

WOLAITA SODO UNIVERSITY

COLLEGE OF BUSSINESS AND ECONOMICS

DEPARTMENT OF ACCOUNTING AND FINANCE

MODULE NAME:

FINANCIAL ACCOUNTING AND REPORTING

Courses included:

- ❖ Intermediate Financial Accounting I
- ❖ Intermediate Financial Accounting II
- ❖ Advanced Financial Accounting I
- ❖ Advanced Financial Accounting II

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WOLAITA SODO UNIVERSITY
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Intermediate financial Accounting – I
(AcFn3021)

March, 2023

Wolaita Sodo, Ethiopia

INTERMEDIATE FINANCIAL ACCOUNTING – I (ACFN3021)

CHAPTER ONE

DEVELOPMENT OF ACCOUNTING PRINCIPLES AND PROFESSIONAL PRACTICE

LEARNING OBJECTIVES

- The environment of financial accounting
- Financial reporting requirements in Ethiopia
- The IASB and its governance structure
- List of IASB pronouncements
- The IASB's conceptual framework for financial reporting
- Objectives of financial reporting
- Qualitative characteristics of financial reports
- Elements of financial statements
- Recognition, measurement, and disclosure concepts
- IFRS-based Financial Statements (IAS 1)

1.1. The environment of financial accounting

Fair presentation of financial affairs is the essence of accounting theory and practice. With the increasing size and complexity of business enterprises and the increasing economic role of government, the responsibility placed on accountants is greater today than ever before. If accountants are to meet this challenge, they must have a logical and consistent body of accounting theory to guide them. This theoretical structure must be realistic in terms of the economic environment and must be designed to meet the needs of users of financial statements.

Financial statements and reports prepared by accountants are vital to the successful working of society. Economists, investors, business executives, labor leaders, bankers, and government officials all rely on these financial statements and reports as fair and meaningful summaries of

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day-to-day business transactions. In addition, these groups are making increased use of accounting as a base for forecasting future economic trends.

1.2. Financial reporting requirements in Ethiopia

Ethiopia passed a financial reporting law in 2014 which requires the use of IFRS by commercial businesses operating in Ethiopia.

- Proclamation No. 847/2014
- Regulation No. 332/2014

The proclamation requires Commercial organizations to follow International Financial Reporting Standards (IFRS), or International Financial Reporting Standards for Small and Medium Enterprises (IFRS for SME) and Charities and societies to follow International Public Sector Accounting Standards (IPSAS) Public auditors to follow International Standards for Auditing.

Public interest entity (PIE) should use the full IFRS. A PIE is a reporting entity that is of significant public relevance because of the nature of its business, its size, its number of employees. PIE also includes banks, insurance companies, and any other financial institutions and public enterprises. Small or medium enterprises (SME) are not public interest entity.

IFRS implementation road map: 3 phase transition over 3 years:

Phase 1: Significant Public Interest Entities (Financial Institutions and public enterprises owned by Federal or Regional Governments- Adoption of IFRS). Adoption start from EFY 2009 (i.e. specifically July 8, 2017);

Phase 2: Other Public Interest Entities (ECX member companies and those that meet PIE quantitative thresholds) adoption of IFRS and IPSAS for Charities and Societies start adoption of the standards at the start of EFY 2010 (i.e specifically July 8, 2018)

Phase 3: Small and Medium-sized Entities adoption of the IFRS for SMEs start adoption of the standards from EFY 2011 (i.e specifically July 8, 2019)

1.3. The IASB and its governance structure

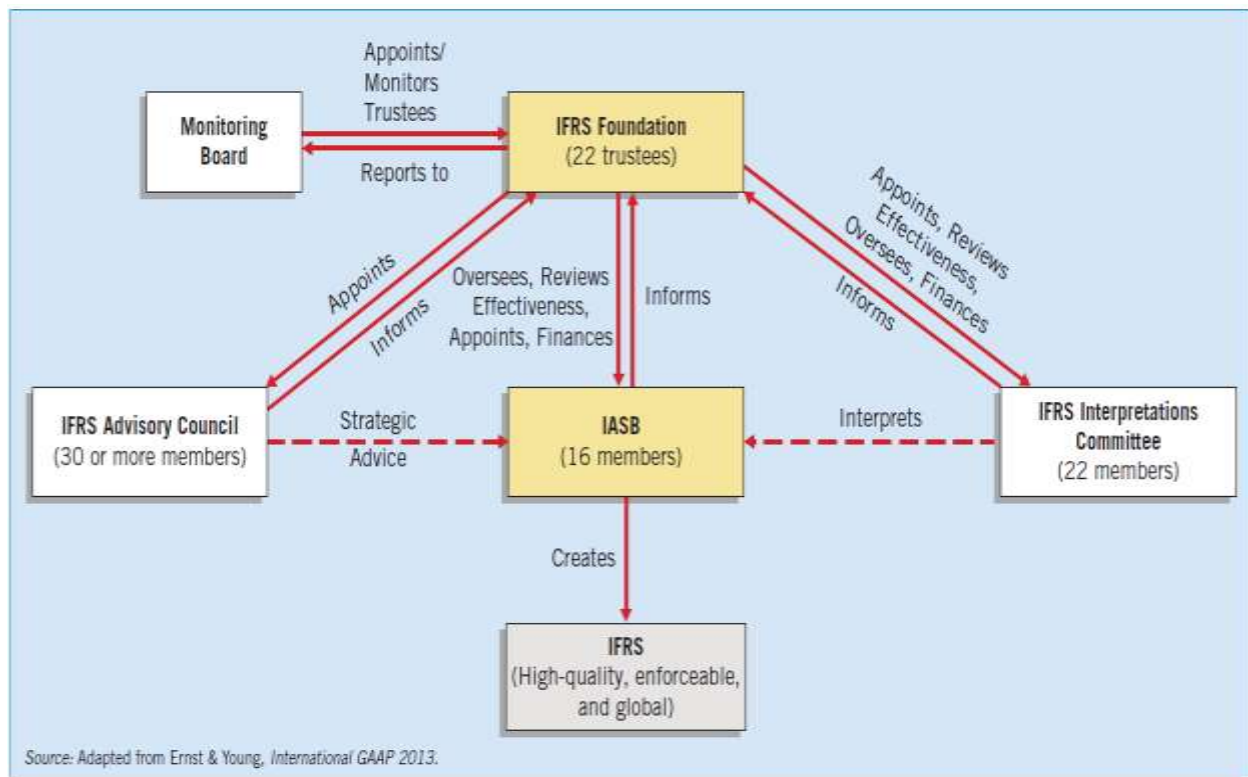
The main international standard-setting organization is based in London, United Kingdom, and is called the International Accounting Standards Board (IASB). The IASB issues International Financial Reporting Standards (IFRS), which are used on most foreign exchanges. As indicated earlier, IFRS is presently used or permitted in over 115 countries and is rapidly gaining acceptance in other countries as well.

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The standard-setting structure internationally is composed of the following four organizations:

1. The IFRS Foundation provides oversight to the IASB, IFRS Advisory Council, and IFRS Interpretations Committee. In this role, it appoints members, reviews effectiveness, and helps in the fundraising efforts for these organizations.
2. The International Accounting Standards Board (IASB) develops, in the public interest, a single set of high-quality, enforceable, and global international financial reporting standards for general-purpose financial statements.
3. The IFRS Advisory Council (the Advisory Council) provides advice and counsel to the IASB on major policies and technical issues.
4. The IFRS Interpretations Committee assists the IASB through the timely identification, discussion, and resolution of financial reporting issues within the framework of IFRS.

In addition, as part of the governance structure, a Monitoring Board was created. The purpose of this board is to establish a link between accounting standard-setters and those public authorities (e.g., IOSCO) that generally oversee them. The Monitoring Board also provides political legitimacy to the overall organization. Illustration below shows the organizational structure for the setting of international accounting standards.



1.4. List of IASB pronouncements

The IASB issues three major types of pronouncements:

1. **International Financial Reporting Standards:** Financial accounting standards issued by the IASB are referred to as International Financial Reporting Standards (IFRS). The IASB has issued 13 of these standards to date, covering such subjects as business combinations and share-based payments. Prior to the IASB (formed in 2001), standard-setting on the international level was done by the International Accounting Standards Committee, which issued International Accounting Standards (IAS). The committee issued 41 IASs, many of which have been amended or superseded by the IASB. Those still remaining are considered under the umbrella of IFRS.
2. **Conceptual Framework for Financial Reporting:** As part of a long-range effort to move away from the problem-by-problem approach, the IASB uses an IFRS conceptual framework. This Conceptual Framework for Financial Reporting sets forth the fundamental objective and concepts that the Board uses in developing future standards of financial reporting. The intent of the document is to form a cohesive set of interrelated concepts—a conceptual framework—that will serve as tools for solving existing and emerging problems in a consistent manner. For example, the objective of general-purpose financial reporting discussed earlier is part of this Conceptual Framework. The Conceptual Framework and any changes to it pass through the same due process (preliminary views, public hearing, exposure draft, etc.) as an IFRS. However, this Conceptual Framework is not an IFRS and hence does not define standards for any particular measurement or disclosure issue. Nothing in this Conceptual Framework overrides any specific international accounting standard.
3. **International Financial Reporting Standards Interpretations:** Interpretations issued by the IFRS Interpretations Committee are also considered authoritative and must be followed. These interpretations cover (1) newly identified financial reporting issues not specifically dealt with in IFRS and (2) issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop, in the absence of authoritative guidance. The IFRS Interpretations Committee has issued over 20 of these interpretations to date.

In keeping with the IASB's own approach to setting standards, the IFRS Interpretations Committee applies a principles-based approach in providing interpretative guidance. To this end, the IFRS Interpretations Committee looks first to the Conceptual Framework as the foundation for formulating a consensus. It then looks to the principles articulated in the applicable standard, if any, to develop its interpretative guidance and to determine that the proposed guidance does not conflict with provisions in IFRS.

The IFRS Interpretations Committee helps the IASB in many ways. For example, emerging issues often attract public attention. If not resolved quickly, these issues can lead to financial crises and scandal. They can also undercut public confidence in current reporting practices. The next step, possible governmental intervention, would threaten the continuance of standard-setting in the private sector. The IFRS Interpretations Committee can address controversial accounting problems as they arise. It determines whether it can resolve them or whether to involve the IASB in solving them. In essence, it becomes a "problem filter" for the IASB. Thus, the IASB will hopefully work on more pervasive long-term problems, while the IFRS Interpretations Committee deals with short-term emerging issues.

1.5. The IASB's conceptual framework for financial reporting

A conceptual framework establishes the concepts that underlie financial reporting. A conceptual framework is a coherent system of concepts that flow from an objective. The objective identifies the purpose of financial reporting. The other concepts provide guidance on (1) identifying the boundaries of financial reporting; (2) selecting the transactions, other events, and circumstances to be represented; (3) how they should be recognized and measured; and (4) how they should be summarized and reported.

Need for a Conceptual Framework

Why do we need a conceptual framework? First, to be useful, rule-making should build on and relate to an established body of concepts. A soundly developed conceptual framework thus enables the IASB to issue more useful and consistent pronouncements over time, and a coherent set of standards should result. Indeed, without the guidance provided by a soundly developed framework, standard-setting ends up being based on individual concepts developed by each member of the standard-setting body.

1.5.1. Objectives of financial reporting

What is the objective (or purpose) of financial reporting? The objective of general-purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments, and providing or settling loans and other forms of credit. Information that is decision-useful to capital providers (investors) may also be useful to other users of financial reporting who are not investors. Let's examine each of the elements of this objective.

General-Purpose Financial Statements

General-purpose financial statements provide financial reporting information to a wide variety of users. For example, when Nestlé (CHE) issues its financial statements, these statements help shareholders, creditors, suppliers, employees, and regulators to better understand its financial position and related performance. Nestlé's users need this type of information to make effective decisions. To be cost-effective in providing this information, general-purpose financial statements are most appropriate. In other words, general-purpose financial statements provide at the least cost the most useful information possible.

Equity Investors and Creditors

The objective of financial reporting identifies investors and creditors as the primary user group for general-purpose financial statements. Identifying investors and creditors as the primary user group provides an important focus of general-purpose financial reporting. For example, when Nestlé issues its financial statements, its primary focus is on investors and creditors because they have the most critical and immediate need for information in financial reports. Investors and creditors need this financial information to assess Nestlé's ability to generate net cash inflows and to understand management's ability to protect and enhance the assets of the company, which will be used to generate future net cash inflows. As a result, the primary user groups are not management, regulators, or some other non-investor group.

Entity Perspective

As part of the objective of general-purpose financial reporting, an entity perspective is adopted. Companies are viewed as separate and distinct from their owners (present shareholders) using this perspective. The assets of Nestlé are viewed as assets of the company and not of a specific

creditor or shareholder. Rather, these investors have claims on Nestlé's assets in the form of liability or equity claims. The entity perspective is consistent with the present business environment where most companies engaged in financial reporting have substance distinct from their investors (both shareholders and creditors). Thus, a perspective that financial reporting should be focused only on the needs of shareholders—often referred to as the proprietary perspective—is not considered appropriate.

Decision-Usefulness

Investors are interested in financial reporting because it provides information that is useful for making decisions (referred to as the decision-usefulness approach). As indicated earlier, when making these decisions, investors are interested in assessing (1) the company's ability to generate net cash inflows and (2) management's ability to protect and enhance the capital providers' investments. Financial reporting should therefore help investors assess the amounts, timing, and uncertainty of prospective cash inflows from dividends or interest, and the proceeds from the sale, redemption, or maturity of securities or loans. In order for investors to make these assessments, the economic resources of an enterprise, the claims to those resources and the changes in them must be understood. Financial statements and related explanations should be a primary source for determining this information.

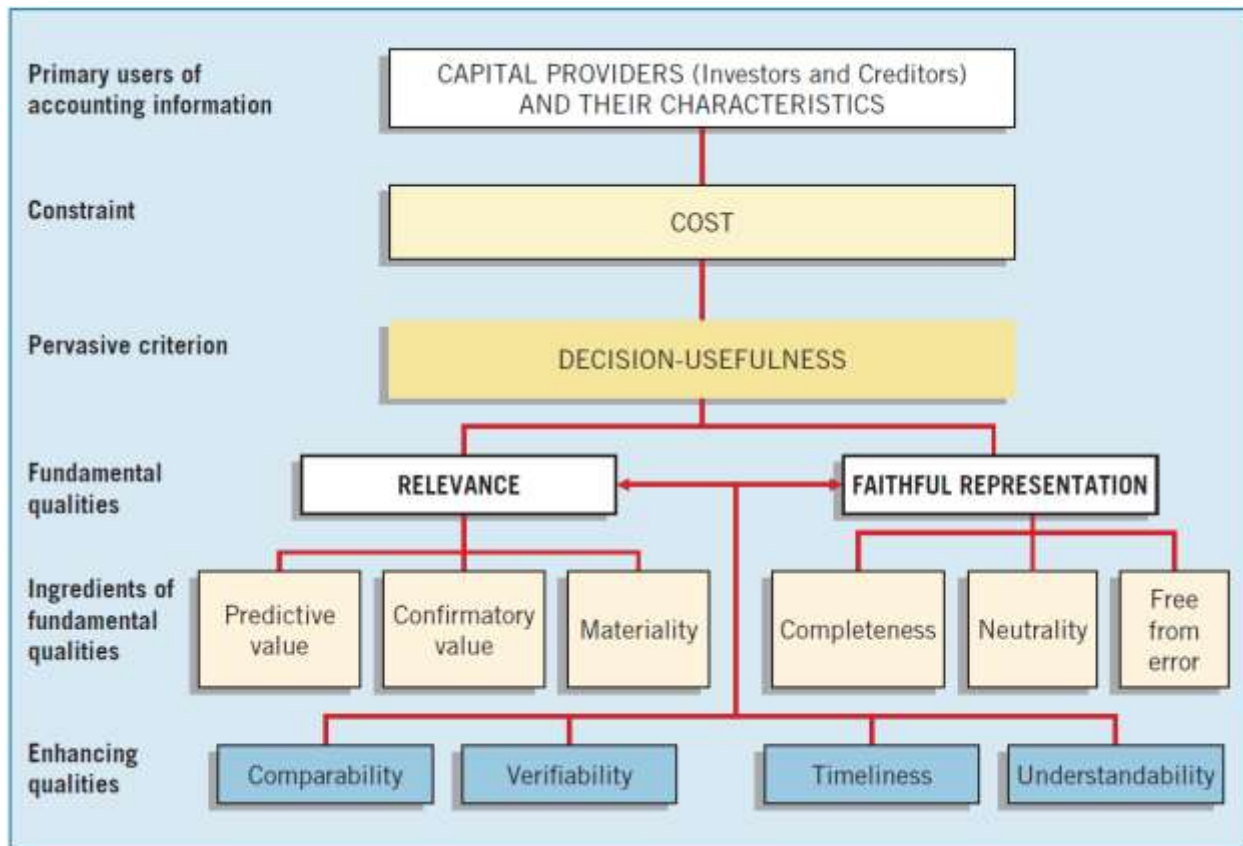
The emphasis on “assessing cash flow prospects” does not mean that the cash basis is preferred over the accrual basis of accounting. Information based on accrual accounting generally better indicates a company's present and continuing ability to generate favorable cash flows than does information limited to the financial effects of cash receipts and payments.

Recall from your first accounting course the objective of accrual-basis accounting: It ensures that a company records events that change its financial statements in the periods in which the events occur, rather than only in the periods in which it receives or pays cash. Using the accrual basis to determine net income means that a company recognizes revenues when it provides the goods or performs the services rather than when it receives cash. Similarly, it recognizes expenses when it incurs them rather than when it pays them. Under accrual accounting, a company generally recognizes revenues when it makes sales. The company can then relate the revenues to the economic environment of the period in which they occurred. Over the long run, trends in

revenues and expenses are generally more meaningful than trends in cash receipts and disbursements.

1.5.2. Qualitative characteristics of financial reports

The IASB identified the qualitative characteristics of accounting information that distinguish better (more useful) information from inferior (less useful) information for decision-making purposes.



1.5.2.1. Fundamental Quality—Relevance

Relevance is one of the two fundamental qualities that make accounting information useful for decision-making.

To be relevant, accounting information must be capable of making a difference in a decision. Information with no bearing on a decision is irrelevant. Financial information is capable of making a difference when it has predictive value, confirmatory value, or both.

Financial information has **predictive value** if it has value as an input to predictive processes used by investors to form their own expectations about the future. Relevant information also helps users confirm or correct prior expectations; it has **confirmatory value**. For example, when Nippon issues its year-end financial statements, it confirms or changes past (or present) expectations based on previous evaluations. It follows that predictive value and confirmatory value are interrelated.

Materiality is a company-specific aspect of relevance. Information is material if omitting it or misstating it could influence decisions that users make on the basis of the reported financial information. An individual company determines whether information is material because both the nature and/or magnitude of the item(s) to which the information relates must be considered in the context of an individual company's financial report.

1.5.2.2. Fundamental Quality—Faithful Representation

Faithful representation is the second fundamental quality that makes accounting information useful for decision-making.

Faithful representation means that the numbers and descriptions match what really existed or happened. Faithful representation is a necessity because most users have neither the time nor the expertise to evaluate the factual content of the information. For example, if Siemens AG's (DEU) income statement reports sales of €60,510 million when it had sales of €40,510 million, then the statement fails to faithfully represent the proper sales amount. To be a faithful representation, information must be complete, neutral, and free of material error.

Completeness means that all the information that is necessary for faithful representation is provided. An omission can cause information to be false or misleading and thus not be helpful to the users of financial reports. For example, when Société Générale (FRA) fails to provide information needed to assess the value of its subprime loan receivables (toxic assets), the information is not complete and therefore not a faithful representation of their values.

Neutrality means that a company cannot select information to favor one set of interested parties over another. Providing neutral or unbiased information must be the overriding consideration. For example, in the notes to financial statements, tobacco companies such as British American Tobacco (GBR) should not suppress information about the numerous lawsuits that have been

filed because of tobacco-related health concerns—even though such disclosure is damaging to the company.

Free from Error: an information item that is free from error will be a more accurate (faithful) representation of a financial item. For example, if UBS (CHE) misstates its loan losses, its financial statements are misleading and not a faithful representation of its financial results. However, faithful representation does not imply total freedom from error. This is because most financial reporting measures involve estimates of various types that incorporate management's judgment. For example, management must estimate the amount of uncollectible accounts to determine bad debt expense. And determination of depreciation expense requires estimation of useful lives of plant and equipment, as well as the residual value of the assets.

1.5.2.3. Enhancing Qualities

Enhancing qualitative characteristics are complementary to the fundamental qualitative characteristics. These characteristics distinguish more-useful information from less-useful information.

Comparability: Information that is measured and reported in a similar manner for different companies is considered comparable. Comparability enables users to identify the real similarities and differences in economic events between companies. For example, historically the accounting for pensions in Japan differed from that in the United States. In Japan, companies generally recorded little or no charge to income for these costs. U.S. companies recorded pension cost as incurred. As a result, it is difficult to compare and evaluate the financial results of Toyota (JPN) or Honda (JPN) to General Motors (USA) or Ford (USA). Investors can only make valid evaluations if comparable information is available.

Verifiability: verifiability occurs when independent measurers, using the same methods, obtain similar results. Verifiability occurs in the following situations.

1. Two independent auditors count Tata Motors' (IND) inventory and arrive at the same physical quantity amount for inventory. Verification of an amount for an asset therefore can occur by simply counting the inventory (referred to as direct verification).
2. Two independent auditors compute Tata Motors' inventory value at the end of the year using the FIFO method of inventory valuation. Verification may occur by checking the

inputs (quantity and costs) and recalculating the outputs (ending inventory value) using the same accounting convention or methodology (referred to as indirect verification).

Timeliness: Timeliness means having information available to decision-makers before it loses its capacity to influence decisions. Having relevant information available sooner can enhance its capacity to influence decisions, and a lack of timeliness can rob information of its usefulness. For example, if Lenovo Group (CHN) waited to report its interim results until nine months after the period, the information would be much less useful for decision-making purposes.

Understandability: Decision-makers vary widely in the types of decisions they make, how they make decisions, the information they already possess or can obtain from other sources, and their ability to process the information. For information to be useful there must be a connection (linkage) between these users and the decisions they make. This link, understandability, is the quality of information that lets reasonably informed users see its significance. Understandability is enhanced when information is classified, characterized, and presented clearly and concisely.

1.5.3. Elements of financial statements

The elements directly related to the measurement of financial position are assets, liabilities, and equity. These are defined as follows.

ASSET: A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

LIABILITY: A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

EQUITY: The residual interest in the assets of the entity after deducting all its liabilities.

The elements of income and expenses are defined as follows.

INCOME: Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

EXPENSES: Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

GAINS: Increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from revenues or investments by owners.

LOSSES: Decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from expenses or distributions to owners.

1.5.4 Recognition, measurement, and disclosure concepts

The third level of the Conceptual Framework consists of concepts that implement the basic objectives of level one. These concepts explain how companies should recognize, measure, and report financial elements and events. Here, we identify the concepts as basic assumptions, principles, and a cost constraint. Not everyone uses this classification system, so focus your attention more on understanding the concepts than on how we classify and organize them. These concepts serve as guidelines in responding to controversial financial reporting issues.

Basic Assumptions

As indicated earlier, the Conceptual Framework specifically identifies only one assumption—the going concern assumption. Yet, we believe there are a number of other assumptions that are present in the reporting environment. As a result, for completeness, we discuss each of these five basic assumptions in turn: (1) economic entity, (2) going concern, (3) monetary unit, (4) periodicity, and (5) accrual basis.

Economic Entity Assumption

The economic entity assumption means that economic activity can be identified with a particular unit of accountability. In other words, a company keeps its activity separate and distinct from its owners and any other business unit.

At the most basic level, the economic entity assumption dictates that Sappi Limited (ZAF) record the company's financial activities separate from those of its owners and managers. Equally

important, financial statement users need to be able to distinguish the activities and elements of different companies, such as Volvo (SWE), Ford (USA), and Volkswagen AG (DEU). If users could not distinguish the activities of different companies, how would they know which company financially outperformed the other?

The entity concept does not apply solely to the segregation of activities among competing companies, such as Toyota (JPN) and Hyundai (KOR). An individual, department, division, or an entire industry could be considered a separate entity if we choose to define it in this manner. Thus, the entity concept does not necessarily refer to a legal entity. A parent and its subsidiaries are separate legal entities, but merging their activities for accounting and reporting purposes does not violate the economic entity assumption.

Going Concern Assumption

Most accounting methods rely on the going concern assumption—that the company will have a long life. Despite numerous business failures, most companies have a fairly high continuance rate. As a rule, we expect companies to last long enough to fulfill their objectives and commitments.

This assumption has significant implications. The historical cost principle would be of limited usefulness if we assume eventual liquidation. Under a liquidation approach, for example, a company would better state asset values at fair value than at acquisition cost. Depreciation and amortization policies are justifiable and appropriate only if we assume some permanence to the company. If a company adopts the liquidation approach, the current/non-current classification of assets and liabilities loses much of its significance.

Labeling anything a long-lived or non-current asset would be difficult to justify. Indeed, listing liabilities on the basis of priority in liquidation would be more reasonable. The going concern assumption applies in most business situations. Only where liquidation appears imminent is the assumption inapplicable. In these cases a total revaluation of assets and liabilities can provide information that closely approximates the company's fair value. You will learn more about accounting problems related to a company in liquidation in advanced accounting courses.

Monetary Unit Assumption

The monetary unit assumption means that money is the common denominator of economic activity and provides an appropriate basis for accounting measurement and analysis. That is, the monetary unit is the most effective means of expressing to interested parties changes in capital and exchanges of goods and services. Application of this assumption depends on the even more basic assumption that quantitative data are useful in communicating economic information and in making rational economic decisions.

Furthermore, accounting generally ignores price-level changes (inflation and deflation) and assumes that the unit of measure – Birr, euros, dollars, or yen—remains reasonably stable. We therefore use the monetary unit assumption to justify adding 1985 pounds to 2015 pounds without any adjustment. It is expected that the pound or other currency, unadjusted for inflation or deflation, will continue to be used to measure items recognized in financial statements. Only if circumstances change dramatically (such as high inflation rates similar to that in some South American countries) will “inflation accounting” be considered.

Periodicity Assumption

To measure the results of a company’s activity accurately, we would need to wait until it liquidates. Decision-makers, however, cannot wait that long for such information.

Users need to know a company’s performance and economic status on a timely basis so that they can evaluate and compare companies, and take appropriate actions. Therefore, companies must report information periodically.

Accrual Basis of Accounting

Companies prepare financial statements using the accrual basis of accounting. Accrual basis accounting means that transactions that change a company’s financial statements are recorded in the periods in which the events occur. For example, using the accrual basis means that companies recognize revenues when it is probable that future economic benefits will flow to the company and reliable measurement is possible (the revenue recognition principle). This is in contrast to recognition based on receipt of cash.

Likewise, under the accrual basis, companies recognize expenses when incurred (the expense recognition principle) rather than when paid.

An alternative to the accrual basis is the cash basis. Under cash-basis accounting, companies record revenue only when cash is received. They record expenses only when cash is paid. The cash basis of accounting is prohibited under IFRS. Why? Because it does not record revenue according to the revenue recognition principle (discussed in the next section). Similarly, it does not record expenses when incurred, which violates the expense recognition principle (discussed in the next section).

Financial statements prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful in making economic decisions.

Basic Principles of Accounting

We generally use four basic principles of accounting to record and report transactions: (1) measurement, (2) revenue recognition, (3) expense recognition, and (4) full disclosure. We look at each in turn.

Measurement Principles

We presently have a “mixed-attribute” system in which one of two measurement principles is used. The most commonly used measurements are based on historical cost and fair value. Selection of which principle to follow generally reflects a trade-off between relevance and faithful representation. Here, we discuss each measurement principle.

Historical Cost: IFRS requires that companies account for and report many assets and liabilities on the basis of acquisition price. This is often referred to as the historical cost principle. Cost has an important advantage over other valuations: It is generally thought to be a faithful representation of the amount paid for a given item.

To illustrate this advantage, consider the problems if companies select current selling price instead. Companies might have difficulty establishing a value for unsold items. Every member of the accounting department might value the assets differently.

Further, how often would it be necessary to establish sales value? All companies close their accounts at least annually. But some compute their net income every month. Those companies

would have to place a sales value on every asset each time they wished to determine income. Critics raise similar objections against current cost (replacement cost, present value of future cash flows) and any other basis of valuation except historical cost.

What about liabilities? Do companies account for them on a cost basis? Yes, they do. Companies issue liabilities, such as bonds, notes, and accounts payable, in exchange for assets (or services), for an agreed-upon price. This price, established by the exchange transaction, is the “cost” of the liability. A company uses this amount to record the liability in the accounts and report it in financial statements. Thus, many users prefer historical cost because it provides them with a verifiable benchmark for measuring historical trends.

Fair Value: Fair value is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” Fair value is therefore a market-based measure. Recently, IFRS has increasingly called for use of fair value measurements in the financial statements.

This is often referred to as the fair value principle. Fair value information may be more useful than historical cost for certain types of assets and liabilities and in certain industries. For example, companies report many financial instruments, including derivatives, at fair value. Certain industries, such as brokerage houses and mutual funds, prepare their basic financial statements on a fair value basis. At initial acquisition, historical cost equals fair value. In subsequent periods, as market and economic conditions change, historical cost and fair value often diverge. Thus, fair value measures or estimates often provide more relevant information about the expected future cash flows related to the asset or liability. For example, when long-lived assets decline in value, a fair value measure determines any impairment loss.

The IASB believes that fair value information is more relevant to users than historical cost. Fair value measurement, it is argued, provides better insight into the value of a company’s assets and liabilities (its financial position) and a better basis for assessing future cash flow prospects. Recently, the Board has taken the additional step of giving companies the option to use fair value (referred to as the fair value option) as the basis for measurement of financial assets and financial liabilities.

Revenue Recognition Principle

When a company agrees to perform a service or sell a product to a customer, it has a performance obligation. When the company satisfies this performance obligation, it recognizes revenue. The revenue recognition principle therefore requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied.

Expense Recognition Principle

Expenses are defined as outflows or other “using up” of assets or incurring of liabilities (or a combination of both) during a period as a result of delivering or producing goods and/or rendering services. It follows then that recognition of expenses is related to net changes in assets and earning revenues. In practice, the approach for recognizing expenses is, “Let the expense follow the revenues.” This approach is the expense recognition principle.

Full Disclosure Principle

In deciding what information to report, companies follow the general practice of providing information that is of sufficient importance to influence the judgment and decisions of an informed user. Often referred to as the full disclosure principle, it recognizes that the nature and amount of information included in financial reports reflects a series of judgmental trade-offs. These trade-offs strive for (1) sufficient detail to disclose matters that make a difference to users, yet (2) sufficient condensation to make the information understandable, keeping in mind costs of preparing and using it.

Users find information about financial position, income, cash flows, and investments in one of three places: (1) within the main body of financial statements, (2) in the notes to those statements, or (3) as supplementary information.

1.6 IFRS-based Financial Statements (IAS 1)

IAS 1 refers to financial statements as “a structured representation of the financial position and financial performance of an entity”.

They are a principal means through which an entity communicates its financial information to external parties.

- ✓ Purpose of Financial Statements
- ✓ They provide information about the :

- ✓ Financial position,
- ✓ Financial performance and

Cash flows of an entity to a wide range of users in making economic decisions. They also show the results of the management's stewardship of the resources entrusted to it. Identification of financial statements: IAS 1 also requires disclosure of:

- ✓ Name of the reporting entity
- ✓ Whether the accounts cover the single entity or a group of entities
- ✓ The date of the end of the reporting period or the period covered by the financial statements (as appropriate)
- ✓ The presentation currency.
- ✓ The level of rounding used in presenting amounts in the financial statements (thousands, millions...)

Complete Set of Financial Statements: IAS 1 defines a complete set of financial statements to be comprised of the following:

- ✓ Statement of financial position as at the end of the period.
- ✓ Statement of profit or loss and other comprehensive income for the period.
- ✓ Statement of changes in equity for the period.
- ✓ Statement of cash flows for the period.
- ✓ Notes to the financial statements.

Statement of Financial Position

- The statement of financial position is presented as a primary statement
- In accordance with IAS 1.60, the entity has presented current and non-current assets, and current and non-current liabilities, as separate classifications in the statement of financial position. IAS 1 does not require a specific order of the two classifications. The entity has elected to present non-current assets and liabilities before current assets and liabilities.
- IAS 1 requires entities to present assets and liabilities in order of liquidity when this presentation is reliable and more relevant.
- Equity presented prior to liabilities
- The statement of financial position is cross-referenced to the notes.

Statement of Profit or Loss

- The statement of profit or loss was presented as a primary statement
- IAS 1.10 suggests titles for the primary financial statements, such as ‘statement of profit or loss and other comprehensive income’ or ‘statement of profit or loss. Entities are, however, permitted to choose. The entity applies the titles suggested in IAS 1.
- IFRS 15.113(a) requires revenue recognized from contracts with customers to be disclosed separately from other sources of revenue, unless presented separately in the statement of comprehensive income or statement of profit or loss. The entity has elected to present the revenue from contracts with customers (hospital service fees) as a line item in the statement of profit or loss separate from the other source of revenue.
- IAS 1.99 requires expenses to be analyzed either by their nature or by their function within the statement of profit or loss, whichever provides information that is reliable and more relevant. If expenses are analyzed by function, information about the nature of expenses must be disclosed in the notes. The entity has presented the analysis of expenses by function.
- The statement of profit or loss is cross-referenced to the notes.

Statement Changes in Equity

- The statement of changes in equity is presented as a primary statement
- The recognition of previously unrecognized land resulted in increased retained earnings and this was presented separately
- The change in depreciable rate from tax based rate to asset’s useful life based rate created decrease in property, plant, and equipment. The entity has elected to recognize this effect in retained earnings
- The statement of changes in equity is cross-referenced to the notes.

Statement of Cash flows

- The cash flow statement is presented as a primary statement.
- IAS 7.18 allows entities to report cash flows from operating activities using either the direct or the indirect method. The entity presents its cash flows using the indirect method.
- The entity has reconciled profit before tax to net cash flows from operating activities. However, reconciliation from profit after tax is also acceptable under IAS 7 Statement of Cash Flows.

- Certain working capital adjustments and other adjustments included in the statement of cash flows, reflect the change in balances between comparative years.
- The statement of cash flow is cross-referenced to the notes.

CHAPTER TWO

FAIR VALUE MEASUREMENT AND IMPAIRMENT

LEARNING OBJECTIVES

- Explain the reasons for the introduction of IFRS 13.
- Describe the basis for the determination of fair value.
- Describe the three valuation methods for the fair value measurement under IFRS 13.
- Explain the three-tier fair value hierarchy applied to the valuation techniques.
- Describe the general disclosure requirements.
- Impairment (IAS 36)
- Definition of impairment
- Measurement of impairment
- Reversal of impairment
- Disclosure on impairment

2.1. Fair Value Measurement

2.1.1. Reasons for the Introduction of IFRS 13

- ✓ The objective of IFRS 13 is to provide a single source of guidance for fair value measurement where it is required by a reporting standard, rather than it being spread throughout several accounting standards.
- ✓ There is now a uniform framework for measurement of fair value for entities around the world who apply either US GAAP or IFRS GAAP.
- ✓ IFRS 13 does not extend the use of fair value, it **provides guidance on how it should be determined when an initial or subsequent fair value measurement** is required by a reporting standard.
- ✓ IFRS 13 does not apply to:

- (a) Share-based payment (IFRS 2)
- Leases (IAS 17)
- NRV in Inventories (IAS 2)
- Value in use in Impairment (IAS 36)
- ✓ IFRS 13 is effective for accounting periods commencing on or after 1 January 2013, with early adoption permitted.

Reasons for the issue of IFRS 13

(a) To **overcome inconsistency** in the **way that fair value measurements** required by a reporting standard are determined for inclusion in the financial statements of an entity.

(b) To **overcome increasing complexity** in **how fair value measurements** are currently **determined** by individual entities in different situations.

(c) To form part of the response of the accountancy profession to the **global financial crisis**.

(d) To **increase and converge the supporting disclosure requirements** to provide information that is relevant to users of financial statements, so that they understand the basis upon which a fair value measurement has been determined and applied with a set of financial statements.

(e) To **increase the extent of convergence between IFRS GAAP and US GAAP** as there is now a common definition for fair value measurement, together with a structure or framework for how it is to be determined when required by either IFRS GAAP and US GAAP.

