<td>CR 10,000</td>
<td>DR —</td>
</tr>
</tbody>
</table>
c) **CPA Way step: Conclude and Advise**

*Spartacus Sports Ltd.
Income statement
For the year ended April 30, 20X2*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$251,300</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>120,820</td>
</tr>
<tr>
<td>Gross margin</td>
<td>130,480</td>
</tr>
</tbody>
</table>

Operating expenses:
- Administration expense: $22,700
- Depreciation expense: 23,849
- Salaries and wages expense: 74,333
- Insurance expense: 700
- Interest expense: 19,215

Net income (loss): $(10,317)

*Spartacus Sports Ltd.
Statement of retained earnings
For the year ended April 30, 20X2*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings, April 30, 20X1</td>
<td>$93,429</td>
</tr>
<tr>
<td>Net income (loss) for the year</td>
<td>(10,317)</td>
</tr>
<tr>
<td>Retained earnings, April 30, 20X2</td>
<td>$83,112</td>
</tr>
</tbody>
</table>
### Spartacus Sports Ltd.
#### Balance sheet
As at April 30, 20X2

**Assets**

Current assets:
- Accounts receivable (net of allowance of $1,780) $25,321
- Inventory 24,102
- Prepaid insurance 5,600

Non-current assets:
- Property, plant and equipment 391,156
- Accumulated depreciation (108,652)

Total assets $337,527

**Liabilities and equity**

Current liabilities:
- Bank indebtedness $45,697
- Accounts payable 12,260
- Accrued liabilities 9,333
- Unearned revenue 4,000
- Interest payable 3,125

Non-current liability:
- Long-term debt 150,000

Total liabilities 224,415

**Shareholders’ equity**

- Common shares 30,000
- Retained earnings 83,112

Total shareholders’ equity 113,112

Total liabilities and shareholders’ equity $337,527
PART 2

Revenue recognition

It is critical to have a solid understanding of IFRS 15 *Revenue from Contracts with Customers*, including what constitutes revenue, how much to recognize, and when accruals should be made. The initiation of revenue is a critical event from which almost everything else flows, such as the recognition of expenses, and is therefore an important concept in accrual accounting.

IFRS 15 defines revenue as “income arising in the course of an entity’s ordinary activities.” It outlines a five-step framework for determining when and how much revenue to recognize, as follows:

1. Identify the contracts with a customer.
2. Identify the performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognize the revenue when (or as) the entity satisfies each performance obligation.

If all of the general criteria are met (approval, rights, payment, commercial substance and collectability), an entity can recognize revenue when it has transferred the promised goods or services to the customer (that is, it has satisfied a performance obligation). When the customer takes control of the asset, the transfer is deemed to be complete.

There are various points in time at which revenue can be recognized. Regardless of the stage at which revenue is recognized, a key requirement is that the performance obligation has been satisfied.

- **Recognition at time of delivery (satisfaction of the performance obligation at a point in time):** This is a common and straightforward method. This is when the transfer of control has occurred between the two parties (the buyer and seller) in the contract.

- **Recognition throughout the contract period (satisfaction of the performance obligation over time):** In some contracts, goods or services may be transferred over a period of time and as such the revenue should be recognized over the same period of time.

The contracts may also have multiple performance obligations and/or more than one distinct good or service. In these situations, revenue for each component can be recognized separately as each performance obligation is completed.

Another aspect of the standard is whether the goods and services are substantially the same or distinct. If they are the same, revenue is typically recognized on a straight-line basis — for example, in the case of a $24,000 contract to provide office-cleaning services for two years, $1,000 of revenue would be recognized each month of the contract.
If goods or services are distinct, an appropriate way to measure progress of the contract must be established — for example, if a public accounting firm has been engaged to provide assurance services to a client, the services will be based on a different hourly charge-out rate for each staff member.

**Recognizing expenses:** All costs pertaining to the sale of goods and services must be recognized at the same time the revenue is recognized. Expenses are recognized at the point in time when the performance obligations are satisfied. If the performance obligations are recognized over a period of time (multiple revenue points), there will also be multiple expense recognition periods.

**Initial and subsequent measurement:** At this point, the transaction price is the net amount to be received for the transfer of goods or services. For common transactions this can be fairly straightforward, but for more complex situations this can be a difficult process. There are additional considerations that may affect the transaction price and the way in which revenue should be recognized:

- **variable consideration** — if the contract has a variable component such as a performance bonus, this would be included if it is highly probable that it will be earned
- **significant financing component** — if payment for services will span a long period of time, the consideration must be adjusted for the time value of money
- **non-cash consideration** — where a company may barter for products instead of transacting in cash
- **consignment arrangements** — having a second party, which does not have control, sell your product

**Cash and cash equivalents**

It is important to have the correct classification of accounts on the statement of financial position. Cash and cash equivalents are usually reported in a single amount and include money in the bank as well as certain types of investments. Investments such as demand deposits and short-term debt securities that can be readily converted into cash and/or mature within three months of acquisition are generally classified as cash equivalents.

**Accounts receivable**

**Recognition:** Accounts receivable are included on the statement of financial position when the selling party has transferred the risks and rewards of ownership of the goods sold to the purchasing party. This will usually be at time of delivery.

**Initial measurement:** Financial assets, including accounts receivable, are initially measured at fair value plus transaction costs. However, short-term accounts receivable that will be received in one year or less are measured at their transaction price.
**Subsequent measurement:** Accounts receivable need to be reported at the lower of cost or net realizable value (that is, the transaction price less an allowance for expected losses/doubtful accounts).

There are two common methods of recording the uncollectible accounts receivable when credit sales take place:

- **Direct write-off method:** Under this method, accounts known to be uncollectible are written off (derecognized) and directly charged to bad debt expense. This method is generally not appropriate as it may not match the expense (bad debt) to the revenue in the period that it was earned. This method is generally used for immaterial amounts and is not IFRS-compliant.

- **Allowance method:** This method is more appropriate as it provides an allowance for doubtful accounts (AFDA) to reduce the accounts receivable to the amount expected to be collected. This records bad debt expense in the same period that the associated revenue is recognized. There are two methods to calculate the estimate of the uncollectible accounts:
  
  i) **Income statement approach:** This is based on a percentage of credit sales. For example, if total sales are $2,000,000, with 90% of these sales on credit, and management estimates that 2.5% of the credit sales are uncollectible, management would record $45,000 ($2,000,000 × 90% × 2.5%) as being uncollectible for the year. The required entry at year end would be a DR to bad debt expense and a CR to AFDA, for the amount of $45,000. This approach calculates the bad debt expense directly; any difference between the estimated bad debts and actual write-offs affects the ending AFDA balance, not the expense.

  ii) **Balance sheet approach:** This method calculates the AFDA based on the accounts receivable that have not been collected at the balance sheet date, based on the age of the accounts. The goal is to end up with an AFDA that equals the amount of the accounts receivable expected to be written off. If a company thought that $46,000 of accounts were uncollectible, and the balance in AFDA was $14,000 CR, an adjustment of $32,000 CR to AFDA would be required to make the balance equal the $46,000 management estimate, with a corresponding debit to bad debt expense.

Under either method of calculating the AFDA, accounts may be written off (DR to AFDA, CR to accounts receivable) if deemed uncollectible, or, the opposite, reinstated if the amount is collected after it had been written off.

**Derecognition:** Accounts receivable are typically derecognized for three reasons: they are collected in the normal course of business, they are written off, or they are transferred or sold to a third party (factoring). Factoring of accounts is typically done when the company wants to raise cash more quickly than the customers are expected to pay the receivables.

**Presentation and disclosure:** Current and non-current receivables are to be presented separately on the statement of financial position. Amounts due from trade receivables, related parties, and other sources are to be presented separately as well.
Practice questions

1. Multiple-choice questions:

   i. In 20X1, Noel Mechanical sold an air conditioning (A/C) unit for $300,000, which included a service agreement to maintain the A/C unit for three years starting at the beginning of 20X2. If sold separately, the A/C unit would have sold for $228,000 and the service agreement would have sold for $72,000. The customer paid the full $300,000 in 20X1.

At December 31, 20X1, what amount would Noel Mechanical recognize as deferred revenue?

   a) $0  
b) $2,000  
c) $72,000  
d) $300,000

Solution

Option c) is correct. It is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. Therefore, the revenue from the equipment should be recognized separately from the service agreement. The revenue from the service agreement should be deferred as the agreement does not start until the beginning of 20X2. The revenue should then be recognized straight-line over 36 months.

