Req. 1

The client should probably be preparing general purpose financial statements because it appears to fall under one of the three criteria stated in SAC 1 (separation of ownership from management, economic influence and size) for determining what is a 'reporting entity'; namely it is of large size. This is likely to mean that a significant number of members of the general community will have an interest in, and be affected by, the entity’s activities.

The reporting entity concept is tied to the information needs of users. It is based on the idea of there being users who are dependent on general purpose financial reports for making decisions about the allocation of resources, so further information about the existence of such users would be highly relevant in this case. Those users could be creditors or potential creditors of the business, its suppliers, its employees and any trade union representatives, customers (especially if there were few if any other businesses supplying the same or similar services), government authorities (if, for example, the business was a major employer in its local area), and so on. These are the main types of users that are also described in the IASB Framework.

Req. 1

The Accounting Standards are somewhat ambivalent about the use of current (market) values. Inventories, for example, must be valued at the lower of cost and net realisable value and should not be written up even if their selling prices have increased. Non-current assets, however, may be revalued upwards in financial statements and must be written down if there has been any ‘impairment’ of their value. Assuming that the ‘carrying amount’ referred to in the question is based upon original cost then, looking at the qualitative characteristics of financial reports as set out in the AASB Framework, the choice of the best way of valuing assets (in terms of the usefulness of the information produced) is based upon trading off the principles of relevance and reliability.

If the City Netball Club was about to liquidate then the current value of assets would usually be more relevant and therefore more useful than the original cost less accumulated depreciation. The original cost figures would, however, normally be considered more objective and ‘reliable’ than current value. In this question, the club is presumably a going concern so that the relatively greater objectivity and reliability of the carrying amount may outweigh the possibly greater relevance of current value information and also be more consistent with the going concern and prudence (or conservatism) principles. However, others would argue for the regular updating of non-current asset valuations. Any decision to revalue assets in an upward direction to ‘fair’ value has to be in accordance with the relevant accounting standard (in this case AASB 116).
This question should make students think about the issues brought up at the end of the chapter relating to the use of market values in financial statements.

**Req. 1**

**Materiality**

Item a. clearly violates the requirement of comparability, and this change and its financial effects should be disclosed in the financial statements with the reason for the change being explained.

Item b. also does really violate the requirement though in practice it is accepted that different firms can and do use different accounting methods. However, each business must disclose the significant accounting policies and methods it adopts, especially where alternative methods are allowed by accounting standards.

Item c. is simply an instance of the application of the materiality principle and does not affect comparability.

Item d. again really does violate the comparability requirement even if this approach is consistently followed by that business. It is similar in this regard to item b. However, it is clearly in breach of the requirements of AASB 102 Inventories and so the practice should be changed. This would avoid any question of breaching the comparability requirement.

**Req. 1**

a. Accrue interest expense at 31 December, based on the *accounting period concept*:

\[
\text{Interest expense } (\$80\ 000 \times .08 \times 3/12) = 1\ 600 \\
\text{Interest payable } = 1\ 600
\]

b. The *accounting entity concept* requires excluding any personal property from the business books and financial statements. A lender, however, might well take these items into account when deciding on the loan request as the loan would likely be to Stan Golfball as an individual or otherwise be personally guaranteed by him. Nonetheless, they should not be included in the financial records of the business.

c. The assets could remain in the books at historical cost of $500 000 based on the *going concern assumption*. Alternatively, they could be revalued to their current value of $650 000 although the increase of $150 000 should be credited to a revaluation surplus account and not reported as a profit (in accordance
with AASB 116). In either case, however, the financial position of the business will need to be closely watched to see if the going concern assumption remains applicable.

(15 min.) E17-6

**Req. 1**

a. Prudence (or Conservatism)
b. Entity
c. Comparability
d. Cost—but whether it is violated depends upon the relevance of the market value.
e. Comparability

(10-15 min.) E17-8

**Req. 1**

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit as reported</td>
<td>$70 000</td>
<td>$52 000</td>
</tr>
<tr>
<td>Corrections for:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accrued salary expense</td>
<td>(4 800)</td>
<td>4 800</td>
</tr>
<tr>
<td>Accrued interest expense</td>
<td>(2 000)</td>
<td>2 000</td>
</tr>
<tr>
<td>Prepaid insurance</td>
<td></td>
<td>2 400</td>
</tr>
<tr>
<td>(2 400)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation expense</td>
<td></td>
<td>(1 800)</td>
</tr>
<tr>
<td>----</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Correct profit</td>
<td></td>
<td>$63 800</td>
</tr>
<tr>
<td>$56 400</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Req. 2**

Aunty's Knitting's profit decreased somewhat (11.6%) (calculated as 63 800 – 56 400 / 63 800). The reported figures indicated a much larger decrease in profit (25.7%) (calculated as 70 000 – 52 000 / 70 000).

(20-25 min.) P17-1

**Req. 1**

**Memo to: Management Committee**

**From:**

**Date:**

**Subject: Disclosure of change in accounting policy**

The basic objective of financial reporting is to provide information that is useful for making and evaluating decisions about the allocation of scarce resources. For example, investors and lenders need relevant information for making predictions about a business' operations and for comparing its actual performance with those predictions.
A change in accounting methods lessens the *comparability* of information from one period to the next. To help investors, lenders and other potential users of the financial statements, when comparing actual results with predicted amounts the business must *disclose* the effect on profit of any accounting changes. Only with this information can outsiders know how well the business is performing. Without this information, they can be led to think that profit was better or worse than a predicted amount when the real reason for the difference in profit was a change in accounting method.

**Req. 2**

A reasonable disclosure note for our accounting change could say:

‘During 20XX, the business changed from the first-in, first-out method to the average cost method for valuing inventory. This change decreased our reported profit for 20XX by [an assumed dollar amount]. The average cost method is a more conservative approach which results in a higher amount for cost of sales in a period of rapidly rising prices but it is believed that this better represents the pattern of usage of our inventory.’

By reporting the profit effect of the accounting change, an investor or lender can adjust the profit back to the basis previously used. This will enable them to compare predicted amounts with actual results and to compare the current year with previous years.

The accounting principles of Comparability and Prudence (or Conservatism) are particularly relevant here.

Student responses may vary.

**Req. 1**

a. Comparability
b. Profit recognition, Prudence
c. Materiality
d. Relevance
e. Cost
f. Relevance
g. Entity
h. Accounting period, Matching
i. Going concern, Matching
j. Reliability, Matching, Prudence