2.1.2. Definitions Relevant to Fair Value

(a) **Fair value** is defined as the price that would be received to **sell an asset or paid to transfer a liability in an orderly transaction** between market participants at the measurement date; i.e. it is an **exit (selling) price**, whether **observable in an active market** (level one input), or estimated using a **valuation technique** (with the use of level 2 and/or level 3 inputs).

(b) **Market participants** **comprise independent buyers and sellers** who are **informed and willing and able to enter into a transaction** in the principal or the

most advantageous market as appropriate.

(c)**Exit price** is the price that would be **received to sell an asset or paid to transfer a liability**.

(d)**Active market** is a market in which transactions for the asset or liability take place with **sufficient frequency and volume to provide pricing information on an ongoing basis**.

(e)**Principal market** is the market with the **greatest volume and level of activity** for the asset or liability.

(f)**Most advantageous market** is the market that **maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs**.

From the above definition, it can be seen that fair value under IFRS 13 is a **market-based measurement, not an entity-specific measurement**.

The definition of fair value **focuses on assets and liabilities** because they are a primary subject of accounting measurement. In addition, this HKFRS shall be applied to an entity's own equity instruments measured at fair value.

2.1.3. The Basis of a Fair Value Measurement

The following factors should be taken into consideration when measuring fair value:

(a)**Unit of account** – The asset or liability to be measured may be an individual asset (e.g. plot of land) or liability, or a group of assets and liabilities (e.g. a cash generating unit or business), depending upon exactly what is required to be measured.

(b)The **measurement** should **reflect the price** at which an **orderly transaction between willing market participants would take place** under current market conditions, i.e. **not a distress transaction**.

(c)The entity must determine the market in which an orderly transaction would take place.

This will be the **principal market** or, **failing that**, the **most advantageous market** that an entity has access to at the measurement date. They will often, but not always, be the same.

(d) Unless there is evidence otherwise, the market that an entity would normally enter into is presumed to be the principal or most advantageous market.

(e) It is quite possible that different entities within a group or different businesses within an entity **may have different principal or most advantageous markets**, for example, **due to their location**.

(f) The valuation or measurement should reflect the **characteristics of the asset or liability** (age, condition, location, restrictions on use or sale, etc.) if they are relevant to market participants.

(g) It is **not adjusted for transaction costs** – they are **not a feature of the asset or liability**, but may be **relevant when determining the most advantageous market**. If location, for example, is a characteristic of the asset, then price may need to be adjusted for any costs that may be incurred to transport an asset to or from a market.

2.1.4. Valuation Techniques

Valuation techniques should be used which are appropriate to the asset or liability at the measurement date and for which sufficient data is available, applying the fair value hierarchy to **maximize the use of observable inputs as far as possible**.

Three valuation techniques

(a) **Income approach** – e.g. where estimated future cash flows may be converted into a single, current amount stated at present value.

(b) **Market approach** – e.g. where prices and other market-related data is used for similar or identical assets, liabilities or groups of assets and liabilities.

(c) **Cost approach** – e.g. to arrive at what may be regarded as **current replacement cost** to determine the cost that would be incurred to replace the service or operational capacity of an asset.

More than one valuation technique may be used in helping to determine fair value in a particular situation. Note that a **change in valuation technique** is regarded as a **change of**

accounting estimate in accordance with IAS 8 which needs to be properly disclosed in the financial statements.

2.1.5. Fair Value Hierarchy

IFRS 13 establishes a hierarchy that categorises the inputs to valuation techniques used to measure fair value.

Inputs	Explanations
Level 1 inputs	● Comprise quoted prices ('observable') in active markets for identical assets and liabilities at the measurement date. ● An active market is regarded as one in which transactions take place with sufficient frequency and volume for reliable pricing information to be provided. ● Thus may still be possible where there is a low volume of transactions, provided that there has been sufficient time for reasonable marketing and other market-related activity to take place and where it is clear that any such transactions are not based upon distress transactions. ● This is regarded as providing the most reliable evidence of fair value and is likely to be used without adjustment.
Level 2 inputs	● Are observable inputs, other than those included within Level 1 above, which are observable directly or indirectly. ● This may include quoted prices for similar (not identical) asset or liabilities in active markets, or prices for identical or similar assets and liabilities in inactive markets. ● Typically, they are likely to require some degree of adjustment to arrive at a fair value measurement.

Level 3 inputs	Are unobservable inputs for an asset or liability, based on the best information available, including information that may be reasonably available relating to market participants.
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2.1.6. General Disclosure Requirements

The general disclosures include:

(a) **Methods and inputs used** in the process to determine a fair value measurement, **together with any changes in valuation techniques** which have been applied from one reporting date to the next.

(b) Information relating to the **hierarchy level** which is applicable to a particular fair value measurement included within the financial statements.

(c) **Any transfers between level one and level two of the valuation hierarchy.**

(d) For the lowest category within the hierarchy, **level three, requirements include details of assumptions used to help determine fair value measurement**, a reconciliation of opening and closing balances and additional information regarding unobservable inputs.

For assets and liabilities measured at fair value and classified as Level 3, a reconciliation of Level 3 changes for the period is required. In addition, companies should report an analysis of how Level 3 changes in fair value affect total gains and losses and their impact on net income. The following is an example of this disclosure.

2.2. Impairment

Impairment is determined by comparing the carrying amount of the asset with its recoverable amount. This is the higher of its **fair value less costs of disposal** and its **value in use**.

There is an established principle that assets should not be carried at above their recoverable amount. An entity should write down the carrying amount of an asset to its recoverable amount if the carrying amount of an asset is not recoverable in full. IAS 36 puts in place a detailed methodology for carrying out impairment reviews and related accounting treatments and disclosures.

Scope

IAS 36 applies to all tangible, intangible and financial assets except inventories, assets arising from construction contracts, deferred tax assets, assets arising under IAS 19 *Employee benefits* and financial assets within the scope of IAS 32 *Financial instruments: presentation*. This is because those IASs already have rules for recognising and measuring impairment. Note also that IAS 36 does not apply to non-current assets held for sale, which are dealt with under IFRS 5 *Non-current assets held for sale and discontinued operations*.

Impairment: A fall in the value of an asset, so that its 'recoverable amount' is now less than its carrying amount in the statement of financial position.

Carrying amount is the net value at which the asset is included in the statement of financial position (i.e. after deducting accumulated depreciation and any impairment losses).

The basic principle underlying IAS 36 is relatively straightforward. If an asset's value in the accounts is higher than its realistic value, measured as its 'recoverable amount', the asset is judged to have suffered an impairment loss. It should therefore be reduced in value, by the amount of the **impairment loss**. The amount of the impairment loss should be **written off against profit** immediately.

The main accounting issues to consider are therefore:

- (a) How is it possible to **identify when** an impairment loss may have occurred?
- (b) How should the **recoverable amount** of the asset be measured?

(c) How should an 'impairment loss' be **reported in the accounts**?

Identifying a potentially impaired asset

An entity should assess at the end of each reporting period whether there are any indications of impairment to any assets. The concept of **materiality** applies, and only material impairment needs to be identified.

If there are indications of possible impairment, the entity is required to make a formal estimate of the **recoverable amount** of the assets concerned.

IAS 36 suggests how **indications of a possible impairment** of assets might be recognised. The suggestions are based largely on common sense.

(a) External sources of information

- (i) A fall in the asset's market value that is more significant than would normally be expected from passage of time over normal use
- (ii) A significant change in the technological, market, legal or economic environment of the business in which the assets are employed
- (iii) An increase in market interest rates or market rates of return on investments likely to affect the discount rate used in calculating value in use
- (iv) The carrying amount of the entity's net assets being more than its market capitalization

(b) Internal sources of information: evidence of obsolescence or physical damage, adverse changes in the use to which the asset is put, or the asset's economic performance

Even if there are no indications of impairment, the following assets must **always** be tested for impairment annually.

- (a) An intangible asset with an **indefinite useful life**
- (b) **Goodwill** acquired in a business combination

Measuring the recoverable amount of the asset

What is an asset's recoverable amount?

The **recoverable amount of an asset** should be measured as the HIGHER VALUE of:

- (a) The asset's fair value less costs of disposal
- (b) Its value in use

An asset's fair value less costs of disposal is the price that would be received to sell the asset in an orderly transaction between market participants at the measurement date, less direct disposal costs, such as legal expenses.

(a) If there is **an active market** in the asset, the fair value should be based on the **market price**, or on the price of recent transactions in similar assets.

(b) If there is **no active market** in the asset it might be possible to **estimate** fair value using best estimates of what market participants might pay in an orderly transaction.

Fair value less costs of disposal **cannot** be reduced, however, by including within costs of disposal any **restructuring or reorganisation expenses**, or any costs that have already been recognised in the accounts as liabilities.

The concept of 'value in use' is very important.

The **value in use** of an asset is measured as the present value of estimated future cash flows (inflows minus outflows) generated by the asset, including its estimated net disposal value (if any) at the end of its expected useful life.

Recognition and measurement of an impairment loss

The rule for assets at historical cost is:

Rule to learn

If the recoverable amount of an asset is lower than the carrying amount, the carrying amount should be reduced by the difference (i.e. the impairment loss) which should be charged as an expense in profit or loss.

The rule for assets held at a revalued amount (such as property revalued under IAS 16) is:

Rule to learn

The impairment loss is to be treated as a revaluation decrease under the relevant IAS.

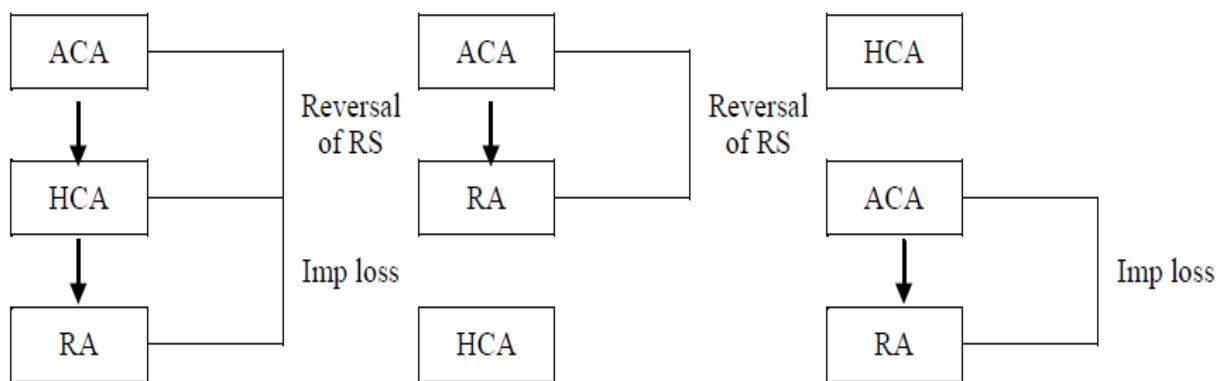
In practice this means:

- To the extent that there is a revaluation surplus held in respect of the asset, the impairment loss should be charged to revaluation surplus
- Any excess should be charged to profit or loss

*A decrease in carrying amount: A summary of the various interactions of carrying amount and recoverable carrying amount when using the **cost model** is shown below.*



*A decrease in carrying amount: A summary of the various interactions of carrying amount and recoverable carrying amount when using the **revaluation model** is shown below.*



If the asset is carried under the *cost model*, the increase in value will be recognised as an impairment loss reversed (income), and is calculated as follows:

Recoverable amount (limited to historical carrying amount)
 Less the actual carrying amount
 Impairment loss reversed

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Cash generating units

*When it is not possible to calculate the recoverable amount of a single asset, then that of its **cash generating unit** should be measured instead*

Use of cash-generating unit

The IAS goes into quite a large amount of detail about the important concept of cash generating units. As a basic rule, the recoverable amount of an asset should be calculated for the asset individually. However, there will be occasions when it is not possible to estimate such a value for an individual asset, particularly in the calculation of value in use. This is because cash inflows and outflows cannot be attributed to the individual asset

If it is not possible to calculate the recoverable amount for an individual asset, the recoverable amount of the asset's cash-generating unit should be measured instead.

A cash-generating unit is the smallest identifiable group of assets for which independent cash flows can be identified and measured.

A mining company owns a private railway that it uses to transport output from one of its mines. The railway now has no market value other than as scrap, and it is impossible to identify any separate cash inflows with the use of the railway itself. Consequently, if the mining company suspects an impairment in the value of the railway, it should treat the mine as a whole as a cash generating unit, and measure the recoverable amount of the mine as a whole.

A bus company has an arrangement with a town's authorities to run a bus service on four routes in the town. Separately identifiable assets are allocated to each of the bus routes, and cash inflows and outflows can be attributed to each individual route. Three routes are running at a profit and one is running at a loss. The bus company suspects that there is an impairment of assets on the loss making route. However, the company will be unable to close the loss-making route, because it is under an obligation to operate all four routes, as part of its contract with the local authority.

Consequently, the company should treat all four bus routes together as a cash generating unit, and calculate the recoverable amount for the unit as a whole.

If an active market exists for the output produced by the asset or a group of assets, this asset or group should be identified as a cash generating unit, even if some or all of the output is used internally.

Cash-generating units should be identified consistently from period to period for the same type of asset unless a change is justified.

The group of net assets less liabilities that are considered for impairment should be the same as those considered in the calculation of the recoverable amount

Allocating goodwill to cash-generating units

Goodwill acquired in a business combination does not generate cash flows independently of other assets. It must be **allocated** to each of the acquirer's **cash-generating units** (or groups of cash-generating units) that are expected to benefit from the synergies of the combination. Each unit to which the goodwill is so allocated should:

- (a) Represent the **lowest level** within the entity at which the goodwill is monitored for internal management purposes
- (b) Not be **larger than a reporting segment** determined in accordance with IFRS 8 *Operating Segments*

It may be impracticable to complete the allocation of goodwill before the first reporting date after a business combination, particularly if the acquirer is accounting for the combination for the first time using provisional values. The initial allocation of goodwill must be completed before the end of the first reporting period after the acquisition date.

Testing cash-generating units with goodwill for impairment

A cash-generating unit to which goodwill has been allocated is tested for impairment annually. The **carrying amount** of the unit, including goodwill, is **compared with the recoverable amount**. If the carrying amount of the unit exceeds the recoverable amount, the entity must recognise an impairment loss.

The annual impairment test may be performed at any time during an accounting period, but must be performed at the **same time every year**.

Accounting treatment of an impairment loss

If, and only if, the recoverable amount of an asset is less than its carrying amount in the statement of financial position, an impairment loss has occurred. This loss should be **recognised immediately**

(a) The asset's **carrying amount** should be reduced to its recoverable amount in the statement of financial position.

(b) The **impairment loss** should be recognised immediately in profit or loss (unless the asset has been revalued in which case the loss is treated as a revaluation decrease).

After reducing an asset to its recoverable amount, the **depreciation charge** on the asset should then be based on its new carrying amount, its estimated residual value (if any) and its estimated remaining useful life.

An impairment loss should be recognised for a **cash - generating unit** if (and only if) the recoverable amount for the cash- generating unit is less than the carrying amount in the statement of financial position for all the assets in the unit. When an impairment loss is recognised for a cash- generating unit, the loss should be allocated between the assets in the unit in the following order.

(a) First, to any assets that are obviously damaged or destroyed

(b) Next, to the **goodwill** allocated to the cash generating unit

(c) Then to all other assets in the cash-generating unit, on a **pro rata basis**

In allocating an impairment loss, the carrying amount of an asset should not be reduced below the highest of:

(a) Its fair value less costs of disposal

(b) Its value in use (if determinable)

(c) Zero

Any remaining amount of an impairment loss should be recognised as a liability if required by other IASs

Reversal of an impairment loss

The annual assessment to determine whether there may have been some impairment should be **applied to all assets**, including assets that have already been impaired in the past.

In some cases, the recoverable amount of an asset that has previously been impaired might turn out to be **higher** than the asset's current carrying value. In other words, there might have been a reversal of some of the previous impairment loss.

(a) The reversal of the impairment loss should be **recognised immediately** as income in profit or loss.

(b) The carrying amount of the asset should be increased to its **new recoverable amount**.

An exception to this rule is for **goodwill**. An impairment loss for goodwill should not be reversed in a subsequent period.

Disclosure

The following information should be disclosed for each class of asset:

The amount of any impairment loss debited:

- a. to expenses (and an indication as to which line item includes the impairment loss, e.g. profit before tax); and
- b. against equity (i.e. the revaluation surplus account).

The amount of any reversals of impairment losses credited:

- a. to income (and an indication as to which line item includes the reversal of the impairment loss, e.g. profit before tax); and
- b. to equity (i.e. revaluation surplus).

This disclosure may be included in a note supporting the calculation of profit or loss (e.g. 'profit before tax' note) or in the note supporting the asset (e.g. the 'property, plant and equipment' note in the reconciliation of carrying amount).

Impairment losses and reversals of previous impairment losses

For every impairment loss or reversal of a previous impairment loss that is considered to be material, the entity must disclose the following:

- The events and circumstances that led to the impairment loss or reversal thereof;
- The nature of the asset (or the description of a cash-generating unit);
- The amount of the impairment loss or impairment loss reversed;
- The reportable segment in which the individual asset or cash-generating unit belongs (if the entity reports segment information);
- whether the recoverable amount is the ‘fair value less costs to sell’ (in which case state whether it was determined with reference to an active market or by way of another method) or the ‘value in use’ (in which case, state the discount rate used in the estimates).

If the above information relating to the recognition and reversal of impairment losses is not disclosed, indicate the main class of assets affected as well as the main events and circumstances that led to the recognition or reversal of the impairment losses.

Impairment testing: cash-generating units versus individual assets

Additional disclosure is required when impairment testing is performed on ‘cash-generating units’ instead of ‘individual assets’:

- A description of the cash-generating unit (e.g. a product line or geographical area);
- The amount of the impairment loss recognised or reversed by class for assets and, if the entity reports segment information, by reportable segment;
- If the aggregation of assets for identifying the cash-generating unit has changed since the previous estimate of the cash-generating unit’s recoverable amount, a description of the current and former way of aggregating assets and the reasons for changing the way the cash-generating unit is identified.

CHAPTER THREE

CASH AND RECEIVABLES

LEARNING OBJECTIVES

- Cash and internal control
- Types of main bank accounts
- Bank reconciliation
- Reporting of Cash and disclosure requirements
- Recognition and valuation of accounts receivable

3.1. Cash and Cash control

Cash, the most liquid of assets, is the standard medium of exchange and provide the basis for measuring and accounting for all other item. It is generally classified as a current asset. To be report as “cash” it must be readily available for the payment of current obligations, it must be free from any contractual restriction that limits its use in satisfying debts.

Cash consists of coins, currency, and available funds on deposit at the bank. Negotiable instruments such as money orders, certified checks, cashiers’ check, personal checks, and bank drafts are viewed as cash. Savings accounts are usually classified as cash, although the bank has a legal right to demand notice before withdrawal. But the privilege of prior notice is rarely exercised by banks, so savings accounts are considered cash.

Certificates of deposits (CDs), deposit receipts, treasury bills, commercial and finance company paper, similar types of deposits, and “short-term paper” that provides small investors with an opportunity to earn high rates of interest are more appropriately classified as temporary investment than cash. The logic for this classification is that these situations usually contain restrictions or penalties on their conversion to cash.

Items that present classification problem are postdated checks, IOUs, travel advances, postage stamps, and special cash funds. Travel advances are properly treated at receivables if the advances are to be collected from the employees or deducted from their salaries. Otherwise,

classification of the travel advance as prepaid expense is more appropriate postdated checks and IOUs are treated as receivables.

Postage stamps on hand are classified as part of office supplies inventory or as a prepaid expense. Petty cash fund and change funds are included in the current assets as cash balance these funds are used to meet current operating expense and to liquidate current liabilities.

Management and control of cash

Cash presents special management and control problems not only because it enters into a great many transactions but also for these reasons.

1. Cash is the single asset readily convertible into any other type of asset.

It is easily concealed and transported, and it is almost universally desired. Correct accounting for cash transactions therefore requires that control be established to ensure that cash belonging to the enterprise is not improperly converted to personal use by someone in, or connected with, the enterprise.

2. The amount of cash owned by an enterprise should be regulated carefully so that neither too much nor too little is available at any time.

Two problems of accounting for cash transactions face the accounting department.

- a. Proper controls must be established to ensure that no unauthorized transactions are entered into by officers or employees;
- b. Information necessary to the proper management of cash on hand and cash transactions must be provided.

Most companies fix the responsibility for obtaining proper record control over cash transactions in the accounting department. Record control of course, is not possible without adequate physical control; therefore the accounting department must take an interest in preventing intentional or unintentional mistakes in cash transactions.

Regulating the amount of cash on hand is primarily a management problem, but accountants must be able to provide the information required by management for regulating cash on hand through the special transactions of borrowing or investing.

Internal controls for cash should

- ❖ Separate custody of and accounting for cash
- ❖ Account for all cash transaction
- ❖ Maintain only the minimum cash balance needed
- ❖ Provide for periodic test counts of cash balances

3.2. Types of main bank accounts

The bank accounts are classified into three categories. These are as follows:

1. Current Account: A Current Account or Demand Deposit Account is a running and active account which may be opened with a bank by a businessman or an organization by making an initial deposit of some amount. This account may also be operated upon any number of times during a working day. This account never becomes time barred, because no interest is paid for credit balance in this account. Before opening a current account, banks are required to obtain references from respectable parties, preferably those of a current account-holder. In case, a person or a party opens an account with the bank without satisfactory references, the banker would be inviting unpleasant results. By accepting deposits on a current account, the banker undertakes to honor his customer's cheques so long as there is enough money to the credit of the customer. In case of current account, there is no limit on the amount or number of withdrawals.

❖ Benefits of Current Accounts

- ❖ The customers derive the following advantages from current accounts:
- ❖ (a) Demand deposits are treated at par with cash. They constitute cheque currency. Cheques are readily accepted in business for making and receiving payments.
- ❖ (b) Businessmen have to receive and make a large number of payments every day. It is difficult to handle cash. The cheque facility removes the difficulty.
- ❖ (c) There are no restrictions on the number of cheques or on the amount to be drawn at a time by one cheque.
- ❖ (d) Overdraft facilities are allowed by the banks to the current account holders.

2. Savings Bank Account: Savings deposit account is meant for small businessmen and individuals who wish to save a little out of their current incomes to safeguard their future and also to earn some interest on their savings. A savings account can be opened with as a small sum of some amount. A minimum balance is to be maintained in the account if cheque book facility is

not required. However, if a cheque book has been issued, a minimum balance of some amount depending on the banks is necessary.

- ❖ There are restrictions on the maximum amount that can be deposited in this account and also on the withdrawals from this account. The bank may not permit more than one or two withdrawals during a week and may lay down a limit on the amount that can be withdrawn at one time.
- ❖ Savings account holders are allowed to deposit cheques, drafts, dividend warrants, etc., which stand in their name only. For this facility, it is necessary that account holder must be introduced by a person having a current or savings account in the same bank. However, the banks do not accept cheques or instruments payable to third party for deposit in the savings bank account. Banks allow interest on deposits maintained in savings accounts according to the rates prescribed by the National Bank of Ethiopia.

3. Fixed Deposit Account: Money in this account is accepted for a fixed period, say one, two or five years. The money so deposited cannot be withdrawn before the expiry of the fixed period. The rate of interest on this account is higher than that on other accounts. The longer the period, the higher is the rate of interest. Fixed deposits are also called “time deposits” or “time liabilities.” Fixed deposits have grown its importance and popularity in Ethiopia during recent years. These deposits constitute more than half of the total bank deposits. The following are the special characteristics of fixed deposits:

- ❖ (a) *Suitability*: Fixed deposits are usually chosen by people who have surplus money and do not require it for some time. These deposit accounts are also favored by the bankers because fixed deposit funds can be utilized by them freely till the due date of the repayment.
- ❖ (b) *Rate of Interest*: The rate of interest and other terms and conditions on which the banks accept fixed deposits are regulated by the National Bank of Ethiopia. The National Bank of Ethiopia revised the rates of interest on fixed deposits several times.
- ❖ Banks can use fixed deposits for the purpose of lending or investments. So they pay higher rate of interest on fixed deposits. Though interest is payable at the stipulated rate, at the maturity of the fixed deposit, banks usually pay interest quarterly or half-yearly also at the request of the depositor.

- ❖ (c) *Restrictions on Withdrawals*: Withdrawal of interest or the principal amount through cheques is not permitted. The depositor is not given a cheque book. At the request of the customer, the banker may credit the amount of interest or the principal to his saving or current account from which he may withdraw the same through cheques.
- ❖ (d) *Payment before Due Date*: Banks also permit encashment of a fixed deposit even before the due date, if the depositor so desires. But the interest agreed upon on such deposit shall be reduced.
- ❖ (e) *Advances against Fixed Deposits*: The banker may also grant a loan to the depositor on the security of the fixed deposit receipt.

3.3. Bank Reconciliation

Once a month, the bank sends each depositor a statement and returns the canceled checks that it has paid and charged to the depositor's account. The returned checks are said to be "canceled" because the bank stamps or cancels, them to show that they have been paid. The bank statement shows the balance at the beginning of the month, the deposits, the checks paid, other debits and credits during the month, and the balance at the end of the month.

Rarely will the balance of a company's cash account exactly equal the cash balance shown on the bank statement. Certain transactions shown in the company's records may not have been recorded by the bank, and certain bank transactions may not appear in the company's records. Therefore, a necessary step in internal control is to prove both the balance shown on the bank statement and the balance of cash in the accounting records.

Bank reconciliation is the process of accounting for the difference between the balances of cash according to the company's records. This process involves making additions to and subtractions from both balances to arrive at the adjusted cash balance.

The most common examples of transactions shown in a company's records but not entered in the bank's records are the following:

1. Outstanding checks: these are checks that have been issued and recorded by the company, but do not yet appear on the bank statement.
2. Deposits in transit: these are deposits that were mailed or taken to the bank but were not received in time to be recorded on the bank statement.

Transactions that may appear on the bank statement but that have not been recorded by the company include the following:

1. **Service charge:** Banks often charge a fee, or a service charge, for the use of a checking account. Many banks have the service charge on a number of factors, such as the average balance of the account during the month or the number of checks drawn.
2. **NSF (Non-Sufficient Funds) check:** A check deposited by the company that is not paid when the company's bank present it to the makers bank. The bank charges the company's account and returns the check so that the company can try to collect the amount due. If the bank has deducted the NSF check from the bank statement but the company has not deducted it from its book balance, an adjustment must be made in the bank reconciliation. The depositor usually reclassifies the NSF check from cash to Account Receivable because the company must now collect from the person or company that wrote the check.
3. **Interest income:** It is very common for banks to pay interest on a company's average balance. These accounts are sometimes called N.O.W or money market accounts but can take other forms. Such interest is reported on the bank statement.
4. **Miscellaneous charges and credits:** Banks also charge for other services such as collection and payment of promissory note, stopping payment on checks and printing checks. The bank notifies the depositor of each deduction including a debit memorandum with the monthly statement. A bank will sometimes serve as an agent in collecting on promissory notes for the depositor. In such case, a credit memorandum will be included.

3.4. Recognition and Valuation of accounts receivables

A receivable is an amount due from another party. Receivables are usually one of the largest current assets on a company's books. The control and analysis of this asset is very important, because receivables are usually the biggest source of a company's cash flow. What happens when your cash flow at home is reduced? You have trouble paying your bills, leading to financial hardship. Companies face this same issue. The proper control over accounts receivables is very important.

Common types of receivables

Accounts Receivable

Accounts Receivables are the most common kind of receivables. Accounts Receivables are amounts due from customers from the sale of services or merchandise on credit. They are usually due in 30 – 60 days. They are classified on the Balance Sheet as current assets.

Notes Receivable

Notes Receivable can arise when the seller asks for a promissory note to replace an Accounts receivable when the customer requests additional time to pay a past-due account. A promissory note is a written promise to pay a specific amount of money, usually including interest, at a future date. If the note is due within a year it is classified as a current asset. If the note is due after one year, it is classified as fixed asset.

Other Receivables

Examples of other receivables are income tax refunds, interest receivable, or receivables from employees. These are not covered in this chapter.

Uncollectible Accounts Receivable

In order to help minimize credit losses, a company needs to be very careful and prudent in extending credit. References and credit scores should be checked and credit worthiness needs to be established before credit is granted.

Once a receivable becomes past due, companies need to put forth great efforts to collect it. The older a receivable gets, the less likely the chance of collection.

A business will usually have some customers that will not pay their debts. GAAP requires that a company estimate the amount of uncollectable receivables at the end of the accounting period and record that amount as Bad Debt Expense. The Bad Debt Expense is recorded in the same year as the sale, complying with the matching principle.

The Allowance Method

As previously mentioned, there will always be customers that don't pay. This could be due to a dispute over the amount owed, or due to cash flow problems experienced by the customer. The amount estimated as uncollectible will be debited to a new operating expense called Bad Debts

Expense. The Bad Debts Expense will be recorded in an adjusting entry that debits Bad Debts Expense and credits Allowance for Doubtful Accounts. The Allowance for Doubtful Accounts is a contra asset account with a normal credit balance.

Valuation of accounts receivables

For most receivables the amount of money to be received and the due date can be reasonably determined. Accountants thus are faced with a relatively certain future inflow of cash and the problem is to determine the net amount of this inflow.

A number of factors must be considered in the valuation of a prospective cash inflow. One factor is the probability that a receivable actually will be collected. For any specific receivable, the probability of collection might be difficult to establish; however, for a large group of receivables a reliable estimate of collectability generally can be made.

The possible non-collectability of receivables is an example of a loss contingency because a future event (inability to collect) confirming the loss is probable and the amount of the loss can be reasonably estimated. If the estimate of possible uncollectable accounts can be made within a range, but no single amount appears to be a better estimate than any other amount within the range, the minimum amount in the range be accrued.

Another factor to be considered in the valuation of accounts receivable is the length of time until collection. The longer the time to maturity the larger is the difference between the maturity value and the present value of accounts receivable. When the time to maturity is long, most contracts between debtors and creditors require the payment of a fair rate of interest, and the present value of such a contract is equal to its face amount. If the time to maturity of account receivable is short, the present value and the amount that will be received on the due date may be ignored.

For example, a 30-day unsecured trade account receivable almost always is recorded at its face amount. The difference between present value and face amount of longer-term receivable always should be considered, because this difference may be material.

CHAPTER FOUR

INVENTORIES

LEARNING OBJECTIVES

- IAS 2
- Scope of IAS 2
- Objectives of IAS 2
- Costs of Inventory
- Inventory cost flow assumption

Introduction

International Accounting Standard 2 *Inventories* (IAS 2) replaces IAS 2 *Inventories* (revised in 1993) and should be applied for annual periods beginning on or after 1 January 2005. Earlier application is encouraged. The Standard also supersedes SIC-1 *Consistency—Different Cost Formulas for Inventories*.

Objective and scope

The objective and scope paragraphs of IAS 2 were amended by removing the words ‘held under the historical cost system’, to clarify that the Standard applies to all inventories that are not specifically excluded from its scope.

Scope clarification

The Standard clarifies that some types of inventories are outside its scope while certain other types of inventories are exempted only from the measurement requirements in the Standard.

Paragraph 3 establishes a clear distinction between those inventories that are entirely outside the scope of the Standard (described in paragraph 2) and those inventories that are outside the scope of the measurement requirements but within the scope of the other requirements in the Standard.

Scope exemptions

Producers of agricultural and forest products, agricultural produce after harvest and minerals and mineral products

The Standard does not apply to the measurement of inventories of producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at net realisable value in accordance with well-established industry practices. The previous version of IAS 2 was amended to replace the words ‘mineral ores’ with ‘minerals and mineral products’ to clarify that the scope exemption is not limited to the early stage of extraction of mineral ores.

Inventories of commodity broker-traders

The Standard does not apply to the measurement of inventories of commodity broker-traders to the extent that they are measured at fair value less costs to sell.

Cost of inventories

Costs of purchase

IAS 2 does not permit exchange differences arising directly on the recent acquisition of inventories invoiced in a foreign currency to be included in the costs of purchase of inventories. This change from the previous version of IAS 2 resulted from the elimination of the allowed alternative treatment of capitalising certain exchange differences in IAS 21 *The Effects of Changes in Foreign Exchange Rates*. That alternative had already been largely restricted in its application by SIC-11 *Foreign Exchange—Capitalisation of Losses from Severe Currency Devaluations*. SIC-11 has been superseded as a result of the revision of IAS 21 in 2003.

Other costs

Paragraph 18 was inserted to clarify that when inventories are purchased with deferred settlement terms, the difference between the purchase price for normal credit terms and the amount paid is recognised as interest expense over the period of financing.

Cost formulas

The Standard incorporates the requirements of SIC-1 *Consistency—Different Cost Formulas for Inventories* that an entity use the same cost formula for all inventories having a similar nature and use to the entity. SIC-1 is superseded.

Prohibition of LIFO as a cost formula

The Standard does not permit the use of the last-in, first-out (LIFO) formula to measure the cost of inventories.

Recognition as an expense

The Standard eliminates the reference to the matching principle.

The Standard describes the circumstances that would trigger a reversal of a write-down of inventories recognised in a prior period.

Disclosure

Inventories carried at fair value less costs to sell

The Standard requires disclosure of the carrying amount of inventories carried at fair value less costs to sell.

Write-down of inventories

The Standard requires disclosure of the amount of any write-down of inventories recognised as an expense in the period and eliminates the requirement to disclose the amount of inventories carried at net realisable value.

CHAPTER FIVE

PROPERTY, PLANT AND EQUIPMENT

LEARNING OBJECTIVES

- Acquisition and Disposition of Property, Plant, and Equipment
- Characteristics of property, plant, and equipment
- Acquisition & valuation of property, plant and equipment

- Costs subsequent to acquisition
- Disposition of property, plant and equipment
- Depreciation, Impairments, and Revaluations

Definitions

Property, plant and equipment are tangible assets that:

- Are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes
- Are expected to be used during more than one period

Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction.

Residual value is the net amount which the entity expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

Entity specific value is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life, or expects to incur when settling a liability.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Carrying amount is the amount at which an asset is recognized in the statement of financial position after deducting any accumulated depreciation and accumulated impairment losses.

An **impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount.

Recognition

In this context, recognition simply means incorporation of the item in the business's accounts, in this case as a non-current asset. The recognition of property, plant and equipment depends on two criteria:

- (a) It is probable that **future economic benefits** associated with the asset will flow to the entity
- (b) The cost of the asset to the entity can be **measured reliably**

These recognition criteria apply to **subsequent expenditure** as well as costs incurred initially. There are no separate criteria for recognising subsequent expenditure.

Property, plant and equipment can amount to **substantial amounts** in financial statements, affecting the presentation of the company's financial position and the profitability of the entity, through depreciation and also if an asset is wrongly classified as an expense and taken to profit or loss.

First criterion: future economic benefits

The **degree of certainty** attached to the flow of future economic benefits must be assessed. This should be based on the evidence available at the date of initial recognition (usually the date of purchase). The entity should be assured that it will receive the rewards attached to the asset and it will incur the associated risks, which will only generally be the case when the rewards and risks have actually passed to the entity. Until then, the asset should not be recognised.

Second criterion: cost measured reliably

It is generally easy to measure the cost of an asset as the **transfer amount on purchase**, ie what was paid for it. **Self-constructed assets** can also be measured easily by adding together the purchase price of all the constituent parts (labour, material etc) paid to external parties.

Separate items

Most of the time assets will be identified individually, but this will not be the case for **smaller items**, such as tools, dies and moulds, which are sometimes classified as inventory and written off as an expense.

Major components or spare parts, however, should be recognised as property, plant and equipment.

For very **large and specialised items**, an apparently single asset should be broken down into its composite parts. This occurs where the different parts have different useful lives and different depreciation rates are applied to each part, eg an aircraft, where the body and engines are separated as they have different useful lives.

Safety and environmental equipment

These items may be necessary for the entity to **obtain future economic benefits** from its other assets. For this reason they are recognized as assets. However the original assets plus the safety equipment should be reviewed for impairment.

Initial measurement

Once an item of property, plant and equipment qualifies for recognition as an asset, it will initially be **measured at cost**.

Components of cost

The standard lists the components of the cost of an item of property, plant and equipment.

Purchase price, less any trade discount or rebate

Import duties and non-refundable purchase taxes

Directly attributable costs of bringing the asset to working condition for its intended use, eg:

- The cost of site preparation
- Initial delivery and handling costs
- Installation costs
- Testing
- Professional fees (architects, engineers)

Initial estimate of the unavoidable cost of dismantling and removing the asset and restoring the site on which it is located

The revised IAS 16 provides **additional guidance on directly attributable** costs included in the cost of an item of property, plant and equipment.