Option a) is incorrect. This assumes that nothing is deferred.

Option b) is incorrect. This is the service revenue that would be recognized each month.

Option d) is incorrect. This assumes that the revenue from the A/C unit and the service agreement should not be separated.
ii. LSJ Inc. has a December 31 fiscal year end. Based on past experience, 2% of LSJ’s credit sales are uncollectible. As at December 31, 20X1, the company had a credit balance of $10,000 in the AFDA. Sales for 20X2 were $3,000,000, and 70% of the sales were credit sales.

Using the income statement approach, what credit balance should LSJ report for the AFDA in its December 31, 20X2, balance sheet?

a) $42,000  
b) $52,000  
c) $60,000  
d) $70,000

Solution

Option b) is correct.

<table>
<thead>
<tr>
<th>DR</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000</td>
<td>$42,000 Allowance for Year 2*</td>
</tr>
<tr>
<td>$10,000</td>
<td>$52,000 Ending balance</td>
</tr>
</tbody>
</table>

* Credit sales = $3,000,000 \times 70\% \times 2\%

Option a) is incorrect. This assumes that the ending allowance balance equals the 20X2 accrual based on credit sales for AFDA.

Option c) is incorrect. This assumes that the entire amount of sales is on credit, and does not add in the opening balance.

Option d) is incorrect. This assumes that the entire amount of sales is on credit, and adds in the opening balance.
2. STM Ltd. follows the balance sheet approach in determining its AFDA. The balance sheet of STM at December 31, 20X1, contained the following information:

```
Trade accounts receivable — (net of AFDA of $24,650)  $821,600
```

The following events occurred during 20X2:

1. An amount of $6,000 was received from the trustee in bankruptcy of REC Ltd. This was the first indication of REC’s financial difficulties, and the accompanying letter said that no further amounts would be paid on the $15,000 total amount owed by REC prior to this payment.
2. An amount of $1,600 was received from Total Risk Ltd. STM had written off Total Risk’s $3,200 account in 20X1.
3. Other accounts receivable, which totalled $24,000, were written off during the period.
4. An aging of accounts receivable at December 31, 20X2, indicated that $34,000 of the outstanding balances was likely to become uncollectible.

**Required:**

Prepare the journal entries for the four transactions above.

**Solution**

**CPA Way step: Assess the Situation**

1.
```
DR Cash  6,000  
DR Allowance for doubtful accounts  9,000  
   CR Accounts receivable  15,000  
```

*To record payment of account in bankruptcy and write off remaining REC balance.*

2.
```
DR Accounts receivable  1,600  
   CR Allowance for doubtful accounts  1,600  
DR Cash  1,600 
   CR Accounts receivable  1,600  
```

*To reinstate Total Risk account previously written off.*

3.
```
DR Allowance for doubtful accounts  24,000  
   CR Accounts receivable  24,000  
```

*To record write-offs of other accounts receivable.*
4. DR Bad debt expense 40,750*
   CR Allowance for doubtful accounts 40,750
   To adjust AFDA to its correct ending balance.

<table>
<thead>
<tr>
<th>AFDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance</td>
</tr>
<tr>
<td>$24,650</td>
</tr>
<tr>
<td>(1) 9,000</td>
</tr>
<tr>
<td>(2) 1,600</td>
</tr>
<tr>
<td>(3) 24,000</td>
</tr>
<tr>
<td>Ending balance</td>
</tr>
<tr>
<td>$34,000</td>
</tr>
</tbody>
</table>

3. Valois Ltd., a construction company, has a contract with a customer for the construction of a new building. This contract is in progress as at March 31, 20X3. Details of the contract are as follows:
   - This contract was negotiated in June 20X1 for $11 million plus a 5% incentive payment payable by the customer to Valois if the contract is fully completed by June 30, 20X3.
   - This contract’s revenue is recognized over time. At March 31, 20X3, the contract is 95% complete. The engineers have assessed that it is 90% probable that the contract will be completed by the end of June 20X3.

Required:

Use the five-step framework outlined above to determine when and how much revenue Valois should recognize for the contract.

Solution

CPA Way step: Assess the Situation
Identify the contracts with a customer: Given — Valois and the customer have entered into a contract to construct a building. Both parties have agreed to the terms of the contract and it is currently in progress.

CPA Way step: Analyze Major Issues
Identify the performance obligations in the contract: The performance obligation in this contract is for Valois to construct a new building.

Determine the transaction price: The transaction price must be calculated because the contract includes a variable component — the 5% incentive payment of $550,000 (5% × $11 million) if the contract is completed by a certain date (June 30, 20X3). The total transaction price of this contract would be $11,550,000.
Allocate the transaction price to the performance obligations in the contract: There is only one performance obligation in this contract (the building), therefore the transaction price is allocated fully to the building.

CPA Way step: Conclude and Advise

Recognize revenue when (or as) the entity satisfies each performance obligation: The total amount of revenue that should be recognized by Valois as of March 31, 20X3, would be calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial price</td>
<td>$11,000,000</td>
</tr>
<tr>
<td>Add: incentive payment (5%)</td>
<td>550,000</td>
</tr>
<tr>
<td>Multiply by percentage completed (95%)</td>
<td></td>
</tr>
<tr>
<td>Revenue to March 31, 20X3</td>
<td><strong>$10,972,500</strong></td>
</tr>
</tbody>
</table>
PART 3

Revenue recognition — Construction contracts

A construction contract can have more than one performance obligation that results in revenue being recognized over a period of time and at certain points in time.

As construction contracts are typically for large projects that span a number of different phases, estimates must be utilized to reliably measure the outcome of the project.

Construction contracts can be separated into two broad categories:

**Cost-plus contracts**: The customer will reimburse the entity for all expenses plus an agreed-upon fee for completing the contract. For example, for the construction of a new building, the customer agrees to pay XYZ Co. a price of total costs plus 10% of total costs incurred. If the total costs of the project were $3,600,000, the customer would pay a total of $3,960,000 ($3,600,000 + $360,000).

**Fixed-price contracts**: The customer will pay the entity a fixed amount for completing the contract. For example, ABC Co. entered into a three-year contract with a customer to construct a new building with a fixed-contract price of $4,500,000. ABC is responsible for paying all the costs, regardless of whether they are higher or lower than $4,500,000. There can be three outcomes with fixed-price contracts:

1. The entity earns an overall profit on the contract and is profitable for all periods.
2. The entity earns an overall profit on the contract but suffers a loss in one or more periods.
3. The entity suffers an overall loss on the contract. An expected total loss must be recorded immediately.

Looking at the example above for ABC in the fixed-price scenario, a four-step process can be used to determine the amount of revenue and cost of goods sold (COGS) for each period:

1. **Estimate the expected profit or loss on the contract**: To do this, the total costs incurred to date are added to the estimated remaining costs. This is compared to the transaction price, and the difference is either a profit or a loss for the entity. **ABC calculated that the costs incurred up to the end of the first year are $1,100,000, with an estimated cost to complete of $2,500,000. The fixed price of the contract is $4,500,000, making the estimated profit $900,000 ($4,500,000 less the estimated total cost of construction of $3,600,000).**

2. **Determine the stage of completion**: The goal is to determine the percentage of completion of the project to be able to calculate how much revenue can be recognized at that point in time. **At the end of the first year, ABC has incurred 31% ($1,100,000 / $3,600,000) of the costs of the project, so the project is 31% complete.**
3. **Calculate revenue:** Calculate the gross revenue to be recognized for the period. The period revenue is equal to: percentage complete × contract price. *The amount of revenue ABC would recognize is 31% × $4,500,000 = $1,395,000.*

4. **Ascertain COGS (expense):** For a profitable contract, this is the sum of all related costs incurred during the period. *For the first year, the COGS for the project would be the $1,100,000 in expenses from step 1.*

**Change in contract price:** If a customer requests additional work beyond the contract requirements, the additional charges (revenue) are considered to be a change in estimate and therefore are accounted for prospectively (moving forward). The revised amount of the contract is the new transaction price.

**Revenue recognition — ASPE and IFRS**

The accounting standards for revenue recognition under ASPE are similar to those under IFRS. The major differences can be summarized as follows:

<table>
<thead>
<tr>
<th>Issue</th>
<th>ASPE</th>
<th>IFRS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Performance obligations are satisfied over a period of time (long-term contracts)</td>
<td>Use either the percentage-of-completion method or the completed contract method.*</td>
<td>Use the percentage-of-completion method.</td>
</tr>
<tr>
<td>Amount of revenue to recognize</td>
<td>Revenues are recognized at the price of the transaction or the consideration given, which is generally assumed to be fair value.</td>
<td>Revenues are recognized at the amount expected to be received.</td>
</tr>
</tbody>
</table>

*Under the completed contract method, revenue and expense are not recognized until the contract has been completed.

