Eighth Edition

MODERN ADVANCED ACCOUNTING IN CANADA

HILTON HERAUF

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8TH EDITION

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Carleton University

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McGraw Hill Education

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Darrell Herauf, CPA, CA, CGA

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Chapter 3 describes three forms of business combinations. The definition of control is discussed and used as the criterion for preparation of consolidated financial statements. The direct and working paper methods are used to illustrate the acquisition method of accounting for a business combination. The new entity method is mentioned as an alternative method of accounting for business combinations for future consideration. Reverse takeovers are covered in an appendix.

Chapter 4 examines the preparation of consolidated financial statements for non–wholly owned subsidiaries at the date of acquisition. The direct method is used in the body of the chapter and the working paper method is used in the appendix. Four theories of consolidation are mentioned, three of which are illustrated. All four are currently or have recently been required under Canadian GAAP. Accounting for contingent consideration and bargain purchases are also illustrated.

Chapter 5 covers the preparation of consolidated financial statements subsequent to the date of acquisition when the parent uses the cost method in its internal records. The amortization and impairment of the acquisition differential is explained and illustrated, including an application of the effective interest method. Appendix A provides an enhanced discussion of goodwill impairment. The parent's journal entries under the equity method are summarized. Ten basic steps in the preparation of consolidated statements are introduced, forming the foundation for the consolidation topics in the chapters that follow. The direct approach is used in the body of the chapter. Appendix B illustrates the working paper approach for the same examples used throughout the chapter.

Chapter 6 discusses and illustrates the accounting for intercompany revenues and expenses, as well as intercompany unrealized profits or losses in inventory and land. The revenue recognition, matching, and historical cost principles are used to explain the rationale for consolidation adjustments associated with the holdback and realization of intercompany profits. The consolidation adjustments when the entities use the revaluation model for reporting land are described in the appendix.

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Chapter 11 concludes the foreign currency portion of the text by examining and illustrating the translation and subsequent consolidation of subsidiaries whose functional currencies are the same as the parent's and whose functional currencies are not the same as the parent's functional currency. The reporting of exchange gains and losses in other comprehensive income is also illustrated. The chapter concludes with two self-study problems on the translation of a foreign operation under the two translation methods and the preparation of consolidated financial statements after translating the foreign operations.

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CHAPTER 1

Conceptual and Case Analysis Frameworks for Financial Reporting

LEARNING OBJECTIVES

After studying this chapter, you should be able to do the following:

LO1 Describe and apply the conceptual framework for financial reporting.

LO2 Describe how accounting standards in Canada are tailored to different types of organizations.

LO3 Identify some of the differences between IFRS and ASPE.

LO4 Analyze and interpret financial statements to assess the impact of different accounting methods on key financial statement ratios.

LO5 (Appendix 1A) Apply the case analysis framework to solve accounting and reporting issues.

Introduction

Welcome to advanced accounting. We wish you a prosperous learning experience. We will study three major accounting topics: consolidations, foreign currency transactions and operations, and not-for-profit and government organizations. The topics are presented and illustrated in accordance with the generally accepted accounting principles (GAAP) that are expected to be in effect in Canada as of January 1, 2017. You may have had some exposure to these topics in your previous accounting courses. We will build on this prior knowledge while we develop a thorough understanding of these selected topics.

Prior to 2008, the study of accounting principles in Canada focused on made-in-Canada accounting standards and involved very little, if any, thought or discussion of accounting standards in other parts of the world. Since then, Canada has adopted International Financial Reporting Standards (IFRS) for public companies and has separate sections in the *CPA Canada Handbook* for public companies, private companies, not-for-profit organizations, and pension plans. The changes in reporting standards were due to the globalization of economic activity. Canadian companies now view the entire world as their marketplace. Not only are they exporting their products to more countries than ever before, but they are also establishing factories and offices in foreign locations. Companies that used to raise capital strictly in their home countries are now finding that capital markets are available to them around the world. Many accounting firms have offices throughout the world, and there are abundant opportunities for their Canadian staff members to transfer to these offices.

Canadian companies are now able to raise capital resources in the world's marketplace.

In this chapter, we will begin by reviewing the conceptual framework for financial reporting. We will then describe and apply a framework for analyzing financial reporting cases. We will close by analyzing the impact of different financial reporting methods on key ratios in a company's financial statements.

LO1 THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

Professional accountants provide a variety of services ranging from accounting to tax planning to assurance to business consulting. In this course, we will focus on financial accounting—that is, providing general-purpose financial information to external users such as investors and creditors. These users usually have limited financial resources to invest in an entity. Users wish to invest where they can earn the highest return with the lowest amount of risk. The general-purpose set of financial statements (balance sheet, income statement, statement of changes in equity, cash flow statement, and notes to the financial statements) will be used by the external users to help them make their resource allocation decisions and to assess the stewardship of management. The general-purpose reports are not the only source of information used for decision making but provide a good starting point.