(a) These costs bring the asset to the location and working conditions necessary for it to be capable of operating in the manner intended by management, including those costs to test whether the asset is functioning properly.

(b) They are determined after deducting the net proceeds from selling any items produced when bringing the asset to its location and condition.

The revised standard also states that income and related expenses of operations that are **incidental** to the construction or development of an item of property, plant and equipment should be **recognized** in profit or loss.

The following costs **will not be part of the cost** of property, plant or equipment unless they can be attributed directly to the asset's acquisition, or bringing it into its working condition.

- Administration and other general overhead costs
- Start-up and similar pre-production costs

- Initial operating losses before the asset reaches planned performance

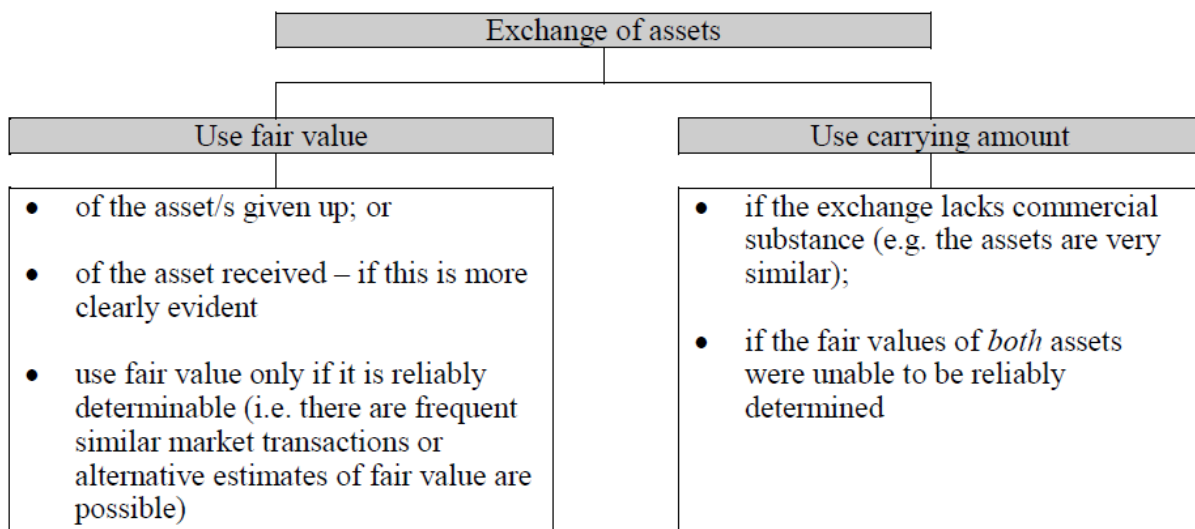
All of these will be recognised as an **expense** rather than an asset.

In the case of **self-constructed assets**, the same principles are applied as for acquired assets. If the entity makes similar assets during the normal course of business for sale externally, then the cost of the asset will be the cost of its production under IAS 2 *Inventories*. This also means that abnormal costs (wasted material, labour or other resources) are excluded from the cost of the asset. An example of a self-constructed asset is when a building company builds its own head office.

Exchanges of assets

IAS 16 specifies that exchange of items of property, plant and equipment, regardless of whether the assets are similar, are measured at **fair value**, **unless the exchange transaction lacks commercial substance** or the fair value of neither of the assets exchanged can be **measured reliably**. If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

The following diagramme may help to simplify the treatment of exchanges of assets:



Measurement subsequent to initial recognition

The standard offers two possible treatments here, essentially a choice between keeping an asset recorded at **cost** or revaluing it to **fair value**.

(a) **Cost model.** Carry the asset at its cost less depreciation and any accumulated impairment loss.

(b) **Revaluation model.** Carry the asset at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. The revised IAS 16 makes clear that the **revaluation model is available only if the fair value of the item can be measured reliably**.

Revaluations

The **market value** of land and buildings usually represents fair value, assuming existing use and line of business. Such valuations are usually carried out by professionally qualified valuers.

In the case of **plant and equipment**, fair value can also be taken as **market value**. Where a market value is not available, however, depreciated replacement cost should be used. There may be no market value where types of plant and equipment are sold only rarely or because of their specialised nature (i.e. they would normally only be sold as part of an ongoing business).

The frequency of valuation depends on the **volatility of the fair values** of individual items of property, plant and equipment. The more volatile the fair value, the more frequently revaluations should be carried out. Where the current fair value is very different from the carrying value then a revaluation should be carried out.

Most importantly, when an item of property, plant and equipment is revalued, **the whole class of assets to which it belongs should be revalued**.

All the items within a class should be **revalued at the same time**, to prevent selective revaluation of certain assets and to avoid disclosing a mixture of costs and values from different dates in the financial statements. A rolling basis of revaluation is allowed if the revaluations are kept up to date and the revaluation of the whole class is completed in a short period of time.

How should any **increase in value** be treated when a revaluation takes place? The debit will be the increase in value in the statement of financial position, but what about the credit? IAS 16

requires the increase to be credited to a **revaluation surplus** (i.e. part of owners' equity), **unless** the increase is reversing a previous decrease which was recognised as an expense. To the extent that this offset is made, the increase is recognised as income; any excess is then taken to the revaluation surplus.

Depreciation

The standard states:

- The **depreciable amount** of an item of property, plant and equipment should be allocated on a systematic basis over its useful life.
- The **depreciation method** used should reflect the pattern in which the asset's economic benefits are consumed by the entity.
- The **depreciation charge** for each period should be recognized as an expense unless it is included in the carrying amount of another asset.

Land and buildings are dealt with separately even when they are acquired together because land normally has an unlimited life and is therefore not depreciated. In contrast buildings do have a limited life and must be depreciated. Any increase in the value of land on which a building is standing will have no impact on the determination of the building's useful life.

Review of useful life

A review of the **useful life** of property, plant and equipment should be carried out **at least at each financial year end** and the depreciation charge for the current and future periods should be adjusted if expectations have changed significantly from previous estimates. Changes are changes in accounting estimates and are accounted for prospectively as adjustments to future depreciation.

Review of depreciation method

The **depreciation method** should also be reviewed **at least at each financial year end** and, if there has been a significant change in the expected pattern of economic benefits from those assets, the method should be changed to suit this changed pattern. When such a change in depreciation method takes place the change should be accounted for as a **change in accounting estimate** and the depreciation charge for the current and future periods should be adjusted

Impairment of asset values

An **impairment loss** should be treated in the same way as a **revaluation decrease** ie the decrease should be **recognised as an expense**. However, a revaluation decrease (or impairment loss) should be charged directly against any related revaluation surplus to the extent that the decrease does not exceed the amount held in the revaluation surplus in respect of that same asset. A **reversal of an impairment loss** should be treated in the same way as a **revaluation increase**, ie a revaluation increase should be recognised as income to the extent that it reverses a revaluation decrease or an impairment loss of the same asset previously recognised as an expense.

Complex assets

These are assets which are made up of separate components. Each component is separately depreciated over their useful life. An example which appeared in a recent examination was that of an aircraft. An aircraft could be considered as having the following components.

Overhauls

Where an asset requires regular overhauls in order to continue to operate, the cost of the overhaul is treated as an additional component and depreciated over the period to the next overhaul.

Retirements and disposals

When an asset is permanently **withdrawn from use, or sold or scrapped**, and no future economic benefits are expected from its disposal, it should be withdrawn from the statement of financial position.

Gains or losses are the difference between the estimated net disposal proceeds and the carrying amount of the asset. They should be recognised as income or expense in profit or loss.

Derecognition

An entity is required to **derecognise the carrying amount** of an item of property, plant or equipment that it disposes of on the date the **criteria for the sale of goods** in IAS 18 *Revenue* would be met. This also applies to parts of an asset.

An entity cannot classify as revenue a gain it realises on the disposal of an item of property, plant and equipment.

Disclosure

The standard has a long list of disclosure requirements, for each class of property, plant and equipment.

(a) **Measurement bases** for determining the gross carrying amount (if more than one, the gross

Carrying amount for that basis in each category)

(b) **Depreciation methods** used

(c) **Useful lives** or depreciation rates used

(d) **Gross carrying amount** and accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period

(e) **Reconciliation** of the carrying amount at the beginning and end of the period showing:

- Additions
- Disposals
- Acquisitions through business combinations
- Increases/decreases during the period from revaluations and from impairment losses
- Impairment losses recognised in profit or loss
- Impairment losses reversed in profit or loss
- Depreciation
- Net exchange differences (from translation of statements of a foreign entity)
- Any other movements

The financial statements should also disclose the following.

(a) Any recoverable amounts of property, plant and equipment

(b) Existence and amounts of **restrictions on title**, and items pledged as security for liabilities

(c) Accounting policy for **the estimated costs of restoring the site**

(d) Amount of expenditures on account of **items in the course of construction**

(e) Amount of commitments to **acquisitions**

Revalued assets require further disclosures.

- (a) Basis used to revalue the assets
- (b) Effective date of the revaluation
- (c) Whether an independent valuer was involved
- (d) Nature of any indices used to determine replacement cost
- (e) Carrying amount of each class of property, plant and equipment that would have been included in the financial statements had the assets been carried at cost less accumulated depreciation and accumulated impairment losses
- (f) Revaluation surplus, indicating the movement for the period and any restrictions on the distribution of the balance to shareholders

The standard also **encourages disclosure** of additional information, which the users of financial statements may find useful.

- (a) The carrying amount of temporarily idle property, plant and equipment
- (b) The gross carrying amount of any fully depreciated property, plant and equipment that is still in use
- (c) The carrying amount of property, plant and equipment retired from active use and held for disposal
- (d) The fair value of property, plant and equipment when this is materially different from the carrying amount

Depreciation accounting

Non-current assets

If an asset's life extends over more than one accounting period, it earns profits over more than one period. It is a **non-current asset**.

With the exception of land held on freehold or very long leasehold, **every non-current asset eventually wears out over time**. Machines, cars and other vehicles, fixtures and fittings, and even buildings do not last forever. When a business acquires a non-current asset, it will have some idea about how long its useful life will be, and it might decide what to do with it.

- (a) Keep on using the non-current asset until it becomes **completely worn out**, useless, and worthless.
- (b) **Sell off** the non-current asset at the end of its useful life, either by selling it as a second-hand item or as scrap.

Since a non-current asset has a cost, and a limited useful life, and its value eventually declines, it follows that a charge should be made in profit or loss to reflect the use that is made of the asset by the business. This charge is called **depreciation**.

Scope

Depreciation accounting is governed by IAS 16 *Property, plant and equipment*. These are some of the IAS 16 definitions concerning depreciation.

- **Depreciation** is the result of systematic allocation of the depreciable amount of an asset over its estimated useful life. Depreciation for the accounting period is charged to net profit or loss for the period either directly or indirectly.
- **Depreciable assets** are assets which:
 - ✓ Are expected to be used during more than one accounting period
 - ✓ Have a limited useful life
 - ✓ Are held by an entity for use in the production or supply of goods and services, for rental to others, or for administrative purposes
- **Useful life** is one of two things:
 - ✓ The period over which a depreciable asset is expected to be used by the entity, or
 - ✓ The number of production or similar units expected to be obtained from the asset by the entity.
- **Depreciable amount** of a depreciable asset is the historical cost or other amount substituted for cost in the financial statements, less the estimated residual value.

An 'amount substituted for cost' will normally be a **current market value** after a revaluation has taken place.

Depreciation

IAS 16 requires the depreciable amount of a depreciable asset to be allocated on a **systematic basis** to each accounting period during the useful life of the asset. **Every part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item must be depreciated separately.**

One way of defining depreciation is to describe it as a means of **spreading the cost** of a non-current asset over its useful life, and so matching the cost against the full period during which it earns profits for the business. Depreciation charges are an example of the application of the accrual assumption to calculate profits.

There are situations where, over a period, an asset has **increased in value**, ie its current value is greater than the carrying value in the financial statements. You might think that in such situations it would not be necessary to depreciate the asset. The standard states, however, that this is irrelevant, and that depreciation should still be charged to each accounting period, based on the depreciable amount, irrespective of a rise in value.

An entity is required to begin depreciating an item of property, plant and equipment when it is available for use and to continue depreciating it until it is derecognised even if it is idle during the period.

Useful life

The following factors should be considered when **estimating the useful life** of a depreciable asset.

- Expected **physical wear and tear**
- **Obsolescence**
- Legal or other **limits** on the use of the assets

Once decided, the useful life should be **reviewed at least every financial year end** and depreciation rates adjusted for the current and future periods if expectations vary significantly from the original estimates. The effect of the change should be disclosed in the accounting period in which the change takes place.

The assessment of useful life requires **judgement** based on previous experience with similar assets or classes of asset. When a completely new type of asset is acquired (ie through technological advancement or through use in producing a brand new product or service) it is still necessary to estimate useful life, even though the exercise will be much more difficult.

The standard also points out that the physical life of the asset might be longer than its useful life to the entity in question. One of the main factors to be taken into consideration is the **physical wear and tear** the asset is likely to endure. This will depend on various circumstances, including the number of shifts for which the asset will be used, the entity's repair and maintenance programme and so on. Other factors to be considered include obsolescence (due to technological advances/improvements in production/ reduction in demand for the product/service produced by the asset) and legal restrictions, eg length of a related lease.

Residual value

In most cases the residual value of an asset is **likely to be immaterial**. If it is likely to be of any significant value, that value must be estimated at the date of purchase or any subsequent revaluation. The amount of residual value should be estimated based on the current situation with other similar assets, used in the same way, which are now at the end of their useful lives. Any expected costs of disposal should be offset against the gross residual value.

Depreciation methods

Consistency is important. The depreciation method selected should be applied consistently from period to period unless altered circumstances justify a change. When the method is changed, the effect should be quantified and disclosed and the reason for the change should be stated.

Various methods of allocating depreciation to accounting periods are available, but whichever is chosen must be applied **consistently**, to ensure comparability from period to period. Change of policy is not allowed simply because of the profitability situation of the entity.

Disclosure

An accounting policy note should disclose the **valuation bases** used for determining the amounts at which depreciable assets are stated, along with the other accounting policies:

IAS 16 also requires the following to be disclosed for each major class of depreciable asset.

- **Depreciation methods** used
- **Useful lives** or the depreciation rates used
- Total **depreciation** allocated for the period
- **Gross amount** of depreciable assets and the related accumulated depreciation

CHAPTER SIX

INVESTMENT PROPERTY

LEARNING OBJECTIVES

- Nature of Investment property
- Initial recognition and measurement of investment property

- Subsequent measurement of investment property
- Presentation and disclosure requirements

The objective of this Standard is to prescribe the accounting treatment for investment property and related disclosure requirements.

This Standard shall be applied in the recognition, measurement and disclosure of investment property.

Among other things, this Standard applies to the measurement in a lessee's financial statements of investment property interests held under a lease accounted for as a finance lease and to the measurement in a lessor's financial statements of investment property provided to a lessee under an operating lease. This Standard does not deal with matters covered in IAS 17 *Leases*, including:

- (a) classification of leases as finance leases or operating leases;
- (b) recognition of lease income from investment property (see also IAS 18 *Revenue*);
- (c) measurement in a lessee's financial statements of property interests held under a lease accounted for as an operating lease;
- (d) measurement in a lessor's financial statements of its net investment in a finance lease;
- (e) accounting for sale and leaseback transactions; and
- (f) disclosure about finance leases and operating leases.

This Standard does not apply to:

- (a) biological assets related to agricultural activity (see IAS 41 *Agriculture*); and
- (b) mineral rights and mineral reserves such as oil, natural gas and similar non regenerative resources.

The following terms are used in this Standard with the meanings specified:

Carrying amount is the amount at which an asset is recognised in the balance sheet.

Cost is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable,

the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, eg IFRS 2 *Share-based Payment*.

Fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

Investment property is property (land or a building—or part of a building—or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

- (a) use in the production or supply of goods or services or for administrative purposes;
or
- (b) sale in the ordinary course of business.

Owner-occupied property is property held (by the owner or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes.

A property interest that is held by a lessee under an operating lease may be classified and accounted for as investment property if, and only if, the property would otherwise meet the definition of an investment property and the lessee uses the fair value model set out in paragraphs 33–55 for the asset recognised. This classification alternative is available on a property-by-property basis. However, once this classification alternative is selected for one such property interest held under an operating lease, all property classified as investment property shall be accounted for using the fair value model. When this classification alternative is selected, any interest so classified is included in the disclosures required by paragraphs 74–78.

Investment property is held to earn rentals or for capital appreciation or both. Therefore, an investment property generates cash flows largely independently of the other assets held by an entity. This distinguishes investment property from owner-occupied property. The production or supply of goods or services (or the use of property for administrative purposes) generates cash flows that are attributable not only to property, but also to other assets used in the production or supply process. IAS 16 *Property, Plant and Equipment* applies to owner-occupied property.

The following are examples of investment property:

- (a) land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business.
- (b) land held for a currently undetermined future use. (If an entity has not determined that it will use the land as owner-occupied property or for short-term sale in the ordinary course of business, the land is regarded as held for capital appreciation.)
- (c) a building owned by the entity (or held by the entity under a finance lease) and leased out under one or more operating leases.
- (d) a building that is vacant but is held to be leased out under one or more operating leases.

The following are examples of items that are not investment property and are therefore outside the scope of this Standard:

- (a) property intended for sale in the ordinary course of business or in the process of construction or development for such sale (see IAS 2 *Inventories*), for example, property acquired exclusively with a view to subsequent disposal in the near future or for development and resale.
- (b) property being constructed or developed on behalf of third parties (see IAS 11 *Construction Contracts*).
- (c) owner-occupied property (see IAS 16), including (among other things) property held for future use as owner-occupied property, property held for future development and subsequent use as owner-occupied property, property occupied by employees (whether or not the employees pay rent at market rates) and owner-occupied property awaiting disposal.
- (d) property that is being constructed or developed for future use as investment property. IAS 16 applies to such property until construction or development is complete, at which time the property becomes investment property and this Standard applies.

However, this Standard applies to existing investment property that is being redeveloped for continued future use as investment property (see paragraph 58).

(e) property that is leased to another entity under a finance lease.

Some properties comprise a portion that is held to earn rentals or for capital appreciation and another portion that is held for use in the production or supply of goods or services or for administrative purposes. If these portions could be sold separately (or leased out separately under a finance lease), an entity accounts for the portions separately. If the portions could not be sold separately, the property is investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administrative purposes.

In some cases, an entity provides ancillary services to the occupants of a property it holds. An entity treats such a property as investment property if the services are insignificant to the arrangement as a whole. An example is when the owner of an office building provides security and maintenance services to the lessees who occupy the building.

In other cases, the services provided are significant. For example, if an entity owns and manages a hotel, services provided to guests are significant to the arrangement as a whole. Therefore, an owner-managed hotel is owner-occupied property, rather than investment property.

It may be difficult to determine whether ancillary services are so significant that a property does not qualify as investment property. For example, the owner of a hotel sometimes transfers some responsibilities to third parties under a management contract. The terms of such contracts vary widely. At one end of the spectrum, the owner's position may, in substance, be that of a passive investor. At the other end of the spectrum, the owner may simply have outsourced day-to-day functions while retaining significant exposure to variation in the cash flows generated by the operations of the hotel.

Judgement is needed to determine whether a property qualifies as investment property. An entity develops criteria so that it can exercise that judgement consistently in accordance with the definition of investment property and with the related guidance in paragraphs 7–13. Paragraph 75(c) requires an entity to disclose these criteria when classification is difficult.

In some cases, an entity owns property that is leased to, and occupied by, its parent or another subsidiary. The property does not qualify as investment property in the consolidated financial statements, because the property is owner-occupied from the perspective of the group. However, from the perspective of the entity that owns it, the property is investment property if it meets the definition in paragraph 5. Therefore, the lessor treats the property as investment property in its individual financial statements.

Recognition

Investment property shall be recognised as an asset when, and only when:

- (a) it is probable that the future economic benefits that are associated with the investment property will flow to the entity; and
- (b) the cost of the investment property can be measured reliably.

An entity evaluates under this recognition principle all its investment property costs at the time they are incurred. These costs include costs incurred initially to acquire an investment property and costs incurred subsequently to add to, replace part of, or service a property.

Under the recognition principle in paragraph 16, an entity does not recognise in the carrying amount of an investment property the costs of the day-to-day servicing of such a property. Rather, these costs are recognised in profit or loss as incurred. Costs of day-to-day servicing are primarily the cost of labour and consumables, and may include the cost of minor parts. The purpose of these expenditures is often described as for the 'repairs and maintenance' of the property.

Parts of investment properties may have been acquired through replacement. For example, the interior walls may be replacements of original walls. Under the recognition principle, an entity recognises in the carrying amount of an investment property the cost of replacing part of an existing investment property at the time that cost is incurred if the recognition criteria are met. The carrying amount of those parts that are replaced is derecognised in accordance with the derecognition provisions of this Standard.

Measurement at recognition

An investment property shall be measured initially at its cost. Transaction costs shall be included in the initial measurement.

The cost of a purchased investment property comprises its purchase price and any directly attributable expenditure. Directly attributable expenditure includes, for example, professional fees for legal services, property transfer taxes and other transaction costs.

The cost of a self-constructed investment property is its cost at the date when the construction or development is complete. Until that date, an entity applies IAS 16. At that date, the property becomes investment property and this Standard applies (see paragraphs 57(e) and 65).

The cost of an investment property is not increased by:

- (a) start-up costs (unless they are necessary to bring the property to the condition necessary for it to be capable of operating in the manner intended by management),
- (b) operating losses incurred before the investment property achieves the planned level of occupancy, or
- (c) abnormal amounts of wasted material, labour or other resources incurred in constructing or developing the property.

If payment for an investment property is deferred, its cost is the cash price equivalent. The difference between this amount and the total payments is recognised as interest expense over the period of credit.

The initial cost of a property interest held under a lease and classified as an investment property shall be as prescribed for a finance lease by paragraph 20 of IAS 17, ie the asset shall be recognised at the lower of the fair value of the property and the present value of the minimum lease payments. An equivalent amount shall be recognised as a liability in accordance with that same paragraph.

Any premium paid for a lease is treated as part of the minimum lease payments for this purpose, and is therefore included in the cost of the asset, but is excluded from the liability. If a property interest held under a lease is classified as investment property, the item accounted

for at fair value is that interest and not the underlying property. Guidance on determining the fair value of a property interest is set out for the fair value model in paragraphs 33–52. That guidance is also relevant to the determination of fair value when that value is used as cost for initial recognition purposes.

One or more investment properties may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The following discussion refers to an exchange of one non-monetary asset for another, but it also applies to all exchanges described in the preceding sentence. The cost of such an investment property is measured at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable. The acquired asset is measured in this way even if an entity cannot immediately derecognise the asset given up. If the acquired asset is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

- (a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred, or
- (b) the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange, and
- (c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

For the purpose of determining whether an exchange transaction has commercial substance, the entity-specific value of the portion of the entity's operations affected by the transaction shall reflect post-tax cash flows. The result of these analyses may be clear without an entity having to perform detailed calculations.

The fair value of an asset for which comparable market transactions do not exist is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not

significant for that asset or (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value. If the entity is able to determine reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure cost unless the fair value of the asset received is more clearly evident.

Measurement after recognition

With the exceptions noted in paragraphs 32A and 34, an entity shall choose as its accounting policy either the fair value model in paragraphs 33–55 or the cost model in paragraph 56 and shall apply that policy to all of its investment property.

IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that a voluntary change in accounting policy shall be made only if the change will result in a more appropriate presentation of transactions, other events or conditions in the entity's financial statements. It is highly unlikely that a change from the fair value model to the cost model will result in a more appropriate presentation.

This Standard requires all entities to determine the fair value of investment property, for the purpose of either measurement (if the entity uses the fair value model) or disclosure (if it uses the cost model). An entity is encouraged, but not required, to determine the fair value of investment property on the basis of a valuation by an independent valuer who holds a recognised and relevant professional qualification and has recent experience in the location and category of the investment property being valued.

An entity may:

- (a) choose either the fair value model or the cost model for all investment property backing liabilities that pay a return linked directly to the fair value of, or returns from, specified assets including that investment property; and
- (b) choose either the fair value model or the cost model for all other investment property, regardless of the choice made in (a).

Some insurers and other entities operate an internal property fund that issues notional units, with some units held by investors in linked contracts and others held by the entity. Paragraph

32A does not permit an entity to measure the property held by the fund partly at cost and partly at fair value.

If an entity chooses different models for the two categories described in paragraph 32A, sales of investment property between pools of assets measured using different models shall be recognised at fair value and the cumulative change in fair value shall be recognised in profit or loss. Accordingly, if an investment property is sold from a pool in which the fair value model is used into a pool in which the cost model is used, the property's fair value at the date of the sale becomes its deemed cost.

Fair value model

After initial recognition, an entity that chooses the fair value model shall measure all of its investment property at fair value, except in the cases described in paragraph 53.

When a property interest held by a lessee under an operating lease is classified as an investment property under paragraph 6, paragraph 30 is not elective; the fair value model shall be applied.

A gain or loss arising from a change in the fair value of investment property shall be recognised in profit or loss for the period in which it arises.

The fair value of investment property is the price at which the property could be exchanged between knowledgeable, willing parties in an arm's length transaction (see paragraph 5). Fair value specifically excludes an estimated price inflated or deflated by special terms or circumstances such as atypical financing, sale and leaseback arrangements, special considerations or concessions granted by anyone associated with the sale.

An entity determines fair value without any deduction for transaction costs it may incur on sale or other disposal.

The fair value of investment property shall reflect market conditions at the balance sheet date.

Fair value is time-specific as of a given date. Because market conditions may change, the amount reported as fair value may be incorrect or inappropriate if estimated as of another

time. The definition of fair value also assumes simultaneous exchange and completion of the contract for sale without any variation in price that might be made in an arm's length transaction between knowledgeable, willing parties if exchange and completion are not simultaneous.

The fair value of investment property reflects, among other things, rental income from current leases and reasonable and supportable assumptions that represent what knowledgeable, willing parties would assume about rental income from future leases in the light of current conditions. It also reflects, on a similar basis, any cash outflows (including rental payments and other outflows) that could be expected in respect of the property. Some of those outflows are reflected in the liability whereas others relate to outflows that are not recognised in the financial statements until a later date (eg periodic payments such as contingent rents).

Paragraph 25 specifies the basis for initial recognition of the cost of an interest in a leased property. Paragraph 33 requires the interest in the leased property to be remeasured, if necessary, to fair value. In a lease negotiated at market rates, the fair value of an interest in a leased property at acquisition, net of all expected lease payments (including those relating to recognised liabilities), should be zero. This fair value does not change regardless of whether, for accounting purposes, a leased asset and liability are recognised at fair value or at the present value of minimum lease payments, in accordance with paragraph 20 of IAS 17. Thus, remeasuring a leased asset from cost in accordance with paragraph 25 to fair value in accordance with paragraph 33 should not give rise to any initial gain or loss, unless fair value is measured at different times. This could occur when an election to apply the fair value model is made after initial recognition.

The definition of fair value refers to 'knowledgeable, willing parties'. In this context, 'knowledgeable' means that both the willing buyer and the willing seller are reasonably informed about the nature and characteristics of the investment property, its actual and potential uses, and market conditions at the balance sheet date. A willing buyer is motivated, but not compelled, to buy. This buyer is neither over-eager nor determined to buy at any price. The assumed buyer would not pay a higher price than a market comprising knowledgeable, willing buyers and sellers would require.

A willing seller is neither an over-eager nor a forced seller, prepared to sell at any price, nor one prepared to hold out for a price not considered reasonable in current market conditions. The willing seller is motivated to sell the investment property at market terms for the best price obtainable. The factual circumstances of the actual investment property owner are not a part of this consideration because the willing seller is a hypothetical owner (eg a willing seller would not take into account the particular tax circumstances of the actual investment property owner).

The definition of fair value refers to an arm's length transaction. An arm's length transaction is one between parties that do not have a particular or special relationship that makes prices of transactions uncharacteristic of market conditions. The transaction is presumed to be between unrelated parties, each acting independently.

The best evidence of fair value is given by current prices in an active market for similar property in the same location and condition and subject to similar lease and other contracts. An entity takes care to identify any differences in the nature, location or condition of the property, or in the contractual terms of the leases and other contracts relating to the property.

In the absence of current prices in an active market of the kind described in paragraph 45, an entity considers information from a variety of sources, including:

- (a) current prices in an active market for properties of different nature, condition or location (or subject to different lease or other contracts), adjusted to reflect those differences;
- (b) recent prices of similar properties on less active markets, with adjustments to reflect any changes in economic conditions since the date of the transactions that occurred at those prices; and
- (c) discounted cash flow projections based on reliable estimates of future cash flows, supported by the terms of any existing lease and other contracts and (when possible) by external evidence such as current market rents for similar properties in the same location and condition, and using discount rates that reflect current market assessments of the uncertainty in the amount and timing of the cash flows.

In some cases, the various sources listed in the previous paragraph may suggest different conclusions about the fair value of an investment property. An entity considers the reasons for those differences, in order to arrive at the most reliable estimate of fair value within a range of reasonable fair value estimates.

In exceptional cases, there is clear evidence when an entity first acquires an investment property (or when an existing property first becomes investment property following the completion of construction or development, or after a change in use) that the variability in the range of reasonable fair value estimates will be so great, and the probabilities of the various outcomes so difficult to assess, that the usefulness of a single estimate of fair value is negated. This may indicate that the fair value of the property will not be reliably determinable on a continuing basis (see paragraph 53).

Fair value differs from value in use, as defined in IAS 36 *Impairment of Assets*. Fair value reflects the knowledge and estimates of knowledgeable, willing buyers and sellers. In contrast, value in use reflects the entity's estimates, including the effects of factors that may be specific to the entity and not applicable to entities in general. For example, fair value does not reflect any of the following factors to the extent that they would not be generally available to knowledgeable, willing buyers and sellers:

- (a) additional value derived from the creation of a portfolio of properties in different locations;
- (b) synergies between investment property and other assets;
- (c) legal rights or legal restrictions that are specific only to the current owner; and
- (d) tax benefits or tax burdens that are specific to the current owner.

In determining the fair value of investment property, an entity does not double-count assets or liabilities that are recognised as separate assets or liabilities. For example:

- (a) equipment such as lifts or air-conditioning is often an integral part of a building and is generally included in the fair value of the investment property, rather than recognised separately as property, plant and equipment.

- (b) if an office is leased on a furnished basis, the fair value of the office generally includes the fair value of the furniture, because the rental income relates to the furnished office. When furniture is included in the fair value of investment property, an entity does not recognise that furniture as a separate asset.
- (c) the fair value of investment property excludes prepaid or accrued operating lease income, because the entity recognises it as a separate liability or asset.
- (d) the fair value of investment property held under a lease reflects expected cash flows (including contingent rent that is expected to become payable). Accordingly, if a valuation obtained for a property is net of all payments expected to be made, it will be necessary to add back any recognised lease liability, to arrive at the fair value of the investment property for accounting purposes.

The fair value of investment property does not reflect future capital expenditure that will improve or enhance the property and does not reflect the related future benefits from this future expenditure.

In some cases, an entity expects that the present value of its payments relating to an investment property (other than payments relating to recognised liabilities) will exceed the present value of the related cash receipts. An entity applies IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to determine whether to recognise a liability and, if so, how to measure it.

CHAPTER SEVEN

NON-CURRENT ASSETS HELD FOR SALE, AND DISCONTINUED OPERATIONS

LEARNING OBJECTIVES

- Nature of NCAHFS and discontinued operations
- Initial recognition and measurement of NCAHFS
- Subsequent measurement of NCAHFS
- Presentation and disclosure requirements
- Measurement, presentation and disclosure of discontinued operations

7.1. Nature of NCAHFS and discontinued operations

- Discontinuing a business operation or deciding to sell a major asset are important commercial events.
- The impact of these events and the way in which they are reported is therefore of much interest to investors, analysts, regulators and other financial statement users.
- IFRS 5 can have a significant effect on a company's profit or loss, the carrying values of its assets and on the presentation of results.

7.2. Initial classification requirements

Requirements to initially classify asset(s) as held for sale:

- the asset(s) must be available for immediate sale in its (their) present condition.
- there is the intention and ability to sell.
- the sale must be highly probable.

Criteria for the sale to be highly probable:

- Management must be committed to a plan to sell the asset;
- An active program to find a buyer must have been initiated;
- The assets are on the market at a price that is reasonable in relation to their estimated current fair values;

7.3. Subsequent measurement of NCAHFS

Sales transactions may sometimes not proceed as initially planned, for example, where a buyer cannot be found or regulatory approval is required. A review of the selling plan is generally necessary at subsequent reporting dates to ensure that the held for sale criteria continue to be met. If the sales transaction is delayed beyond the initial one-year period, it is necessary to consider the reasons for the delay. IFRS5 allows an extension of the held for

sale classification only if the delay is caused by events or circumstances beyond the entity's control and there is sufficient evidence that the entity remains committed to its plan to sell the asset (or disposal group) (IFRS5.9). The standard identifies only three scenarios in which a delay is considered to be beyond the entity's control and the held for sale classification may be continued (provided that the sales transaction is still highly probable and that the asset(s) is (are) still available for immediate sale).

7.4. Presentation and disclosure requirements

The sale is expected to be within 1 year from the date of classification (except for circumstances beyond the entity's control, but the firm is still committed to sale)

Significant changes to or a withdrawal from the selling plan are unlikely.

- *In the statement of financial position a noncurrent asset or assets of a disposal group held for sale separately from other assets, but within current assets*
- The major classes of assets and liabilities classified as held for sale are separately disclosed either in the statement of financial position or in the notes (except where the disposal group is a newly acquired subsidiary that meets the criteria to be classified as held for sale on acquisition).

7.5. Classification as discontinuing Operation

- A discontinued operation is a component of an entity that either has been disposed of or is classified as held for sale, and:
 - represents either a separate major line of business or a geographical area of operations
 - is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations, or
 - is a subsidiary acquired exclusively with a view to resale
- A component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

How to present discontinued operations

- Once you identify a discontinued operation, you should present it *separately from other continuing operations in your financial statements*.
- More specifically, An entity shall disclose (IFRS5.33):
 - *In the statement of comprehensive income: a single amount comprising the total of:*
 - The post-tax profit or loss of discontinued operations, and
 - The post tax gain or loss recognized on the measurement to fair value less costs to sell or on the disposal of assets or disposal groups.
 - *In the statement of cash flows: the net cash flows attributable to the operating, investing and financing activities of discontinued operations.*
- the amount of income from continuing operations and from discontinued operations attributable to owners of the parent, presented either in the notes or in the statement of comprehensive income.

Disclosures

- IFRS 5 requires the following disclosures about assets (or disposal groups) that are held for sale:
 - description of the non-current asset or disposal group
 - description of facts and circumstances of the sale (disposal) and the expected timing
 - impairment losses and reversals, if any, and where in the statement of comprehensive income they are recognised
 - if applicable, the reportable segment in which the non-current asset (or disposal group) is presented in accordance with [IFRS 8 Operating Segments](#)

CHAPTER EIGHT

INTANGIBLE ASSETS

LEARNING OBJECTIVES

- Characteristics and classifications of intangibles
- Valuation and amortization of intangibles

8.1. Characteristics and classifications

Christian Dior's (FRA) most important asset is its brand image, not its store fixtures. The Coca-Cola Company's (USA) success comes from its secret formula for making Coca-Cola, not its plant facilities. The world economy is dominated by information and service providers. For these companies, their major assets are often intangible in nature.

What exactly are intangible assets? Intangible assets have three main characteristics.

1. They are identifiable. To be identifiable, an intangible asset must either be separable from the company (can be sold or transferred), or it arises from a contractual or legal right from which economic benefits will flow to the company.
2. They lack physical existence. Tangible assets such as property, plant, and equipment have physical form. Intangible assets, in contrast, derive their value from the rights and privileges granted to the company using them.
3. They are not monetary assets. Assets such as bank deposits, accounts receivable, and long-term investments in bonds and shares also lack physical substance. However, monetary assets derive their value from the right (claim) to receive cash or cash equivalents in the future. Monetary assets are not classified as intangibles.

In most cases, intangible assets provide benefits over a period of years. Therefore, companies normally classify them as non-current assets.