**Presentation and disclosure:** The value of work performed is presented as either a contract asset or liability (this account tracks construction-related costs and is netted against progress billings, which tracks earned revenue), and the entity is required to disclose sufficient information for users to understand the nature, amount, timing, and any uncertainty of revenues arising from the contract.

**Cash and internal control**

Cash is one of the assets that is most susceptible to theft and misappropriation. As such, it is necessary that an entity have internal controls to safeguard against these risks. Segregating duties between custody of cash and record-keeping is one of the best internal controls an entity can implement.

**Bank reconciliation:** Examination of the entity’s bank statement allows for a comparison of the transactions recorded by the bank and those in the financial records in order to reconcile the differences between the two. Differences could be due to errors (such as a transposition error) or timing (such as a cheque having been written but not cashed yet). For example,
Suppose your end-of-month bank balance is $1,500 and your general ledger cash balance is $1,700. When you look at your records, you see that the bank has charged $25 in fees, and a deposit of $175 was not recorded in the bank at the end of the month. To reconcile the accounts, you would need to do the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Bank balance</th>
<th>General ledger balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Closing</td>
<td>$1,500</td>
<td>$1,700</td>
</tr>
<tr>
<td>Subtract: Fees</td>
<td></td>
<td>(25)</td>
</tr>
<tr>
<td>Add: Deposit in transit</td>
<td>175</td>
<td></td>
</tr>
<tr>
<td>Reconciling balance</td>
<td>$1,675</td>
<td>$1,675</td>
</tr>
</tbody>
</table>

You would need to journalize any items in the general ledger balance, as these are not reflected yet:

- **DR** Bank fees 25  
- **CR** Cash 25

**Non-trade receivables — Notes receivable**

Non-trade receivables that are supported by a written contract are known as promissory notes. These specify the amount owing, the dates of repayment for the principal and interest, and the interest amounts that are to be repaid. Notes receivable are recognized when the entity has a legal right to receive cash, and the notes are initially measured at fair value plus transaction costs. Notes receivable are subsequently measured at amortized cost, and derecognized as they are collected in the normal course of business or written off. The primary requirement regarding disclosure and presentation is that the current and non-current notes receivable be presented separately on the statement of financial position.

**Inventory**

Inventory can be tracked under a perpetual system (which keeps a running balance of inventory that is increased for each purchase and decreased for each sale) or a periodic system (which records each inventory purchase in a purchases account and adjusts inventory quantities based on physical counts). Inventory is initially measured by attributing all costs directly related to the acquisition of the goods. Subsequently, inventory is measured at the lower of cost or net realizable value.

There are several methods used for costing inventory, which affect expense recognition (derecognition). When inventory items are not interchangeable, each item should be costed using specific identification. If specific identification cannot be used (such as a large number of interchangeable inventory items), the value is allocated according to one of the three other cost formulas listed below, as chosen by the entity. Specific identification is also listed, to give a complete list of the available inventory costing methods.

- **first in, first out (FIFO)** — taking the oldest items from inventory first
- **weighted average** — using a weighted average cost for the value of each item sold
• **last in, first out (LIFO)** — taking the most recent inventory costs first; used widely in the United States but not permitted by IFRS or ASPE

• **specific identification** — using the actual cost allocated to the item; used when each item in inventory is unique, and easily identifiable, such as jewelry or vehicles

**Methods of estimating inventory:** In some circumstances (such as a company losing inventory due to a fire or the preparation of interim financial statements where the cost of completing a full physical inventory count is prohibitive), an entity may use estimation to determine an approximate value of inventory on hand. The gross profit method uses the historical gross profit from previous financial statements and the relationship between net sales, COGS, and goods available for sale. The retail method uses a cost ratio between current retail selling prices and the cost of inventory to calculate an estimate of inventory on hand.

**Disclosure and presentation:** The disclosure requirements are quite extensive, the main one being that the current and non-current inventories be presented separately on the statement of financial position.

**Practice questions**

1. Multiple-choice questions
   
i. RRE Inc. builds a department store in a city centre. The contract price of the job is $50,000,000. Information about costs is as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Costs incurred during the year</th>
<th>Estimated costs to complete</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$5,000,000</td>
<td>35,000,000</td>
</tr>
<tr>
<td>2</td>
<td>$19,000,000</td>
<td>13,500,000</td>
</tr>
<tr>
<td>3</td>
<td>$15,000,000</td>
<td>—</td>
</tr>
</tbody>
</table>

The company uses the percentage-of-completion method to account for long-term construction contracts. How much profit will be recognized in Year 2? (Round all calculations to two decimal places.)

a) $1,250,000  
b) $6,750,000  
c) $8,000,000  
d) $10,231,000

**Solution**

Option b) is **correct**.

Calculation of profit to record:

**Year 1**

Percentage of completion = $5,000,000 / ($5,000,000 + $35,000,000) = 12.50%
Revenue earned = $50,000,000 × 12.5% = $6,250,000  
Profit in Year 1 = $6,250,000 – $5,000,000 = $1,250,000

Year 2
Percentage of completion = ($5,000,000 + $19,000,000) / ($5,000,000 + $19,000,000 + $13,500,000) = 64%  
Total revenue earned = $50,000,000 × 64% = $32,000,000  
Revenue to record in current period = $32,000,000,000 – $6,250,000 = $25,750,000  
Profit in Year 2 = $25,750,000 – $19,000,000 = $6,750,000

Option a) is incorrect. This is the expected profit in Year 1, not Year 2.

Option c) is incorrect. This does not deduct the profit already calculated and earned in Year 1.

Option d) is incorrect. This uses only Year 2 cost information and ignores cost and profit in Year 1:

- Percentage of completion = $19,000,000 / ($19,000,000 + $13,500,000) = 58.46%
- Expected profit = $50,000,000 – ($19,000,000 + $13,500,000)
  = $17,500,000 × 58.46% = $10,231,000

ii. Gebbus Inc. had the following transactions for Product X during the month of May:

<table>
<thead>
<tr>
<th>Date</th>
<th>Transaction</th>
<th>Units</th>
<th>Total cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 1</td>
<td>Opening inventory</td>
<td>4,500</td>
<td>$40,500</td>
</tr>
<tr>
<td>May 3</td>
<td>Purchase</td>
<td>2,000</td>
<td>$19,000</td>
</tr>
<tr>
<td>May 9</td>
<td>Sold</td>
<td>(3,000)</td>
<td>?</td>
</tr>
<tr>
<td>May 12</td>
<td>Purchase</td>
<td>2,500</td>
<td>$21,875</td>
</tr>
<tr>
<td>May 19</td>
<td>Sold</td>
<td>(1,500)</td>
<td>?</td>
</tr>
<tr>
<td>May 29</td>
<td>Sold</td>
<td>(1,700)</td>
<td>?</td>
</tr>
</tbody>
</table>

Assuming Gebbus uses a perpetual inventory system and the weighted average costing method, what is the COGS for Product X during the month of May? (Round all interim calculations to five decimal places, and final dollar amounts to zero decimal places.)

a) $56,058  
b) $56,175  
c) $56,215  
d) $56,650
Solution

Option c) is correct.

Calculate average cost of Product X on each sales date:

<table>
<thead>
<tr>
<th>Date</th>
<th>Transaction</th>
<th>Units</th>
<th>Total cost</th>
<th>Average cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 1</td>
<td>Opening inventory</td>
<td>4,500</td>
<td>$40,500</td>
<td>$9.00</td>
</tr>
<tr>
<td>May 3</td>
<td>Purchase</td>
<td>2,000</td>
<td>19,000</td>
<td>$9.50</td>
</tr>
<tr>
<td></td>
<td></td>
<td>6,500</td>
<td>59,500</td>
<td>$9.15385</td>
</tr>
<tr>
<td>May 9</td>
<td>Sold</td>
<td>(3,000)</td>
<td>(27,462)</td>
<td>$9.15385</td>
</tr>
<tr>
<td>May 12</td>
<td>Purchase</td>
<td>2,500</td>
<td>21,875</td>
<td>$8.75</td>
</tr>
<tr>
<td></td>
<td></td>
<td>6,000</td>
<td>53,913</td>
<td>$8.9855</td>
</tr>
<tr>
<td>May 19</td>
<td>Sold</td>
<td>(1,500)</td>
<td>(13,478)</td>
<td>$8.9855</td>
</tr>
<tr>
<td>May 29</td>
<td>Sold</td>
<td>(1,700)</td>
<td>(15,275)</td>
<td>$8.9855</td>
</tr>
</tbody>
</table>

Total COGS = $27,462 + $13,478 + $15,275 = $56,215.

