EXERCISE 23-1 (15-20 minutes)

(a) **Some examples of illegal acts (the violation of laws and regulations) may include:**
- **paying bribes or "kickbacks" to secure business for the entity**
- **criminal activities committed by the company or its employees on behalf of the company**
- **violations of laws and regulations that enter into the determination of financial statement amounts or disclosures, such as the tax laws**
- **violations of laws and regulations that have a fundamental effect on the entity's industry and its operations, such as violating pollution control and environmental laws for a chemical company.**

(b) **Generally, illegal acts, if detected by authorities, are likely to give rise to criminal penalties often including some form of financial liability. As a result, when an illegal act occurs and an accountant or auditor fails to detect it, a material liability may be omitted from the financial statements (as, arguably, all illegal acts are material). Another possibility is that the potential liability fails to satisfy the requirements of accrual, in which case note disclosure of the contingency will incorrectly be omitted from the financial statements. In addition, revenues and expenses derived from an illegal act, if material in relation to the financial statements, should be disclosed.**

(c) **Factors that could indicate that the inherent risk of violation of laws and regulations is greater than normal include the following:**
- **violations of laws and regulations by the entity in the current or previous years**
- **recent, well-publicized violations of laws and regulations by other companies in the industry**
- **laws and regulations that are new or unusually complex**
- **lack of experience on the part of management in interpreting or applying specific laws and regulations**
- **active monitoring by regulators or other groups**

EXERCISE 23-3 (20-25 minutes)

(a)

Maffin Corp.:

Building (net)	700	
Retained Earnings	100	
Contributed Surplus	200	
Cash		1,000

The transaction is not in the normal course of operations for the two companies and there is arguably no material change in the ownership interest in the building. The transaction would therefore be measured at its carrying amount.

The adjustment to contributed surplus / retained earnings is considered to be a capital payment by Maffin Corp. and a capital receipt by Grey Inc.

Grey Inc.:

Cash	1,000	
Contributed Surplus		300
Building (net)		700

(b)

Cash	1,100	
Gain on sale of building		400
Building (net)		700

A gain of $400 on sale of the building is recognized as income by Maffin Corp. It is not appropriate to reverse the original debit of $300 made to equity and recognize a gain in Grey Inc. now that Maffin Corp. has sold the building.

(c) If Maffin could purchase the building at an amount less than the carrying amount on Grey's financial statements, consideration should be given to whether the value of the building is impaired and should be written down in Grey's books prior to transfer at the reduced carrying amount.

EXERCISE 23-3 (Continued)

(d)

Maffin Corp.:

Building (net)	1,000	
Cash		1,000

The transaction is in the normal course of operations for the two companies and there is commercial substance. It is therefore appropriate for Grey to recognize a gain of $300. Maffin would record the building at the exchange amount.

Grey Inc.:

Cash	1,000	
Gain on sale of building		300
Building (net)		700

Maffin Corp. – Sale of building in 2012

Cash	1,100	
Gain on sale of building		100
Building (net)		1,000

EXERCISE 23-3 (Continued)

(e) Option 1: Transaction measured at carrying amount:

2011:	
Maffin Corp. – No impact on the income statement	**$ 0**
Grey Inc. – No impact on the income statement	**0**
2012:	
Maffin Corp. – Gain	**400**
Total income for 2011 and 2012	**$ 400**

Option 2: Transaction measured at exchange amount:

2011:	
Maffin Corp. – No impact on the income statement	**$ 0**
Grey Inc. – Gain of $300	**300**
2012:	
Maffin Corp. – Gain of $100	**100**
Total income for 2011 and 2012	**$ 400**

Regardless of the method used, the combined income for the consolidated reporting unit will be the same. The purchase and sale of the building between Maffin and Grey become cancelled in the process of eliminating intercompany balances. The transaction with the "unrelated" external party provides the objective measurement of the gain to the reporting unit.

Grey and, to the lesser extent, Maffin, however is required to report to certain of their users as separate reporting units. In this case, the measurement of intercompany transactions becomes important in accurately reflecting economic substance. We can see that under option two, a portion of the gain ($300) is earned by Grey and the remainder is earned by Maffin, whereas under option one, the entire amount of the gain is earned by Maffin. The method of reporting will have significant impact on the income of each company.

EXERCISE 23-6 (15-20 minutes)

1.	(a)	4.	(b)	7.	(c)	10.	(c)
2.	(c)	5.	(c)	8.	(b)	11.	(a)
3.	(b)	6.	(c)	9.	(a)	12.	(b)