8.2. Valuation and Amortization of Intangibles

8.2.1. Valuation of Intangibles

8.2.1.1. Purchased Intangibles

Companies record at cost intangibles purchased from another party. Cost includes all acquisition costs plus expenditures to make the intangible asset ready for its intended use. Typical costs include purchase price, legal fees, and other incidental expenses. Sometimes

companies acquire intangibles in exchange for shares or other assets. In such cases, the cost of the intangible is the fair value of the consideration given or the fair value of the intangible received, whichever is more clearly evident. What if a company buys several intangibles, or a combination of intangibles and tangibles? In such a “basket purchase,” the company should allocate the cost on the basis of fair values. Essentially, the accounting treatment for purchased intangibles closely parallels that for purchased tangible assets.

8.2.1.2. Internally Created Intangibles

Businesses frequently incur costs on a variety of intangible resources, such as scientific or technological knowledge, market research, intellectual property, and brand names. These costs are commonly referred to as research and development (R&D) costs. Intangible assets that might arise from these expenditures include patents, computer software, copyrights, and trademarks. For example, Nokia (FIN) incurred R&D costs to develop its communications equipment, resulting in patents related to its technology. In determining the accounting for these costs, Nokia must determine whether its R&D project is at a sufficiently advanced stage to be considered economically viable. To perform this assessment, Nokia evaluates costs incurred during the research phase and the development phase.

8.2.2. Amortization of Intangibles

The allocation of the cost of intangible assets in a systematic way is called amortization. Intangibles have either a limited (finite) useful life or an indefinite useful life. For example, a company like Disney (USA) has both types of intangibles. Disney amortizes its limited-life intangible assets (e.g., copyrights on its movies and licenses related to its branded products). It does not amortize indefinite-life intangible assets (e.g., the Disney trade name or its Internet domain name).

8.2.2.1. Limited-Life Intangibles

Companies amortize their limited-life intangibles by systematic charges to expense over their useful life. The useful life should reflect the periods over which these assets will contribute to cash flows. Disney, for example, considers these factors in determining useful life:

1. The expected use of the asset by the company.

2. The effects of obsolescence, demand, competition, and other economic factors. Examples include the stability of the industry, known technological advances, legislative action that results in an uncertain or changing regulatory environment, and expected changes in distribution channels.
3. Any provisions (legal, regulatory, or contractual) that enable renewal or extension of the asset's legal or contractual life without substantial cost. This factor assumes that there is evidence to support renewal or extension. Disney also must be able to accomplish renewal or extension without material modifications of the existing terms and conditions.
4. The level of maintenance expenditure required to obtain the expected future cash flows from the asset. For example, a material level of required maintenance in relation to the carrying amount of the asset may suggest a very limited useful life.
5. Any legal, regulatory, or contractual provisions that may limit the useful life.
6. The expected useful life of another asset or a group of assets to which the useful life of the intangible asset may relate (such as lease rights to a studio lot).

The amount of amortization expense for a limited-life intangible asset should reflect the pattern in which the company consumes or uses up the asset, if the company can reliably determine that pattern. For example, assume that Second Wave, Inc. purchases a license to provide a specified quantity of a gene product called Mega. Second Wave should amortize the cost of the license following the pattern of use of Mega. If Second Wave's license calls for it to provide 30 percent of the total the first year, 20 percent the second year, and 10 percent per year until the license expires, it would amortize the license cost using that pattern. If it cannot determine the pattern of production or consumption, Second Wave should use the straight-line method of amortization. When Second Wave amortizes this license, it should show the charges as expenses. It should credit either the appropriate asset accounts or separate accumulated amortization accounts.

The amount of an intangible asset to be amortized should be its cost less residual value. The residual value is assumed to be zero, unless at the end of its useful life the intangible asset has value to another company. For example, if Hardy Co. commits to purchasing an intangible asset from U2D Co. at the end of the asset's useful life, U2D Co. should reduce

the cost of its intangible asset by the residual value. Similarly, U2D Co. should consider fair values, if reliably determined, for residual values.

IFRS requires companies to assess the estimated residual values and useful lives of intangible assets at least annually. What happens if the life of a limited-life intangible asset changes? In that case, the remaining carrying amount should be amortized over the revised remaining useful life. Companies must also evaluate the limited-life intangibles annually to determine if there is an indication of impairment. If there is indication of impairment, an impairment test is performed.

An impairment loss should be recognized for the amount that the carrying amount of the intangible is greater than the recoverable amount. Recall that the recoverable amount is the greater of the fair value less costs to sell or value-in-use. (We will cover impairment of intangibles in more detail later in the chapter.)

8.2.2.2. Indefinite -Life Intangibles

If no factors (legal, regulatory, contractual, competitive, or other) limit the useful life of an intangible asset, a company considers its useful life indefinite. An indefinite life means that there is no foreseeable limit on the period of time over which the intangible asset is expected to provide cash flows. A company does not amortize an intangible asset with an indefinite life. To illustrate, assume that Double Klik Inc. acquired a trademark that it uses to distinguish a leading consumer product. It renews the trademark every 10 years. All evidence indicates that this trademark product will generate cash flows for an indefinite period of time. In this case, the trademark has an indefinite life; Double Klik does not record any amortization.

Companies also must test indefinite-life intangibles for impairment at least annually. The impairment test for indefinite-life intangibles is similar to the one for limited-life intangibles. That is, an impairment loss should be recognized for the amount that the carrying amount of the indefinite-life intangible asset is greater than the recoverable amount.

**WOLAITA SODO UNIVERSITY
COLLEGE OF BUSINESS AND ECONOMICS
DEPARTMENT OF ACCOUNTING & FINANCE**

**Intermediate financial Accounting – II
(AcFn3022)**

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Wolaita Sodo, Ethiopia

INTERMEDIATE FINANCIAL ACCOUNTING – II (ACFN3022)

CHAPTER ONE

CURRENT LIABILITIES, PROVISIONS, AND CONTINGENCIES

1.1. Nature and types of current liabilities

The question, “What is a liability?” is not easy to answer. For example, are preference shares a liability or an ownership claim? The first reaction is to say that preference shares are in fact an ownership claim, and companies should report them as part of equity. In fact, preference shares have many elements of debt as well. The issuer (and in some cases the holder) often has the right to call the shares within a specific period of time—making it similar to a repayment of principal. The dividends on the preference shares are in many cases almost guaranteed (the cumulative provision)—making it look like interest.

To help resolve some of these controversies, the IASB, as part of its Conceptual Framework, defines a liability as a present obligation of a company arising from past events, the settlement of which is expected to result in an outflow from the company of resources, embodying economic benefits. In other words, a liability has three essential characteristics:

1. It is a present obligation.
2. It arises from past events.
3. It results in an outflow of resources (cash, goods, services).

Because liabilities involve future disbursements of assets or services, one of their most important features is the date on which they are payable. A company must satisfy currently maturing obligations in the ordinary course of business to continue operating. Liabilities with a more distant due date do not, as a rule, represent a claim on the company's current resources. They are therefore in a slightly different category. This feature gives rise to the basic division of liabilities into (1) current liabilities and (2) non-current liabilities.

Recall that current assets are cash or other assets that companies reasonably expect to convert into cash, sell, or consume in operations within a single operating cycle or within a year (if completing more than one cycle each year). Similarly, a **current liability** is reported if one of two conditions exists:

1. The liability is expected to be settled within its normal operating cycle; or
2. The liability is expected to be settled within 12 months after the reporting date.

This definition has gained wide acceptance because it recognizes operating cycles of varying lengths in different industries. The **operating cycle** is the period of time elapsing between the acquisition of goods and services involved in the manufacturing process and the final cash realization resulting from sales and subsequent collections. Industries that manufacture products requiring an aging process as well as certain capital-intensive industries have an operating cycle of considerably more than one year. In these cases, companies classify operating items, such as accounts payable and accruals for wages and other expenses, as current liabilities, even if they are due to be settled more than 12 months after the reporting period.

Here are some typical current liabilities:

Accounts payable	Customer advances and deposits
 Notes payable	Unearned revenues
 Current maturities of long-term debt	Sales and value-added taxes
 Short-term obligations expected to be refinanced	Income taxes payable
 Dividends payable	Employee-related liabilities

➤ ***Accounts Payable***

Accounts payables, or trade accounts payable, are balances owed to others for goods, supplies, or services purchased on open account. Accounts payable arise because of the time lag between the receipt of services or acquisition of title to assets and the payment for them. The terms of the sale (e.g., 2/10, n/30 or 1/10, E.O.M.) usually state this period of extended credit, commonly 30 to 60 days. Most companies record liabilities for purchases of goods upon receipt of the goods. If title has passed to the purchaser before receipt of the goods, the company should record the transaction at the time of title passage. A company must pay special attention to transactions occurring near the end of one accounting period and at the beginning of the next. It needs to ascertain that the record of goods received (the inventory) agrees with the liability (accounts payable), and that it records both in the proper period. Measuring the amount of an account payable poses no particular difficulty. The invoice received from the creditor specifies the due date and the exact outlay in money that is

necessary to settle the account. The only calculation that may be necessary concerns the amount of cash discount.

➤ *Notes Payable*

Notes payable are written promises to pay a certain sum of money on a specified future date. They may arise from purchases, financing, or other transactions. Some industries require notes (often referred to as **trade notes payable**) as part of the sales/purchases transaction in lieu of the normal extension of open account credit. Notes payable to banks or loan companies generally arise from cash loans. Companies classify notes as short-term or long-term, depending on the payment due date. Notes may also be interest-bearing or zero-interest-bearing.

Interest-Bearing Note Issued

A zero-interest-bearing note does explicitly state an interest rate on the face of the note. Accordingly, the payee of the note is expected to pay the principal plus the interest (interest rate multiplied by the principal) upon maturity of the note.

Zero-Interest-Bearing Note Issued

A company may issue a zero-interest-bearing note instead of an interest-bearing note. A zero-interest-bearing note does not explicitly state an interest rate on the face of the note. **Interest is still charged**, however. At maturity, the borrower must pay back an amount greater than the cash received at the issuance date. In other words, the borrower receives in cash the present value of the note. The present value equals the face value of the note at maturity minus the interest or discount charged by the lender for the term of the note.

➤ *Current Maturities of Long-Term Debt*

When only a part of a long-term debt is to be paid within the next 12 months, as in the case of serial bonds that it retires through a series of annual installments, the company reports the maturing portion of long-term debt as a current liability and the remaining portion as a long-term debt.

However, a company should classify as current any liability that is **due on demand** (callable by the creditor) or will be due on demand within one year (or operating cycle, if longer). Liabilities often become callable by the creditor when there is a violation of the debt agreement. For example, most debt agreements specify a given level of equity to debt be maintained, or specify that working capital be of a minimum amount. If the company violates an agreement, it must classify the debt as current because it is a reasonable expectation that existing working capital will be used to satisfy the debt.

➤ *Dividends Payable*

A **cash dividend payable** is an amount owed by a corporation to its shareholders as a result of board of directors' authorization (or in other cases, vote of shareholders). At the date of declaration, the corporation assumes a liability that places the shareholders in the position of creditors in the amount of dividends declared. Because companies always pay cash dividends within one year of declaration (generally within three months), they classify them as current liabilities. On the other hand, companies do not recognize accumulated but undeclared dividends on cumulative preference shares as a liability. Why? Because **preference**

dividends in arrears are not an obligation until the board of directors authorizes the payment. Nevertheless, companies should disclose the amount of cumulative dividends unpaid in a note, or show it parenthetically in the share capital section. Dividends payable in the form of additional shares are not recognized as a liability. Such **share dividends** do not require future outlays of assets or services. Companies generally report such undistributed share dividends in the equity section because they represent retained earnings in the process of transfer to share capital.

➤ ***Customer Advances and Deposits***

Current liabilities may include **returnable cash deposits** received from customers and employees. Companies may receive deposits from customers to guarantee performance of a contract or service or as guarantees to cover payment of expected future obligations

Unearned Revenues

A magazine publisher receives payment when a customer subscribes to its magazines. An airline company sells tickets for future flights and software companies issue coupons that allow customers to upgrade to the next version of their software. How do these companies account for **unearned revenues** that they receive before providing goods or performing services?

- 1) When a company receives an advance payment, it debits Cash and credits a current liability account identifying the source of the unearned revenue.
- 2) When a company recognizes revenue, it debits the unearned revenue account and credits a revenue account.

➤ ***Sales and Value-Added Taxes Payable***

Most countries have a consumption tax. Consumption taxes are generally either a sales tax or a value-added tax (VAT). The purpose of these taxes is to generate revenue for the government similar to the corporate or personal income tax. These two taxes accomplish the same objective—to tax the final consumer of the good or service. However, the two systems use different methods to accomplish this objective.

Sometimes, the sales tax collections credited to the liability account are not equal to the liability as computed by the governmental formula. In such a case, companies make an adjustment of the liability account by recognizing a gain or a loss on sales tax collections. Many companies do not segregate the sales tax and the amount of the sale at the time of sale. Instead, the company credits both amounts in total in the Sales Revenue account. Then, to reflect correctly the actual amount of sales and the liability for sales taxes, the company debits the Sales Revenue account for the amount of the sales taxes due the government on these sales and credits the Sales Taxes Payable account for the same amount.

1.2 PROVISIONS

A **provision** is a liability of uncertain timing or amount (sometimes referred to as an *estimated liability*). Provisions are very common and may be reported either as current or non-current depending on the date of expected payment.

Common types of provisions are obligations related to litigation, warranties or product guarantees, business restructurings, and environmental damage. The difference between a provision and other liabilities (such as accounts or notes payable, salaries payable, and dividends payable) is that **a provision has greater uncertainty about the timing or amount of the future expenditure required to settle the obligation.**

Recognition of a Provision

Companies accrue an expense and related liability for a provision only if the following three conditions are met.

1. A company has a present obligation (legal or constructive) as a result of a past event;
2. It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
3. A reliable estimate can be made of the amount of the obligation.

If these three conditions are not met, no provision is recognized. In applying the first condition, the past event (often referred to as the *past obligatory event*) must have occurred. In applying the second condition, the term **probable** is defined as “more likely than not to occur.” This phrase is interpreted to mean the probability of occurrence is greater than 50 percent. If the probability is 50 percent or less, the provision is not recognized.

A **constructive obligation** is an obligation that derives from a company’s actions where:

1. By an established pattern of past practice, published policies, or a sufficiently specific current statement, the company has indicated to other parties that it will accept certain responsibilities; and
2. As a result, the company has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Measurement of Provisions

How does a company like **Toyota** (JPN), for example, determine the amount to report for its warranty cost on its automobiles? How does a company like **Carrefour** (FRA) determine its liability for customer refunds? Or, how does **Novartis** (CHE) determine the amount to report for a lawsuit that it probably will lose? And, how does a company like **Total S.A.** (FRA) determine the amount to report as a provision for its remediation costs related to environmental clean-up?

IFRS provides an answer: The amount recognized should be the **best estimate of the expenditure required to settle the present obligation**. Best estimate represents the amount that a company would pay to settle the obligation at the statement of financial position date. In determining the best estimate, the management of a company must use judgment, based on past or similar transactions, discussions with experts, and any other pertinent information

Common Types of Provisions

Here are some common areas for which provisions may be recognized in the financial statements:

- | | |
|--------------------------|----------------------|
| 1. Lawsuits | 4. Environmental |
| 2. Warranties | 5. Onerous contracts |
| 3. Consideration payable | 6. Restructuring |

Although companies generally report only one current and one non-current amount for provisions in the statement of financial position, IFRS also requires extensive disclosure related to provisions in the notes to the financial statements. Companies do not record or report in the notes to the financial statements general risk contingencies inherent in business operations (e.g., the possibility of war, strike, uninsurable catastrophes, or a business recession).

Litigation Provisions

Companies must consider the following factors, among others, in determining whether to record a liability with respect to **pending or threatened litigation** and actual or possible **claims** and **assessments**.

1. The **time period** in which the underlying cause of action occurred.
2. The **probability** of an unfavorable outcome.
3. The ability to make a **reasonable estimate** of the amount of loss.

To report a loss and a liability in the financial statements, the cause for litigation must have occurred on or before the date of the financial statements. It does not matter that the company became aware of the existence or possibility of the lawsuit or claims after the date of the financial statements but before issuing them. To evaluate the probability of an unfavorable outcome, a company considers the following: the nature of the litigation, the progress of the case, the opinion of legal counsel, its own and others' experience in similar cases, and any management response to the lawsuit.

With respect to **unfiled suits** and **unasserted claims and assessments**, a company must determine

- 1) the degree of **probability** that a suit may be filed or a claim or assessment may be asserted, and
- 2) the **probability** of an unfavorable outcome.

Warranty Provisions

A **warranty (product guarantee)** is a promise made by a seller to a buyer to make good on a deficiency of quantity, quality, or performance in a product. Manufacturers commonly use it as a sales promotion technique. Automakers, for instance, "hyped" their sales by extending their new-car warranty to seven years or 100,000 miles. For a specified period of time following the date of sale to the consumer, the manufacturer may promise to bear all or part of the cost of replacing defective parts, to perform any necessary repairs or servicing without charge, to refund the purchase price, or even to "double your money back."

Warranties and guarantees entail future costs. These additional costs, sometimes called "after costs" or "post-sale costs," frequently are significant. Although the future cost is indefinite as to amount, due date, and even customer, a liability is probable in most cases. Companies should recognize this liability in the accounts if they can reasonably estimate it. The estimated amount of the liability includes all the costs that the company will incur after sale and delivery and that are incident to the correction of defects or deficiencies required under the warranty provisions. Thus, warranty costs are a classic example of a provision.

Companies often provide one of two types of warranties to customers:

- I. Warranty that the product meets agreed-upon specifications in the contract at the time the product is sold. This type of warranty is included in the sales price of a company's product and is often referred to as an assurance-type warranty.

- II. Warranty that provides an additional service beyond the assurance-type warranty. This warranty is not included in the sales price of the product and is referred to as a service-type warranty. As a result, it is recorded as a separate performance obligation.

Assurance-Type Warranty; Companies do not record a separate performance obligation for assurance-type warranties. This type of warranty is nothing more than a quality guarantee that the good or service is free from defects at the point of sale. These types of obligations should be expensed in the period the goods are provided or services performed (in other words, at the point of sale). In addition, the company should record a warranty liability. The estimated amount of the liability includes all the costs that the company will incur after sale due to the correction of defects or deficiencies required under the warranty provisions.

Service-Type Warranty; A warranty is sometimes sold separately from the product. For example, when you purchase a television, you are entitled to an assurance-type warranty. You also will undoubtedly be offered an extended warranty on the product at an additional cost, referred to as a service-type warranty. In most cases, service-type warranties provide the customer a service beyond fixing defects that existed at the time of sale. Companies record a service-type warranty as a separate performance obligation

1.3. CONTINGENCIES

In a general sense, all provisions are contingent because they are uncertain in timing or amount. However, IFRS uses the term “contingent” for liabilities and assets that are not recognized in the financial statements.

Contingent Liabilities

Contingent liabilities are not recognized in the financial statements because they are (1) a possible obligation (not yet confirmed as a present obligation), (2) a present obligation for which it is not probable that payment will be made, or (3) a present obligation for which a reliable estimate of the obligation cannot be made. Examples of contingent liabilities are:

-  A lawsuit in which it is only possible that the company might lose.
-  A guarantee related to collectibility of a receivable.

Unless the possibility of any outflow in settlement is remote, companies should disclose the contingent liability at the end of the reporting period, providing a brief description of the nature of the contingent liability and, where practicable:

- 1) An estimate of its financial effect;
- 2) An indication of the uncertainties relating to the amount or timing of any outflow; and
- 3) The possibility of any reimbursement.

1.4 Presentation of Current Liabilities

In practice, current liabilities are usually recorded and reported in financial statements at their full maturity value. Because of the short time periods involved, frequently less than one year, the difference between the present value of a current liability and the maturity value is usually not large. The profession accepts as immaterial any slight overstatement of liabilities that results from carrying current liabilities at maturity value.

The current liabilities accounts are commonly presented after non-current liabilities in the statement of financial position. Within the current liabilities section, companies may list the accounts in order of maturity, in descending order of amount, or in order of liquidation preference.

CHAPTER TWO

NON-CURRENT LIABILITIES

2.1. Nature and classifications of non-current liabilities

Non-current liabilities (sometimes referred to as long-term debt) consist of an expected outflow of resources arising from present obligations that are not payable within a year or the operating cycle of the company, whichever is longer. Bonds payable, long-term notes payable, mortgages payable, pension liabilities, and lease liabilities are examples of non-current liabilities.

A corporation, per its bylaws, usually requires approval by the board of directors and the shareholders before bonds or notes can be issued. The same holds true for other types of long-term debt arrangements.

Generally, long-term debt has various covenants or restrictions that protect both lenders and borrowers. The indenture or agreement often includes the amounts authorized to be issued, interest rate, due date(s), call provisions, property pledged as security, sinking fund requirements, working capital and dividend restrictions, and limitations concerning the assumption of additional debt. Companies should describe these features in the body of the financial statements or the notes if important for a complete understanding of the financial position and the results of operations.

Issuing Bonds

A bond arises from a contract known as a bond indenture. A bond represents a promise to pay (1) a sum of money at a designated maturity date, plus (2) periodic interest at a specified rate on the maturity amount (face value). Individual bonds are evidenced by a paper certificate and typically have a Br 1,000 face value. Companies usually make bond interest payments semiannually although the interest rate is generally expressed as an annual rate. The main purpose of bonds is to borrow for the long term when the amount of capital needed is too large for one lender to supply. By issuing bonds in Br 100, Br 1,000, or Br 10,000 denominations, a company can divide a large amount of long-term indebtedness into many small investing units, thus enabling more than one lender to participate in the loan.

A company may sell an entire bond issue to an investment bank, which acts as a selling agent in the process of marketing the bonds. In such arrangements, investment banks may either underwrite the entire issue by guaranteeing a certain sum to the company, thus taking the risk of selling the bonds for whatever price they can get (firm underwriting). Or, they may sell the bond issue for a commission on the proceeds of the sale (best-efforts underwriting). Alternatively, the issuing company may sell the bonds directly to a large institution, financial or otherwise, without the aid of an underwriter (private placement).

Types and Ratings of Bonds

SECURED AND UNSECURED BONDS. **Secured bonds** are backed by a pledge of some sort of collateral. Mortgage bonds are secured by a claim on real estate. Collateral trust bonds are secured by shares and bonds of other corporations. Bonds not backed by collateral are **unsecured**. A **debenture bond** is unsecured. A “junk bond” is unsecured and also very risky, and therefore pays a high interest rate. Companies often use these bonds to finance leveraged buyouts.

TERM, SERIAL BONDS, AND CALLABLE BONDS. Bond issues that mature on a single date are called **term bonds**; issues that mature in installments are called **serial bonds**. Serially maturing bonds are frequently used by school or sanitary districts, municipalities, or other local taxing bodies that receive money through a special levy. **Callable bonds** give the issuer the right to call and retire the bonds prior to maturity.

CONVERTIBLE, COMMODITY-BACKED, AND DEEP-DISCOUNT BONDS. If bonds are convertible into other securities of the corporation for a specified time after issuance, they are **convertible bonds**.

Two types of bonds have been developed in an attempt to attract capital in a tight money market—commodity-backed bonds and deep-discount bonds. **Commodity-backed bonds** (also called **asset-linked bonds**) are redeemable in measures of a commodity, such as barrels of oil, tons of coal, or ounces of rare metal.

Deep-discount bonds, also referred to as **zero-interest debenture bonds**, are sold at a discount that provides the buyer’s total interest payoff at maturity.

REGISTERED AND BEARER (COUPON) BONDS. Bonds issued in the name of the owner are **registered bonds** and require surrender of the certificate and issuance of a new certificate to complete a sale. A **bearer** or **coupon bond**, however, is not recorded in the name of the owner and may be transferred from one owner to another by mere delivery.

INCOME AND REVENUE BONDS. **Income bonds** pay no interest unless the issuing company is profitable. **Revenue bonds**, so called because the interest on them is paid from specified revenue sources, are most frequently issued by airports, school districts, counties, toll-road authorities, and governmental bodies.

2.2. Recognition and valuation of bonds

The issuance and marketing of bonds to the public does not happen overnight. It usually takes weeks or even months. First, the issuing company must arrange for underwriters that will help market and sell the bonds. Then, it must obtain regulatory approval of the bond issue, undergo audits, and issue a prospectus (a document that describes the features of the bond and related financial information). Finally, the company must generally have the bond certificates printed. Frequently, the issuing company establishes the terms of a bond indenture well in advance of the sale of the bonds. Between the time the company sets these terms and the time it issues the bonds, the market conditions and the financial position of the issuing corporation may change significantly. Such changes affect the marketability of the bonds and thus their selling price.

The selling price of a bond issue is set by the supply and demand of buyers and sellers, relative risk, market conditions, and the state of the economy. The investment community

values a bond at the **present value of its expected future cash flows**, which consist of (1) interest and (2) principal. The rate used to compute the present value of these cash flows is the interest rate that provides an acceptable return on an investment commensurate with the issuer's risk characteristics.

The interest rate written in the terms of the bond indenture (and often printed on the bond certificate) is known as the **stated, coupon, or nominal rate**. The issuer of the bonds sets this rate. The stated rate is expressed as a percentage of the **face value** of the bonds (also called the **par value, principal amount, or maturity value**).

Bonds Issued at Par

If the rate employed by the investment community (buyers) is the same as the stated rate, the bond sells at par. That is, the par value equals the present value of the bonds computed by the buyers (and the current purchase price).

Bonds Issued at Discount or Premium

If the rate employed by the investment community (buyers) differs from the stated rate, the present value of the bonds computed by the buyers (and the current purchase price) will differ from the face value of the bonds. The difference between the face value and the present value of the bonds determines the actual price that buyers pay for the bonds. This difference is either a discount or premium.

 If the bonds sell for less than face value, they sell at a **discount**.

 If the bonds sell for more than face value, they sell at a **premium**.

The rate of interest actually earned by the bondholders is called the **effective yield or market rate**. If bonds sell at a discount, the effective yield exceeds the stated rate.

Conversely, if bonds sell at a premium, the effective yield is lower than the stated rate. Several variables affect the bond's price while it is outstanding, most notably the market rate of interest. There is an inverse relationship between the market interest rate and the price of the bond.

When bonds sell at less than face value, it means that investors demand a rate of interest **higher** than the stated rate. Usually, this occurs because the investors can earn a higher rate on alternative investments of equal risk. They cannot change the stated rate, so they refuse to pay face value for the bonds. Thus, by changing the amount invested, they alter the effective rate of return. The investors receive interest at the stated rate computed on the face value, but they actually earn at **an effective rate that exceeds the stated rate because they paid less than face value for the bonds**.

Effective-Interest Method

As discussed earlier, by paying more or less at issuance, investors earn a rate different than the coupon rate on the bond. Recall that the issuing company pays the contractual interest

rate over the term of the bonds but also must pay the face value at maturity. If the bond is issued at a discount, the amount paid at maturity is more than the issue amount. If issued at a premium, the company pays less at maturity relative to the issue price.

The company records this adjustment to the cost as **bond interest expense** over the life of the bonds through a process called **amortization**. **Amortization of a discount increases bond interest expense. Amortization of a premium decreases bond interest expense.**

The required procedure for amortization of a discount or premium is the **effective interest method** (also called **present value amortization**). Under the effective-interest method, companies:

1. Compute bond interest expense first by multiplying the carrying value (book value) of the bonds at the beginning of the period by the effective-interest rate.
2. Determine the bond discount or premium amortization next by comparing the bond interest expense with the interest (cash) to be paid.

The effective-interest method produces a periodic interest expense equal to **a constant percentage of the carrying value of the bonds**.

Bonds Issued Between Interest Dates

Companies usually make bond interest payments semiannually, on dates specified in the bond indenture. When companies issue bonds on other than the interest payment dates, bond investors will pay the issuer the interest accrued from the last interest payment date to the date of issue. The bond investors, in effect, pay the bond issuer in advance for that portion of the full six-months' interest payment to which they are not entitled because they have not held the bonds for that period. Then, on the next semiannual interest payment date, the bond investors will receive the full six-month' interest payment.

LONG-TERM NOTES PAYABLE

The difference between current notes payable and **long-term notes payable** is the maturity date. Short-term notes payable are those that companies expect to pay within a year or the operating cycle—whichever is longer. Long-term notes are similar in substance to bonds in that both have fixed maturity dates and carry either a stated or implicit interest rate. However, notes do not trade as readily as bonds in the organized public securities markets. Non-corporate and small corporate enterprises issue notes as their long-term instruments. Larger corporations issue both long-term notes and bonds.

Accounting for notes and bonds is quite similar. **Like a bond, a note is valued at the present value of its future interest and principal cash flows. The company amortizes any discount or premium over the life of the note**, just as it would the discount or premium on a bond. Companies compute the present value of an **interest-bearing note**, record its issuance, and amortize any discount or premium and accrual of interest in the same way that they do for bonds

Notes Issued at Face Value

 The issuance of the note recorded as follows.

Cash	XXX	
Notes Payable		XXX

 The interest incurred each year as follows.

Interest Expense (Principal* Rate)	XXX
Cash	XXX

Notes Not Issued at Face Value

Zero-Interest-Bearing Notes

If a company issues a zero-interest-bearing (non-interest-bearing) note solely for cash, it measures the note's present value by the cash received. The implicit interest rate is the **rate that equates the cash received with the amounts to be paid in the future**. The issuing company records the difference between the face amount and the present value (cash received) as a **discount and amortizes that amount to interest expense over the life of the note**.

Mortgage Notes Payable

A common form of long-term notes payable is a mortgage note payable. A **mortgage note payable** is a promissory note secured by a document called a mortgage that pledges title to property as security for the loan. Individuals, proprietorships, and partnerships use mortgage notes payable more frequently than do corporations. (Corporations usually find that bond issues offer advantages in obtaining large loans.)

The borrower usually receives cash for the face amount of the mortgage note. In that case, the face amount of the note is the true liability, and no discount or premium is involved. When the lender assesses "points," however, the total amount received by the borrower is less than the face amount of the note. Points raise the effective-interest rate above the rate specified in the note. A point is 1 percent of the face of the note.

Lenders have partially replaced the traditional **fixed-rate mortgage** with alternative mortgage arrangements. Most lenders offer **variable-rate mortgages** (also called floating rate or adjustable-rate mortgages) featuring interest rates tied to changes in the fluctuating market rate. Generally, the variable-rate lenders adjust the interest rate at either one- or three-year intervals, pegging the adjustments to changes in the prime rate or the London Interbank Offering (LIBOR) rate.

2.3 Extinguishments

How do companies record the payment of non-current liabilities—often referred to as extinguishment of debt. If a company holds the bonds (or any other form of debt security) to maturity, the answer is straightforward: The company does not compute any gains or losses. It will have fully amortized any premium or discount and any issue costs at the date the bonds mature. As a result, the carrying amount, the maturity (face) value, and the fair value of the bond are the same. Therefore, no gain or loss exists.

In this section, we discuss extinguishment of debt under three common additional situations:

1. Extinguishment with cash before maturity,
2. Extinguishment by transferring assets or securities, and
3. Extinguishment with modification of terms.

Extinguishment with Cash before Maturity

In some cases, a company extinguishes debt before its maturity date. The amount paid on extinguishment or redemption before maturity, including any call premium and expense of reacquisition, is called the reacquisition price. On any specified date, the carrying amount of

the bonds is the amount payable at maturity, adjusted for unamortized premium or discount. Any excess of the net carrying amount over the reacquisition price is a gain from extinguishment. The excess of the reacquisition price over the carrying amount is a loss from extinguishment. At the time of reacquisition, the unamortized premium or discount must be amortized up to the reacquisition date.

Extinguishment by Exchanging Assets or Securities

In addition to using cash, settling a debt obligation can involve either a transfer of noncash assets (real estate, receivables, or other assets) or the issuance of the debtor's shares. In these situations, **the creditor should account for the non-cash assets or equity interest received at their fair value.**

The debtor must determine the excess of the carrying amount of the payable over the fair value of the assets or equity transferred (gain). The debtor recognizes a gain equal to the amount of the excess. In addition, the debtor recognizes a gain or loss on disposition of assets to the extent that the fair value of those assets differs from their carrying amount (book value).

Extinguishment with Modification of Terms

In many of these situations, the creditor may grant a borrower concession with respect to settlement. The creditor offers these concessions to ensure the highest possible collection on the loan. For example, a creditor may offer one or a combination of the following modifications:

1. Reduction of the stated interest rate.
2. Extension of the maturity date of the face amount of the debt.
3. Reduction of the face amount of the debt.
4. Reduction or deferral of any accrued interest.

CHAPTER THREE

INVESTMENTS

3.1 Nature and classification of investments

Accounting for financial assets

A financial asset is cash, an equity investment of another company (e.g., ordinary or preference shares), or a contractual right to receive cash from another party (e.g., loans, receivables, and bonds).

Financial Accounting and Reporting Module (include 4 courses)

Some users of financial statements support a single measurement—fair value—for all financial assets. They view fair value as more relevant than other measurements in helping investors assess the effect of current economic events on the future cash flows of a financial asset. In addition, they believe that the use of a single method promotes consistency in valuation and reporting on the asset, thereby improving the usefulness of the financial statements. Others disagree. These financial statement users note that many investments are not held for sale but rather for the income they will generate over the life of the investment. They believe cost-based information (referred to as amortized cost) provides the most relevant information for predicting future cash flows in these cases. Finally, some express concern that using fair value information to measure financial assets is unreliable when markets for the investments are not functioning in an ordinary fashion.

After much discussion, the IASB decided that reporting all financial assets at fair value is not the most appropriate approach for providing relevant information to financial statement users. The IASB noted that both fair value and a cost-based approach can provide useful information to financial statement readers for particular types of financial assets in certain circumstances. As a result, the IASB requires that companies classify financial assets into two measurement categories—amortized cost and fair value—depending on the circumstances.

In general, IFRS requires that companies determine how to measure their financial assets based on two criteria:

- ✚ The company's business model for managing its financial assets; and
- ✚ The contractual cash flow characteristics of the financial asset.

If a company has (1) a business model whose objective is to hold assets in order to collect contractual cash flows and (2) the contractual terms of the financial asset provides specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding, then the company should use amortized cost.

Equity investments are generally recorded and reported at fair value. Equity investments do not have a fixed interest or principal payment schedule and therefore cannot be accounted for at amortized cost. Companies account for investments based on the type of security, as indicated below.

Type of Investment	Assessment of Accounting Criteria	Valuation Approach
Debt	Meets business model (held-for-collection) and contractual cash flow tests.	Amortized cost
	Does not meet the business model test (not held-for-collection).	Fair value
Equity	Does not meet contractual cash flow test.	Fair value*

*For some equity investments for which the investor exercises some control over the investee, use the equity method.

3.2 DEBT INVESTMENTS

Debt investments are characterized by contractual payments on specified dates of principal and interest on the principal amount outstanding. Companies measure debt investments at amortized cost if the objective of the company's business model is to hold the financial asset to collect the contractual cash flows (**held-for-collection**). **Amortized cost** is the initial recognition amount of the investment minus repayments, plus or minus cumulative amortization and net of any reduction for uncollectibility. If the criteria for measurement at amortized cost are not met, then the debt investment is valued and accounted for at fair value. **Fair value** is the amount for which an asset could be exchanged between knowledgeable willing parties in an arm's length transaction.

Debt Investments—Amortized Cost

Only debt investments can be measured at amortized cost. If a company like Carrefour (FRA) makes an investment in the bonds of Nokia (FIN), it will receive contractual cash flows of interest over the life of the bonds and repayment of the principal at maturity. If it is Carrefour's strategy to hold this investment in order to receive these cash flows over the life of the bond, it has a held-for-collection strategy and it will measure the investment at amortized cost.

Companies must amortize premiums or discounts using the **effective-interest method**. They apply the effective-interest method to bond investments in a way similar to that for bonds payable. To compute interest revenue, companies compute the effective-interest rate or yield at the time of investment and apply that rate to the beginning carrying amount (book value) for each interest period. The investment carrying amount is increased by the amortized discount or decreased by the amortized premium in each period. Sometimes, a company sells a bond investment before its maturity.

Debt Investments—Fair Value

In some cases, companies both manage and evaluate investment performance on a fair value basis. In these situations, these investments are managed and evaluated based on a documented risk-management or investment strategy based on fair value information. For example, some companies often hold debt investments with the intention of selling them in a short period of time. These debt investments are often referred to as **trading investments** because companies frequently buy and sell these investments to generate profits from short-term differences in price.