Option a) is incorrect. This uses weighted average costing and a periodic inventory system:
Goods available for sale = $40,500 + $19,000 + $21,875 = $81,375
Total units available for sale = 4,500 + 2,000 + 2,500 = 9,000
Weighted average cost per unit = $81,375 / 9,000 = $9.041667
Units sold = 3,000 + 1,500 + 1,700 = 6,200
COGS = 6,200 × $9.041667 = $56,058

Option b) is incorrect. This uses LIFO:
Ending inventory = 2,800 units
Cost of ending inventory = 2,800 × ($40,500 / 4,500) = 2,800 × $9 = $25,200
Goods available for sale = $40,500 + $19,000 + $21,875 = $81,375
COGS = $81,375 − $25,200 = $56,175

Option d) is incorrect. This uses FIFO:
May 9 sales — 3,000 × ($40,500 / 4,500) = 3,000 × $9.00 = $27,000
May 19 sales — 1,500 × $9.00 = $13,500
May 29 sales — 1,700 × ($19,000 / 2,000) = 1,700 × $9.50 = $16,150
Total COGS = $27,000 + $13,500 + $16,150 = $56,650
2. CLP Construction has entered into a $2,600,000 contract, and has provided the following information regarding this construction project:

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual costs per year</td>
<td>$ 400,000</td>
<td>$ 300,000</td>
<td>$ 550,000</td>
</tr>
<tr>
<td>Cumulative actual costs</td>
<td>A 400,000</td>
<td>700,000</td>
<td>1,250,000</td>
</tr>
<tr>
<td>Estimated total costs</td>
<td>B 1,000,000</td>
<td>1,200,000*</td>
<td>1,250,000*</td>
</tr>
<tr>
<td>Percentage complete</td>
<td>A / B 40%</td>
<td>58%</td>
<td>100%</td>
</tr>
</tbody>
</table>

*In Year 2, the total estimated costs increased by $200,000. In Year 3, the total estimated costs increased by $50,000.

Required:

Using the percentage-of-completion method, determine the gross profit and revenue to recognize for each year. Remember that the formula to recognize revenue is:

\[
\text{Revenue to recognize in current period} = \text{Estimated total revenue} - \text{Total revenue recognized in prior period(s)}
\]

\[
\frac{\text{Costs incurred to date}}{\text{Estimated total costs}} \times \frac{\text{Estimated total revenue}}{\text{Revenue to recognize in prior period(s)}} = \text{Revenue to recognize in current period}
\]

Solution

CPA Way step: Analyze Major Issues

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total revenue in contract</td>
<td>A $2,600,000</td>
<td>$2,600,000</td>
<td>$2,600,000</td>
</tr>
<tr>
<td>Percentage complete</td>
<td>B 40%</td>
<td>58%</td>
<td>100%</td>
</tr>
<tr>
<td>A × B</td>
<td>$1,040,000</td>
<td>$1,508,000</td>
<td>$2,600,000</td>
</tr>
</tbody>
</table>

Less: Revenue recognized in prior period:

- Revenue recognized before Year 1: 0
- Revenue to recognize, Year 1: $1,040,000
- Year 1 revenue recognized: 1,040,000
- Revenue to recognize, Year 2: $ 468,000
- Year 2 revenue recognized: 468,000
- Revenue to recognize, Year 3: $1,092,000

Gross profit to recognize:

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue recognized</td>
<td>$1,040,000</td>
<td>$ 468,000</td>
<td>$1,092,000</td>
</tr>
<tr>
<td>Actual costs incurred during year</td>
<td>400,000</td>
<td>300,000</td>
<td>550,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>$ 640,000</td>
<td>$ 168,000</td>
<td>$ 542,000</td>
</tr>
</tbody>
</table>
3. Stern Inc.’s accountant is in the process of completing Stern’s bank reconciliation for the month of May. The May 31, 20X7, balance as per the bank statement is $2,780, and the balance in the general ledger cash account is $3,235. The accountant has noted two reconciling items:

- The May bank statement shows $15 for bank fees. This has not been recorded in the general ledger.
- A cheque was received in payment of a customer account for $440 on May 31. The amount was recorded in the general ledger on May 31, but the accountant was not able to deposit the cheque at the bank until June 2.

**Required:**

a) Complete a bank reconciliation for Stern Inc. for the month of May 20X7.

b) Complete the journal entries required for the bank reconciliation.

**Solution**

a) **CPA Way step: Analyze Major Issues**

<table>
<thead>
<tr>
<th></th>
<th>Bank as per the bank</th>
<th>General ledger balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance as per bank</td>
<td>$2,780</td>
<td>$3,235</td>
</tr>
<tr>
<td>Add: Outstanding deposit</td>
<td>440</td>
<td></td>
</tr>
<tr>
<td>Balance as at May 31</td>
<td>$3,220</td>
<td>$3,220</td>
</tr>
</tbody>
</table>

b) **CPA Way step: Conclude and Advise**

Journal entries are only required for reconciling items noted on the general ledger side of the reconciliation. As such, an adjustment should be made to record the bank fees for the month. The journal entry would be as follows:

DR Bank fee expense 15
CR Cash 15
PART 4

Property, plant and equipment

Property, plant and equipment (PPE) refers to tangible assets that are held for use in the production or supply of good or services, for rental to others, or for administrative purposes, and are expected to be used during more than one period. The long-term use is what distinguishes PPE from office supplies or inventories.

**Recognition:** The cost of PPE shall only be recognized as an asset if it is probable that future economic benefits associated with the asset will flow to the entity and that the cost of the item can be measured reliably.

**Initial measurement:** PPE is initially recorded at cost. In addition to the purchase price, the cost of the PPE includes any costs directly attributable to bringing the asset to the location and condition necessary for its intended use. Costs such as import duties, delivery, installation and site preparation are included in the cost of the asset. Costs related to general overhead allocation and refundable taxes (GST and HST) are excluded from the cost base.

For self-constructed assets (such as the building of a warehouse), the costs are determined using the same principles as for acquired assets but exclude costs such as profit elements. Certain borrowing costs, such as interest, can be capitalized under certain circumstances until the asset is ready for its intended use.

**Bundled purchases:** When a company acquires a group (or bundle) of assets in a single transaction, and the purchase price of each item is not detailed, the purchasing company must allocate the purchase price to the specific assets. The allocation is typically made based on the estimated relative fair value of the component parts. For example, if $100,000 was paid for two pieces of equipment with estimated fair values of $48,000 and $60,000, respectively, the costs allocated to the two pieces of equipment would be $44,444 \([($48,000/$108,000) \times $100,000]\) for the first, and $55,556 \([($60,000/$108,000) \times $100,000]\) for the second.

**Exchange of non-monetary assets**

Entities sometimes acquire PPE through the exchange of non-monetary assets. The value at which the asset acquired is recorded depends on the nature of the transaction. When the asset given up is ordinarily sold by the business in its day-to-day activities, the transaction is considered a sale. A sale is recorded at the value of the consideration received, so both the sales revenue and the asset received are recorded at the new asset’s fair market value. For example, if a company that sells office furniture trades a table and chairs (assets given up) for a motor vehicle (asset received), the sales revenue is equal to the fair value of the motor vehicle, and the motor vehicle is included in PPE at its fair market value.

However, when the asset given up is not ordinarily sold by the business in its day-to-day activities, the transaction is a purchase transaction, and assets purchased are recorded at cost. In a non-monetary exchange, the cost is the fair value of the asset given up, unless the fair value of the asset received is more clearly evident. For example, if the company that sells
Office furniture exchanges kitchen equipment from its staff room (assets given up) for a motor vehicle (asset received), the motor vehicle value is recorded at the fair value of the kitchen equipment, unless the fair value of the motor vehicle can be determined more readily. The disposition of the kitchen equipment will result in a gain or loss, depending on whether the fair value is greater or less than its carrying value.

