CHAPTER 2 ACCRUAL ACCOUNTING FRAMEWORK

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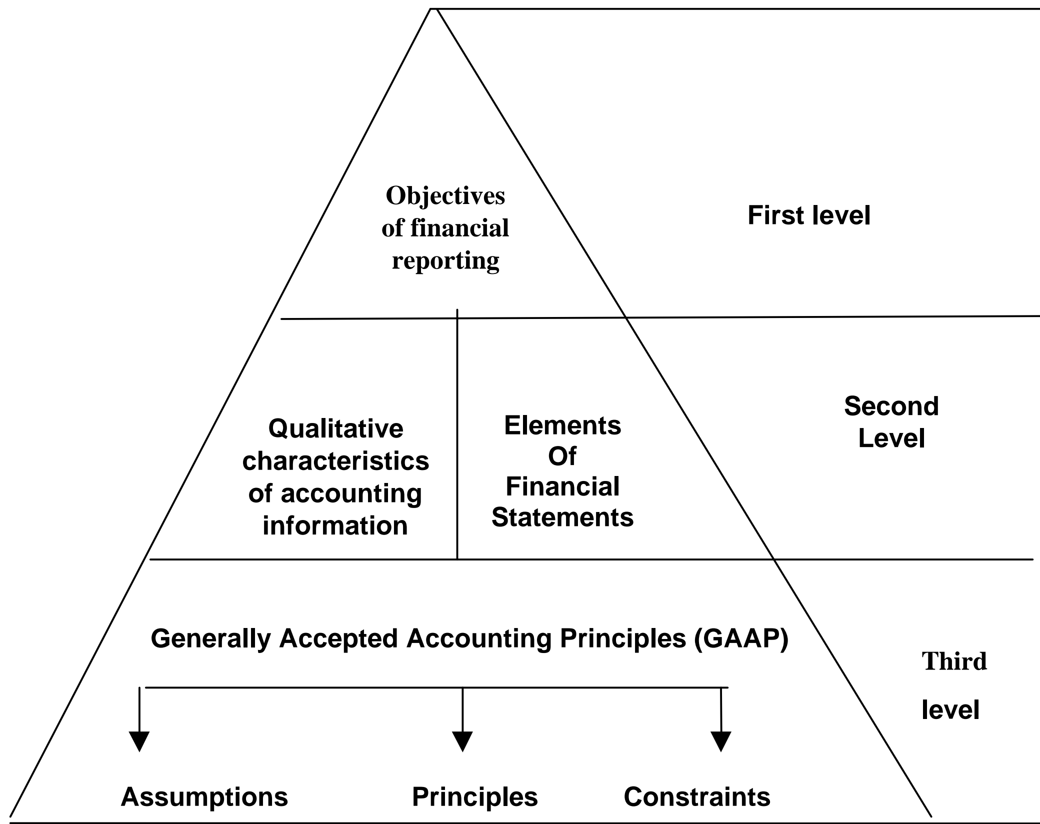
1. The Accrual Accounting Framework

As outlined in Treasury Board Accounting Standard 1.1 - Policy and Principles, Correctional Service Canada (CSC) will follow generally accepted accounting principles (GAAP) as defined in the Canadian Institute of Chartered Accountants Public Sector Accounting Board (PSAB) Handbook.

Specifically, departments will use the "expense basis" of accounting as referred to in the handbook (PS Section 1500.93) as opposed to past use of the expenditure basis of accounting. Subject to modifications or interpretations by the Treasury Board, the PSAB Handbook will be the authoritative reference manual. In situations where a specific item is not covered in the PSAB Handbook, then the Canadian Institute of Chartered Accountants (CICA) Handbook will be used.

2. The Conceptual Framework of Accounting

The entire process of accounting can be viewed from the conceptual framework. The framework attempts to summarize an organization's purpose behind accounting for economic events, as well as the factors to consider when doing so.