Companies that account for and report debt investments at fair value follow the same accounting entries as debt investments held-for-collection during the reporting period. That is, they are recorded at amortized cost. However, **at each reporting date, companies adjust the amortized cost to fair value, with any unrealized holding gain or loss reported as part of net income (fair value method)**. An **unrealized holding gain or loss** is the net change in the fair value of a debt investment from one period to another.

The Unrealized Holding Gain or Loss—Income account is reported in the "Other income and expense" section of the income statement as part of net income. This account is closed to net income each period. The Fair Value Adjustment account is not closed each period and is simply adjusted each period to its proper valuation. The Fair Value Adjustment balance is not

shown on the statement of financial position but is simply used to restate the debt investment account to fair value.

Over the life of the bond investment, interest revenue and the gain on sale are the same using either amortized cost or fair value measurement. However, under the fair value approach, an unrealized gain or loss is recorded in income in each year as the fair value of the investment changes. Overall, the gains or losses net out to zero.

In some situations, a company meets the criteria for accounting for a debt investment at amortized cost, but it would rather account for the investment at fair value, with all gains and losses related to changes in fair value reported in income. The most common reason is to address a measurement or recognition “mismatch.”

To address this mismatch, companies have the option to report most financial assets at fair value. This option is applied on an instrument-by-instrument basis and is generally available only at the time a company first purchases the financial asset or incurs a financial liability. If a company chooses to use the fair value option, it measures this instrument at fair value until the company no longer has ownership.

EQUITY INVESTMENTS

An equity investment represents ownership interest, such as ordinary, preference, or other capital shares. It also includes rights to acquire or dispose of ownership interests at an agreed-upon or determinable price, such as in warrants and rights. The cost of equity investments is measured at the purchase price of the security. Broker’s commissions and other fees incidental to the purchase are recorded as expense.

The degree to which one corporation (investor) acquires an interest in the shares of another corporation (investee) generally determines the accounting treatment for the investment subsequent to acquisition. The classification of such investments depends on the percentage of the investee voting shares that is held by the investor:

1. Holdings of less than 20 percent (fair value method)—investor has passive interest.
2. Holdings between 20 percent and 50 percent (equity method)—investor has significant influence.
3. Holdings of more than 50 percent (consolidated statements)—investor has controlling interest.

The accounting and reporting for equity investments depends on the level of influence and the type of security involved.

Holdings of Less Than 20%

When an investor has an interest of less than 20 percent, it is presumed that the investor has little or no influence over the investee. There are two classifications for holdings less than 20 percent. Under IFRS, the presumption is that equity investments are held-for-trading. That is, companies hold these securities to profit from price changes. As with debt investments that are held-for-trading, the general accounting and reporting rule for these investments is to value the securities at fair value and record unrealized gains and losses in net income (fair value method).

However, some equity investments are held for purposes other than trading. For example, a company may be required to hold an equity investment in order to sell its products in a

particular area. In this situation, the recording of unrealized gains and losses in income, as is required for trading investments, is not indicative of the company's performance with respect to this investment. As a result, IFRS allows companies to classify some equity investments as non-trading. Non-trading equity investments are recorded at fair value on the statement of financial position, with unrealized gains and losses reported in other comprehensive income.

Equity Investments—Trading (Income)

Upon acquisition, companies record equity investments at fair value.

When an investor owns less than 20 percent of the shares of another corporation, it is presumed that the investor has relatively little influence on the investee. As a result, **net income earned by the investee is not a proper basis for recognizing income from the investment by the investor**. Why? Because the increased net assets resulting from profitable operations may be permanently retained for use in the investee's business, therefore, **the investor earns net income only when the investee declares cash dividends**.

Equity Investments—Non-Trading (OCI)

The accounting entries to record non-trading equity investments are the same as for trading equity investments, except for recording the unrealized holding gain or loss. For non-trading equity investments, companies **report the unrealized holding gain or loss as other comprehensive income**. Thus, the account titled Unrealized Holding Gain or Loss—Equity is used.

Similar to the accounting for trading investments, when an investor owns less than 20 percent of the ordinary shares of another corporation, it is presumed that the investor has relatively little influence on the investee. Therefore, **the investor earns income when the investee declares cash dividends**.

Holdings Between 20% and 50%

An investor corporation may hold an interest of less than 50 percent in an investee corporation and thus not possess legal control. However, an investment in voting shares of less than 50 percent can still give an investor the ability to exercise significant influence over the operating and financial policies of an investee.

Another important consideration is the extent of ownership by an investor in relation to the concentration of other shareholdings. To achieve a reasonable degree of uniformity in application of the "significant influence" criterion, the profession concluded that an investment (direct or indirect) of 20 percent or more of the voting shares of an investee should lead to a presumption that in the absence of evidence to the contrary, an investor has the ability to exercise significant influence over an investee. In instances of "significant influence" (generally an investment of 20 percent or more), the investor must account for the investment using the **equity method**.

Equity Method

Under the **equity method**, the investor and the investee acknowledge a substantive economic relationship. The company originally records the investment at the cost of the shares acquired but subsequently adjusts the amount each period for changes in the investee's net assets. That is, **the investor's proportionate share of the earnings (losses) of the investee periodically increases (decreases) the investment's carrying amount. All dividends received by the**

investor from the investee also decrease the investment's carrying amount. The equity method recognizes that the investee's earnings increase the investee's net assets, and that the investee's losses and dividends decrease these net assets.

Using dividends as a basis for recognizing income poses an additional problem. For example, assume that the investee reports a net loss. However, the investor exerts influence to force a dividend payment from the investee. In this case, the investor reports income even though the investee is experiencing a loss. In other words, using dividends as a basis for recognizing income fails to report properly the economics of the situation.

Investee Losses Exceed Carrying Amount. If an investor's share of the investee's losses exceeds the carrying amount of the investment, should the investor recognize additional losses? Ordinarily, the investor should discontinue applying the equity method and not recognize additional losses. If the investor's potential loss is not limited to the amount of its original investment (by guarantee of the investee's obligations or other commitment to provide further financial support) or if imminent return to profitable operations by the investee appears to be assured, the investor should recognize additional losses.

Holdings of More Than 50%

When one corporation acquires a voting interest of more than 50 percent in another corporation, it is said to have a **controlling interest**. In such a relationship, the investor corporation is referred to as the **parent** and the investee corporation as the **subsidiary**. Companies present the investment in the ordinary shares of the subsidiary as a long-term investment on the separate financial statements of the parent.

When the parent treats the subsidiary as an investment, the parent generally prepares **consolidated financial statements**. Consolidated financial statements treat the parent and subsidiary corporations as a single economic entity. Whether or not consolidated financial statements are prepared, the parent company generally accounts for the investment in the subsidiary **using the equity method** as explained in the previous section of this chapter.

Impairment of Value

A company should evaluate every held-for-collection investment, at each reporting date, to determine if it has suffered impairment—a loss in value such that the fair value of the investment is below its carrying value.¹⁰ For example, if an investee experiences a bankruptcy or a significant liquidity crisis, the investor may suffer a permanent loss. If the company determines that an investment is impaired, it writes down the amortized cost basis of the individual security to reflect this loss in value. The company accounts for the write-down as a realized loss, and it includes the amount in net income.

For debt investments, a company uses the impairment test to determine whether “it is probable that the investor will be unable to collect all amounts due according to the contractual terms.” If an investment is impaired, the company should measure the loss due to the impairment. This impairment loss is calculated as the difference between the carrying amount plus accrued interest and the expected future cash flows discounted at the investment's historical effective-interest rate.

Recovery of Impairment Loss

Subsequent to recording an impairment, events or economic conditions may change such that the extent of the impairment loss decreases (e.g., due to an improvement in the debtor's credit rating). In this situation, some or all of the previously recognized impairment loss shall be reversed with a debit to the Debt Investments account and crediting Recovery of Impairment Loss.

Transfers between Categories

Transferring an investment from one classification to another should occur only when the business model for managing the investment changes. The IASB expects such changes to be rare. Companies account for transfers between classifications prospectively, at the beginning of the accounting period after the change in the business model.

Summary of Reporting Treatment of Investments

Below is the summary of the major debt and equity investment classifications and their reporting treatment.

Classification	Valuation Approach and Reporting on the Statement of Financial Position	Income Effects
Debt Investment		
1. Meets business model (held-for-collection) and contractual cash flow tests.	Amortized cost. Current or Non-current assets.	Interest is recognized as revenue.
2. Does not meet the business model test (not held-for-collection).	Fair value. Current assets.	Interest is recognized as revenue. Unrealized holding gains and losses are included in income.
3. Fair value option.	Fair value. Current or Non-current assets.	Interest is recognized as revenue. Unrealized holding gains and losses are included in income.
Equity Investment		
1. Does not meet contractual cash flow test; holdings less than 20 percent (trading).	Fair value. Current assets.	Dividends are recognized as revenue. Unrealized holding gains and losses are included in income.
2. Does not meet contractual cash flow test; holdings less than 20 percent (non-trading).	Fair value. Non-current assets.	Dividends are recognized as revenue. Unrealized holding gains and losses are not included in income but in other comprehensive income.
3. Holdings greater than 20 percent (significant influence or control).	Investments originally recorded at cost with periodic adjustment for the investor's share of the investee's income or loss, and decreased by all dividends received from the investee. Non-current assets.	Revenue is recognized to the extent of the investee's income or loss reported subsequent to the date of the investment.

CHAPTER FOUR LEASES

4.1 THE LEASING ENVIRONMENT

Aristotle once said, “Wealth does not lie in ownership but in the use of things!” Clearly, many companies have decided that Aristotle is right, as they have become heavily involved in leasing assets rather than owning them.

A **lease** is a contractual agreement between a **lessor** and a **lessee** that gives the lessee, for a specified period of time, the right to use specific property owned by the lessor in return for specified, and generally periodic, cash payments (rents). An essential element of the lease agreement is that the lessor transfers less than the total interest in the property. Because of the financial, operating, and risk advantages that the lease arrangement provides, many businesses and other types of organizations lease substantial amounts of property as an alternative to ownership. Any type of equipment or property can be leased, such as railcars, helicopters, bulldozers, schools, golf club facilities, barges, medical scanners, computers, and so on. The largest class of leased equipment is information technology equipment. Next are assets in the transportation area, such as trucks, aircraft, and railcars.

Who Are the Players?

A lease is a contractual agreement between a lessor and a lessee. This arrangement gives the lessee the right to use specific property, owned by the lessor, for an agreed period of time. In return for the use of the property, the lessee makes rental payments over the lease term to the lessor.

✚ Who are the lessors that own this property? They generally fall into one of three categories:

❖ Banks.

Banks are the largest players in the leasing business. They have low-cost funds, which give them the advantage of being able to purchase assets at less cost than their competitors. Banks also have been more aggressive in the leasing markets. They have decided that there is money to be made in leasing, and as a result they have expanded their product lines in this area. Finally, leasing transactions are now more standardized, which gives banks an advantage because they do not have to be as innovative in structuring lease arrangements.

❖ Captive leasing companies.

Captive leasing companies are subsidiaries whose primary business is to perform leasing operations for the parent company.

❖ Independents.

Independents are the final category of lessors. Independents have not done well over the last few years. Their market share has dropped fairly dramatically as banks and captive leasing companies have become more aggressive in the lease-financing area. Independents do not have point-of-sale access, nor do they have a low cost of funds advantage. What they *are* often good at is developing innovative contracts for lessees. In addition, they are starting to act as captive finance companies for some companies that do not have a leasing subsidiary.

Advantages of Leasing

The growth in leasing indicates that it often has some genuine advantages over owning property, such as:

1. 100% financing at fixed rates. Leases are often signed without requiring any money down from the lessee. This helps the lessee conserve scarce cash—an especially desirable feature for new and developing companies. In addition, lease payments often remain fixed which protects the lessee against inflation and increases in the cost of money. The following comment explains why companies choose a lease instead of a conventional loan: “Our local bank finally came up to 80 percent of the purchase price but wouldn’t go any higher, and they wanted a floating interest rate. We just couldn’t afford the down payment, and we needed to lock in a final payment rate we knew we could live with.”

2. Protection against obsolescence. Leasing equipment reduces risk of obsolescence to the lessee, and in many cases passes the risk of residual value to the lessor. For example, **Elan** (IRL) (a pharmaceutical maker) leases computers. Under the lease agreement, Elan may turn in an old computer for a new model at any time, canceling the old lease and writing a new one. The lessor adds the cost of the new lease to the balance due on the old lease, less the old computer’s trade-in value. As one treasurer remarked, “Our instinct is to purchase.” But if a new computer is likely to come along in a short time, “then leasing is just a heck of a lot more convenient than purchasing.” Naturally, the lessor also protects itself by requiring the lessee to pay higher rental payments or provide additional payments if the lessee does not maintain the asset.

3. Flexibility. Lease agreements may contain less restrictive provisions than other debt agreements. Innovative lessors can tailor a lease agreement to the lessee’s special needs. For instance, the duration of the lease—the **lease term**—may be anything from a short period of time to the entire expected economic life of the asset. The rental payments may be level from year to year, or they may increase or decrease in amount. The payment amount may be predetermined or may vary with sales, the prime interest rate, a price index, or some other factor. In most cases, the rent is set to enable the lessor to recover the cost of the asset plus a fair return over the life of the lease.

4. Less costly financing. Some companies find leasing cheaper than other forms of financing. For example, start-up companies in depressed industries or companies in low tax brackets may lease to claim tax benefits that they might otherwise lose. Depreciation deductions offer no benefit to companies that have little if any taxable income. Through leasing, the leasing companies or financial institutions use these tax benefits. They can then pass some of these tax benefits back to the user of the asset in the form of lower rental payments.

5. Tax advantages. In some cases, companies can “have their cake and eat it too” with tax advantages that leases offer. That is, for financial reporting purposes, companies do not report an asset or a liability for the lease arrangement. For tax purposes, however, companies can capitalize and depreciate the leased asset. As a result, a company takes deductions earlier rather than later and also reduces its taxes. A common vehicle for this type of transaction is a “synthetic lease” arrangement, such as that described in the opening story for **Krispy Kreme** (USA).

6. Off-balance-sheet financing. Certain leases do not add debt on a statement of financial position or affect financial ratios. In fact, they may add to borrowing capacity. Such **off-balance-sheet financing** is critical to some companies.

ACCOUNTING BY THE LESSEE

If Air France (the lessee) **capitalizes** a lease, it records an asset and a liability generally equal to the present value of the rental payments. ILFC (the lessor), having transferred substantially all the benefits and risks of ownership, recognizes a sale by removing the asset from the statement of financial position and replacing it with a receivable.

A lease is classified as a **finance lease** if it transfers substantially all the risks and rewards incidental to ownership. In order to record a lease as a finance lease, the lease must be non-cancelable. The IASB identifies the four criteria listed for assessing whether the risks and rewards have been transferred in the lease arrangement.

Capitalization Criteria

Three of the four **capitalization criteria** that apply to lessees are controversial and can be difficult to apply in practice. We discuss each of the criteria in detail on the following pages.

Transfer of Ownership Test

If the lease transfers ownership of the asset to the lessee, it is a finance lease. This criterion is not controversial and easily implemented in practice.

Bargain-Purchase Option Test

A **bargain-purchase option** allows the lessee to purchase the leased property for a price that is **significantly lower** than the property's expected fair value at the date the option becomes exercisable. At the inception of the lease, the difference between the option price and the expected fair value must be large enough to make exercise of the option reasonably assured.

Economic Life Test

If the lease period is for a major part of the asset's economic life, the lessor transfers most of the risks and rewards of ownership to the lessee. Capitalization is therefore appropriate. However, determining the lease term and what constitutes the major part of the economic life of the asset can be troublesome.

The IASB has not defined what is meant by the "major part" of an asset's economic life. In practice, following the IASB hierarchy, it has been customary to look to U.S. GAAP, which has a 75 percent of economic life threshold for evaluating the economic life test. While the 75 percent guideline may be a useful reference point, it does not represent an automatic cutoff point.

Recovery of Investment Test

If the present value of the minimum lease payments equals or exceeds substantially all of the fair value of the asset, then a lessee should capitalize the leased asset.

As with the economic life test, the IASB has not defined what is meant by "substantially all" of an asset's fair value. In practice, it has been customary to look to U.S. GAAP, which has a 90 percent of fair value threshold for assessing the recovery of investment test. Again, rather than focusing on any single element of the lease classification indicators, lessees and lessors should consider all relevant factors when evaluating lease classification criteria

Determining the present value of the minimum lease payments involves three important concepts: (1) minimum lease payments, (2) executory costs, and (3) discount rate.

Minimum Lease Payments. The lessee is obligated to make, or expected to make, minimum lease payments in connection with the leased property. These payments include: Minimum rental payments, Guaranteed residual value, Penalty for failure to renew or extend the lease and Bargain-purchase option

Executory Costs. Like most assets, leased tangible assets incur insurance, maintenance, and tax expenses—called **executory costs**—during their economic life. Executory costs do not represent payment on or reduction of the obligation. Many lease agreements specify that the lessee directly pays executory costs to the appropriate third parties. In these cases, the lessor can use the rental payment **without adjustment** in the present value computation.

Discount Rate. A lessee computes the present value of the minimum lease payments using the **implicit interest rate**. This rate is defined as the discount rate that, at the inception of the lease, causes the aggregate present value of the minimum lease payments and the unguaranteed residual value to be equal to the fair value of the leased asset.

Asset and Liability Accounted for Differently

In a finance lease transaction, the lessee uses the lease as a source of financing. The lessor finances the transaction (provides the investment capital) through the leased asset. The lessee makes rent payments, which actually are installment payments. Therefore, over the life of the rented property, **the rental payments to lessor constitute a payment of principal plus interest.**

Asset and Liability Recorded

Under the finance lease method, the lessee treats the lease transaction as if it purchases the leased property in a financing transaction. That is, lessee acquires the property and creates an obligation. Therefore, it records a finance lease as an asset and a liability at the lower of (1) the present value of the minimum lease payments (excluding executor costs) or (2) the fair value of the leased asset at the inception of the lease. The rationale for this approach is that companies should not record a leased asset for more than its fair value.

Depreciation Period

One troublesome aspect of accounting for the depreciation of the capitalized leased asset relates to the period of depreciation. If the lease agreement transfers ownership of the asset to lessee (criterion 1) or contains a bargain-purchase option (criterion 2), lessee depreciates the leased property consistent with its normal depreciation policy for other leased property, **using the economic life of the asset.**

On the other hand, if the lease does not transfer ownership or does not contain a bargain-purchase option, then lessee depreciates it over the **term of the lease**. In this case, the leased property reverts to lessor after a certain period of time.

Effective-Interest Method

Throughout the term of the lease, the lessee uses the **effective-interest method** to allocate each lease payment between principal and interest. This method produces a periodic interest expense equal to a constant percentage of the carrying value of the lease obligation. When applying the effective-interest method to finance leases, lessee must use the same discount rate that determines the present value of the minimum lease payments.

Depreciation Concept

Although lessee computes the amounts initially capitalized as an asset and recorded as an obligation at the same present value, the **depreciation of the leased property and the discharge of the obligation are independent accounting processes** during the term of the lease. It should depreciate the leased asset by applying conventional depreciation methods: straight-line, sum-of-the-years' digits, declining-balance, units of production, etc.

Finance Lease Method (Lessee)

To illustrate a finance lease, assume that **CNH Capital** (NLD) (a subsidiary of CNH Global) and **Ivanhoe Mines Ltd.** (CAN) sign a lease agreement dated January 1, 2015, that calls for CNH to lease a front-end loader to Ivanhoe beginning January 1, 2015. The terms and provisions of the lease agreement and other pertinent data are as follows.

- ✚ The term of the lease is five years. The lease agreement is non-cancelable, requiring equal rental payments of \$25,981.62 at the beginning of each year (annuity-due basis).
- ✚ The loader has a fair value at the inception of the lease of \$100,000, an estimated economic life of five years, and no residual value.
- ✚ Ivanhoe pays all of the executory costs directly to third parties except for the property taxes of \$2,000 per year, which is included as part of its annual payments to CNH.
- ✚ The lease contains no renewal options. The loader reverts to CNH at the termination of the lease.
- ✚ Ivanhoe's incremental borrowing rate is 11 percent per year.
- ✚ Ivanhoe depreciates similar equipment that it owns on a straight-line basis.
- ✚ CNH sets the annual rental to earn a rate of return on its investment of 10 percent per year; Ivanhoe knows this fact.

The lease meets the criteria for classification as a finance lease for the following reasons.

1. The lease term of five years, being equal to the equipment's estimated economic life of five years, satisfies the economic life test.
2. The present value of the minimum lease payments (\$100,000) equals the fair value of the loader (\$100,000).

The minimum lease payments are \$119,908.10 ($\$23,981.62 \times 5$). Ivanhoe computes the amount capitalized as leased assets as the present value of the minimum lease payments (excluding executory costs—property taxes of \$2,000).

Operating Method (Lessee)

Under the **operating method**, rent expense (and the associated liability) accrues day by day to the lessee as it uses the property. **The lessee assigns rent to the periods benefiting from the use of the asset and ignores, in the accounting, any commitments to make future payments.** The lessee makes appropriate accruals or deferrals if the accounting period ends between cash payment dates.

❖ ***Comparison of Finance Lease with Operating Lease***

The total charges to operations are the same over the lease term whether accounting for the lease as a finance lease or as an operating lease. Under the finance lease treatment, the charges are higher in the earlier years and lower in the later years. If using an accelerated method of depreciation, the differences between the amounts charged to operations under the

two methods would be even larger in the earlier and later years. If using a finance lease instead of an operating lease, the following occurs: (1) an increase in the amount of reported debt (both short-term and long-term), (2) an increase in the amount of total assets (specifically long-lived assets), and (3) lower income early in the life of the lease and, therefore, lower retained earnings.

CHAPTER FIVE

DEFERRED TAXATION

Companies spend a considerable amount of time and effort to minimize their income tax payments. And with good reason, as income taxes are major costs of doing business for most companies. Yet, at the same time, companies must present financial information to the investment community that provides a clear picture of present and potential tax obligations and tax benefits. In today's competitive markets, managers are expected to look for loopholes in the tax law that a company can exploit to pay less tax to various tax authorities.

5.1. *Accounting income versus taxable income*

Companies must file income tax returns following the guidelines developed by the appropriate tax authority. Because IFRS and tax regulations differ in a number of ways, so frequently do pretax financial income and taxable income. Consequently, the amount that a company reports as tax expense will differ from the amount of taxes payable to the tax authority.

Pretax financial income is a financial reporting term. It also is often referred to as income before taxes, income for financial reporting purposes, or income for book purposes. Companies determine pretax financial income according to IFRS. They measure it with the objective of providing useful information to investors and creditors.

Taxable income (income for tax purposes) is a tax accounting term. It indicates the amount used to compute income taxes payable. Companies determine taxable income according to the tax regulations. Income taxes provide money to support government operations.

5.2. *Recap of temporary versus permanent differences*

Income taxes payable can differ from income tax expense. Specific Differences Numerous items create differences between pretax financial income and taxable income. For purposes of accounting recognition, these differences are of two types: (1) temporary and (2) permanent.

Temporary Differences

Taxable temporary differences are temporary differences that will result in taxable amounts in future years when the related assets are recovered. Deductible temporary differences are temporary differences that will result in deductible amounts in future years, when the related book liabilities are settled. Taxable temporary differences give rise to recording deferred tax liabilities. Deductible temporary differences give rise to recording deferred tax assets.

Determining a company's temporary differences may prove difficult. A company should prepare a statement of financial position for tax purposes that it can compare with its IFRS statement of financial position. Many of the differences between the two statements of financial position are temporary differences.

An assumption inherent in a company's IFRS statement of financial position is that companies recover and settle the assets and liabilities at their reported amounts (carrying amounts). This assumption creates a requirement under accrual accounting to recognize currently the deferred tax consequences of temporary differences. That is, companies recognize the amount of income taxes that are payable (or refundable) when they recover and settle the reported amounts of the assets and liabilities, respectively. Bellow shows the reversal of the temporary difference described above and the resulting taxable amounts in future periods.



Permanent Differences

Some differences between taxable income and pretax financial income are permanent. Permanent differences result from items that (1) enter into pretax financial income but never into taxable income, or (2) enter into taxable income but never into pretax financial income.

Governments enact a variety of tax law provisions to attain certain political, economic, and social objectives. Some of these provisions exclude certain revenues from taxation, limit the deductibility of certain expenses, and permit the deduction of certain other expenses in excess of costs incurred. A company that has tax-free income, non-deductible expenses, or allowable deductions in excess of cost has an effective tax rate that differs from its statutory (regular) tax rate. Since permanent differences affect only the period in which they occur, they do not give rise to future taxable or deductible amounts. As a result, **companies recognize no deferred tax consequences for permanent differences.**

5.3. Deferred tax liabilities versus deferred tax assets

A. Deferred tax liability

It is the deferred tax consequences attributable to taxable temporary differences. In other words, a deferred tax liability represents the increase in taxes payable in future years as a result of taxable temporary differences existing at the end of the current year.

Companies may also compute the deferred tax liability by preparing a schedule that indicates the future taxable amounts due to existing temporary differences. Below is Schedule of Future Taxable Amounts

Financial statement effects

Income taxes payable is reported as a current liability, and the deferred tax liability is reported as a non-current liability. Companies also are required to show the components of income tax expense either in the income statement or in the notes to the financial statements

B. Deferred tax asset

A deferred tax asset is the deferred tax consequence attributable to deductible temporary differences. In other words, a deferred tax asset represents the increase in taxes refundable (or saved) in future years as a result of deductible temporary differences existing at the end of the current year.

The deferred tax benefit results from the increase in the deferred tax asset from the beginning to the end of the accounting period. The deferred tax benefit is a negative component of income tax expense.

Financial Statement Effects

Income taxes payable is reported as a current liability, and the deferred tax asset is reported as a non-current asset.

5.4. Tax losses carried forward

Every management hopes its company will be profitable. But hopes and profits may not materialize. For a start-up company, it is common to accumulate operating losses while it expands its customer base but before it realizes economies of scale. For an established company, major events such as a labor strike, rapidly changing regulatory and competitive forces, or a general economic recession such as that experienced in the wake of the COVID-19 pandemic can cause expenses to exceed revenues—a net operating loss.

A net operating loss (NOL) occurs for tax purposes in a year when tax deductible expenses exceed taxable revenues. An inequitable tax burden would result if companies were taxed during profitable periods without receiving any tax relief during periods of net operating losses. Under certain circumstances, therefore, tax laws permit taxpayers to use the losses of one year to offset the profits of other years.

Companies accomplish this income-averaging provision through the carry forward of net operating losses. Under this provision, a company pays no income taxes for a year in which it incurs a net operating loss. In addition, it can reduce future taxes payable as discussed below.

Through the use of a loss carry forward, a company may carry the net operating loss forward to offset future taxable income and reduce taxes payable in future years. Operating losses can be substantial. Because companies use carry forwards to offset future taxable income, the tax effect of a loss carry forward represents future tax savings. However, realization of the future tax benefit depends on future earnings, an **uncertain prospect**.

The key accounting issue is whether there should be different requirements for recognition of a deferred tax asset for (a) deductible temporary differences, and (b) operating loss carry forwards. The IASB's position is that in substance these items are the same—both are tax deductible amounts in future years. As a result, **the Board concluded that there should not be different requirements for recognition of a deferred tax asset from deductible temporary differences and operating loss carry forwards.**

Non-Recognition Revisited

Whether the company will realize a deferred tax asset depends on whether sufficient taxable income exists or will exist within the carry forward period available under tax law. To the extent that it is not probable that taxable profit will be available against which the unused tax losses or unused tax credits can be utilized, the deferred tax asset is not recognized.

Forming a conclusion that recognition of a loss carry forward is probable is difficult when there is negative evidence (such as cumulative losses in recent years). However, companies often cite positive evidence indicating that recognition of the carry forward is warranted.

Unfortunately, the subjective nature of determining impairment for a deferred tax asset provides a company with an opportunity to manage its earnings. As one accounting expert notes, "The 'probable' provision is perhaps the most judgmental clause in accounting." Some companies may recognize the loss carry forward immediately and then use it to increase income as needed. Others may take the income immediately to increase capital or to offset large negative charges to income.

5.5. Disclosures

In explaining the relationship between tax expense (benefit) and accounting income, companies use an applicable tax rate that provides the most meaningful information to the users of its financial statements. These income tax disclosures are required for several reasons:

1. **Assessing quality of earnings.** Many investors seeking to assess the quality of a company's earnings are interested in the relation between pretax financial income and taxable income. Analysts carefully examine earnings that are enhanced by a favorable tax effect, particularly if the tax effect is non-recurring.
2. **Making better predictions of future cash flows.** Examination of the deferred portion of income tax expense provides information as to whether taxes payable are likely to be higher or lower in the future.
3. **Predicting future cash flows for operating loss carryforwards.** Companies should disclose the amounts and expiration dates of any operating loss carryforwards for tax purposes. From this disclosure, analysts determine the amount of income that the company may recognize in the future on which it will pay no income tax.

REVENUE RECOGNITION

6.1 Overview of revenue recognition

Most revenue transactions pose few problems for revenue recognition. This is because, in many cases, the transaction is initiated and completed at the same time. However, not all transactions are that simple. For example, consider a cell phone contract between a company such as **Vodafone** (GBR) and a customer. The customer is often provided with a package that may include a handset, free minutes of talk time, data downloads, and text messaging service. In addition, some providers will bundle that with a fixed-line broadband service. At the same time, the customer may pay for these services in a variety of ways, possibly receiving a discount on the handset and then paying higher prices for connection fees and so forth. In some cases, depending on the package purchased, the company may provide free applications in subsequent periods. How, then, should the various pieces of this sale be reported by Vodafone? The answer is not obvious.

It is therefore not surprising that a recent survey of financial executives noted that the revenue recognition process is increasingly more complex to manage, more prone to error, and more material to financial statements compared to any other area in financial reporting. The report went on to note that revenue recognition is a top fraud risk and that regardless of the accounting rules followed (IFRS or U.S. GAAP), the risk of errors and inaccuracies in revenue reporting is significant

Recently, the IASB and FASB issued a converged standard on revenue recognition entitled *Revenue from Contracts with Customers*. [1] To address the inconsistencies and weaknesses of the previous approaches, a comprehensive revenue recognition standard now applies to a wide range of transactions and industries. The Boards believe this new standard will improve IFRS and U.S. GAAP by:

- (a) Providing a more robust framework for addressing revenue recognition issues.
- (b) Improving comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets.
- (c) Simplifying the preparation of financial statements by reducing the number of requirements to which companies must refer.
- (d) Requiring enhanced disclosures to help financial statement users better understand the amount, timing, and uncertainty of revenue that is recognized.

New Revenue Recognition Standard

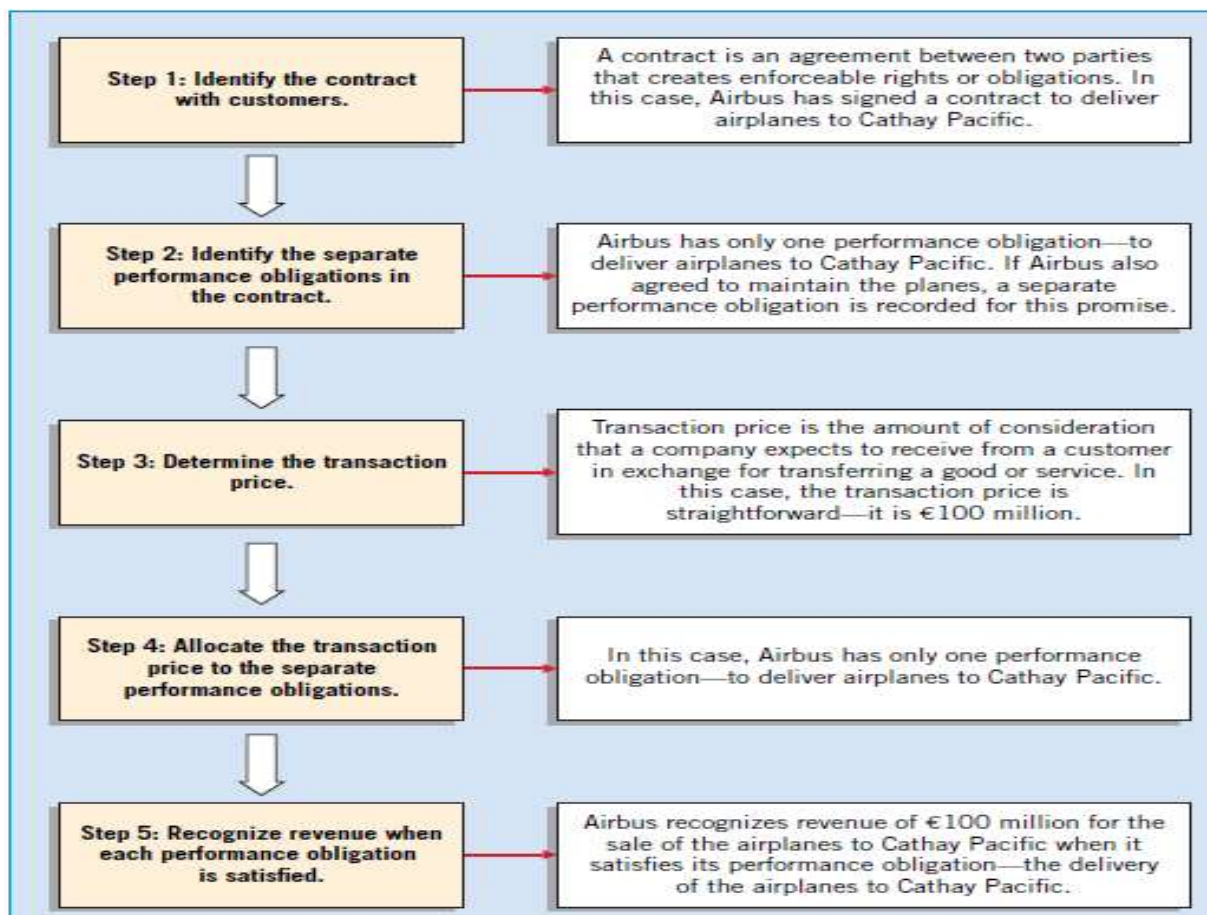
The new standard, *Revenue from Contracts with Customers*, adopts an **asset-liability approach** as the basis for revenue recognition. The asset-liability approach recognizes and measures revenue based on changes in assets and liabilities. The Boards decided that focusing on

- (a) The recognition and measurement of assets and liabilities and

(b) Changes in those assets or liabilities over the life of the contract brings more discipline to the measurement of revenue, compared to the “risk and rewards” criteria in prior standards.

Under the asset-liability approach, companies account for revenue based on the asset or liability arising from contracts with customers. Companies are required to analyze contracts with customers because these contracts are the lifeblood of most companies. Contracts indicate the terms of the transaction and the measurement of the consideration. Without contracts, companies cannot know whether promises will be met.

THE FIVE-STEP PROCESS



Identifying the Contract with Customers—Step 1

A **contract** is an agreement between two or more parties that creates enforceable rights or obligations. Contracts can be written, oral, or implied from customary business practice in some cases, there are multiple contracts related to the transaction, and accounting for each contract may or may not occur, depending on the circumstances. These situations often develop when not only a product is provided but some type of service is performed as well.

Contract Criteria for Revenue Guidance

Apply Revenue Guidance to Contracts If:	Disregard Revenue Guidance to Contracts If:
• The contract has commercial substance; • The parties to the contract have approved the contract and are committed to perform their respective obligations; • The company can identify each party's rights regarding the goods or services to be transferred; and • The company can identify the payment terms for the goods and services to be transferred. • It is probable that the company will collect the consideration to which it will be entitled.³	• The contract is wholly unperformed, and • Each party can unilaterally terminate the contract without compensation.

In some cases, a company should combine contracts and account for them as one contract.

Basic Accounting

Revenue from a contract with a customer cannot be recognized until a contract exists. On entering into a contract with a customer, a company obtains rights to receive consideration from the customer and assumes obligations to transfer goods or services to the customer (performance obligations). The combination of those rights and performance obligations gives rise to an (net) asset or (net) liability. If the measure of the remaining rights exceeds the measure of the remaining performance obligations, the contract is an asset (a contract asset). Conversely, if the measure of the remaining performance obligations exceeds the measure of the remaining rights, the contract is a liability (a contract liability). However, a company does not recognize contract assets or liabilities until one or both parties to the contract perform.

A key feature of the revenue arrangement is that the signing of the contract by the two parties is not recorded until one or both of the parties *perform under the contract*. Until performance occurs, no net asset or net liability occurs.