**Subsequent measurement (PPE) — Replacement versus repairs**

The day-to-day costs of maintaining an asset (such as an oil change, battery replacement or minor maintenance on a vehicle) are considered repairs and maintenance expenditures and should be expensed. Expenditures that are more significant, such as a new engine in a vehicle, are capitalized. Often professional judgment must be exercised to determine the appropriate classification of these costs.

**Subsequent measurement (PPE) — Cost and revaluation models**

PPE can be subsequently measured using either the cost or the revaluation model, and the chosen model must be applied to an entire class of assets. The cost model is most commonly used and measures the asset at its original cost, less accumulated depreciation and any accumulated impairment losses.

The revaluation model is not widespread; it is used when there are significant differences between the fair value and cost of the assets (common in the real estate industry, such as land). This model can only be used if the fair value can be reliably measured, and assets must be revalued regularly to ensure the carrying amount does not differ materially from its fair value.

Under the revaluation model, cumulative revaluation gains are credited to a revaluation surplus account in other comprehensive income (OCI), while cumulative losses are charged to net income (profit or loss).

<table>
<thead>
<tr>
<th>Overall prior effect</th>
<th>Current period</th>
<th>Revaluation effect — gain</th>
<th>Revaluation effect — loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall (cumulative) loss on revaluation based on all revaluations done up to prior statement of financial position date</td>
<td>Current period gain is credited to profit and loss up to the cumulative amount of loss previously recognized. The remaining excess is credited to OCI.</td>
<td>The current period loss is debited to profit and loss and is added to the cumulative loss on the asset.</td>
<td></td>
</tr>
<tr>
<td>Overall (cumulative) gain on revaluation based on all revaluations done up to prior statement of financial position date</td>
<td>Current period gain is credited to OCI and is added to the cumulative gain of the asset.</td>
<td>The current period loss is debited to OCI up to the amount of cumulative gain previously recognized. The remaining deficit is debited to profit or loss.</td>
<td></td>
</tr>
</tbody>
</table>
Subsequent measurement (PPE) — Depreciation and depletion

The purpose of depreciation is to expense the depreciable cost of the asset over its estimated useful life. The type of asset generally dictates the terminology used to describe the depreciation:

<table>
<thead>
<tr>
<th>Term</th>
<th>Generally used for</th>
<th>Depreciation method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation</td>
<td>Tangible assets other than natural resources</td>
<td>• straight-line</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• declining balance</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• units of production</td>
</tr>
<tr>
<td>Depletion</td>
<td>Tangible natural resources</td>
<td>• typically units of production</td>
</tr>
<tr>
<td>Amortization</td>
<td>Intangible assets (finite life)</td>
<td>• straight-line over life of asset</td>
</tr>
</tbody>
</table>

The depreciation method used is at the discretion of the company and should reflect the pattern in which the asset’s future economic benefits are expected to be consumed by the entity. There are three widely used methods of depreciation:

- **Straight-line:** This is a time-based method that results in a constant charge to depreciation expense over the useful life of the asset. Depreciation expense is calculated as the depreciable amount divided by the useful life. For example, a building with a cost of $5,000,000 and no salvage value has a useful life of 10 years. The depreciation expense recognized every year will be $500,000 ($5,000,000 / 10 years).

- **Declining balance (diminishing balance):** This method is also time-based, with the assumption that the greatest benefits from the use of the asset will be received in the first year, and the benefits will decrease each year thereafter. The associated depreciation is therefore highest in the first year and declines each subsequent year. Depreciation is calculated as the net book value of the asset multiplied by the depreciation rate expressed as a percentage. For example, machinery with a net book value of $300,000 has a depreciation rate of 25%. The depreciation expense for the first year would be $75,000 ($300,000 × 25%).

- **Units of production:** This is a usage-based method. The depreciation rate is based on units of usage or an output basis for the period relative to the expected total units of usage or outputs of the life of the asset. For example, equipment costing $130,000 was expected to last 80,000 machine hours with no salvage value. The depreciation expense per machine hour is $1.625 ($130,000/80,000). During the first year, 20,000 machine hours were used. The depreciation expense for the first year is $32,500 (20,000 hours × $1.625).

**Derecognition (PPE):** When the asset is sold or when no future economic benefits are expected from its use or disposal, PPE should be derecognized (removed from the accounting records). Depending on whether any proceeds received on disposition are greater or less than the net book value of the asset (cost less the accumulated depreciation) at the time of derecognition, there may be a gain or loss on disposal.

**Disclosure (PPE):** The requirements for PPE are extensive. Since there are many choices available to the company, it is necessary to disclose information such as the choice of measurement basis (cost or revaluation), depreciation method and estimated useful life.
Intangible assets

Intangible assets are identifiable non-monetary assets with no physical substance, such as copyrights, franchises, licences, patents and trademarks. To recognize an intangible asset, the following four tests must be met:

1. The asset must be separately identifiable.
2. It must be controlled by the entity.
3. It must be probable that the asset will create revenue or cost reductions for the entity.
4. The entity must be able to reliably measure the cost of the asset.

Intangible assets are initially measured at cost. Intangible assets are subsequently measured using either the cost or the revaluation model (similar to PPE), and amortized (for finite life assets) or tested annually for impairment (indefinite life assets). The intangible assets are derecognized when the assets are disposed of or when no future economic benefits are expected. Disclosure requirements for intangible assets are similar to those for tangible assets.

Goodwill

Goodwill is an asset representing the future economic benefits arising from other assets acquired in a business combination. Similar to intangible assets, goodwill lacks physical substance, but because it is not separately identifiable it is not classified as an intangible asset. Goodwill is not amortized; rather, it is tested annually for impairment.

Impairment

Impairment occurs when the carrying amount of an asset exceeds its recoverable amount (what it can earn through its sale or use). If impaired, the asset should be written down to its recoverable amount. It is difficult to isolate the cash flows generated by an individual asset, so cash flows are identified for a cash-generating unit (CGU), the smallest identifiable group of assets that generates independent cash inflows that can be specifically tracked. When testing for impairment, a CGU’s carrying value is compared to the recoverable amount that the CGU can generate. The recoverable amount is the higher of an asset’s fair value less costs to sell and its value in use. An example of a CGU could be an individual store in a supermarket chain.

For example, XYZ Co., an oil-services company, has a division whose net asset value is $14,200 ($170 of this is goodwill); the recoverable amount of this division is $12,350. This would result in an impairment loss of $1,850 ($14,200 – 12,350), which would have to be recorded by XYZ. A total of $170 would be allocated to reduce the value of goodwill to zero first. The remaining $1,680 would be allocated proportionately to the remaining assets.

Reversal of impairment losses

Impairment losses on goodwill can never be reversed. For intangible assets and depreciable PPE valued using the cost model, reversals of impairment losses are limited to increasing the carrying amount/net book value of the asset to what it would have been now if the impairment had not taken place and the asset had continued to be depreciated at the same rate as before the impairment occurred.
Practice questions

1. Multiple-choice questions

i. At the end of 20X1, JJW Ltd. owns a patent (intangible asset) with a remaining useful life of 10 years and a carrying amount of $400,000. JJW expects future cash flows from this patent to total $390,000. The patent’s fair value is $350,000 and the disposal costs are expected to be $15,000. The discounted cash flows (value in use) would be $375,000.

What impairment loss would JJW record on its books if it is a publicly traded enterprise?

a) $0  
b) $10,000  
c) $25,000  
d) $65,000

Solution

Option c) is correct. If and only if the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable amount. The recoverable amount is the higher of an asset’s fair value less costs to sell and its value in use.

Recoverable amount = Higher of ($350,000 – $15,000) = $335,000 or $375,000 = $375,000.

Therefore, the impairment loss would be $400,000 – $375,000 = $25,000.

Option a) is incorrect. This assumes no loss.  
Option b) is incorrect. This assumes the loss is the difference between the carrying value and the undiscounted cash flows.  
Option d) is incorrect. This assumes the loss is the difference between the carrying value and the fair value less disposal.

ii. Which of the following items meets the definition of an intangible asset?

a) Business licence granted by the government to operate in the industry for five years  
b) Recruitment and training of the workforce to increase a company’s sales and profitability  
c) Substantial advertising to promote a company’s products  
d) Investment in 200,000 shares of another company
Solution

Option a) is correct. A business licence is an intangible asset, as it meets all definition criteria: the cost of the business licence can be determined, it is controlled by the entity that holds the licence and it will generate economic benefits.

Option b) is incorrect. Recruitment and training is not an intangible asset, as it is unlikely that the company has control over the workforce to ensure they provide future economic benefits. The workforce is tangible (human capital) and thus does not meet the definition of an intangible asset.