This conceptual framework is summarized in the above diagram. The first level sets out the objectives as described above, or *why* account for economic events in a particular way. The third level, recognition and measurement guidelines, provides guidance on *how* CSC employees should account for economic events. The second level, which incorporates both the qualitative characteristics of accounting information and the elements of financial statements, serves as a bridge or connection between these two levels.

3. Objectives of Financial Reporting

Two broad underlying objectives of accounting for CSC's economic events are as follows:

A. to provide relevant and understandable data concerning the financial affairs of the Department to external parties (e.g., the Government of Canada and the public); and
B. to provide relevant information for decision making to the management of the Department.

In an effort to provide such financial information, the departmental employees responsible for recording and reporting such information must be aware of and understand the basic accounting framework against which all economic events may be analyzed.

4. Qualitative Characteristics of Accounting Information

Choosing an acceptable accounting method, the amount and type of information to be disclosed, and the format in which the information is to be presented involves determining which of several alternatives provides the most useful information for decision-making purposes. To help distinguish the more useful information from the less useful information, the CICA Handbook identifies four qualitative characteristics that make information useful. They include the following:

- **decision usefulness** - provides no justification for accounting activity or a basis on which to assess the costs of providing reports; and is dependent on the extent to which there is an appropriate linkage between decision makers and their ability to understand financial information, recognizing that there are constraints on the information that can be provided;

- **understandability -** requires that users be capable of understanding the information as it was intended to be understood by the presenters of the information;

- **relevance** - present financial information when it can influence the decisions of users and contains predictive value (helps predict the outcome of events), feedback value (confirms or corrects prior expectations) and timeliness.

- **reliability** - the information is in agreement with the actual underlying transactions and events, is capable of independent verification, and is reasonably free from error or bias; and

- **comparability** - the information is measured and reported in a similar manner for different departments in a given year or for the same department in different years.

5. Elements of Financial Statements

The financial statements of all organizations contain the same basic elements, although they may be referred to under different terms in some cases. The basic elements of CSC's financial statements are as follows:

- Assets
- Liabilities
- Net Assets/Liabilities
- Revenues
- Expenses
- Gains
- Losses
- Net Results

Each of these elements will be examined throughout this accounting policy manual.

6. Generally Accepted Accounting Principles

Generally Accepted Accounting Principles are the broad rules of accounting developed and accepted by the accounting profession in conformity with the objectives of accounting, the fundamental underlying assumptions, principles and constraints.

While an item may meet the definition of an element of financial statements, it may not be recognized in the financial statements. Recognition means inclusion of an item in the financial statements and does not mean note disclosure in the notes to

the financial statements. Measurement is the process of determining the amount at which an item is recognized in the financial statements.

6.1 Assumptions

Assumptions are broad yet specific aspects of the total environment in which accounting normally operates, and they are of direct significance in relationship to the broad spectrum of the objectives of accounting.

6.1.1 Economic entity (separate entity) assumption

Accounting deals with specific and separate business entities. Each business is considered a separate accounting entity and distinct from its owners and other business entities. A department and the Canadian public are considered separate entities for accounting purposes. Under the Separate Entity assumption, all accounting records and reports are developed from the viewpoint of the particular entity. This assumption provides the basis for clear-cut differentiation of the transactions of the organization from those of its owners.

6.1.2 Going concern (continuity) assumption

The assumption of continuity, frequently called the going concern assumption, assumes that the business (organization) is not expected to liquidate in the foreseeable future. It does not imply that accounting assumes permanent life. Rather, there is a presumption of continuity for a period of time sufficient to carry out contemplated operations on a non-liquidation basis. The classification of assets and liabilities as current or long-term relies on this assumption. If continuity is not assumed then all assets and liabilities become current and the distinction between current and long term loses its significance. If an entity expects to be liquidated, then the assumption of continuity is inappropriate and all elements are accounted for on the basis of net realizable value.

6.1.3 Monetary unit assumption

The unit-of-measure assumption specifies that accounting should measure and report the results of economic activities of an entity in terms of a monetary unit such as the Canadian dollar. The assumption recognizes that the monetary unit is an effective means of communicating financial information, and being a common denominator, allows dissimilar things to be aggregated. During times of inflation or deflation dollars of different purchasing power are inter-mingled as if they were of equal purchasing power. The practice of ignoring the changes in purchasing power of the dollar assumes that fluctuations in the purchasing power of the monetary unit due to inflation are not material.