Contract Modifications

Companies sometimes change the contract terms while it is ongoing; this is referred to as a contract modification. When a contract modification occurs, companies determine whether a new contract (and performance obligations) results or whether it is a modification of the existing contract.

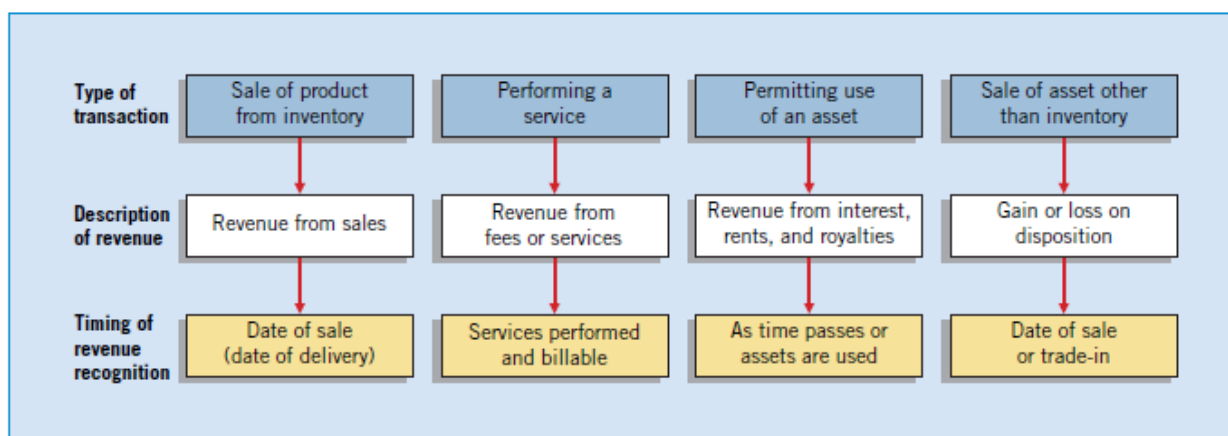
Separate Performance Obligation. A company accounts for a contract modification as a new contract if both of the following conditions are satisfied:

- The promised goods or services are distinct (i.e., the company sells them separately and they are not interdependent with other goods and services), and
- The company has the right to receive an amount of consideration that reflects the standalone selling price of the promised goods or services.

Identifying Separate Performance Obligations—Step 2

A **performance obligation** is a promise in a contract to provide a product or service to a customer. This promise may be explicit, implicit, or possibly based on customary business practice. To determine whether a performance obligation exists, **the company must provide a distinct product or service.**

Below is a summary of some classic situations when revenue is recognized



Determining the Transaction Price—Step 3

The **transaction price** is the amount of consideration that a company expects to receive from a customer in exchange for transferring goods and services. The transaction price in a contract is often easily determined because the customer agrees to pay a fixed amount to the company over a short period of time. In other contracts, companies must consider the following factors.

- ✓ Variable consideration
- ✓ Time value of money
- ✓ Non-cash consideration
- ✓ Consideration paid or payable to customers

Variable Consideration

In some cases, the price of a good or service is dependent on future events. These future events might include discounts, rebates, credits, performance bonuses, or royalties. In these cases, the company estimates the amount of variable consideration it will receive from the contract to determine the amount of revenue to recognize. Companies use either the expected value, which is a probability-weighted amount, or the most likely amount in a range of possible amounts to estimate variable consideration. Companies select among these two methods based on which approach better predicts the amount of consideration to which a company is entitled.

Estimating Variable Consideration

Expected Value: Probability-weighted amount in a range of possible consideration amounts.	Most Likely Amount: The single most likely amount in a range of possible consideration outcomes.
- May be appropriate if a company has a large number of contracts with similar characteristics. - Can be based on a limited number of discrete outcomes and probabilities.	May be appropriate if the contract has only two possible outcomes.

A word of caution—a company only allocates variable consideration if it is reasonably assured that it will be entitled to that amount. Companies therefore may only recognize variable consideration if (1) they have experience with similar contracts and are able to estimate the cumulative amount of revenue, and (2) based on experience, it is highly probable

that there will not be a significant reversal of revenue previously recognized. If these criteria are not met, revenue recognition is constrained

Time Value of Money

Timing of payment to the company sometimes does not match the transfer of the goods or services to the customer. In most situations, companies receive consideration after the product is provided or the service performed. In essence, the company provides financing for the customer. Companies account for the time value of money if the contract involves a significant financing component. When a sales transaction involves a significant financing component (i.e., interest is accrued on consideration to be paid over time), the fair value is determined either by measuring the consideration received or by discounting the payment using an imputed interest rate. The imputed interest rate is the more clearly determinable of either (1) the prevailing rate for a similar instrument of an issuer with a similar credit rating, or (2) a rate of interest that discounts the nominal amount of the instrument to the current sales price of the goods or services. The company will report the effects of the financing either as interest expense or interest revenue.

As a practical expedient, companies are not required to reflect the time value of money to determine the transaction price if the time period for payment is less than a year.

Non-Cash Consideration

Companies sometimes receive consideration in the form of goods, services, or other non-cash consideration. When these situations occur, **companies generally recognize revenue on the basis of the fair value of what is received.** In addition, companies sometimes receive contributions (e.g., donations and gifts). A contribution is often some type of asset (e.g., securities, land, buildings, or use of facilities) but it could be the forgiveness of debt. In these cases, companies recognize revenue for the fair value of the consideration received. Similarly, customers sometimes contribute goods or services, such as equipment or labor, as consideration for goods provided or services performed. This consideration should be recognized as revenue based on the fair value of the consideration received.

Consideration Paid or Payable to Customers

Companies often make payments to their customers as part of a revenue arrangement. Consideration paid or payable may include discounts, volume rebates, coupons, free products, or services. In general, these elements reduce the consideration received and the revenue to be recognized.

Allocating the Transaction Price to Separate Performance Obligations—Step 4

Companies often have to allocate the transaction price to more than one performance obligation in a contract. If an allocation is needed, the transaction price allocated to the various performance obligations is based on their relative fair values. The best measure of fair value is what the company could sell the good or service for on a standalone basis, referred to as the **standalone selling price**. If this information is not available, companies should use their best estimate of what the good or service might sell for as a standalone unit.

Below is a summary of the approaches that companies follow.

Allocation Approach	Implementation
Adjusted market assessment approach	Evaluate the market in which it sells goods or services and estimate the price that customers in that market are willing to pay for those goods or services. That approach also might include referring to prices from the company's competitors for similar goods or services and adjusting those prices as necessary to reflect the company's costs and margins.
Expected cost plus a margin approach	Forecast expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.
Residual approach	If the standalone selling price of a good or service is highly variable or uncertain, then a company may estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract. ⁶

CHAPTER SEVEN

ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

Accounting alternatives diminish the comparability of financial information between periods and between companies; they also obscure useful historical trend data. For example, if Toyota (JPN) revises its estimates for equipment useful lives, depreciation expense for the current year will not be comparable to depreciation expense reported by Toyota in prior years. Similarly, if Tesco (GBR) changes to FIFO inventory pricing while Marks and Spencer plc (GBR) uses the retail method, it will be difficult to compare these companies' reported results. A reporting framework helps preserve comparability when there is an accounting change.

The IASB has established a reporting framework that involves two types of accounting changes.

The two types of accounting changes are:

1. Change in accounting policy. A change from one accepted accounting policy to another one. For example, Alcatel-Lucent (FRA) changed its method of accounting for actuarial gains and losses from using the corridor approach to immediate recognition.
2. Change in accounting estimate. A change that occurs as the result of new information or additional experience. As an example, Daimler AG (DEU) revised its estimates of the useful lives of its depreciable property recently due to modifications in its productive processes.

A third category necessitates changes in accounting, though it is not classified as an accounting change.

3. Errors in financial statements. Errors result from mathematical mistakes, mistakes in applying accounting policies, or oversight or misuse of facts that existed when preparing the financial statements. For example, a company may incorrectly apply the retail inventory method for determining its final inventory value.

The IASB classifies changes in these categories because each category involves different methods of recognizing changes in the financial statements.

7.1 *Treatment of changes in accounting policy*

By definition, a change in accounting policy involves a change from one accepted accounting policy to another. For example, a company might change the basis of inventory pricing from average-cost to FIFO. Or, it might change its method of revenue recognition for long-term construction contracts from the cost-recovery to the percentage-of-completion method.

Companies must carefully examine each circumstance to ensure that a change in policy has actually occurred. Adoption of a new policy in recognition of events that have occurred for the first time or that were previously immaterial is not a change in accounting policy. For example, a change in accounting policy has not occurred when a company adopts an inventory method (e.g., FIFO) for newly acquired items of inventory, even if FIFO differs from that used for previously recorded inventory. Another example is certain marketing expenditures that were previously immaterial and expensed in the period incurred. It would not be considered a change in accounting policy if they become material and so may be acceptably deferred and amortized.

Finally, what if a company previously followed an accounting policy that was not acceptable? Or, what if the company applied a policy incorrectly? In such cases, this type of change is a correction of an error. For example, a switch from the cash (income tax) basis of accounting to the accrual basis is a correction of an error. Or, if a company deducted residual value when computing double-declining depreciation on plant assets and later recomputed depreciation without deducting estimated residual value, it has corrected an error.

There are three possible approaches for reporting changes in accounting policies:

- Report changes currently. In this approach, companies report the cumulative effect of the change in the current year's income statement. The cumulative effect is the difference in prior years' income between the newly adopted and prior accounting policy. Under this approach, the effect of the change on prior years' income appears only in the current-year income statement. The company does not change prior- year financial statements.

Advocates of this position argue that changing prior years' financial statements results in a loss of confidence in financial reports. How do investors react when told that the earnings computed three years ago are now entirely different? Changing prior periods, if permitted, also might upset contractual arrangements based on the old figures. For example, profit-sharing arrangements computed on the old basis might have to be recomputed and completely new distributions made, creating numerous legal problems. Many practical

difficulties also exist: The cost of changing prior period financial statements may be excessive, or determining the amount of the prior period effect may be impossible on the basis of available data.

- Report changes retrospectively. Retrospective application refers to the application of a different accounting policy to recast previously issued financial statements as if the new policy had always been used. In other words, the company “goes back” and adjusts prior years’ statements on a basis consistent with the newly adopted policy. The company shows any cumulative effect of the change as an adjustment to beginning retained earnings of the earliest year presented.

Advocates of this position argue that retrospective application ensures comparability. Think for a moment what happens if this approach is not used: The year previous to the change will be on the old method; the year of the change will report the entire cumulative adjustment; and the following year will present financial statements on the new basis without the cumulative effect of the change. Such lack of consistency fails to provide meaningful earnings-trend data and other financial relationships necessary to evaluate the business.

- Report changes prospectively (in the future). In this approach, previously reported results remain. As a result, companies do not adjust opening balances to reflect the change in policy. Advocates of this position argue that once management presents financial statements based on acceptable accounting policies, they are final; management cannot change prior periods by adopting a new policy. According to this line of reasoning, the current-period cumulative adjustment is not appropriate because that approach includes amounts that have little or no relationship to the current year’s income or economic events.

Given these three possible approaches, which does the accounting profession prefer? The IASB requires that companies use the retrospective approach. Why? Because it provides financial statement users with more useful information than the cumulative-effect or prospective approaches. The rationale is that changing the prior statements to be on the same basis as the newly adopted policy results in greater consistency across accounting periods. Users can then better compare results from one period to the next.

7.2 *Treatment of changes in accounting estimates*

To prepare financial statements, companies must estimate the effects of future conditions and events. For example, the following items require estimates.

1. Bad debts.
2. Inventory obsolescence.
3. Useful lives and residual values of assets.
4. Periods benefited by deferred costs.
5. Liabilities for warranty costs and income taxes.
6. Recoverable mineral reserves.

7. Change in depreciation estimates.
8. Fair value of financial assets or financial liabilities.

A company cannot perceive future conditions and events and their effects with certainty. Therefore, estimating requires the exercise of judgment. Accounting estimates will change as new events occur, as a company acquires more experience, or as it obtains additional information.

Prospective Reporting

Companies report prospectively changes in accounting estimates. That is, companies should not adjust previously reported results for changes in estimates. Instead, they account for the effects of all changes in estimates in (1) the period of change if the change affects that period only (e.g., a change in the estimate of the amount of bad debts affects only the current period's income), or (2) the period of change and future periods if the change affects both (e.g., a change in the estimated useful life of a depreciable asset affects depreciation expense in the current and future periods). The IASB views changes in estimates as normal recurring corrections and adjustments, the natural result of the accounting process. It prohibits retrospective treatment.

The circumstances related to a change in estimate differ from those for a change in accounting policy. If companies reported changes in estimates retrospectively, continual adjustments of prior years' income would occur. It seems proper to accept the view that, because new conditions or circumstances exist, the revision fits the new situation (not the old one). Companies should therefore handle such a revision in the current and future periods.

Companies sometime find it difficult to differentiate between a change in estimate and a change in accounting policy. Is it a change in policy or a change in estimate when a company changes from deferring and amortizing marketing costs to expensing them as incurred because future benefits of these costs have become doubtful? If it is impossible to determine whether a change in policy or a change in estimate has occurred, the rule is this: Consider the change as a change in estimate.

Another example is a change in depreciation (as well as amortization or depletion) methods. Because companies change depreciation methods based on changes in estimates about future benefits from long-lived assets, it is not possible to separate the effect of the accounting policy change from that of the estimates. As a result, companies account for a change in depreciation methods as a change in estimate.

A similar problem occurs in differentiating between a change in estimate and a correction of an error, although here the answer is more clear-cut. How does a company determine whether it overlooked the information in earlier periods (an error) or whether it obtained new information (a change in estimate)? Proper classification is important because the accounting treatment differs for corrections of errors versus changes in estimates. The general rule is this: Companies should consider careful estimates that later prove to be incorrect as changes in estimate. Only when a company obviously computed the estimate incorrectly because of lack of expertise or in bad faith should it consider the adjustment an error. There is no clear demarcation line here. Companies must use good judgment in light of all the circumstances.

Disclosures

A company should disclose the nature and amount of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods (unless it is impracticable to estimate that effect). For the most part, companies need not disclose changes in accounting estimate made as part of normal operations, such as bad debt allowances or inventory obsolescence, unless such changes are material.

7.3 Treatment of changes in errors

No business, large or small, the number of accounting errors that lead to restatement has stabilized. However, without accounting and disclosure guidelines for the reporting of errors, investors can be left in the dark about the effects of errors.

Certain errors, such as misclassifications of balances within a financial statement, are not as significant to investors as other errors. Significant errors would be those resulting in overstating assets or income, for example. However, investors should know the potential impact of all errors. Even “harmless” misclassifications can affect important ratios. Also, some errors could signal important weaknesses in internal controls that could lead to more significant errors.

In general, accounting errors include the following types:

1. A change from an accounting policy that is not generally accepted to an accounting policy that is acceptable. The rationale is that the company incorrectly presented prior periods because of the application of an improper accounting policy. For example, a company may change from the cash (income tax) basis of accounting to the accrual basis.
2. Mathematical mistakes, such as incorrectly totaling the inventory count sheets when computing the inventory value.
3. Changes in estimates that occur because a company did not prepare the estimates in good faith. For example, a company may have adopted a clearly unrealistic depreciation rate.
4. An oversight, such as the failure to accrue or defer certain expenses and revenues at the end of the period.
5. A misuse of facts, such as the failure to use residual value in computing the depreciation base for the straight-line approach.
6. The incorrect classification of a cost as an expense instead of an asset, and vice versa.

Accounting errors occur for a variety of reasons. Below are the 11 major categories of accounting errors that drive statements

Financial Accounting and Reporting Module (include 4 courses)

Accounting Category	Type of Restatement
Expense recognition	Recording expenses in the incorrect period or for an incorrect amount.
Revenue recognition	Improper revenue accounting, including instances in which revenue was improperly recognized, questionable revenues were recognized, or any other number of related errors that led to misreported revenue.
Misclassification	Misclassifying significant accounting items on the statement of financial position, income statement, or statement of cash flows. These include restatements due to misclassification of current or non-current accounts or those that impact cash flows from operations.
Equity—other	Improper accounting for EPS, restricted shares, warrants, and other equity instruments.
Reserves/Contingencies	Errors involving accounts receivables' bad debts, inventory reserves, income tax allowances, and loss contingencies.
Long-lived assets	Asset impairments of property, plant, and equipment; goodwill; or other related items.
Taxes	Errors involving correction of tax provision, improper treatment of tax liabilities, and other tax-related items.
Equity—other comprehensive income	Improper accounting for comprehensive income equity transactions including foreign currency items, revaluations of plant assets, unrealized gains and losses on certain investments in debt, equity securities, and derivatives.
Inventory	Inventory costing valuations, quantity issues, and cost of sales adjustments.
Equity—share options	Improper accounting for employee share options.
Other	Any restatement not covered by the listed categories, including those related to improper accounting for acquisitions or mergers.
Sources: T. Baldwin and D. Yoo, "Restatements—Traversing Shaky Ground," <i>Trend Alert</i> , Glass Lewis & Co. (June 2, 2005), p. 8; and "2012 Financial Restatements," <i>Audit Analytics</i> (March 2013).	

As soon as a company discovers an error, it must correct the error. Companies record corrections of errors from prior periods as an adjustment to the beginning balance of retained earnings in the current period. Such corrections are called prior period adjustments.

If it presents comparative statements, a company should restate the prior statements affected, to correct for the error. The company need not repeat the disclosures in the financial statements of subsequent periods.

CHAPTER EIGHT

STATEMENT OF CASH FLOWS

8.1 Usefulness of the statement

The statement of cash flows provides information to help investors, creditors, and others assess the following (see Underlying Concepts):

1. The entity's ability to generate future cash flows. A primary objective of financial reporting is to provide information with which to predict the amounts, timing, and uncertainty of future cash flows. By examining relationships between items such as sales and net cash flow from operating activities, or net cash flow from operating activities and increases or decreases in cash, it is possible to better predict the future cash flows than is possible using accrual-basis data alone.
2. The entity's ability to pay dividends and meet obligations. Simply put, cash is essential. Without adequate cash, a company cannot pay employees, settle debts, pay out dividends, or acquire equipment. A statement of cash flows indicates where the company's cash comes from and how the company uses its cash. Employees, creditors, shareholders, and customers should be particularly interested in this statement because it alone shows the flows of cash in a business.

3. The reasons for the difference between net income and net cash flow from operating activities. The net income number is important: It provides information on the performance of a company from one period to another. But some people are critical of accrual-basis net income because companies must make estimates to arrive at it. Such is not the case with cash. Thus, as the opening story showed

story showed, financial statement readers can benefit from knowing why a company's net income and net cash flow from operating activities differ and can assess for themselves the reliability of the income number.

4. The cash and non-cash investing and financing transactions during the period. Besides operating activities, companies undertake investing and financing transactions. Investing activities include the purchase and sale of assets other than a company's products or services. Financing activities include borrowings and repayments of borrowings, investments by owners, and distributions to owners. By examining a company's investing and financing activities, a financial statement reader can better understand why assets and liabilities increased or decreased during the period. For example, by reading the statement of cash flows, the reader might find answers to following questions:

- Why did cash decrease for Aixtron Aktiengesellschaft (DEU) when it reported net income for the year?
- How much did Telefónica, S.A. (ESP) spend on property, plant, and equipment, and intangible assets last year?
- Did dividends paid by BP plc (GBR) increase last year?
- How much money did Coca-Cola (USA) borrow last year?
- How much cash did Delhaize Group (BEL) use to repurchase ordinary shares?

Underlying Concepts

Reporting information in the statement of cash flows contributes to meeting the objective of financial reporting.

8.2 Preparation of the statement

Companies prepare the statement of cash flows differently from the three other basic financial statements. For one thing, it is not prepared from an adjusted trial balance. The cash flow statement requires detailed information concerning the changes in account balances that occurred between two points in time. An adjusted trial balance will not provide the necessary data. Second, the statement of cash flows deals with cash receipts and payments. As a result, the company must adjust the effects of the use of accrual accounting to determine cash flows. The information to prepare this statement usually comes from three sources:

Comparative statements of financial position provide the amount of the changes in assets, liabilities, and equities from the beginning to the end of the period.² Current income statement data help determine the amount of net cash provided by or used by operations during the period.

3. Selected transaction data from the general ledger provide additional detailed information needed to determine how the company provided or used cash during the period.

Preparing the statement of cash flows from the data sources above involves three major steps:

Step 1. Determine the change in cash. This procedure is straightforward. A company can easily compute the difference between the beginning and the ending cash balance from examining its comparative statements of financial position.

Step 2. Determine the net cash flow from operating activities. This procedure is complex. It involves analyzing not only the current year's income statement but also comparative statements of financial position as well as selected transaction data.

Step 3. Determine net cash flows from investing and financing activities. A company must analyze all other changes in the statement of financial position accounts to determine their effects on cash.

8.3 Significant non-cash financing and investing activities

Because the statement of cash flows reports only the effects of operating, investing, and financing activities in terms of cash flows, it omits some significant non-cash transactions and other events that are investing or financing activities. Among the more common of these non-cash transactions that a company should report or disclose in some manner are the following.

1. Acquisition of assets by assuming liabilities (including finance lease obligations) or by issuing equity securities.
2. Exchanges of non-monetary assets.
3. Refinancing of long-term debt.
4. Conversion of debt or preference shares to ordinary shares.
5. Issuance of equity securities to retire debt.

Investing and financing transactions that do not require the use of cash are excluded from the statement of cash flows. If material in amount, these disclosures may be either narrative or summarized in a separate schedule. This schedule may appear in a separate note or supplementary schedule to the financial statements.

CHAPTER NINE

AGRICULTURAL ACCOUNTING

9.1 Basic terminologies in agricultural accounting

Active market

Exists when; the items traded are homogenous, willing buyers and sellers can normally be found at any time and prices are available to the public

Agricultural activity

The management of the transformation of a biological asset for sale into agricultural produce or another biological asset

Biological asset

A living animal or plant

Agricultural produce

The harvested produce of the entity's biological assets

Biological transformation

The process of growth, degeneration, production, and procreation that cause an increase in the value or quantity of the biological asset

Harvest

The process of detaching produce from a biological asset or cessation of its life

Bearer plant

is a living plant that:

- Is used in the production or supply of agricultural produce
- Is expected to bear produce for more than one period
- Has a remote likelihood of being sold (except scrap sales)

9.2 Recognition and Measurements

Recognition

Biological assets or agricultural produce are recognized when: - Entity controls the asset as a result of a past event

Probable that future economic benefit will flow to the entity; and

Fair value or cost of the asset can be measurement reliably

Measurements

Biological asset; initially:

At fair value less estimated point-of-sale costs (except where fair value cannot be estimated reliably)

If no reliable measurement of fair value, biological assets are stated at cost.

Subsequently:

At fair value less estimated point-of-sale costs (except where fair value cannot be estimated reliably)

If no reliable measurement of fair value, biological assets are stated at cost less accumulated depreciation and accumulated impairment losses.

Agricultural produce

Produce harvested from biological assets is measured at fair value less costs to sell at the point of harvest

Such measurement is the cost at the date when applying IAS 2 Inventory or another applicable IFRS.

FAIR VALUE GAINS AND LOSSES

Biological asset

The gain or loss on initial recognition is included in profit or loss in the period in which it arises

Subsequent change in fair value is included in profit or loss in the period it arises.

Agricultural produce

The gain or loss on initial recognition is included in included in profit or loss in the period in which it arises.

INABILITY TO MEASURE FAIR VALUE

Once the fair value of the biological asset becomes reliably measureable, the fair value must be used to measure the biological asset

Once a non-current biological asset meets the criteria to be defined as held for sale (or as part of a disposal group classified as held for sale) then it is presumed fair value can be measured reliably.

WOLAITA SODO UNIVERSITY
COLLEGE OF BUSINESS AND ECONOMICS
DEPARTMENT OF ACCOUNTING & FINANCE

**ADVANCED FINANCIAL ACCOUNTING
– I (ACFN4101)**

MARCH, 2023

WOLAITA SODO, ETHIOPIA

ADVANCED FINANCIAL ACCOUNTING I (ACFN4101)

Module Name: Advanced Financial Accounting I

Objectives of the module

Upon the successful completion of this module, students should be able to:

- Understand financial accounting concepts and IFRS as they apply for external financial reporting purpose

- Understand the nature of financial statements and the inherent limitations in their preparation and use
- Explain the application of international financial reporting standards in the recognition, measurement, and reporting of assets, liabilities, shareholders' equity, and lease operation.
- Prepare statement of cash flows based on complex business transactions.
- Analyze and correct the effects of accounting changes and errors.

Course Description

This course addresses the skills needed to apply some selected financial reporting standards in business environments. The topics covered in the course include income taxes, share-based compensation, agriculture, insurance contracts, statement of cash flows, and asset valuation.

Course Objectives

In this, course students examine several complex topics and their effect on financial reporting and disclosure. The course is designed to cover a selected group of financial accounting topics under IFRS. Upon successful completion of this course the student will be able to:

- Record, analyze and report financial information related to income taxes, biological assets, insurance contracts, share-based compensations, and employee benefits.
- Prepare and present statement of cash flows.
- Undertake valuation of financial assets for financial reporting purposes.

Course Contents

1. Income Taxes

- 1.1. The tax base concept
- 1.2. Recognition of deferred tax liabilities and assets
 - 1.2.1. Future taxable temporary differences
 - 1.2.2. Future deductible temporary differences
- 1.3. Recognition of current and deferred tax
- 1.4. Accounting for net operating losses
- 1.5. Income tax presentation and disclosures

2. Share-based Compensation

- 2.1. Overview of Share-based Payments
- 2.2. Share-based Payments Settled with Equity
- 2.3. Share-based Payments Settled with Cash
- 2.4. Share-based Payments with Cash Alternatives
- 2.5. Counterparty Has Choice of Settlement
- 2.6. Issuer Has Choice of Settlement
- 2.7. Share-based Payment Disclosures

3. Accounting for Agriculture

- 3.1. Basic Terms and Scope
- 3.2. The Nature of Biological Assets
- 3.3. Recognition and Measurement of Biological Assets
- 3.4. Presentation and Disclosure Issues

4. Insurance Contracts

- 4.1. Insurance Contract Aggregation
- 4.2. Initial Recognition of Insurance Contracts
- 4.3. Initial Measurement of Insurance Contracts
- 4.4. Estimated Future Cash Flows
- 4.5. Discount Rates Used
- 4.6. Risk Adjustment for Non-Financial Risk
- 4.7. Contractual Service Margin
- 4.8. Subsequent Measurement of Insurance Contracts
- 4.9. Modification of Insurance Contracts
- 4.10. Derecognition of Insurance Contracts
- 4.11. Presentation of Insurance Contract Information
- 4.12. Disclosures

5. Revisiting the Statement of Cash Flows

- 5.1. Importance of statement of cash flows
- 5.2. Classifications of cash flows
- 5.3. Preparing the statement of cash flows

6. Asset Valuation for Financial Reporting

- 6.1. Basics of valuation

6.2. Overview of International Valuation Standards (IVS)

6.3. Valuation approaches

6.3.1. Market approach

6.3.2. Income approach

6.3.3. Cost approach

6.4. Valuation report

Text Book:

Kieso, Weygandt and Warfield, **Intermediate Accounting, IFRS Edition** (3rd Ed. John Wiley & Sons, Inc. 2014).

CHAPTER ONE

INCOME TAXES (1517)

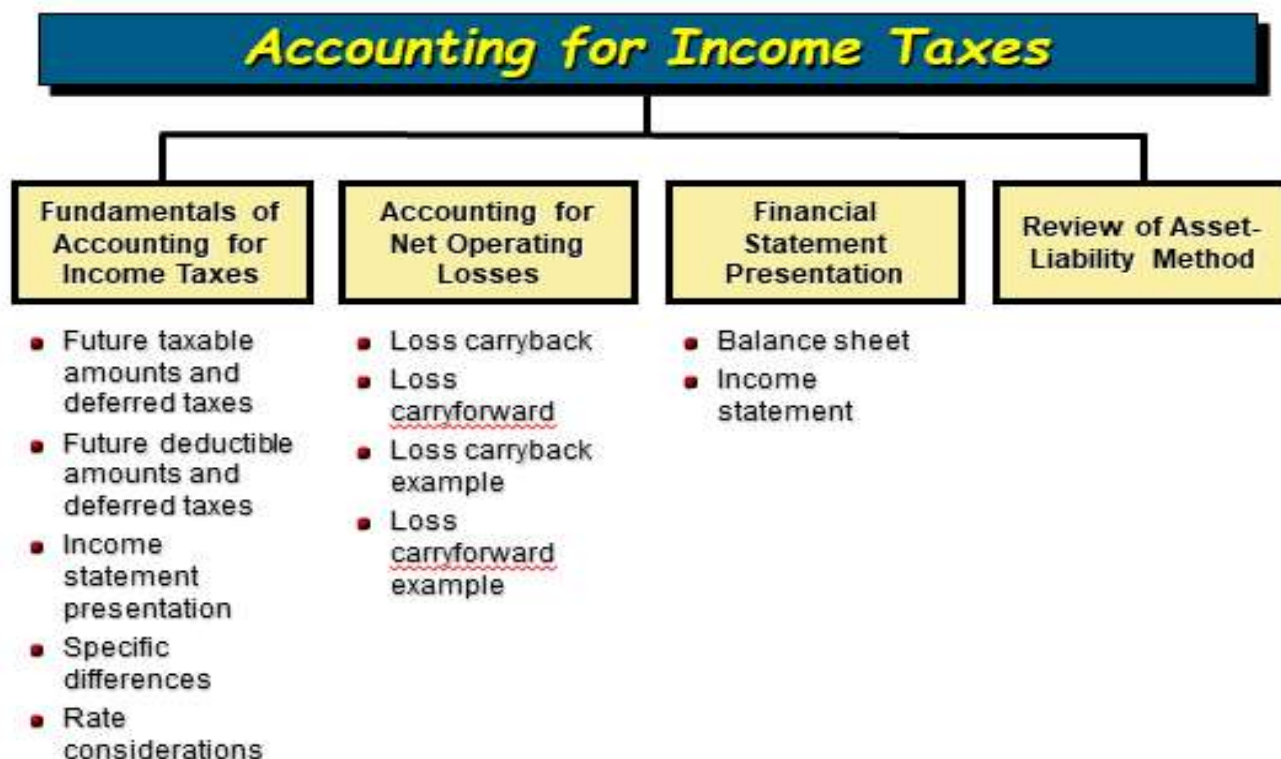
LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Identify differences between pretax financial income and taxable income.
2. Describe a temporary difference that results in future taxable amounts.
3. Describe a temporary difference that results in future deductible amounts.
4. Explain the purpose of a deferred tax asset valuation allowance.
5. Describe the presentation of income tax expense in the income statement.
6. Describe various temporary and permanent differences.
7. Explain the effect of various tax rates and tax rate changes on deferred income taxes.
8. Apply accounting procedures for a loss carryback and a loss carryforward.
9. Describe the presentation of deferred income taxes in financial statements.
10. Indicate the basic principles of the asset-liability method.

This chapter also includes numerous conceptual discussions that are integral to the topics presented here.

1.1. Tax Base Concept



Fundamentals of Accounting for Income Taxes

Companies also must file income tax returns following the guidelines developed by the appropriate tax authority. Because IFRS and tax regulations differ in a number of ways, so frequently do pretax financial income and taxable income.

Corporations must file income tax returns following the guidelines developed by the Internal Revenue Service (IRS), thus they:

- ✓ calculate taxes payable based upon IRS code,
- ✓ calculate income tax expense based upon GAAP

Consequently, the amount that a company reports as tax expense will differ from the amount of taxes payable to the tax authority.

Fundamental Differences between Financial and Tax Reporting

Pretax financial income is a financial reporting term. It also is often referred to as income before taxes, income for financial reporting purposes, or income for book purposes. Companies determine pretax financial income according to IFRS. They measure it with the objective of providing useful information to investors and creditors.

Taxable income (income for tax purposes) is a tax accounting term. It indicates the amount

used to compute income taxes payable. Companies determine taxable income according to the tax regulations. Income taxes provide money to support government operations.

ILLUSTRATION 19.2 Intermediate Accounting 3rd Edition Kieso, Weygandt, and Warfield, page number 1520.

1.2. Recognition of deferred tax liabilities and assets

Future Taxable Amounts and Deferred Taxes

Income taxes payable can differ from income tax expense. This can happen when there are temporary differences between the amounts reported for tax purposes and those reported for book purposes.

Temporary Differences

A **Temporary Difference** is the difference between the tax basis of an asset or liability and its reported (carrying or book) amount in the financial statements that will result in **taxable** amounts or **deductible** amounts in future years.

Future Taxable Amounts

Deferred Tax Liability represents the increase in taxes payable in future years as a result of taxable temporary differences existing at the end of the current year.

Future Deductible Amounts

Deferred Tax Asset represents the increase in taxes refundable (or saved) in future years as a result of deductible temporary differences existing at the end of the current year.

ILLUSTRATION 19.5 Intermediate Accounting 3rd Edition Kieso, Weygandt, and Warfield, page number 1521.

1.3. Recognition of current and deferred tax

Income tax expense has two components—current tax expenses (the amount of income taxes payable for the period) and deferred tax expense. Deferred tax expense is the increase in the deferred tax liability balance from the beginning to the end of the accounting period.

A deferred tax liability is the deferred tax consequences attributable to taxable temporary differences. In other words, a deferred tax liability represents the increase in taxes payable in future years as a result of taxable temporary differences existing at the end of the current year.

Companies credit taxes due and payable to Income Taxes Payable and credit the increase in deferred

taxes to Deferred Tax Liability. They then debit the sum of those two items to Income Tax Expense.

- ❖ Income taxes payable is reported as a current liability, and the deferred tax liability is reported as a non-current liability
- ❖ Companies also are required to show the components of income tax expense either in the income statement or in the notes to the financial statements.

ILLUSTRATION: 19.6 to 19.12 - Intermediate Accounting 3rd Edition Kieso, Weygandt, and Warfield

1.4.Accounting for net operating losses

Every management hopes its company will be profitable. But hopes and profits may not materialize. For a start-up company, it is common to accumulate operating losses while expanding its customer base but before realizing economies of scale. For an established company, a major event such as a labor strike, a rapidly changing regulatory environment, or a competitive situation can cause expenses to exceed revenues—a net operating loss.

- ❖ A net operating loss (NOL) occurs for tax purposes in a year when tax-deductible expenses exceed taxable revenues. An inequitable tax burden would result if companies were taxed during profitable periods without receiving any tax relief during periods of net operating losses. Under certain circumstances, therefore, tax laws permit taxpayers to use the losses of one year to offset the profits of other years.
- ❖ Companies accomplish this income-averaging provision through the carryback and carryforward of net operating losses. Under this provision, a company pays no income taxes for a year in which it incurs a net operating loss.

Loss Carryback

Through use of a loss carryback, a company may carry the net operating loss back two years and receive refunds for income taxes paid in those years. The company must apply the loss to the earlier year first and then to the second year. It may carry forward any loss remaining after the two-year carryback up to 20 years to offset future taxable income.

Loss Carryforward

A company may forgo the loss carryback and use only the loss carryforward option, offsetting future taxable income for up to 20 years.

ILLUSTRATION 19.36 to 19.44 - Intermediate Accounting 3rd Edition Kieso, Weygandt, and Warfield

1.5.Income tax presentation and disclosures

Statement of Financial Position

Companies classify taxes receivable or payable as current assets or current liabilities. Although current tax assets and liabilities are separately recognized and measured, they are often offset in the statement of financial position. The offset occurs because companies normally have a legally enforceable right to set off a current tax asset (Income Taxes Receivable) against a current tax liability (Income Taxes Payable) when they relate to income taxes levied by the same taxation authority.

Deferred tax assets and deferred tax liabilities are also separately recognized and measured but may be offset in the statement of financial position. The net deferred tax asset or net deferred tax liability is reported in the non-current section of the statement of financial position

Income statement

Companies allocate income tax expense (or benefit) to continuing operations, discontinued operations, other comprehensive income, and prior period adjustments. This approach is referred to as intraperiod tax allocation. In addition, the components of income tax expense (benefit) may include:

- ❖ Current tax expense (benefit).
- ❖ Any adjustments recognized in the period for current tax of prior periods.
- ❖ The amount of deferred tax expense (benefit) relating to the origination and reversal of temporary differences.
- ❖ The amount of deferred tax expense (benefit) relating to changes in tax rates or the imposition of new taxes.
- ❖ The amount of the benefit arising from a previously unrecognized tax loss, tax credit, or temporary difference of a prior period that is used to reduce current and deferred tax expense.