Cautionary Note: *The titles of the financial statements in International Accounting Standard (IAS) 1 are the recommended titles, but not mandatory. Many Canadian companies now use and will likely continue to use the titles* balance sheet *(rather than* statement of financial position*) and* income statement *(rather than* statement of profit or loss*). In this textbook, we will use both sets of titles. We will also vary the ordering of assets, liabilities, and shareholders' equity. In some cases, current assets will appear first and shareholders' equity will appear last. In other cases, long-term assets will be followed by current assets and shareholders' equity will precede liabilities on the credit side of the statement of financial position. Both formats are acceptable under IAS 1. In the problems and illustrations that do not involve other comprehensive income (OCI), we will focus only on the statement of profit or loss (i.e., the income statement) rather than the statement of comprehensive income, and on preparing a statement of retained earnings rather than preparing a complete statement of changes in equity.*

In most cases, users want to receive the general-purpose financial statements prepared in accordance with generally accepted accounting principles (GAAP) because by following these principles the information is made relevant, reliable, understandable, and comparable. However, there are times when users may want or require special-purpose financial reports that do not follow GAAP. For example, entities may need to prepare non-GAAP-based statements for legislative or regulatory purposes or for contract compliance. Or a prospective lender may want to receive a balance sheet with assets reported at fair value rather than historical cost. As accountants, we are able to provide financial information in a variety of formats or using a variety of accounting policies, because we have the skills and abilities to produce this information. If we do provide fair-value-based financial statements, we cannot say that the statements were prepared in accordance with GAAP. We would simply state that the statements were prepared in accordance with the policies described in the notes to the financial statements.

GAAP encompass broad principles and conventions of general application, as well as rules and procedures that determine accepted accounting practices at a particular time. The process of developing GAAP is political. Both preparers and users of financial statements have an opportunity to comment on a proposal for a new accounting standard before it becomes generally accepted. If a new requirement is preferred by the preparers but not accepted by users, it is unlikely to become part of GAAP. Therefore, as we study existing accounting practices and proposed changes, we need to continually evaluate whether information provided by a reporting entity will satisfy users' needs.

> *Financial statements should cater to the needs of the users.*

In most cases, the users of the financial statements have access to information about the entity in addition to that provided in the financial statements. For example, the owner of a private company may also be the manager and would have intimate knowledge of the company. In such cases, the owner/manager may place less reliance on the financial statements than outside investors in public companies do. In other situations, the owner may not understand the financial reporting for complex transactions such as business combinations. In both of these situations, the owners may feel that the costs of complying with some of the complex sections of the *Handbook* are not worth the benefit. They may prefer to issue more simplified statements. The Chartered Professional Accountants of Canada (CPA Canada) recognized this difference in users' needs. In 2011, the *Handbook* was reorganized and is now segregated into different parts for different types of organizations.

> *The* Handbook *is divided into different parts to cater to different types of reporting entities.*

The *CPA Canada Handbook* is an authoritative document in Canada because many legal statutes require its use. For example, companies incorporated under the *Canada Business Corporations Act* and certain provincial "Companies Acts" are required to prepare financial statements in accordance with the *CPA Canada Handbook*. Publicly traded companies are required to submit financial statements that comply with GAAP to the securities commissions under which they are registered.

The *CPA Canada Handbook* provides the accounting and reporting requirements as well as explanations and guidance for most transactions and events encountered by an entity. When an entity following IFRS encounters transactions or events not explicitly addressed by the standards, it should adopt accounting practices consistent with the spirit of the standards and consistent with financial statement concepts. These concepts are described in the "The Conceptual Framework for Financial Reporting," a document found just prior to IFRS in Part I of the *Handbook*. Entities reporting under Accounting Standards for Private Enterprises (ASPE) should adopt accounting practices consistent with Section 1000 *Financial Statement Concepts* in Part II of the *Handbook*.

The *financial statement concepts* describe the principles and assumptions underlying the preparation of financial statements. They are very important parts of GAAP, because they provide the framework for the development and issuance of other financial accounting standards. The main items included in this document are as follows:

- The objective of general-purpose financial reporting
- Qualitative characteristics of useful financial information
- Underlying assumptions
- Definition, recognition, and measurement of the elements of financial statements

You will probably recognize most of the concepts and remember studying them in your intermediate accounting courses. If you can explain the accounting practices learned there in terms of these basic concepts, you should have no trouble applying these concepts in the new situations we will encounter in this course. If you do not understand or cannot explain accounting requirements in terms of these basic concepts, it is never too late. As you study the accounting requirements in this course, try to understand them in terms of the basic concepts and principles the *Handbook* describes.