Option c) is incorrect. Substantial advertising is an expense, not an intangible asset, as there is insufficient future benefit to give rise to an asset.

Option d) is incorrect. Investments are monetary assets, not intangible assets.

2. During 20X4, Yvo Corp. installed a production assembly line to manufacture furniture. In 20X5, Yvo purchased a new machine and rearranged the assembly line to install this machine. The rearrangement did not increase the estimated useful life of the assembly line, but it did result in significantly more efficient production. The following expenditures were incurred in connection with this project:

<table>
<thead>
<tr>
<th>Description</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machine</td>
<td>$75,000</td>
</tr>
<tr>
<td>Import duties</td>
<td>5,000</td>
</tr>
<tr>
<td>Labour to install machine</td>
<td>14,000</td>
</tr>
<tr>
<td>Parts added in rearranging existing assembly line</td>
<td>40,000</td>
</tr>
<tr>
<td>Labour and overhead to rearrange the assembly line</td>
<td>18,000</td>
</tr>
<tr>
<td>General overhead allocation</td>
<td>3,500</td>
</tr>
</tbody>
</table>

Required:

How much of the above expenditures related to the production assembly line asset should be capitalized in 20X5?

Solution

CPA Way step: Conclude and Advise

The general overhead allocation costs should not be included in the cost base. All other expenditures are considered necessary costs to prepare the asset for its intended use (and therefore can be capitalized). The amount that can be capitalized is as follows: $75,000 + 5,000 + 14,000 + 40,000 + 18,000 = $152,000.
3. River Lea Inc. acquired vacant land for $750,000 on January 1, 20X3. The land was revalued to $840,000 on December 31, 20X5. Due to an economic downturn in the city, by December 31, 20X6, the land was valued at $690,000.

**Required:**

Describe how River Lea would account for the changes in value for the land. Assume River Lea uses the revaluation model.

**Solution**

**CPA Way step: Analyze Major Issues**

River Lea would allocate $90,000 as a credit to OCI for revaluation surplus because the fair value has increased, with a corresponding debit to the land account. The value of the land would be the fair value, $840,000.

At the end of December 31, 20X6, the fair value has decreased by $150,000 since December 31, 20X5. This is the amount by which the asset is impaired at the end of 20X6.

This decrease should be accounted for as follows: a debit of $90,000 to OCI to eliminate the surplus recorded in the previous year, and a debit to profit and loss for the remaining $60,000, with a $150,000 credit to the land account. The value of the land would be the fair value, $690,000.
PART 5

Passive investments in financial assets

Investors can take many approaches when deciding on the type of investment to select when they have excess cash to invest. The purchase of investments can be either strategic (for full control or significant influence) or passive. Warren Buffett is an example of an investor who selects passive investments.

The purpose of investing in passive investments is to protect and increase the value of excess cash in order to provide for future cash needs. Passive investments are accounted for in accordance with IFRS 9 Financial Instruments.

This section will focus on financial assets, for example cash, shares of a company, or a right to receive other financial assets, such as accounts receivable, from another enterprise. Financial assets are recognized when the entity first becomes part of the contract. After the financial asset has been recognized, it needs to be classified and measured based on the entity’s business model for managing the asset and the characteristics of the cash flows it will generate. The entity’s intention is important as it determines how the asset should be classified.

There are three categories (classifications) of passive financial assets:

- **Financial assets measured at amortized cost**: These financial assets are debt securities, and the intention is to hold these with the purpose of collecting contractual cash flows (principal and interest) for the life of the investment. An example would be purchasing a bond, as there is an obligation to pay interest on specific dates and to repay the principal at maturity.

- **Financial assets measured at fair value through other comprehensive income (FVOCI)**: These financial assets are debt securities, and the intention is to sell them prior to maturity to realize a profit. The entity may hold the investment to maturity, but it has the option to sell the investment at a profit earlier, rather than to collect contractual cash flows. Examples are bonds, mortgages and loans. The key difference between amortized cost and FVOCI is the intention of the holder.

- **Financial assets measured at fair value through profit or loss (FVPL)**: These financial assets do not have contractual cash flows and do not meet the intentions or objectives of the previous two categories. Examples would be equity securities of a publicly traded company.

There are some exceptions to the above classifications. An entity can make an irrevocable decision to classify an equity security as FVOCI; this is most commonly done if the entity prefers that the profit and loss not be affected by unrealized gains and losses on the investment. An election is not available if the company intends to sell the equity instruments in the near future. These assets will be classified as FVOCI–elect. On the opposite end, a debt instrument that has been classified as amortized cost or FVOCI can be irrevocably classified.
as an FVPL financial asset if this action eliminates or significantly reduces a measurement or recognition inconsistency and provides more relevant financial information.

**Initial measurement**

Most financial assets, including financial assets at FVPL, are initially measured at fair value.

**Subsequent measurement and impairment allowance**

<table>
<thead>
<tr>
<th>Statement of financial position</th>
<th>Statement of comprehensive income</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Amortized cost</strong></td>
<td></td>
</tr>
<tr>
<td>• Subsequent measurement — at amortized cost</td>
<td>• Interest income is recognized in profit or loss using the effective interest method.</td>
</tr>
<tr>
<td>• Impairment allowance — deducted from amortized cost if needed</td>
<td>• Impairment allowance should be recognized in profit or loss if needed.</td>
</tr>
</tbody>
</table>

**FVOCI**

<table>
<thead>
<tr>
<th>Statement of financial position</th>
<th>Statement of comprehensive income</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Subsequent measurement — at fair value</td>
<td>• Debt instruments: Interest income is recognized in profit or loss using the effective interest method based on the original acquisition cost. Unrealized gains or losses not explained by the income amortization when instrument is remeasured to fair value are recognized in OCI.</td>
</tr>
<tr>
<td></td>
<td>• Equity instruments: Earned dividends are recorded in profit or loss. Unrealized gains or losses when instrument is remeasured to fair value are recognized in OCI.</td>
</tr>
<tr>
<td></td>
<td>• Impairment allowance should be recognized in OCI if needed.</td>
</tr>
</tbody>
</table>
**FVPL**

| Subsequent measurement — at fair value | Interest income and earned dividends are recognized in profit or loss. Interest income is recorded using the stated rate of interest.  
- Unrealized gains or losses when instrument is remeasured at FVPL are recognized in profit or loss.  
- No impairment allowance required as instruments are already reported at fair value. |

**Effective interest method:** This is used to determine the amount of interest revenue and amortized cost to recognize over the expected life of the financial asset or liability. The effective interest method discounts the expected future cash payments over the life of the asset or liability. The interest revenue reported is measured using the market rate of interest in effect when the investment was purchased, and it is based on the carrying value of the investment.

**Derecognition**

When the financial asset has expired (or all risks and rewards have been transferred), it should be removed (derecognized) from the financial statements. Immediately before the derecognition of the financial asset the entity will need to recognize any gains or losses:

- For amortized cost, update amortized cost to record any interest income earned in the last period.
- For FVOCI, update carrying value to current market value, with any gains/losses flowing through OCI.
- For FVPL, update investment to market value, with any gains/losses flowing through profit or loss.

The accounting treatment for the cumulative gains or losses previously recognized in OCI depends on whether the financial asset is a debt FVOCI or equity FVOCI— elect instrument:

- **Debt investment:** The cumulative gains or losses previously recognized in OCI are reclassified from accumulated other comprehensive income (AOCI) to profit or loss (in other words, the OCI is recycled to net income). AOCI gains are credited to profit or loss; AOCI losses are debited to profit or loss.

- **Equity investment:** The cumulative gains or losses previously recorded may be reclassified from AOCI to retained earnings (in other words, the OCI is not recycled to net income). AOCI gains are credited to retained earnings; AOCI losses are debited to retained earnings. This process is, however, not mandatory, and the cumulative gains or losses may remain in AOCI forever.
**Change in business model**

It is possible for an entity to change its business model for investments in debt securities, but such changes are rare. A change may affect the way the entity classifies its financial assets; for example, an instrument previously classified as FVPL may be eligible to be reclassified to amortized cost.

**Presentation and disclosure**

Extensive disclosure requirements are contained in IFRS 9 requiring, for example, the separate presentation of items such as revenue, impairment losses, gains or losses arising from the derecognition of financial assets at amortized cost (statement of comprehensive income), and the separate presentation of the total carrying amount for each class of financial assets (statement of financial position or notes to the financial statements).