6.1.4 Periodicity assumption

While the results of operations of a specific business enterprise cannot be known with certainty until the business has completed its lifespan, regular financial reports are necessary because financial statement users need timely financial information. The business community and government have imposed a calendar constraint on accounting that requires assigning changes in the economic elements of an enterprise to a series of short time periods. The general time period assumption for accounting and reporting is one year. This assumption underlines the use of accruals and deferrals that distinguish accrual basis accounting from cash basis accounting. The financial statements of an enterprise bear dates that reflect the time period involved. The Balance Sheet is dated as of a particular date, such as March 31 for the year-end in the case of the Government of Canada. The Income Statement is dated for the calendar period covered, whether it is a month, quarter or year.

7. Principles

Principles are the broad rules of accounting and are not to be confused with procedures that describe how to apply the principle. In determining when and how to measure, record and report assets, liabilities, revenues and expenses, CSC employees must factor in each of the following principles.

7.1 Historical cost

Historical cost provides the basis for reporting consistent, objective and verifiable information in financial statements. Historical cost is based upon the principle that the actual cash or cash-equivalent cost be used for the initial accounting recognition; it is the amount recorded in the accounts and reported on the financial statements. Historical cost requires that transactions and events be recognized in financial statements at the amount of cash or cash equivalents paid or received, or the fair value ascribed to them when the transaction took place.

When non-cash consideration is involved, e.g. an asset is received as a gift or contribution in exchange for some other non-monetary asset, cost is measured as the market value of the resources given or market value of the item received whichever is the more reliable. When an asset is acquired in settlement of a debt, the cost should be determined as the present value of the future cash payments under the terms of the debt.

7.2 Revenue realization

The revenue principle requires that the accrual basis be used to recognize the realization of revenue. It specifies when the revenue should be recognized and reported in the financial statements, consistent with the recognition criteria. Revenue is recognized as earned, when the activity required before sale or transfer of ownership is complete – i.e. when goods are delivered or services are performed and substantially all risks and rewards of ownership have passed from the seller to the purchaser.

Revenue is measured as the market value of the resources received or the product or service given, whichever is the more reliably determinable. Under the revenue principle, revenue from the sale of goods or services is recognized when the earning process is complete and the purchaser takes possession. The earning process is defined as complete when collection from the purchaser is reasonably assured and there exist no unestimatable costs associated with the sale.

7.3 Matching

The matching principle is predicated on accrual basis accounting for revenue and expenses. Revenues for a given reporting period should be recognized in conformity with the revenue principle when the conditions for revenue recognition are met; that is, they are recognized as they are earned. Expenses incurred in earning the recognized revenue should be recognized in the same period, not just when they are paid or when they affect an appropriation.

Under the matching principle, if revenue is carried over from a prior period or deferred to a future period the expenses associated with earning such revenue should also be carried over or deferred. The following illustrates this principle: the cost of capital assets that are purchased to support the delivery of specific program outputs over some future period would be deferred and amortized over the lesser of life of the asset or duration of delivery of the program outputs.

This type of expense recognition involves making assumptions about the consumption of the asset deployed in the generation of associated revenues or delivery of program outputs. The cost of a capital asset is allocated over the accounting periods during which the asset is used because it is assumed that the asset contributes to the generation of program outputs throughout its useful life.
In general accounting literature, the matching principle normally refers to the matching of revenue and expenses. However, with minor exceptions, departments do not generate major amounts of non-tax revenue but are funded through appropriations. As such, the matching principle must take on a slightly different interpretation. Consequently, revenues should be recognized when the goods and/or services have been rendered and expenses should be matched to program delivery outputs of services to the public.

7.4 Full disclosure

The full disclosure principle requires that financial statements report all relevant information bearing on the economic affairs of a business enterprise. The objective of full disclosure is to provide external users of the financial statements with accounting information they need to make intelligent, informed decisions.