All accounting practices should be able to be traced back to and supported by the conceptual framework.

By gaining a broad understanding of the logic and basic principles behind the accounting requirements, you will develop confidence and be able to apply these basic principles in a wide variety of situations. Rather than simply accepting accounting practices or memorizing specific requirements in the *Handbook,* you will begin to understand the logic of the requirements and evaluate whether these are consistent with the basic financial statement concepts. You will soon realize that most of the requirements in accounting can be understood, developed, and derived from these basic principles and concepts. Then, in turn, you will be able to use professional judgment to apply these principles to whatever situation you may encounter.

Professional Judgment

Judgment is the ability to make a decision in situations in which the answer is not clear-cut. Professional judgment is the ability to make decisions for issues encountered by professionals in carrying out their day-to-day responsibilities. It is a skill developed over many years of studying and learning from one's experiences. It is not learned by memorization of requirements or answers to certain problems. It often involves choices between meaningful alternatives and the ability to understand the consequences of one's actions.

Lots of judgment is involved when preparing financial statements.

In the preparation of financial statements, judgment needs to be applied in three main areas. First, accounting policies such as when to recognize revenue and whether to consolidate a special-purpose entity involve making a decision after considering various methods. The method adopted for a particular company must be appropriate for that company on the basis of its existing situation. For example, if Company A is selling to customers with poor credit histories and without obtaining security for the receivables from these customers, it is appropriate to recognize revenue when cash is received. If competitors are selling to customers with very high credit ratings, it is appropriate for them to recognize revenue when the goods are delivered. The professional judgment of an accountant will take these factors into consideration and recognize that although one method might be appropriate for the competitors, another might be more appropriate for Company A.

Second, judgment is involved in making accounting estimates of many kinds. What is the estimated useful life of property, plant, and equipment? What is the recoverable amount for goodwill? Will a forward contract be effective as a hedge of expected sales for the next three years? The answers to these questions are not clearly defined. In the classroom, we are usually provided with this information, but in the real world we must gather data and make our own assessment. Whether we feel that the company can continue as a going concern or not would likely have a material impact on the valuation of goodwill and the bottom line on the income statement.

> *Judgment is involved when adopting accounting policies, making estimates, and writing the notes to the financial statements.*

Third, judgment is involved in deciding what to disclose and how to disclose it in the notes to the financial statements. For example, in disclosing a contingent liability resulting from a lawsuit, the company might simply say that it has been sued but no provision is made in the financial statements because it feels that the lawsuit has no merit; or it might provide details of the lawsuit and give some probabilities of different outcomes in the note.

Is there too much latitude in accounting? Do the financial statements ever portray the complete facts? One could argue that there is no latitude because accountants are not free to randomly select any reporting method. They must represent faithfully what really happened and what really exists using the generally accepted conceptual framework. If the revenue has been earned, then the revenue should be recognized. If the expenditure will provide a future benefit, then the cost of the expenditure should be recognized as an asset. Latitude is necessary so that the accountant can choose the accounting treatment to reflect the real situation. If the requirements are written too rigidly, companies may be forced to use methods that do not reflect their own situations.

> *Financial statements should present what really happened during the period: that is, they should tell it how it is.*

If accountants take their jobs seriously and have high ethical standards, they will present the financial statements as reliably as possible by using appropriate accounting policies, by making the best estimates possible, and by making honest and forthright statements in the notes to the financial statements. They will use judgment to fairly present the financial position and financial performance of the entity. Otherwise, the individual accountants and the entire accounting profession will lose credibility.

In this course, we will have an opportunity to develop our judgment skills and to exercise judgment through the use of cases. The cases provide realistic scenarios where conflicts exist and choices must be made. As we have indicated, the answers are not usually clear-cut. In fact, different valid answers can be defended. For these cases, it is how you support your recommendation that is important, as opposed to what your final recommendation is. You will need to apply basic principles and use judgment to come up with an answer that "tells it how it is" as accurately as possible. In so doing, you will be developing the skills required of a professional accountant. See Appendix 1A for a discussion and illustration of a generic approach for analyzing and solving a case with issues in the domain of the aspiring accountant.

LO2 ACCOUNTING STANDARDS IN CANADA

The *CPA Canada Handbook* contains five parts as follows:

Part #	*Applicable To:*	*Name for Standards*
I	Publicly accountable entities	IFRS
II	Private enterprises	ASPE
III	Not-for-profit organizations	
IV	Pension plans	
V	All entities not yet using other parts	Pre-changeover GAAP

The next few sections describe a bit of the history behind the development of different standards for different entities and the choices available for these entities in applying the different parts of the *CPA Canada Handbook*.