**Practice questions**

1. Multiple-choice questions

   i. Which of the following statements is true?

      a) Financial instruments are classified based on when the asset matures.
      b) An entity can reverse an election to classify an equity instrument as FVOCI–elect as long as it results in providing more relevant financial information.
      c) All financial assets must be subsequently measured at amortized cost.
      d) All interest income is recognized in profit or loss.

**Solution**

Option d) is correct. This statement is true. Regardless of the classification, the financial asset interest income is recorded through profit or loss.

Option a) is incorrect. The financial asset is classified based on the business model of the entity, how long it intends to hold onto the investment and if the objective is to make a profit.

Option b) is incorrect. Any elections to classify an equity instrument as FVOCI–elect are irrevocable.

Option c) is incorrect. The method used to subsequently measure the financial asset depends on the initial classification and on whether it was classified as amortized cost, FVOCI or FVPL.
ii. During its 20X5 fiscal year, Deresh Inc. derecognized an investment in bonds classified as FVOCI, which sold for its fair value of $540,000. The carrying value of the investment was $525,000, and the debit balance in AOCI pertaining to this investment was $20,000. What amount of loss will be recorded upon derecognition of this financial instrument?

   a) $5,000  
b) $15,000  
c) $20,000  
d) $35,000

**Solution**

Option a) is correct. The investment must be adjusted to fair value before derecognition:

*Investment classified as FVOCI*

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in financial asset at FVOCI</td>
<td>15,000</td>
</tr>
<tr>
<td>OCI — holding gain on financial assets at FVOCI</td>
<td>15,000</td>
</tr>
<tr>
<td>($540,000 – $525,000)</td>
<td></td>
</tr>
</tbody>
</table>

*To adjust the investment to its fair value prior to derecognition.*

The AOCI amount is a $5,000 DR balance, so this must be removed upon derecognition:

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss on disposal of financial asset at FVOCI</td>
<td>5,000</td>
</tr>
<tr>
<td>($15,000 – $20,000)</td>
<td></td>
</tr>
<tr>
<td>AOCI</td>
<td>5,000</td>
</tr>
</tbody>
</table>

*To recycle the accumulated OCI on the investment to profit or loss upon derecognition.*

Option b) is incorrect. This is the difference between the carrying value and the fair value of the instrument and does not take into account the $20,000 DR balance in AOCI. This is the gain that would be reported in the year if the investment were an equity instrument.

Option c) is incorrect. This is the balance in AOCI and does not take into account the change in fair value that occurred prior to derecognition.

Option d) is incorrect. You incorrectly debited AOCI instead of crediting it for the adjustment to fair value.
2. MLF Inc. recently made a number of investments. The company’s accountant is not very familiar with the requirements of IFRS 9 and has asked for your guidance on how the recent acquisitions should be reported in the company’s financial statements.

i) Shares in GFF Inc.
MLF purchased 10,000 shares of GFF, a publicly traded company, for the express purpose of reselling them in the short term to make a trading profit.

ii) Shares in RPT Inc.
MLF purchased 30,000 shares of RPT, a publicly traded company, as a long-term, passive investment. The company owners have indicated that they would prefer that the company’s reported profit and loss not be affected by unrealized gains and losses on the investment.

iii) Bonds issued by JF Inc.
MLF purchased $5 million in bonds issued by JF due in 20 years. Interest is payable annually at 5%. MLF’s business model for this asset is to hold the investment to collect its contractual cash flows.

iv) Mortgages
MLF bought a portfolio of mortgages from a building society. The mortgages are due to be repaid over the next 15 to 20 years. Due to current economic conditions, the mortgages were acquired at a substantial discount to their book value. MLF intends to sell the mortgages for a profit when the underlying economic conditions improve. During the holding period, the company will receive principal and interest. MLF’s business model for this investment is to sell it at an opportune time while collecting contractual cash flows in the interim.

Required:

Explain how each of the financial assets should be reported in MLF’s financial statements.

Solution

CPA Way step: Conclude and Advise

i) Shares in GFF Inc.
This investment must be reported at FVPL. Given that the shares are a held-for-trading investment in equity instruments, the option to irrevocably designate them as FVOCI–elect is not applicable.

ii) Shares in RPT Inc.
This investment could be reported at FVPL or irrevocably designated as FVOCI–elect. Reporting the investment at FVOCI–elect is likely more appropriate, given the owners’ preference that MLF’s reported profit or loss not be affected by unrealized holding gains or losses on the investment.
iii) Bonds issued by JF Inc.
This investment should be reported at amortized cost, as this is in keeping with the objectives of MLF’s business model. Also, the cash inflows pertain solely to the payment of principal and interest.

iv) Mortgages
This investment should be reported at FVOCI, as this is in keeping with the objectives of MLF’s business model. The current business model of MLF is to receive the contractual cash inflows, which pertain solely to the payment of principal and interest, and selling the investment at an opportune time.
PART 6

Statement of cash flows

The purpose of the statement of cash flows (SCF) is to illustrate a business’s capacity to generate cash and its need for cash resources. More simply put, it shows how the entity is generating its cash, if it needs additional cash, and what sources (through debt or equity) it is getting its cash from. It is important to understand the cash inflows and outflows of an entity because proper management of cash flows is a critical success factor for companies — cash pays the bills, not net income. IAS 7 Statement of Cash Flows sets out the requirements for presentation and disclosure of cash flow information.

An SCF reconciles the beginning cash and cash equivalents balance to the ending balance. Cash includes cash on hand and demand deposits. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash.

Cash flows arise from three types of activities:

- **Operating activities**: These are cash flows that arise from the normal day-to-day operations of the business. For example, a pizza restaurant’s operating cash flows would include cash received from selling the pizzas and monies paid for supplies, rent and so on.

- **Investing activities**: These are cash flows that are expended and received from the purchase and sale of the infrastructure necessary to run the business. Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents — for example, the purchase of a pizza oven and the sale of a delivery vehicle.

- **Financing activities**: These are cash inflows and outflows of monies due to creditors and owners. Examples include proceeds raised from the issuance of shares and the repayment of long-term debt. It should be noted that while accounts payable are monies due to suppliers, they arise due to day-to-day activities. As such, accounts payable are considered an operating activity, not a financing activity.

**Classification of dividends and interest**: Entities have a choice when classifying cash flows from interest and dividends received and paid. The receipt of interest and dividends is either an operating or an investing activity. The payment of interest and dividends is either an operating or a financing activity.

**Non-cash transactions**: Not all transactions involve cash flows. IAS 7 states that investing and financing activities that do not involve cash are not reported on the SCF, but the transactions are still disclosed in the notes to the financial statements. For example, a stock split would increase the outstanding shares in a company, but this transaction does not affect cash in any way, so would not be reported on the SCF.
Direct and indirect method of presentation

Under IAS 7, an entity can use one of two methods when preparing the SCF: the direct method or the indirect method. The difference between the two methods is in how the operating activities section of the statement is prepared. The two methods are similar in that they achieve the same end result (reconciliation of changes in cash balances), but the presentation of the reconciliation is quite different. Both methods are IFRS-compliant; however, the indirect method is more commonly seen in practice.

To summarize:
- For operating activities, either the direct or indirect method can be used. (This document will focus primarily on the indirect method as this is most consistent with past and current Canadian practice.)
- For investing and financing activities, the investing and financing sections are exactly the same under both the direct and indirect method.

Preparing an SCF

The process of preparing the SCF involves making adjustments to convert the company’s accrual-based income statement to a cash-based statement. The change in cash (the difference between the beginning and ending cash balances) can be explained by analyzing the change in the items on the statement of financial position.

To understand the logic of the preparation of the SCF, consider the following:
- Assets = Liabilities + Equity
- Cash + Non-cash assets = Liabilities + Equity
- Cash = Liabilities + Equity – Non-cash assets
- \( \Delta \text{Cash} = \Delta \text{Liabilities} + \Delta \text{Equity} - \Delta \text{Non-cash assets} \) (where \( \Delta \) = change in)

As a result, the change in cash is explained by analyzing the changes in all the other balance sheet accounts.