Full disclosure requires that:

- the accounting information reported be understandable and free from misleading statements or information that may lead the reader to make a wrong inference; and
- the major and special accounting policies used by the reporting organization are explained in the notes to the financial statements.

Furthermore, the full disclosure principle stipulates that the primary objective is to report the economic substance of a transaction, rather than its form.

7.5 Consistency

Consistency involves applying accounting constraints and assumptions in the same manner from one accounting period to the next. This is particularly important if users are to compare successive years' accounts, for example, to identify trends in revenue and expenses. There is a presumption that an accounting principle once applied should not change. Changes in accounting policies and practices should generally only be made when those changes will result in fairer presentations of financial results. While the need to change accounting principles is infrequent, circumstances nevertheless may arise where a change in accounting principle is desirable or required and notwithstanding the need for consistency changes are permitted. In order to provide a basis for comparison prior period statements would be restated under the new principle with explanatory notes.

8. Constraints

When deciding what information must be recorded and reported in order to make the financial statements useful to management and the public, CSC employees must consider several constraints. These constraints play a key role in CSC's decision to report financial information.

8.1 Cost-Benefit

Cost-benefit constraints often affect the reporting of accounting information. The underlying concept is that the benefit derived by specific users of information exceeds the cost of providing it. Benefits may include improved decision making by users (managers, other governments, parliament) of the financial information. Costs include the direct cost of gathering and reporting information and the indirect cost of the effect of decisions made by external users of the information on the operation of the business entity.

8.2 Materiality

This concept holds that items of small significance need not be accorded strict theoretical treatment. If CSC employees were to approach the process of accounting for departmental transactions from a strict theoretical point of view, accuracy and compliance are of utmost importance. Yet one must also consider the

practicalities of using this strict approach. The cost more of maintaining this high level of accuracy and compliance may actually exceed the benefit of doing so. As such, under the materiality concept, strict adherence to principle is not required where the accuracy of the financial statements is not significantly influenced.

Materiality is a term used to describe the significance of financial statement information to users. An item, or an aggregate of items, is material if it is probable that its omission or misstatement would influence or change a decision. In other words the inclusion or omission of an immaterial item or amount must not change or influence the decision of a rational decision-maker. It is difficult to provide firm guidelines to help judge when an item is or is not material because materiality depends on the relative size of the item compared to the size of other items and the nature of the item itself.

It is CSC policy to ensure that the materiality of all transactions is considered when preparing the Department's financial statements.

All material items are required to be disclosed in the financial statements of CSC. All items that could result in a material misstatement of the financial statements of CSC, either individually or cumulatively, shall be considered when preparing the financial statements.

The following criteria and characteristics shall be considered when applying the concept of materiality:

- **All items** that could result in a material misstatement of the financial statements of CSC , either individually or cumulatively, shall be considered when preparing the financial statements.

- **Quantitative Materiality** - The Auditor General of Canada normally uses 0.5% to 2% of total expenditures for purposes of calculating financial materiality.

- **Qualitative Materiality** - Examples of items that would be considered as qualitative materiality and, where these items would lead to a contingent liability, material loss of assets or a material loss of revenue, are:

  - unlawful activity;
  - fraud;
  - change to performance measures;
  - failure to comply with a regulatory requirement;
  - future materiality;
  - compliance with GAAP;
  - misstatement of segment information; and
  - Appropriations – everything is material.

- **Conformance** to the Canadian Institute of Chartered Accountants (CICA) and Public Sector Accounting Board (PSAB) handbooks provide accounting and financial reporting standards to be applied in external financial statement reporting.

- **Management Reporting** – managers make operational decisions and these decisions generally require a greater amount of information, in greater detail, than that provided by financial statements. Therefore, if the level of decision making is lower, the amount that would influence a decision is lower as well. Thus materiality amounts for management are lower than those for general purpose financial statements.