GAAP FOR PUBLICLY ACCOUNTABLE ENTERPRISES Public companies seemed to be moving toward American accounting standards when in 1998 the CPA Canada announced that it would work with the Financial Accounting Standards Board (FASB) to harmonize the accounting standards of the United States and Canada, at the same time encouraging the International Accounting Standards Board (IASB) in its efforts to develop global accounting standards.

At one time, Canada intended to harmonize its standards with those of the United States.

The concept of harmonization would probably have proven to be a fairly difficult one, because Canadian accounting standards tend to be broad-based while American standards tend to be based on detailed rules. This problem was alleviated when the CPA Canada's position changed in 2006 with the announcement of the adoption of a strategic plan that would see the harmonization of the *CPA Canada Handbook* with IFRS for *publicly accountable enterprises*. A publicly accountable enterprise (PAE) is defined as an entity other than a not-for-profit organization or a government or another entity in the public sector that

(i) has issued, or is in the process of issuing, debt or equity instruments that are, or will be, outstanding and traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets), or

(ii) holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses.

Canadian publicly accountable enterprises had to report under IFRS starting in 2011.

Banks, credit unions, insurance companies, securities brokers or dealers, mutual funds, and investment banks typically meet the second of these criteria. Other entities may also hold assets in a fiduciary capacity for a broad group of outsiders, because they hold and manage financial resources entrusted to them by clients, customers, or members not involved in the management of the entity. However, if an entity does so for reasons incidental to one of its primary businesses (as, for example, may be the case for some travel or real estate agents, or cooperative enterprises requiring a nominal membership deposit), it is not considered publicly accountable.

Harmonization was chosen instead of the simple adoption of the international standards because security regulations and federal and provincial Companies Acts require financial reporting to be in accordance with Canadian GAAP. Because of this requirement, Part I of the *CPA Canada Handbook* now contains standards that are the same as IFRS. Rather than always referring to Part I of the *Handbook*, we will simply refer to IFRS. Commencing in 2011, Canadian publicly accountable enterprises had to report under IFRS.

Part I of the CPA Canada Handbook *contains IFRS.*

The IFRSs were quite similar to Canadian standards prior to the adoption of the international standards, because they are based on similar conceptual frameworks and reach similar conclusions. However, there were many differences in the detailed requirements. IFRS often allow for optional treatments and in some instances allow or require the use of fair values in financial statement measurements, whereas Canadian standards did not often allow optional treatments and tended to require more historical cost measurements.

IFRS allows the use of fair values and optional treatments to a greater degree than pre-changeover Canadian GAAP (Part V of the CPA Canada Handbook).

GAAP FOR PRIVATE ENTERPRISES In the 1970s, there was considerable discussion in Canada of Big GAAP versus Little GAAP. The question was: Should there be different standards for big companies and little companies?

It was argued that accounting standards were becoming increasingly complex and that a small company's costs of preparing its financial statements in compliance with the standards were greater than the benefits received by the users of such statements. Hence, small companies should be granted some sort of relief from having to use complex and hard-to-understand standards. Counterarguments suggested that the concept of fair presentation and comparability could not be achieved with different sets of standards, and the dividing line between big and small would be too arbitrary to be useful. After much study and discussion, the concept of Big GAAP/Little GAAP was abandoned.

The cost-benefit constraint is used when determining whether a private enterprise can use simpler reporting methods.

In the meantime, the issuance of new, complex financial reporting standards continued, and the last straw, so to speak, was the issuance of both the section on presentation and disclosure of financial instruments and the exposure draft on the related measurement issues in the early 1990s. The issue of different standards was revisited by a CPA Canada task force, but this time in relation to public versus non-public companies. The task force considered two basic approaches:

- A non-GAAP approach whereby non-public companies could use accounting policies completely separate from GAAP. An example is the use of cash-basis reporting instead of the required accrual basis. This approach was abandoned mainly because provincial and federal Companies Acts require companies to prepare financial statements in accordance with the *CPA Canada Handbook*.
- A GAAP approach. This was looked at from two perspectives: full differentiation and partial differentiation. Full differentiation would encompass two distinct sets of GAAP, somewhat similar to the accounting for non-profit organizations and governments (discussed in Chapter 12). Partial differentiation encompasses one set of accounting standards with different treatments. This latter approach was adopted in 2002 when Section 1300 *Differential Reporting* was issued and certain sections of the *CPA Canada Handbook* were amended to allow optional treatments.

Companies were following GAAP when they adopted differential reporting options.

Section 1300 allowed a qualifying enterprise to select which reporting options it would apply when it prepared its financial statements. The differential reporting options allowed were contained in individual *Handbook* sections, and only a few sections contained such options.