CHAPTER TWO

SHARE-BASED COMPENSATION

2.1. Overview of Share-based Payments

Form of compensation in which the amount of the compensation employees receive is tied to the market price of company stock. An executive compensation plan is tied to performance in a strategy that uses compensation to motivate its recipients.

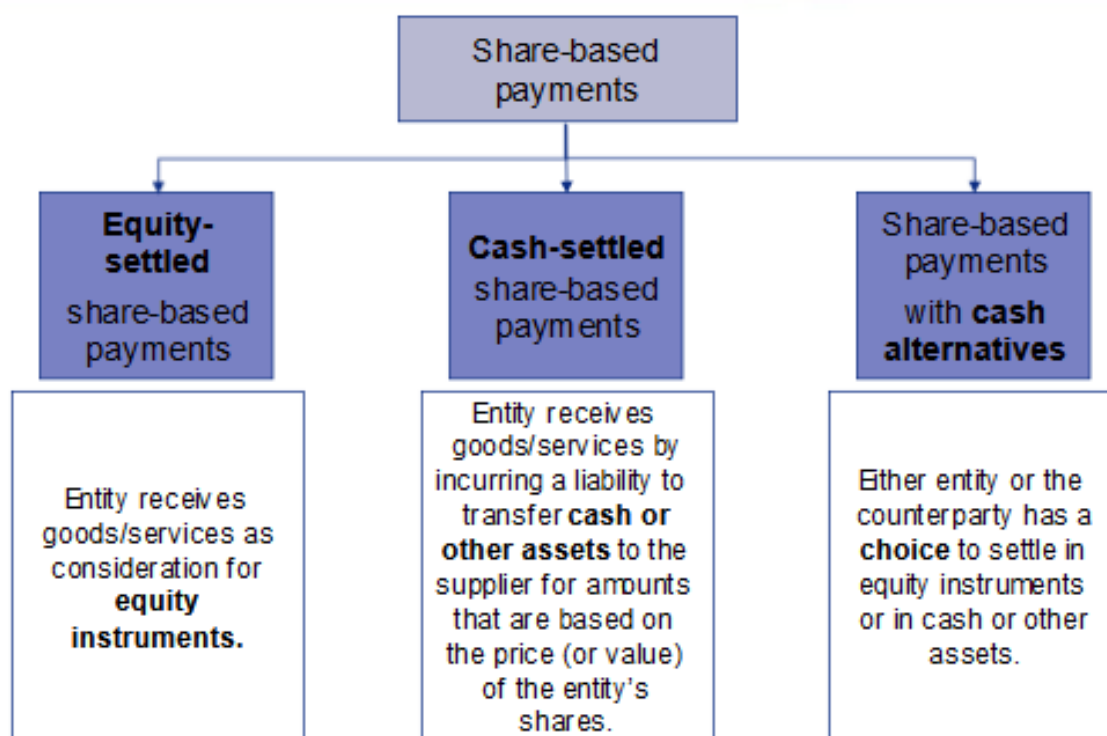
Form of compensation in which the amount of the compensation employees receive is tied to the market price of company stock.

An executive compensation plan is tied to performance in a strategy that uses compensation to motivate it recipients. These share-based compensation plans –stock awards, stock options, and -stock appreciation rights, create shareholders' equity. The nature of this compensation will impact the way earnings per share is calculated.

Whichever form such a plan assumes, the accounting objective is to record the fair value of compensation expense over the periods in which related services are performed.

This requires:

1. Determining the fair value of the compensation.
2. Expensing that compensation over the periods in which participants perform services.



Form of compensation in which the amount of the compensation employees receive is tied to the market price of company stock. An executive compensation plan is tied to performance in a strategy that uses compensation to motivate it recipients. These share-based compensation plans – stock awards, stock options, and -stock appreciation rights, create shareholders' equity. The nature of this compensation will impact the way earnings per share is calculated.

- Salary, pension and other benefits often form part of an executive's employment

package

- A share-based payment is a transaction in which an entity receives or acquires goods or services either as consideration for its equity instruments or by incurring liabilities for amounts based on the price of the entity's shares or other equity instruments of the entity
- IFRS 2 *Share-based Payment* sets out measurement principles and specific requirements for three types of share-based payment transactions:
 1. **Equity-settled share-based payment transactions**
 2. **Cash-settled share-based payment transactions**
 3. **Share-based payment transactions with cash alternatives**

2.2. **Equity-settled share-based payment transactions**

- Measure **goods or services** received, and corresponding increase in equity (recognised in OCI), at FV of **goods** and **services** received
- If FV cannot be estimated reliably, then measure their value by reference to the FV of the equity instruments granted

Example

A company issues share options in order to pay for the purchase of inventory. The share options were issued on 1 June 2010. The inventory was eventually sold on 31 December 2012. The value of the inventory on 1 June 2010 was €6 million and this value was unchanged up to the date of sale. The sale proceeds were €8 million. The shares issued have a market value of €6.3 million.

Requirement

How will this transaction be dealt with in the financial statements?

Solution

IFRS 2 states that the FV of the goods and services received should be used to value the share options unless the FV of the goods cannot be measured reliably. Thus equity would be increased by €6 million and inventory increased by €6 million. The inventory value will be expensed on sale (DR SPLOCI – P/L and CR Equity).

Transactions with employees and others providing similar services

- FV of the services received are referred to the FV of the equity granted, as it is not possible to estimate reliably the FV of the services received

- FV of equity should be measured at the grant date
- Typically, share options are granted to employees as part of their remuneration package
- Usually, it is not possible to measure directly the services received for particular components of the employee's remuneration package
- It might also not be possible to measure the FV of the total remuneration package independently without measuring directly the FV of equity instruments granted
- Equity instruments may contain conditions which must be met before entitlement to the shares
- Conditions related to the market price of shares are ignored for the purposes of estimating the number of equity shares that will vest (on the basis these have been taken into account when fair-valuing the shares)
- Because of the difficulty of measuring the FV of the services received, this is done with reference to the FV of the equity instrument granted
- There is no reversal of amounts previously recognised if options are forfeited or are not exercised

Modification of terms and conditions

- Terms of a share-based payment transaction may be modified
- For example, by altering the exercise price, the number of shares granted or the vesting conditions
- Must recognise at least the amount that would have been recognised had the terms not changes, together with any incremental cost over the remaining vesting period

Cancellation or settlement

- If equity-settled share-based transactions are cancelled or settled, then the entity must immediately recognise any amount that would otherwise have been recognised over a vesting period
- Any payments up to the FV of the equity instruments granted at cancellation or at settlement is a repurchase of an equity interest (i.e. DR Equity)
- Any payment in excess of the FV of equity instrument granted at cancellation or at settlement is recognised as an expense in arriving at profit or loss in the SPLOCI – P/L

2.3. **Cash-settled share-based payment transactions**

- Where goods and services are paid for at amounts based upon the price of a company's equity instruments (e.g. share appreciation rights)
- The expense is the cash paid by the company
- Goods and services acquired and liability incurred should be measured at the FV of the liability
- Until the liability is settled, the entity should re-measure the fair value of the liability at each reporting date and at the date of settlement, with any changes in fair value recognised in SPLOCI – P/L
- The services received, and the liability, should be recognised as the services are rendered

2.4. **Share-based payment transactions with cash alternatives**

Where the terms of the arrangement provide either the entity or the counterparty with the choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments, the entity should account for that transaction, or the components of that transaction, as a *cash-settled share-based payment transaction* if, and to the extent that, the entity has incurred a liability to settle in cash or other assets, or as an equity-settled share-based payment transaction if, and to the extent that, no such liability has been incurred.

2.5. **Share-based Payment Disclosures**

IFRS 2 requires extensive disclosure requirements under three main headings:

1. Information that enables users of financial statements to understand the nature and extent of the share based payment transactions that existed during the period
2. Information that allows users to understand how the FV of the goods or services received or the FV of the equity instruments which have been granted during the period was determined
3. Information that allows users of financial statements to understand the affect of expenses which have arisen from share based payment transactions on the entities income statement in the period

CHAPTER THREE

ACCOUNTING FOR AGRICULTURE

3.1. Basic Terms and Scope

Agricultural accounting, or AG accounting, is the process of accounting for your farm, ranch, or related business. Keeping accurate and up-to-date records helps you to prepare for tax time, create financial statements, make informed decisions, and measure your farm's financial health.

- Biological assets – living plant or animal (except bearer plants)
- Agricultural produce – point of harvest

Excludes:

- Land related to agricultural activity
- Intangible assets related to agricultural activity
- Biological assets held for provision or supply of services

Bearer Plants

- A bearer plant is a living plant that:
 - Is used in the production or supply of agricultural produce:
 - Is expected to bear produce for more than one period: and
 - Has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.
- Bearer plants are accounted for in accordance with IPSAS 17

Examples

Biological assets	Agricultural produce	Products – result of processing after harvest
Sheep	Wool	Yarn/carpet
Trees in timber plantation	Felled trees	Logs, lumber
Cotton plants	Harvested cotton	Thread, clothing
Dairy cattle	Milk	Cheese
Pigs	Carcass	Sausages, cured ham
Tea bushes	Picked leaves	Tea
Grape vines	Picked grapes	Wine
Fruit trees	Picked fruit	Processed fruit

3.2. The Nature of Biological Assets

Agricultural Activity

- Management of biological transformation & harvest of biological assets
- Diverse activities
 - Capability to change
 - Management of change
 - Measurement of change
- Biological transformation results in asset changes or production of agricultural produce

1.3. Recognition and Measurement of Biological Assets

The entity controls the assets as result of past event. It is probable that the future economic benefits associated with the asset will flow to the entity. The FV or cost of the asset to the entity can be measured reliably. Measurement At each year end all biological assets should be measured at FV less estimate point-of-sale costs. If a FV cannot be determined because market determined price or values are not available. Then the biological asset can be measured at cost less accumulated depreciation and impairment losses.

- Recognize biological asset or agricultural produce when:
 - Entity controls asset as result of past event
 - Probable future economic benefits/service potential will flow to entity
 - Fair value or cost can be measured reliably
- Measured at fair value less costs to sell
- If non-exchange transaction, same
- Agricultural produce harvested from biological assets measured at fair value less costs to sell at point of harvest
- Grouping according to attributes allowed

Subsequent Measurement

- Measured at Fair Value less Costs to Sell at each reporting date
- Agricultural Produce - Fair Value less Costs to Sell at point of harvest
- Gains or losses – Recognized in Surplus or Deficit for the period in which they arise

1.4. Presentation and Disclosure Issues

In the SFP biological assets should be classified as separate class of asset falling under either current or non-current classifications. Biological asset should be sub classified into:

- 1) Class of animal or plant
- 2) Nature of activities (consumable or bearer)
- 3) Maturity or immaturity for intended purpose.
 - Gain/loss on initial recognition
 - Consumable/bearer biological assets
 - Biological assets held for sale and those held for distribution at no/nominal charge
 - Nature of activities & estimates of physical quantities
 - Reconciliation

CHAPTER FOUR

INSURANCE CONTRACTS

4.1. Overview Insurance contracts

Definition

- An insurance contract is “a contract under which one party – the issuer – accepts ‘significant insurance risk’ from another party – the policyholder.”
- If a “specified uncertain future event – the insured event – adversely affects the policyholder”, then the policyholder has a right to obtain compensation from the issuer under the contract.
- This definition raises several further questions, which are discussed in this section.
- What form can an insurance arrangement take?
- What is ‘insurance risk’?
- When is insurance risk ‘significant’?
- What is an ‘uncertain future event’?
- What is an ‘adverse effect’ on the policyholder?

What form can an insurance arrangement take?

- The **relationship** between an insurer and the policyholder is **established by a contract**.
- A ‘contract’ is an agreement between two or more parties that creates enforceable rights and obligations.
- Enforceability is a matter of law.
- Contracts can be **written, oral or implied** by the entity’s customary business

practices.

- Contracts that have the legal form of insurance but **pass all significant insurance risk back to the policyholder are not insurance contracts.**
- For example, some financial reinsurance contracts pass all significant insurance risk back to the accident by adjusting payments made by the accident as a direct result of insured losses.
- Some group contracts also have similar features.
- These contracts are normally financial instruments or service arrangements and are accounted for under **IFRS 9 or IFRS 15**, as applicable.

What is insurance risk?

- **Insurance risk:** is a risk, **other than financial risk**, that is transferred from the policyholder to the issuer of a contract.
- The issuer accepts a risk from the policyholder that the policyholder was already exposed to.
- **A contract is not an insurance contract** if it exposes the issuer **only to financial risk** but **not to significant insurance risk**.
- However, contracts that expose the issuer to **both financial risk and significant insurance risk** are **insurance contracts**.

The following table includes examples of insurance risk and financial risk.

Insurance risk	Financial risk
Risks such as: – death or survival – injury – illness – disability – loss of property due to damage or theft – failure of a debtor to make a payment when it is due – a possible change in a non-financial variable that is specific to a party to the contract	The risk of a possible future change in one or more of: – interest rates – financial instrument prices – commodity prices – currency exchange rates – indices of prices or rates – credit ratings or credit indices – any other variable, except for a non-financial variable that is specific to a party to the contract

The risk of a possible future change in a non-financial variable is an insurance risk only if that variable is specific to a party to the contract.



When is insurance risk ‘significant’?

- **Insurance risk** is significant only if there is a scenario that **has commercial substance** in which, on a **present value basis**, there is a possibility that an issuer could:
 - **suffer a loss caused by** the insured event; and
 - **pay significant additional** amounts beyond what would be paid if the insured event had not occurred.
- To **have commercial substance**, a scenario has to have a **discernible effect** on the economics of the transaction.

What is an ‘uncertain future event’?

- Transfer of uncertainty (or risk) is the essence of an insurance contract.
- Therefore, for a contract to be an insurance contract, **uncertainty** is required at the contract’s **inception** over at least one of the following:
 - the probability that an insured event will occur;
 - when it will occur; or
 - how much the insurer will need to pay if it occurs.

What is an ‘adverse effect’ on the policyholder?

- The definition of an insurance contract requires an **adverse effect on the policyholder** as a precondition for compensation.

- **Lapse risk** or **'persistency risk'** is the risk that the policyholder will cancel the contract at a time other than when the issuer expected when pricing the contract.
- This risk is not considered an insurance risk because the payment to the policyholder is not contingent on an uncertain future event that adversely affects the policyholder.
- The risk of unexpected increases in the administrative costs associated with servicing a contract is known as **'expense risk'**.
- This risk does not include unexpected costs associated with the insured event and is not an insurance risk, because an unexpected change in these expenses does not adversely affect the policyholder.

The Background to Insurance Accounting

Challenges of insurance accounting

- Reverse production cycle
- Premium usually upfront & certain
- Costs of claims uncertain (amount & timing)
- Non - life or general insurance are short
- Life insurance long term

Simple example

- Household contents policy
- Upfront premium = £1,200
- Cover for 1 year



- Estimated cash outflows = insurance liability
- Premium – insurance liability = expected profit

Actuary analyzes the financial costs of risk and uncertainty. They use mathematics, statistics, and financial theory to assess the risk of potential events, and they help businesses and clients develop policies that minimize the cost of that risk. Actuaries' work is essential to the insurance industry.

CHAPTER FIVE

REVISITING THE STATEMENT OF CASH FLOWS

5.1. Importance of statement of cash flows

The information may help users assess the following aspects:

- The entity's ability to generate future cash flows
- The entity's ability to pay dividends and meet obligations
- The reasons as to why net income and net cash flow from operating activities differ
- Cash and non-cash investing and financing activities during the year

The cash flow statement provides information about:

- the cash receipts (cash inflows), and
- uses of cash (cash outflows) during the period

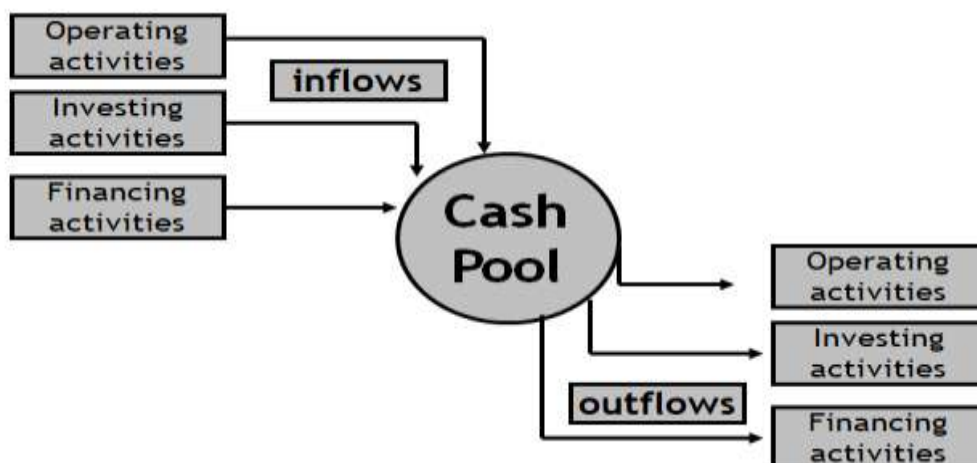
Inflows and outflows are reported for:

- operating activities,
- investing activities, and
- financing activities during the period

5.2. Classifications of cash flows

Inflows and outflows are reported for:

- operating activities,
- investing activities, and
- financing activities during the period



5.3. Preparing the statement of cash flows

There are two methods of preparing the statement of cash flows:

1. the indirect method and
2. the direct method

The indirect method derives cash flows from accrual basis statements.

The direct method determines cash flows directly for each source or use of cash.

Direct Cash Flow Method

This method measures only the cash received, typically from customers, and the cash payments made, such as to suppliers. These inflows and outflows are then calculated to arrive at the net cash flow.

This method of calculating cash flow takes more time since you need to track payments and receipts for every cash transaction.

Figures used in this method are presented in a straightforward manner. They can be calculated using the beginning and ending balances of various asset and liability accounts and assessing their net decrease or increase.

Indirect Cash Flow Method

Using this method, cash flow is calculated through modifying the net income by adding or subtracting differences that result from non-cash transactions. This is done in order to come up with an accurate cash inflow or outflow.

Instead of presenting transactional data like the direct method, the calculation begins with the net income figure found in the income statement of the company and makes adjustments to undo the impact of accruals that were made during the accounting period.

Text Book:

Kieso, Weygandt and Warfield, **Intermediate Accounting**, IFRS Edition (3rd Ed. John Wiley & Sons, Inc. 2014).

College of Business and Economics

Department of Accounting and Finance

Advanced Financial Accounting II (ACFN4102)

MARCH, 2022

WOLAITA SODO, ETHIOPIA

ADVANCED FINANCIAL ACCOUNTING II (ACFN4102)

Chapter One

Joint Arrangements

1.1. Definition of Joint Ventures

Joint ventures are partnerships formed when two or more parties pool resources for the purpose of undertaking a specific project, such as the development or marketing of a product. Joint ventures are owned, operated, and jointly controlled by a small group of owners or investors as separate business projects operated for the mutual benefit of the ownership group. Joint ventures may take the legal form of partnerships or they may be separately incorporated entities.

The owners or investors (venturers) in a joint venture may or may not have equal ownership interests in the venture. A venturer's share may range from as low as 5% or 10% to over 50%, but no less. All venturers usually participate in the overall management of the venture. Significant decisions generally require the consent of all venturers regardless of the percentage of ownership so that no individual venturer has unilateral control.

❖ Traditional joint ventures:

A **joint ventures** differs from a partnership in that it is limited to carrying out a single project, such as production of a motion picture or construction of a building. Historically, joint ventures were used to finance the sale or exchange of a cargo of merchandise in a foreign country. In an era when marine transportation and foreign trade involved many hazards, individuals (venturers) would band together to undertake a venture of this type. The capital required usually was larger than one person could provide, and the risks were too high to be borne alone. Because of the risks involved and the relatively short duration of the project, no net income was recognized until the venture was completed, at the end of the voyage, the net income or net loss was divided among the venturers, and their association was ended.

In its traditional form, the accounting for a joint venture did not follow the accrual basis of accounting. The assumption of continuity was not appropriate; instead of the determination of net income at regular intervals, the measurement and reporting of net income or loss awaited the completion of the venture.

❖ Present-Day Joint Ventures:

In today's business, joint ventures are less common but still are employed for many projects such as (1) the acquisition, development, and sale of real property; (2) exploration for oil and gas; and (3) construction of bridges, buildings, and dams.

The term *corporate joint venture* also is used by many large American Corporations to describe overseas operations by a corporation whose ownership is divided between an American Company and foreign company. Many examples of jointly owned companies also are found in some domestic industries. A corporate joint venture and accounting for such a venture currently are described in **APB Opinion No. 18**, “The Equity Method of Accounting for Investments in Common Stock,” as follows:

“Corporate joint venture” refers to a corporation owned and operated by a small group of businesses (the “joint venturers”) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venture may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity which is a subsidiary of one of the “joint venturers” is not a corporate joint venture. The ownership of a corporate joint venture seldom changes, and its stock is usually not traded publicly. A minority public ownership, however, does not preclude a corporation from being a corporate joint venture.

The Accounting Principles Board (APB) concludes that the equity method best enables investors in corporate joint ventures to reflect the underlying nature of their investment in those ventures. Therefore, investors should account for investments in common stock of corporate joint ventures by the equity method, in consolidated financial statements.

When investments in common stock of corporate joint ventures or other investments accounted for under the equity method are, in the aggregate, material in relation to the financial position or results of operations of an investor, it may be necessary for summarized information as to assets, liabilities, and results of operations of the investees to be presented in the notes or in separate statements, either individually or in group as appropriate.

A recent variation of the corporate joint venture is the *limited liability company* (LLC) joint venture, which is the corporate version of the *limited liability partnership* (LLP).



Choosing a Joint Venture Vehicle

Three basic legal structures can be used for joint venture, these being:

- A limited liability company (i.e. a corporate vehicle);
- A partnership or limited partnership (i.e. an unincorporated vehicle); or
- A purely contractual co-operation agreement.

A partnership is the relation which subsists between persons carrying on a business in common with a view to a profit. There are also certain “**hybrid**” vehicles or arrangements, such as a limited liability partnership, with characteristics from more than one of the above categories. Whilst tax and commercial factors may sometimes lead to the use of an unincorporated vehicle, e.g. a partnership or limited partnership, the majority of ongoing business ventures tend to use a corporate vehicle whose share capital is divided between the joint venturers. The advantages of using a corporate vehicle are:

- a company is a universally recognized medium and gives a strong identity for dealings with third parties;
- it allows for a management and employee structure to be put in place;
- the participants have the benefit of a limited liability and the flexibility to raise finance; and
- the company will survive as the same entity despite a change in its share ownership;



Co-operation Agreement

The simplest form of association for joint ventures is an arrangement under which the participants agree to associate as independent contractors rather than shareholders in a company or partners in a legal partnership. This type of agreement is often referred to as a consortium or co-operation agreement and is suitable where the parties wish to avoid the formality and permanence of a corporate vehicle.

Here the rights and duties of participants as between themselves and third parties and the duration of their legal relationship will be derived from the provision of the joint venture agreement, any associated agreements and general common law rules (*also refer to Commercial Code of Ethiopia 1960; Art. 271 to 279*).

Such an agreement should set out the obligations and commitments of the individual partners and how a return on investment will be achieved. Even though no corporate vehicle is involved and the venturers will not be partners in a legal sense, it is possible for them to be exposed to claims and liabilities because of the activities of their co-participants on a contractual or quasi-contractual basis. Therefore, an indemnity should be included in the agreement under which one party will indemnify the other for any losses that are caused through the actions of the co-participants.



Documentation Involved

Joint venture transactions call for clear well drafted documentation. Basic legal documents for establishing a joint venture are likely to be:

- A joint venture/shareholders' agreement; and
- The memorandum and articles of association of the joint venture company.

The purpose of a shareholders' agreement will be to establish the basic rights and obligations of the parties and to ensure the company and its business are established and run in accordance with the participants' objectives. A further purpose is to prescribe, as far as possible, for what will happen if difficulties occur.

In the case of non-corporate joint venture structures, the basic objectives of any formal arrangement between the participants will be substantially similar to that of a shareholders' agreement with essential differences reflecting where appropriate the absence of a separate legal vehicle and the fact that the joint venture may relate to a project of finite duration.



Managing the Joint Venture Company

An important function of the shareholders' agreement and articles of association is to reflect the agreed arrangements for managing the joint venture vehicle. Different considerations will apply if it is a 50/50 joint venture where there is likely to be equal representation on the board as opposed to a joint venture involving a minority shareholder who requires special protection.



Board of the joint venture company

Firstly it should be established whether the board of the joint venture will have an executive role or whether there will also be an executive body with a secondary supervisory body consisting of shareholder representatives who approve the strategy and important decisions.

There will be some matters that the venturers will regard as crucial to protect the value of investments. It is not unusual for these to be subject to shareholder approval rather than board approval.

It is not essential for the management rights and responsibilities to correspond with equity ownership. Therefore, a party may be given greater management rights, for example, rights over decisions affecting technical and management areas. A director may face a conflict between the interests of the venture and interests of his appointing company.

There is a balance to be struck between his duty to exercise, his power for the benefit of the venture as a whole and his duty to protect the shareholder who appointed him. In practice, the appointee can exercise his powers in accordance with the wishes of the appointing shareholder provided that, in doing so, he does not act blindly, but considers the venture as a whole. To the extent that there are areas for conflict, it may be better for these to be dealt with at shareholder level.

1.2. Accounting for Joint ventures

Regardless of their legal form of organization, joint ventures must maintain accounting records and prepare financial statements just like any other enterprise. The primary users of the joint ventures financial statements are the venturers, who need to record their share of the profit or loss of the venture and to value their investment in it. Most of the accounting principles and procedures used by joint ventures are the same as those used by other business enterprises.

The most significant accounting issue for most joint ventures is the recording of initial capital contributions, particularly noncash contributions. Such contributions should be recorded on the books of the venture at the fair value of the assets contributed on the date of contribution, unless the fair value of the assets is not readily or reliably determinable or the recoverability of that value is in doubt. This general rule does not apply, however, to assets contributed by a

venturer who controls a venture. In those circumstances, the assets should be recorded on the books of the venture at the same amount at which they were carried on the venturer's books because there has been no effective change in control over the assets.



Accounting for Investments in Joint Ventures

Since joint venturers have rights and obligations that may differ from their ownership percentages assuring them of significant influence even at ownership percentages of less than 20%, the application of customary equity or consolidation accounting is not always appropriate. Interests in incorporated joint ventures are accounted for in accordance with APB Opinion No. 18, which mandates use of the equity method. Accounting for interests in joint ventures that are organized as partnerships or undivided interests is discussed in an AICPA staff interpretation of APB Opinion No. 18 which states that many of the provisions of the Opinion are appropriate in accounting for such investments.

In 1979, the AICPA's Accounting Standards Executive Committee issued an Issues Paper entitled *Joint Venture Accounting*.



Financial Statement Presentation

There are a number of different methods that venturers use to display their interest in joint ventures in their financial statements. The AICPA Issues Paper mentioned previously describes seven different methods, only four of which are considered acceptable. The methods described in the Accounting Standard Executive Committee (AcSEC) advisory conclusions are not interchangeable; that is, each should be applied when specified circumstances exist. The four methods are briefly described in the following paragraphs.

One-Line Equity Method: This method involves the application of the "traditional" equity method of accounting described in APB Opinion No. 18. The Issues Paper expresses the position that this method should remain the prevalent method of accounting for joint venture investments. Since most joint ventures give each investor significant influence over the venture, the equity method is generally more appropriate than the historical cost method used when an investor has only minor influence.

Many venturers prefer to use the equity method because it reflects the venturer's exposure to only the net liabilities of the venture by presenting the investment as a net position. The equity method also reflects the investor's share of the net income of the venture in the income statement for the period in which the net income is earned by the joint venture. Critics point out that it tends to obscure the nature and volume of the business of investors that conduct significant operation through joint ventures. It also excludes certain assets and liabilities that may be essential to an investor's business from the investor's balance sheet and elements of revenue and expense that arise from the venture's operations from the investor's income statement.

Proportionate Consolidation Method: Under this method, the investor's proportionate share of the assets, liabilities, revenues, and expenses is combined with similar items in the

investor's financial statements. This method is often used in the real estate and oil and gas industries. The Issues Paper on joint venture accounting recommends that the proportionate consolidation method be used only in situations in which venturer's liabilities are several rather than joint. The SEC, however, generally has not favored proportionate consolidation and use of the method in other industries has thus been constrained. AICPA SOP 78-9, "Accounting for Investments in Real Estate Ventures," states that the usual full consolidation or equity methods should be applied to *corporate* joint ventures in the real estate industry.

While the proportionate consolidation method provides information in an entity's financial statements that may be useful to present and potential investors on past and prospective changes in the economic resources and obligations of the entity, its critics point out that it is based on the concept of control over pieces of the joint venture even though such control does not actually exist.

Similarly, the method combines net assets in the balance sheet and operations in the income statement that the investor owns and controls directly with those over which the investor may have little or no control.

Full Consolidation: The Issues Paper recommends that when a venturer has control of a joint venture, the full or traditional consolidation method of accounting be used as described in FASB Statement No. 94, "Consolidation of All Majority-Owned Subsidiaries." That method involves the combination of the assets, liabilities, revenues, and expenses of the joint venture with those of the venturer in the venturer's financial statements. The portion of the venture's net assets owned by the other venturers is shown as a liability on the venturer's balance sheet and is usually described as a *minority interest*.

Cost Method: Presenting an investment in a joint venture at cost is permissible only for immaterial investments.

Combination of Methods: Some investors believe that a combination of these methods is the most appropriate way to present an investment in a joint venture in their financial statements. Those investors might use one method for the balance sheet and another for the income statement. When a combination of methods is used, it generally involves use of the one-line equity method in the balance sheet and the proportionate consolidation method in the income statement. The AICPA Issues Paper recommends against using a combination of methods.

i. Accounting for a Corporate or LLC Joint Venture

The complexity of modern business, the emphasis on good organization and strong internal control, the importance of income taxes, the extent of government regulations, and the need for preparation and retention of adequate accounting records are strong arguments for establishing a separate set of accounting records for every corporate joint venture of large size and long duration. In the stockholders' equity accounts of the joint venture, each venturer's account is credited for the amount of cash or noncash assets invested. The fiscal year of the joint venture may or may not coincide with the fiscal years of the venturers, but

the use of the accrual basis of accounting and periodic financial statements for the venture permit regular reporting of the share of net income or loss allocable to each venture.

The accounting records of such a corporate joint venture include the usual ledger accounts for assets, liabilities, stockholders' equity, revenue, and expenses. The entire accounting process should conform to generally accepted accounting practices, from the recording of transactions to the preparation of financial statements.

ii. Accounting for an Unincorporated Joint Venture

As indicated on the APB Opinion No. 18, it required venturers to use the equity method of accounting for investments in corporate joint ventures. That Opinion did not address accounting for investments in *unincorporated* joint ventures. However, the AICPA subsequently interpreted **APB Opinion No. 18** as follows:

Because the investor-venturer in an unincorporated joint venture owns an undivided interest in each asset and is proportionately liable for its share of each liability, the provisions of APB Opinion No. 18 related the equity method of accounting may not apply in some industries. For example, where it is the established industry practice such as in some oil and gas venture accounting, the investor-venturer may account in its financial statements for its pro rata share of the assets, liabilities, revenues, and expenses of the venture.

In view of the foregoing, it appears that either of two alternative methods of accounting may be adopted by investors in unincorporated joint ventures; thus, some investors have the option of using either the **equity method of accounting** or a **proportionate share method of accounting** for the investments.

To illustrate the two methods, assume that Dinsho Company and Muger Company each invested Br.600,000 for a 50% interest in an unincorporated joint venture on January 1, 2008. Condensed financial statements (other than a statement of cash flows) for the joint venture, Dimu Company, for 2008 were as follows:

DIMU COMPANY (a joint venture)						
Income Statement						
For Year Ended December 31, 2008						
Revenue						Br. 3,000,000
Less: Cost and expenses						<u>2,250,000</u>
Net income						<u>Br. 750,000</u>
Division of net income:						
Dinsho Company					Br. 375,000	
Muger Company					<u>375,000</u>	
Total					<u>Br.750,000</u>	

DIMU COMPANY (a joint venture)					
Statement of Venturers' Capital					
For Year Ended December 31, 2008					
			Dinsho Company	Mugar Company	Combined
Investments, Jan. 1			Br.600,000	Br.600,000	Br. 1,200,000
Add: Net income			<u>375,000</u>	<u>375,000</u>	<u>750,000</u>
Venturers' capital, end of year			<u>Br.975,000</u>	<u>Br.975,000</u>	<u>Br. 1,950,000</u>
DIMU COMPANY (a joint venture)					
Balance Sheet					
December' 31, 2008					
			Assets		
Current Assets					Br.2,400,000
Other Assets					<u>3,600,000</u>
Total Assets					<u>Br.6,000,000</u>
			Liabilities and Venturers' Capital		
Current liabilities					Br.1,200,000
Long-term debt					2,850,000
Venturers' Capital:					
Dinsho Company				Br.975,000	
Muger Company				<u>975,000</u>	<u>1,950,000</u>
Total liabilities and Venturers' capital					<u>Br.6,000,000</u>

Under the equity method of accounting, both Dinsho Company and Muger Company prepare the following journal entries for the investment in Dimu Company:

2008			
Jan. 1	Investment in Dimu Company (Joint Venture)	600,000	
	Cash		600,000
	To record investment in joint venture.		
Dec. 31	Investment in Dimu Company (Joint Venture)	375,000	
	Investment Income		375,000
	To record share of Dimu Company net income (Br.750,000 × 0.50 = Br.375,000).		

Under the proportionate share method of accounting, in addition to the two foregoing journal entries, both Dinsho Company and Muger Company prepare the following journal entry for their respective shares of the assets, liabilities, revenues, and expenses of Dimu Company:

2008			
Dec. 31	Current Assets (Br. 2,400,000 × 0.50)	1,200,000	
	Other Assets (Br.3,600,000 × 0.50)	1,800,000	
	Costs and Expenses (Br.2,250,000 × 0.50)	1,125,000	

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Investment Income	375,000	
Current Liabilities (Br.1,200,000 × 0.50)		600,000
Long-Term Debt (Br.2,850,000 × 0.50)		1,425,000
Revenue (Br.3,000,000 × 0.50)		1,500,000
Investment in Dimu Company (Joint Venture)		975,000
To record proportionate share of joint venture's assets, liabilities, revenue, and expenses.		

The use of equity method of accounting for unincorporated joint venture is consistent with the accounting for corporate joint ventures specified by APA Opinion No. 18. However, information on material assets and liabilities of a joint venture may be relegated to a note to financial statements, thus the resulting in off-balance sheet financing. The proportionate share method of accounting for unincorporated joint ventures avoids the problem of off-balance sheet financing but has the questionable practice of including portions of assets such as plant assets in each venturer's balance sheet.

As it was given on the Financial Accounting Standards Board's statement (SFAC No. 2) that "Information about an enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises," it is understandable to have two significantly different generally accepted accounting methods for investments in joint ventures. Accordingly, the FASB has undertaken a study of the accounting for investments for which the equity method of accounting presently is used.

In International Accounting Standard 31 (IAS 31), "Financial Reporting of Interests in Joint Ventures," the International Accounting Standards Board permits either the proportionate consolidation method (analogous to the proportionate share method described before) or the equity method for a venturer's investment in a jointly controlled entity, which might be a corporation or a partnership. As pointed out before, U.S. generally accepted accounting principles require the equity method of accounting for investments in corporate joint ventures but permit either the equity method or the proportionate share method of accounting for investments in unincorporated joint ventures.

Chapter Two: Accounting for Public Enterprises in Ethiopia

2.2. Historical Background of Public Enterprises in Ethiopia

This section briefly acquaints you with characteristics, accounting and managerial implications of state owned enterprises in Ethiopian context. It also addresses the reorganization of Ethiopian public enterprises with Proclamation Number 25/1992.

What are Public Enterprises?

In other courses you may have read the various types of funds, one of which was an enterprises fund. You remember that an enterprise fund is under the category of proprietary fund which is operated and managed in similar manner to commercial businesses.

Public Enterprise is a business organization wholly or partly owned by the state and controlled through a public authority. Some public enterprises are placed under public ownership because, for social reasons, it is thought that the service or product should be provided by a state monopoly. Utilities (gas, electricity, water, etc.), broadcasting, telecommunications and certain forms of transport are examples of this kind of public enterprise.