- **Transaction Level** – CSC must apply the concept of materiality when recording individual transactions. Materiality at a transaction level determines the timing of when a transaction is recorded, or the frequency of recording; and the classification of the elements of the transaction.

  Examples of timing and frequency of transaction recording include transactions for the purchase of goods and services. Theoretically these transactions should be recorded when the goods or services are received rather on receipt of an invoice. During the year CSC will accrue only those items in excess of $100,000, while at year-end CSC will follow the Receiver General (RG) PAYE limits for accruals.

  An example of the classification of transactions is prepaid expenses. In theory all prepaid items should be recorded as an asset and allocated to expense over the life of the prepaid. However, many such items, for example a two-year magazine subscription, would be too small to influence any decision and would be expensed in the year the prepaid is incurred.

- **Inventories** - With very few exceptions, the concept of materiality does not apply in recording and reporting on appropriations usage; all items are important.

  It should be noted that specific disclosures in annual financial statements required by legislation must be complied with regardless of the amounts involved.

  Care should be taken in reporting immaterial items since reporting them could otherwise impair the clarity and understandability of the financial statements and notes.

  In CSC, guidelines for materiality have been defined as follows:

  - Corporate Accounting in CSC is responsible for reviewing materiality of all items annually;

- all capital assets in excess of $10,000 shall be recorded as capital assets and disclosed on the Statement of Financial Position. The resulting amortization will be disclosed on the Statement of Operations;
- all Accounts Receivable shall be disclosed on the Statement of Financial Position;
- all material inventories shall recorded on the Statement of Financial Position;
- all Accounts Payable shall be disclosed in the Statement of Financial Position;
- monthly, accrued liabilities in excess of $100,000 shall be disclosed in the financial statements. At the year-end all Accrued liabilities that are within the PAYE limits will be disclosed in the financial statements;
- all material revenues and expenses will be disclosed in the Statement of Operations. The level of detail for disclosure will be as determined by the classifications in the Chart of Accounts;
- all material contingent liabilities shall be disclosed in the notes to the financial statements; and
- for Ex Gratia payments there is no materiality limit and all details are reported.

8.3 Substance over form

Financial statements should present the economic substance of transactions and events even though their legal form may suggest a different treatment. As such, departments must ensure that transactions and events affecting their entity are presented in the financial statements in a manner that is in agreement with the actual underlying transactions and events. Thus, transactions and events are accounted for and presented in a manner that conveys their substance rather than necessarily their legal or other form. The following example illustrates the application of substance over form:

- A lessee would be accounted for a capital lease in the same manner as he/she would account for the acquisition of an asset and the assumption of an obligation. This treatment is required since the lease transfers substantially all of the benefits and risks of ownership related to the leased property from the lessor to the lessee.

8.4 Industry peculiarities

The rigid application of a single standard accounting and reporting practice, regardless of the nature of the business of the reporting entity, may cause an inaccurate interpretation of the economic results of its operations. Because accounting focuses on usefulness, the peculiarities and practices of an industry may warrant selective exceptions to accounting principles and practices. This constraint permits special accounting for specific items, where there is a clear precedent in the industry based on uniqueness, usefulness, substance over form, and representational faithfulness.

Differences in accounting may occur due to specific legal or legislative requirements. This is especially applicable to organizations that are subject to significant and pervasive regulatory controls. When departures are made from generally accepted accounting principles, full disclosure of the rationale, nature and extent of the departure must be made in the notes to the financial statements.

8.5 Verifiability

Verifiability is required to ensure that a given piece of accounting information is what it purports to be. It is important that the source of information is correct and reliable. Verifiability requires that there must be an audit trail(s) back to the information source documents so that they may be checked for accuracy. This implies having alternative information sources available as backup.

9. Financial Statement Presentation and Disclosure

The notes to the financial statements will include statements of accounting policies. It is fundamental to the understanding and interpretation of general-purpose financial statements that those who use them are aware of the accounting policies on which they are based. Accounting policies typically contain a description of the reporting entity, any legislative requirements under which the financial statements are prepared, the basis of accounting, the measurement base and the detailed accounting policies and procedures used.