In order to complete an SCF, the following information is needed:
- the entity’s statement of comprehensive income for the period
- the entity’s comparative statement of financial position
- select transaction data

Using this information, and following the indirect method, the starting point for the operating activities section of the SCF is profit or loss (not including OCI). Adjustments are made for the following:
- Non-operating items such as interest expense or dividends, which may be included elsewhere on the SCF
• Non-cash items:
  o Accounting adjustments such as depreciation, amortization of intangible assets and gain/loss on sale of assets
    ▪ These are non-cash items in that the amount on the statement of comprehensive income does not represent cash received or paid. As such, in completing a reconciliation of the changes in the cash balances for the year, these amounts need to be removed from net income.
    ▪ A gain or loss on the sale of an asset is a blend of cash flows and the net book value of the asset. Proceeds are a cash inflow and added to cash flows from investing activities; there should be no impact on operating activities. The gain or loss reported on the statement of comprehensive income must be removed by either deducting the gain that was reported or adding back the loss that was deducted.

• Working capital movements, such as changes in receivables, payables, inventories, accruals and prepayments
  o These must be added to or deducted from net income because they affect the cash inflows and outflows.

Here are some tips to help remember the impact of a transaction and its required adjustment on the SCF when analyzing working capital movements:

• Increases/decreases in assets have the opposite impact on cash flow from operating activities. So if current assets increase (for example, if there is an increase in the inventory balances), there is a deduction from net income to arrive at the proper cash flow. The cash used to purchase the additional inventory (current asset increase) has not been included in COGS (deduction from net income), so the increase in inventory is deducted from net income to arrive at the cash flow from operating activities.
  o A common area of confusion with this is when there is an increase to accounts receivable and how this results in a deduction when calculating operating cash flows. Sales revenue is included in the calculation of net income when the items are sold, but if accounts receivable are increasing, the cash has not yet been received for this increased amount. The deduction from net income is to remove the increase in accounts receivable from sales and profit.

• Increases/decreases in operating liabilities have a parallel impact on cash flow from operating activities. For example, when there is an increase in liabilities (an increase in trade payables in the liabilities section), the expense has been deducted from net income, but there has been no cash outflow. The increase in payables is added to net income to add back these unpaid amounts.

To summarize:
• Increase in current asset → Deduct from net income → Less cash from operating activities
• Decrease in current asset → Increase to net income → More cash from operating activities
• Increase in current liability → Increase to net income → More cash from operating activities
• Decrease in current liability → Decrease to net income → Less cash from operating activities

The following example focuses on the use of the indirect method in preparing the operating activities portion of the SCF, as this is one of the more complex areas in preparing the SCF. The investing and financing sections of the SCF will be covered in detail during the course.

**XYZ Inc.**

**Statement of comprehensive income**

For the year ended December 31, 20X5

| Revenue | $18,000 |
| Cost of sales | (11,700) |
| Gross profit | 6,300 |
| Distribution and administrative expenses | (3,500) |
| Interest expense | (200) |
| Depreciation expense | (400) |
| Operating income | 2,200 |
| Gain on sale of equipment | 100 |
| Net income before income taxes | 2,300 |
| Income tax expense | (300) |
| Net income | $2,000 |

**XYZ Inc.**

**Statement of financial position (exacts)**

As at December 31

| 20X5 | 20X4 |
| Current assets |  |
| Accounts receivable | $4,500 | $3,900 |
| Current liabilities |  |
| Accounts payable | $2,700 | $1,800 |
| Interest payable | 825 | 1,000 |

Select transaction data for XYZ:

• During the year, XYZ received $60 in cash dividends.

• Dividends received and interest paid are classified as operating activities.

Using the information above, the starting point is net income. Adjustments need to be made to net income to convert the company's accrual-based income statement to a cash-based statement. Adjustments are made for non-operating items, non-cash items and changes to current assets and liabilities that are operating activities.
INDIRECT METHOD

XYZ Inc.
Statement of cash flows (partial)
For the year ended December 31, 20X5

Cash flow from operating activities
Net income $2,000
Adjustments for:
  Depreciation 400
  Gain on sale of equipment (100)
  Dividend income1  (60)
  Interest expense 200
Subtotal 2,440
Increase in accounts receivable (600)
Increase in accounts payable 900
Cash generated from operating activities 2,740
Dividends received2 60
Interest paid [($200 – ($825 – $1,000))]3 (375)
Net cash from operating activities $2,425

1 The sale itself is an investing activity because it relates to the sale of equipment required to run the business; it is not an operating activity. The gain on the sale is an accounting adjustment that is considered a non-cash item.

2 The dividends received must be deducted from net income and are added back after cash generated from operating activities because IFRS requires that dividends (and interest) paid must be separately disclosed.

3 Interest expense is $200, but the decrease in interest payable means that $375 of cash was paid for interest.

Practice questions

1. Multiple-choice questions:
   i. Which of the following transactions would be classified as a financing activity?
      a) The purchase of machinery with cash
      b) Payment of cash to suppliers for the purchase of inventory
      c) The receipt of cash dividends
      d) Cash proceeds from the issuance of shares of the entity
Solution

Option d) is correct. Issuance of shares is a financing activity because the entity is engaging in a transaction to raise (cash) capital for the organization.

Option a) is incorrect. The purchase of machinery is classified as an investing activity because the machinery is infrastructure necessary to run the business.

Option b) is incorrect. Payment to suppliers for inventory is classified as an operating activity because inventory is used in day-to-day operations.

Option c) is incorrect. The receipt of dividends can be classified as an operating or an investing activity, but is not considered a financing activity.

ii. Presented below are the transactions of Absolute Inc. that occurred during 20X3, after reporting net income of $32,000:

- A tract of land was purchased for $18,000 cash.
- Long-term notes payable in the amount of $27,800 were paid off in cash.
- Inventory decreased from $110,000 to $95,000.
- Accounts payable increased by $26,000.
- Accounts receivable increased by $56,000.
- Depreciation expense of $25,000 was recorded.

What would be the net increase or decrease in cash from operating activities reported on the SCF for the year ended December 31, 20X3?

a) $3,800 decrease  
b) $10,000 increase  
c) $42,000 increase  
d) $102,000 increase

Solution

Option c) is correct. The increase in operating activities reported on the SCF would be as follows:

Net income earned $32,000  
Add back depreciation 25,000  
Decrease in inventory 15,000  
Increase in accounts payable 26,000  
Increase in accounts receivable (56,000)  
Increase (decrease) in cash from operating activities $42,000
Option a) is incorrect. This calculation includes all transactions as operating activities:

Net income earned $32,000
Add back depreciation 25,000
Decrease in inventory 15,000
Increase in accounts payable 26,000
Increase in accounts receivable (56,000)
Retirement of long-term payable (27,800)
Purchase of land (18,000)
Increase (decrease) in cash from operating activities $ (3,800)

Option b) is incorrect. This calculation omits net income as the starting point:

Add depreciation $25,000
Decrease in inventory 15,000
Increase in accounts payable 26,000
Increase in accounts receivable (56,000)
Increase (decrease) in cash from operating activities $10,000

Option d) is incorrect. This calculation deducts accounts payable and adds accounts receivable:

Net income earned $32,000
Add back depreciation 25,000
Decrease in inventory 15,000
Increase in accounts payable (26,000)
Increase in accounts receivable 56,000
Increase (decrease) in cash from operating activities $102,000

2. Globex Corp.’s accounting policy is to report all cash flows arising from interest and dividends in the operating activities section of the SCF. Globex’s activities for the year ended December 31, 20X5, included the following:

- Net income for 20X5 totalled $415,000.
- Accounts payable decreased by $26,000 in 20X5.
- A $15,000 investment classified at amortized cost matured during the year.
- Inventory decreased by $13,000 during the year.
- Interest revenue for the period was $8,000. The interest receivable account increased by $6,000.
- A $20,000 cash dividend was declared and paid.
- An investment was sold at its book value for $6,000.
- Prepaid expenses increased by $4,000 during the year.
• Depreciation expense for the year was $23,000.
• $85,000 was paid to acquire shares.

**Required:**

Prepare the cash flows from the operating activities section of the December 31, 20X5, SCF for Globex using the indirect method.

**Solution**

**Globex Corp.**  
**Statement of cash flows (partial)**  
**Year ended December 31, 20X5**

Cash flows from operating activities
- Net income $415,000
- Adjustments for:
  - Depreciation 23,000
  - Decrease in inventory 13,000
  - Increase in prepaid expenses (4,000)
  - Decrease in accounts payable (26,000)
  - Interest income (8,000)
- Cash generated from operating activities 413,000
- Interest received ($8,000 – $6,000)* 2,000
- Dividends paid (20,000)
- Net cash from operations $395,000

*There was $8,000 of revenue received, but the increase in interest receivable means that only $2,000 of cash in interest was received.*