Background of Ethiopian Public Enterprises

Public Enterprises in Ethiopia: Proclamation No. 25/1992

❖ Definition of terms:

- **Public Enterprise (Art. 2 (2)):** a wholly state owned public enterprise established pursuant to Proclamation No.25/1992 to carry on for gain: manufacturing, distribution, service rendering or other economic and related activities.
- **Total Assets (Art. 2 (3)):** all immovable and movable property, receivables, cash and bank balances of the enterprise including intangible assets, deferred charges and other debit balances.
- **Net Total Assets (Art. 2 (4)):** total assets less current liabilities, long-term debts, deferred income and other liabilities.
- **Capital (Art. 2 (5)):** the original value of the net total assets assigned to the enterprise by the state at the time of its establishment or any time thereafter.
- **Net profit (Art. 2 (7)):** any excess of all revenue and other receipts over costs and operating expenses properly attributable to the operations of the financial year including depreciation, interest and taxes.
- **State Dividend (Art. 2 (9)):** remaining balance after deduction of the transfers to the legal reserve fund and other reserve fund from the net profits.
- **Paid up capital (Art. 20 (1)):** the paid up capital shall not be less than 25% of the authorized capital at the time of establishment.
- **Authorized capital (Art. 20 (2)):** the authorized capital of the enterprise shall be fully paid up within 5 years from the date of its establishment.

- **Legal reserve (Art. 29 (2)):** five percent (5%) of net income of the financial year.



Accounting and Financial Reporting

Articles 27- 29:

- Public enterprise follow generally accepted accounting principles.
- The financial year is determined by the supervising authority.
- Accounts should be closed at least once a year, within three months following the end of the financial year.
- The enterprise shall prepare a report on the state of its activities and affairs during the last financial year, including a statement of achievements and major plans and programs to be implemented in the near future.
- Legal reserve 5% of net profits until such reserve equals 20% of the capital of the enterprise. The legal reserve is used to cover losses and unforeseeable expenses and liabilities.
- Other reserve funds may be established with the approval of the supervisory authority.

❖ Auditor General

Articles 32 – 34 deal with the appointment of Auditors; obligation to cooperate; and powers, duties, & liability of auditors. It is the supervising authority that will ascertain that external auditors appointed by it satisfy the criteria set by the Auditor General and that they are free from being under any form of influence. Plus, the supervising authority shall determine the term of external auditors. The establishment of the Supervising Authority came to the scene through Proclamation No. 412/2004.

The term public enterprise is used widely, but there is no single, generally accepted definition that attaches to the term. But, it is important to understand what is being referred to. This is because Public Enterprises have features of both private and public sector organizations. Like private companies, they are engaged in commercial activity with the intent of profit-making, often in competition with other private sector companies. Like public sector agencies, they are required to execute government policies, often in the form of delivering non-commercial services or community service obligations.

As suggested in some literatures, three characteristics are considered to be essential in classifying an organization as a public enterprise: (i) its principal function is to engage in commercial activities in the private sector, (ii) it is controlled by government, and (iii) it has an independent legal existence from government and the executive.

Although the provision of these services by public enterprises is a common practice in Ethiopia and elsewhere, private companies are generally allowed to provide such services subject to strict legal regulations. In some countries industries such as railways, coal mining, steel, banking, and insurance have been nationalized for ideological reasons, while another

group, such as armaments and aircraft manufacture, have been brought into the public sector for strategic reasons.

❖ **Commercial Activities**

The term 'commercial activities' refers to 'the sale of goods or services for financial return in an open market, that is, in a market where the consumers of the goods or services are not limited to government-funded bodies'.

It should be noted that not all Public Enterprises engage in commercial activities in the same way. Some are monopoly suppliers of goods or services (such as Ethiopian Telecommunications Corporation (ETC), Ethiopian Electric Power Corporation (EEPCO), Ethiopian Air Lines (EAL), etc.), while others (such as Meta Abo, Bedelle, Harar Breweries, commercial Bank of Ethiopia (CBE), etc.) operate in competitive markets with private sector companies. Commercial activity need not be the only activity of a public enterprise but it will be its principal activity.

It allows that Public Enterprises will often be required to discharge community service obligations (that is, provide goods or services at subsidized or less than market prices and which might therefore not be provided if the public enterprise operated on a purely commercial basis).

❖ **Government Control**

There are also variations on the Government control. The question of control lies at the heart of accountability. Control is a vague term; it can be exercised generally or in relation to specific issues.

- It can be exercised permanently or intermittently;
- It can come from inside the public enterprise or be imposed from outside,
- It can be actual or potential (sometimes control is exercised by the threat or potential of actual control), and
- It can be a combination of these factors.

Two methods of control that have been used in relation to Public Enterprises are:

- the appointment of government officers to the board of management, or
- Direct ownership.

Some Public Enterprises are controlled by virtue of being wholly owned by the government, whereas, other Public Enterprises are partly owned by private sector interests, often as a step towards the full privatization of the entity.

In partly-owned Public Enterprises, there is a question about the level of ownership which is necessary to give the government control over the entity. There are no precise answers to this question. As we move along the scale from 100 per cent ownership through 50 per cent to

minority government ownership, we encounter entities which are more properly regarded as private, although the point at which this happens will vary depending on the company.

One attempt at a categorical answer is relying on a test which is similar to that found in the FASB statements for defining the relationship of holding company to subsidiary company.

That is, the Government is said to control a public enterprise if the Government:

- ❖ controls the composition of the Public Enterprises board of directors
- ❖ can cast, or control the casting of, more than one half of the maximum number of votes that might be cast at a general meeting of the company, or
- ❖ holds more than one-half of the issued shares in the public enterprise.

However, there are other standards of control that might be used. For example, we could borrow the control threshold which is used in regulating company takeovers, and say that anything over a 20 per cent ownership of voting shares constitutes effective control.

❖ **Independent Legal Existence**

Ethiopian Public Enterprises Proclamation No. 25/1992 in article 7 has put legal personality and Liability of public enterprises. According to this article, sub (1), a public enterprise shall have legal personality stating in sub (2) that it may not be held liable beyond its total assets. It is important to stress that the formal independence of a public enterprise will not be negated by the level of control which government exercises over the public enterprise.

Accounting for Formation and Operation of Public Enterprises

❖ **Accounting for Formation**

Illustrative Example: Assume that the Government formed ABC Enterprise with authorized capital of Br.75 million in accordance with the requirements of Proc. No. 25/1992 with investment of cash, Br.22.5 million; and equipment, at current fair value, Br.1.05 million. The journal entry to record the investment in ABC Enterprise as follows:

Cash -----	22,500,000
Equipment (at fair value) -----	1,050,000
State Capital -----	23,550,000

To record investment in ABC Enterprise.

❖ **Accounting for Operation**

To illustrate accounting for operation of public enterprise, the trial balance for ABC Enterprise for the financial year ending June 30, 2008 is presented as follows:

ABC Enterprise
Trial Balance
June 30, 2008

	(In '000 Birr)	
Cash -----	Br.15,075	
Accounts Receivable -----	3,900	
Property, Plant & Equipment -----	3,300	
Accumulated Depreciation -----		Br. 75
Accounts Payable -----		225
Notes Payable -----		300
State Capital -----		23,550
Sales -----		7,500
Operating Expenses -----	4,425	
Purchases -----	4,950	
	<u>Br.31,650</u>	<u>Br.31,650</u>

❖ **Additional information**

☞ Ending inventory is Br.2.4 million.

☞ The Board of Directors' has decided to establish other reserves of Br.150,000 from the net income of the year.

☞ The current profit tax rate is 30%.

❖ **Required**

1. Prepare an income statement for ABC Enterprise for the year ended June 30, 2008.
2. Prepare journal entries for transfer of net income to legal reserve and other reserves, and to recognize state dividend payable.
3. Prepare the balance sheet at June 30, 2008.

1. Income Statement ABC Enterprise

Income Statement

For the Year Ended June 30, 2008

	(In '000 Birr)
Sales -----	Br.7,500
Cost of Goods Sold -----	<u>2,550</u>
Gross Profit -----	Br.4,950
Operating Expenses -----	<u>4,425</u>
Income before tax -----	Br. 525
Income tax expense (30%) -----	<u>157.5</u>
Net Income -----	<u>Br.367.5</u>

2. Journal Entries

Income Summary -----	367,500	
Legal Reserve (5% × Br.367,500) -----		18,375
Retained Earnings -----		150,000
State Dividend Payable -----		199,125
Income Tax Expense -----	157,500	
Income Tax Payable -----		157,500

3. Balance Sheet

ABC Enterprise

Balance Sheet

June 30, 2008

(In '000 Birr)

Assets	
Cash -----	15,075
Accounts Receivable -----	3,900
Inventory -----	2,400
Property, Plant & Equipment -----	3,300
Less: Accumulated Depreciation -----	<u>(75)</u>
Total Assets -----	<u>24,600</u>
Liabilities and Capital	
Accounts Payable -----	225
Income Tax Payable -----	157.5
Notes Payable -----	300
State Dividend Payable -----	199.1
State Capital -----	23,550
Legal Reserve -----	18.4
Other Reserves -----	<u>150</u>
Total Liabilities and Capital -----	<u>24,600</u>

2.3. Privatization of Public Enterprises in Ethiopia

❖ Privatization Defined

Privatization can be defined as the act of reducing the role of government, or increasing the role of the private sector, in an activity or in the ownership of assets.

The privatization process covers not only the ownership and management transfer of a public enterprise (PE) to the private sector through sales, but also other forms of privatization such as lease arrangements, management contracts, cutbacks in government activities, denationalization, deregulation, etc. Thus, privatization is basically the transfer of government owned assets to the private sector.

❖ Objectives of Privatization

In principle, public enterprises (PEs) could operate in much the same way as private enterprises, maximizing or at least concentrating on profits. In practice, however, PEs are rarely pure profit maximize. This is partly due to the greater weight attached to social objectives rather than financial objectives.

The assertion that the state is relatively inefficient in production, distribution and financial sector is rather without proof; the issue that the private sector is relatively more efficient in this area of activities is inconclusive. Theoretically, with the prevalence of competitive market, a public enterprise, allowed fully to operate competitively in the market is likely to perform as efficient as the corresponding private sector enterprise in that same market.

Generally, the change of ownership from state to private may not necessarily improve the efficiency and profitability of enterprises. But in practice, the new private owners, pushed by the need for more profit and survival in the competitive environment, could invest more on new technologies, make managers accountable for bad performance, as a result inefficiencies could be minimized and profitability improved.

Different stakeholders are to view the objectives of privatization differently. The economists' case for privatization rests on the expectation that it will enhance efficiency in the supply of a product or service and expect privatized firms to be more efficient than state owned ones. Privatization is designed to substitute the single objective of maximizing profits for the typically mixed objectives of public enterprises, and focuses on the task of raising revenue and lowering costs.

In general, the main objectives of privatization often include the following:

- ❖ Achieving wider share ownership,
- ❖ Introducing more competition,
- ❖ Changing the public-private sector mix,
- ❖ Improving the performance of public enterprises, and
- ❖ Reducing the frequent political interference in the day-to-day activities of public enterprises.

Thus, privatization is widely expected to improve the financial and operating performance. There are several reasons to expect improved performance in a privatized firm. The first is the issue of objectives. A privately owned company knows that it will not survive if it is consistently unprofitable; lenders will not lend and new equity will not be raised. Pursuing of commercial success is a prerequisite for survival. Profitability is usually a good measure of success. Related to objective is the issue of accountability. The obligation of the company to account its Board for commercial performance, and the obligation of the Board to account to equity owners for returns on, and enhancement of the value of, that equity, is powerful force.

❖ **Advantages and Disadvantages of Privatization**

▪ **Advantages of Privatization**

The major benefits of privatization can be summarized as follows:

- **Greater Efficiency and Productivity of Enterprises:** It has been argued that the main benefits of privatization would come from the greater efficiency and productivity of enterprises after privatization. Freed from government control with its set of incompatible objectives, privatized firms can focus on being competitive to produce, at low cost and acceptable quality. This would lead to more efficient use of resources and improve economic output.
- **Increased Competition in the Economy:** Governments see privatization as a way to increase competition in the economy, and thereby a private sector that is more flexible, more responsive to customers, and more efficient than the public alternatives.

- **Revenue to the Government:** The government would generate revenue from both the sale of assets in public enterprises as well as from increased tax revenues from restructured and more productive enterprises.
- **Capital Market Development:** Privatization is also believed to have an impact on capital market development, which is a key to economic growth.
- **Means of Foreign Direct Investment (FDI):** Privatization has also a positive impact on attracting foreign direct investment. Many countries that are privatizing would like to attract strategic foreign investor into a public enterprise because such investor can bring capital, new technology, new export market access, and professional management to the enterprise.

▪ **Disadvantages of Privatization**

Some of the risks associated with privatization can be summarized as follows:

- **Monopolistic tendency:** Privatization alone without the introduction of competition may simply transform a state monopoly into a private monopoly. The privatized firm may pursue profits more vigorously, but that pursuit, if it took the form of increased prices, could worsen allocative efficiency.
- **Possibility of Failure:** If undertaken without careful preparation, and change in major policy elements such as the labor, the trade, the finance and the pricing policy, privatization can cause some firms to fail needlessly. If the transfer of enterprises is made to a private owner with no vision, plan, and entrepreneurial skill, it will result in unnecessary closure of the privatized firms. The vision, the capacity and potential of the private sector to run the firms to be privatized are necessary preconditions to realize the promises of privatization.

❖ **Privatization Modalities**

Privatization can be achieved through a number of transactions involving money or not (vouchers). These transactions are called Modalities, which in simple word mean methods of privatization. Selection of modality depends on the characteristics of the enterprise as well as the objectives of the government. Some enterprises may have identifiable needs (investment, management, market, etc.) while others could be managed by anybody. The government may want to spread ownership, empower local investor, go out of operation while retaining ownership, etc. The major types of modalities used throughout the world include the following.

- **Voucher Method:** This method also called mass privatization or non-sale distribution method may not raise revenue but it can reduce the level of required subsidies.
- **Sale of PE shares to the Public:** The ownership of the PE is transferred from the public sector to the private sector through partial or total sales of shares. Partial sale of shares refers to cases where the government decides to sell part of its share holdings to the public at large. The remaining shares may be retained in view of controlling or influencing decisions. Total sales (complete divestiture) involve the outright sale of all shares to a single buyer, to the public or to the workers and management of the PE to be privatized.

- **Sale of PE Shares to Workers and Management:** The selling of shares of the company to its workers and management through direct give way, leveraged buyout or some combination of the two.
- **Cut Backs in PE's Activities:** Cut backs in PE activities are another approach to privatization. The encouragement of private capital to participate in the economy as well as the restriction of PE's activities will enhance competition and the efficient use of resources.
- **Deregulation:** Deregulation refers to the removal of specific monopoly rights and other protective privileges given to PEs. In order to influence the stability of prices or other regulatory purposes the government usually gives special powers and privileges to certain government units. The restriction as well as the removal of their special privileges will enhance the free entry and exit of enterprises in the market and ultimately ensure competition.
- **Liquidation and Withdrawal:** This method is used in cases where no combination of new investment, ownership, and operational changes exist which would give the enterprise a positive net present value in terms of future cash flows. Therefore, in cases where PEs are chronic money losers and their financial investigation reveal that their long-term viability are at stake, liquidation is taken as an option.
- **Other forms of privatization include:**

- Joint ventures,
- Management contract for fee,
- Lease arrangements,
- Restitution of property to former owners,
- Debt-equity swaps,
- Franchising, etc.

❖ **Privatization in Ethiopia**

As part of the country's economic policy, the Ethiopian Privatization Agency (EPA) had passed through a number of years of implementation of the proclamation for privatization of public enterprises. Since its establishment by Proclamation No. 87/1994, the agency has privatized about 224 Public Enterprises, branches and units which consist of department stores, warehouses, small hotels and tourism, factories, farms, agro-industries, and so on. It still continues to privatize the remaining enterprises.

▪ **Privatization Modalities used by EPA**

From the different modalities of privatization as discussed above, so far the Agency has put into practice the following:

- Asset Sale,
- Lease/Hire/Sale,
- Joint Venture with Strategic Investor,
- Management Contract,
- Competitive sale of Shares,
- The restricted tender, and
- Negotiated sale
- Employee and Management Buy Out (Safety Net Program),

Illustrative example:

To illustrate for privatization of public enterprises in Ethiopia, assume that the following information is given for ABC Company, a public enterprise, which is privatized on June 2008.

ABC Company
Balance Sheet
June 30, 2008
(In '000 Birr)

Assets	
Cash -----	15,075
Accounts Receivable -----	3,900
Inventory -----	2,400
Property, Plant & Equipment (net) -----	<u>3,225</u>
Total Assets -----	<u>24,600</u>
Liabilities and Capital	
Accounts Payable -----	225

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Income Tax Payable -----	157.5
Notes Payable -----	300
State Dividend Payable -----	199.1
State Capital -----	23,550
Legal Reserve -----	18.4
Other Reserves -----	<u>150</u>
Total Liabilities and Capital -----	<u>24,600</u>

An investor agreed on a competitive bid with Br.30 million to acquire the ABC Company.
The market values of the assets are as follows (In '000 Birr):

Accounts Receivable	Br.3,000
Inventory	3,000
Property, Plant & Equipment (net)	4,500

Require: Journalize the transaction.

This transaction can be journalized under two cases, similar to the one proposed for accounting for incorporation of partnership under unit two of this module, for which only one set of accounting for incorporation was illustrated.

Case 1: Continuing (modified) with accounting records of ABC Company (In '000 Birr)

Inventory -----	600	
Property, Plant & Equipment (net)-----	1,275	
Goodwill* -----	5,306.6	
State Capital -----	23,550	
Legal Reserve -----	18.4	
Retained Earnings -----	150	
Accounts Receivable -----		900
Z, Capital -----		30,000
Cost	Br.30,000.00	
Less: Net Assets:		
State Capital	Br.23,550	
Legal Reserve	18.4	
Retained Earnings	150	
Revaluation of Net assets	<u>975</u>	<u>24,693.4</u>
* Goodwill		<u>Br.5,306.6</u>

Case 2: New set of accounting records

Cash -----	15,075	
Accounts Receivable -----	3,000	
Inventory -----	3,000	
Property, Plant & Equipment (net) -----	4,500	
Goodwill -----	5,306.6	
Accounts Payable -----		225
Income Tax Payable -----		157.5
Notes Payable -----		300
State Dividend Payable -----		199.1
Z, Capital -----		30,000

Chapter Three: Accounting for Sales Agencies and Branch Operations

3.1. Distinguishing Sales Agency, Branches and Divisions

Sales Agency and Branch

The difference between a sales agency and a branch most often has to do with the degree of autonomy. A *sales agency*, sometimes referred to simply as an “agency,” usually is not an autonomous operation but acts on behalf of the *principal office*. The agency may display and demonstrate sample merchandise, take orders, and arrange for delivery. The home office typically fills the orders because a sales agency usually does not stock inventory. Merchandise selection, advertising, granting of credit, collection on accounts, and other aspects of operating the home office usually conducts the businesses.

A branch office usually has more autonomy and provides a greater range of services than a sales agency does, although the degree differs with the individual company. A branch typically stocks merchandise and fills customers’ orders. For some companies the branches perform their own credit function, while for other companies the home office handles credit. The manager of a branch office is normally given some degree of autonomy in order to provide better service to the branch customer. The amount of autonomy that the branch manager is granted by the home office will vary from firm to firm, but regardless of the responsibility granted, he or she is subject to the control of the home office and is governed by general corporate policies. To provide the home office management with the information needed to evaluate the performance of the branch manager, the branch is normally accounted for as a separate segment or responsibility center for internal purposes. However, for external reporting purposes, combined financial statements for the home office and branch operations are prepared in order to evaluate the financial position and operating performance of the firm as a whole.

Many different types of companies operate through branches. Nearly everyone has visited branches of major department store chains such as Mega Book Shops and Petroleum Oil Retailers. Banks have been especially aggressive in expanding through extensive networks of branch banks. Some manufacturing companies also conduct business through a comparable system of operating locations, usually referred to as “plants.” For example, Moha Soft Drinks operates assembly plants at many different sites, including locations in Dessie, Addis Ababa, and Awasa.

There is little management decision making in a sales agency; decisions are made at the home office, and the agency conducts routine operations. The manager of a sales agency does not keep a financial accounting system; operations of the agency are recorded on the books of the home office. To provide information to on each agency, revenue and expense transactions of a particular agency are recorded in accounts identified with that agency. For control purposes, assets other than cash transferred to an agency are recorded in accounts identified with the agency. A petty cash is established for the purpose of paying small expenditures that can be settled more conveniently by the agency. The degree of management decision making in branches usually is greater than in sales agencies but differs considerably from company to company.

❖ Accounting for Sales Agencies

Because a sales agency normally does not have an accounting system, the home office records all transactions involving the agency. For some types of transactions, the entries recorded by the home office are based on source documents generated by the agency. For example, the home

office may record agency transactions based on sales invoices, payroll records, and documented petty cash vouchers provided by a sales agency. Other transactions may be recorded based on source documents provided by external parties directly to the home office. For example, the utility companies providing gas, electricity, water, and phone service to the agency might bill the home office directly. The home office normally accounts for the assets, revenues, and expenses of each agency separately. This allows the home office to maintain control over the assets and provides information for assessing the performance of each agency.

Branch and Division

As a business enterprise grows, it may establish one or more branches to market its products over a large territory. The term branch is used to describe a business unit located at some distance from the home office. This unit carries merchandise obtained from the home office, marks sales, approves customers' credit, and makes collections from its customers.

A branch may obtain merchandise solely from the home office or portion may be purchased from outside suppliers. The cash receipts of the branch often are deposited in a bank account belonging to the home office; the branch expenses then are paid from an **imprest cash fund** or a bank account provided by the home office. As the imprest cash fund is depleted, the branch submits a list of cash payments supported by vouchers and receives a check or an electronic or wire transfer from the home office to replenish the fund.

The use of an imprest cash fund gives the home office considerable control over the cash transactions of the branch. However, it is common practice for a large branch to maintain its own bank accounts. The extent of autonomy and responsibility of a branch varies, even among different branches of the business enterprise.

A segment of a business enterprise also may be operated as a **division**, which generally has more autonomy than a branch. The accounting procedures for a division not organized as a separate corporation (**subsidiary company**) are similar to used for branches. When a business segment is operated as a separate corporation, consolidated financial statements generally are required.

3.2. Accounting System for a Branch

The accounting of one business enterprise with branches may provide for a complete set of accounting records at each branch; policies of another such enterprise may keep all accounting records in the home office. For example, branches of drug and grocery chain stores submit daily reports and business documents to the home office, which enters all transactions by branches in computerized accounting records kept in a central location. The home office may not even conduct operations of its own; it may serve only as an accounting and control center for the branches.

A branch may maintain a complete set of accounting records consisting of journals, ledgers, and a chart of accounts similar to those of an independent business enterprise. Financial statements are prepared by the branch accountant and forwarded to the home office. The number and types of ledger accounts, the internal control structure, the form and content of the financial statements, and the accounting policies generally are prescribed by the home office.

This section focuses on a branch operation that maintains a complete set of accounting records. Transaction recorded by a branch should include all controllable expenses and revenue for which the branch manager is responsible. If the branch manager has responsibility over all branch assets, liabilities, revenue, and expenses, the branch accounting records should reflect this responsibility. Expenses such as depreciation often are not subject to control by a branch

manager; therefore, both the branch plant assets and the related depreciation ledger accounts generally are maintained by the home office.

3.2.1. Reciprocal Ledger Accounts

The accounting records maintained by a branch include a Home Office ledger account that is credited for all merchandise, cash, or other assets provided by the home office; it is debited for all cash, merchandise, or other assets sent by the branch to the home office or to other branches. The **Home Office account** is a **quasi-ownership equity account** that shows the net investment by the home office in the branch. At the end of an accounting period when the branch close its accounting records, the Income Summary account is closed to the Home Office account. A net income increases the credit balance of the Home Office account; a net loss decreases this balance.

In the home office accounting records, a reciprocal ledger account with a title such as investment in Branch is maintained. This noncurrent asset account is debited for cash, merchandise, and services provided to the branch by the home office, and for net income reported by the branch. It is credited for cash or other assets received from the branch, and for net losses reported by the branch. Thus the Investment in Branch account reflects the **equity method of accounting**. A separate investment account generally is maintained by the home office for each branch. If there is only one branch, the account title is likely to be Investment in Branch; if there are numerous branches, each account title includes a name or number to identify each branch.

3.2.2. Expenses Incurred by Home Office and Allocated to Branches

Some business enterprises follow a policy of notifying each branch of expenses incurred by the home office on the branch's behalf. As earlier, plant assets located at a branch generally are carried in the home office accounting records. If a plant asset is acquired by the home office for the branch, the journal entry for the acquisition is debit to an appropriate asset account such as Equipment: Branch and a credit to Cash or an appropriate liability account. If the branch acquires a plant asset, it debits the Home office ledger account and credits Cash or an appropriate liability account. The home office debits an asset account such as Equipment: Branch and credits Investment in Branch.

The home office also usually acquires insurance, pays property and other taxes, and arranges for advertising that benefits all branches. Clearly, such expenses as depreciation, property taxes, insurance, and advertising must be considered in determining the profitability of a branch. A policy decision must be made as to whether these expense data are to be retained at the home office or are to be reported to the branches so that the income statement prepared for each branch will give a complete picture of its operations. An expense incurred by the home office and allocated to a branch is recorded by the home office by a debit to an appropriate expense ledger account; the branch debits an expense account and credits Home Office.

If the home office does not make sales, but functions only as an accounting and control center, most or all of its expenses may be allocated to the branches. To facilitate comparison of the operating results of the various branches, the home office may charge each branch interest on the capital invested in that branch. Such interest expense recognized by the branches would be offset by interest revenue recognized by the home office and would not be displayed in the **combined** income statement of the business enterprise as a whole.

3.2.3. Alternative Methods of Billing Merchandise Shipment to branches

There are three alternative methods available to the home office for billing merchandise shipped to its branches. The shipments may be billed (1) at home office cost, (2) at a percentage above home office cost, or (3) at the branch's retail selling price.

✓ *Remember that the shipment of merchandise to a branch does not constitute a **sale**, because ownership of the merchandise does not change.*

Billing **at home office cost** is the simplest procedure and is widely used. It avoids the complication of unrealized gross profit in inventories and permits the financial statements of branches to give a meaningful picture of operations.

However, billing merchandise to branches at home office cost attributes all gross profits of the enterprise to the branches, even though some of the merchandise may be manufactured by the home office. Under these circumstances, home office cost may not be the most realistic basis for billing shipment to branches.

Billing shipments to a branch **at a percentage above home office cost** (such as 110% of cost) may be intended to allocate a reasonable gross profit to the home office. When merchandise is billed to a branch at a price above home office cost, ***the net income reported by the branch is understated and the ending inventories are overstated for the enterprise as a whole.*** Adjustments must be made by the home office to eliminate the excess of billed prices over cost (***inter-company profits***) in the preparation of combined financial statements for the home office and the branch.

Billing shipments to a branch **at branch retail selling prices** may be based on a desire to strengthen internal control over inventories. The Inventories ledger account of the branch shows the merchandise received and sold at retail selling prices. The home office will show the ending inventories that should be on hand at retail prices. The home office record of shipments to a branch, when considered along with sales reported by the branch, provides a perpetual inventory states at selling prices. If the physical inventories taken periodically at the branch do not agree with the amount thus computed, an error or theft may be indicated and should be investigated promptly.

3.2.4. Financial Statement for Branch and for Home Office

A. Separate Financial Statement for Branch and for Home Office

A separate income statement and balance sheet should be prepared for a branch so that management of the enterprise may review the operating results and financial position of the branch. The branch's income statement has no unusual features if merchandise is billed to the branch at home office cost. However, if merchandise is billed to the branch at branch retail selling prices, the branch's income statement will show a net loss approximating the amount of operating expenses. The only unusual aspect of the balance sheet for a branch is the use of the Home Office ledger account in lieu of the ownership equity accounts for a separate business enterprise. The separate financial statements prepared for a branch may be revised at the home office to include expenses incurred by the home office allocable to the branch and to show the results of branch operations after elimination of any inter-company profits on merchandise shipments.

Separate financial statement also may be prepared for the home office so that management will be able to appraise the results of its operation and its financial position. However, it is important to emphasize that separate financial statements of the home office and of the branch are prepared

for internal use only; they do not meet the needs of investors or other external users of financial statements.

B. Combined Financial Statements for Home Office and Branch

A balance sheet for distribution to creditors, and government agencies must show the financial position of a business enterprise having branches as a **single entity**. A convenient starting point in the preparation of a combined balance sheet consists of the adjusted trial balances of the home office and of the branch. A working paper for the combination of the trial balances is illustrated on page 120.

The assets and liabilities of the branch are substituted for the Investment in Branch ledger account included in the home office trial balance. Similar accounts are combined to produce a single total amount for cash, trade accounts receivable, and other assets and liabilities of the enterprise as a whole.

In the preparation of a combined balance sheet, reciprocal ledger accounts are eliminated because they have no significance when the branch and home office report as a single entity. The balancers of the Home Office account is offset against the balance of the Investment in Branch account; also, any receivables and payables between the home office and the branch (or between two branches) are eliminated.

The operating results of the enterprise (the home office and all branches) are shown by an income statement in which the revenue and expenses of the branches are combined with corresponding revenue and expenses for the home office. Any intercompany profits or losses are eliminated.

Illustrative Journal Entries for Operation of a Branch

Assume that Smaldino Company bills merchandise to Mason Branch **at home office cost** and that Mason branch maintains complete accounting records and prepares financial statements.

Both the home office and the branch use the perpetual inventory system. Equipment used at the branch is carried in the home office accounting records. Certain expenses, such as advertising and insurance, incurred by the home office on behalf of the branch, are billed to the branch. Transactions and events during the first year (2005) of operations of Mason Branch are summarized below (start-up costs are disregarded):

1. Cash of Br.1,000 was forwarded by the home office to Mason branch.
2. Merchandise with a home office cost of Br.60,000 was shipped by the home office to Mason Branch.
3. Equipment was acquired by Mason branch for Br.500, to be carried in the home office accounting records. (Other plant assets for Mason branch generally are acquired by the home office.)
4. Credit sales by Mason branch amounted to Br.80,000; the branch's cost of the merchandise sold was Br.45,000.
5. Collections of trade accounts receivable by Mason Branch amounted to Br.62,000.
6. Payments for operating expenses by Mason Branch totaled Br.20,000.
7. Cash of Br.37,500 was remitted by Mason Branch to the home office.
8. Operating expenses incurred by the home office and charged to Mason Branch totaled Br.3,000.

These transaction and events are recorded by the home office and by Mason Branch as follows (explanations for the journal entries are omitted):

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Home Office Accounting Records			Mason Branch Accounting Records		
Journal Entries			Journal Entries		
(1)	Investment in mason Branch Cash	1,000	1,000	Cash Home Office	1,000 1,000
(2)	Investment in Mason Branch Inventories	60,000	60,000	Inventories Home Office	60,000 60,000
(3)	Equipment: Mason Branch Investment in Mason Branch	500	500	Home Office Cash	500 500
(4)	None			Trade Accounts Receivable Cost of Goods Sold Sales Inventories	80,000 45,000 80,000 45,000
(5)	None			Cash Trade Accounts Receivable	62,000 62,000
(6)	None			Operating Expenses Cash	20,000 20,000
(7)	Cash Investment in Mason branch	37,500	37,500	Home Office Cash	37,500 37,500
(8)	Investment in Mason Branch Operating Expenses	3,000	3,000	Operating Expenses Home Office	3,000 3,000

If a branch obtains merchandise from outsiders as well as from office, the merchandise acquired from the home office may be recorded in separate Inventories from Home Office ledger account. In the home office accounting records, the investment in Mason Branch ledger account has a debit balance of Br.26,000 [before the accounting records are closed and the branch net income of Br.12,000 (Br.80,000 – Br.45,000 – Br.20,000 – Br.3,000 = Br.12,000) is transferred to the Investment in Mason Branch ledger account], as illustrated below.

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Reciprocal ledger Account in Accounting Records of Home Office Prior to Equity- Method Adjusting Entry

Investment in Mason Branch					
Date	Explanation	Debit	Credit	Balance	
2005	Cash sent to branch	1,000		1,000 dr	In the accounting records of Mason Branch, the Home Office ledger account has a credit balance of Br.26,000 (before the accounting records are closed and the net income of
	Merchandise billed to branch at home Office cost	60,000		61,000 dr	
	Equipment acquired by branch, carried in home office accounting records		500	60,500 dr	
	Cash received from branch		37,500	23,000 dr	
	Operating expenses billed to branch	3,000		26,000dr	
Home Office					
Date	Explanation	Debit	Credit	Balance	
2005	Cash received from home office		1,000	1,000 cr	
	Merchandise received from home office		60,000	61,000 cr	
	Equipment acquired	500		60,500 cr	
	Cash sent to home office	37,500		23,000 cr	
	Operating expenses billed by home office		3,000	26,000 cr	

Br.12,000 is transferred to the Home Office account), as shown below:

Reciprocal ledger Account in Accounting Records of Mason Branch prior to Closing Entry

- **Working Paper for Combined Financial Statements**

Dear students from earlier readings, what do you think is working paper? The purpose of a working paper, as you may recall is to help facilitate the preparation of the financial statements once the trial balance has been prepared to see the equality of debits and credits. In this section we will discuss how we will make use of a working paper to prepare financial combining a branch and Head office.

A working paper for combined financial statement has there purposes: (1) to combine ledger account balances for like revenue, expenses, assets, and liabilities, (2) to eliminate any intercompany profits or losses, and (3) to eliminate the reciprocal accounts.

To illustrate the use of working paper and the preparation of combined financial statement we will continue to use data from Mason Branch and Smaldino Company seen above.

Assume that the perpetual inventories of Br.15,000 (Br.60,000 – Br.45,000 = Br.15,000) at the end of 2005 for Mason Branch had been verified by a physical count. The working paper

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illustrated below for Smaldino Company is based on the transactions and events illustrated above and additional assumed data for the home office trial balance. All the routine year-end adjusting entries (except the home office entries below) are assumed to have been made, and the working paper is begun with the adjusted trial balances of the home office and Mason Branch. Income taxes are disregarded in this illustration.

Note that the Br.26,000 debit balance of the Investment in Mason Branch ledger account and the Br.26,000 credit balance of the Home Office account are the balances **before the respective accounting records are closed**, that is, before the Br.12,000 net income of Mason branch is entered in these two reciprocal accounts. In the eliminations column, elimination (a) offsets the balance of the Investment in Mason Branch account against the balance of the Home Office account. **This elimination appears in the working paper only**; it is not entered in the accounting records of either the home office of Mason Branch because its only purpose is to facilitate the preparation of combined financial statements.

Combined Financial Statements Illustrated

The following working paper provides the information for the combined financial statements (excluding a statement of cash flows) of Smaldino Company.

SMALDINO COMPANY Working Paper for Combined Financial Statements of Home Office and Mason Branch For Year Ended December 31,2005 (Perpetual Inventory System: Billings at Cost)				
	Adjusted Trial Balances		Elimination	Combined
	Home Office	Mason Branch		
	Dr (Cr)	Dr (Cr)		
Income statement				
Sales	(400,000)	(80,000)		(480,000)
Cost of goods sold	235,000	45,000		280,000
Operating expenses	90,000	23,000		113,000
Net income (to statement of retained earnings below)	75,000	12,000		87,000
Total	-0-	-0-		-0-
Statement of Retained Earnings				
Retained earnings, beginning of year	(70,000)			(70,000)
Net (income)(from income statement above)	(75,000)	(12,000)		(87,000)
Dividends declared	40,000			40,000
Retained earnings, end of year (to balance sheet below)				117,000
Total				-0-
Balance Sheet				
Cash	25,000	5,000		30,000
Trade accounts receivable (net)	39,000	18,000		57,000

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Inventories	45,000	15,000		60,000
Investment in Mason branch	26,000		(a)(26,000)	
Equipment	150,000			150,000
Accumulated depreciation of equipment	(10,000)			(10,000)
Trade accounts payable	(20,000)			(20,000)
Home office		(26,000)	(a)26,000	
Common stock, Br.10 par	(150,000)			(150,000)
Retained earnings (from statement of retained earnings above)				(117,000)
Total	-0-	-0-	-0-	-0-

(a) To eliminate reciprocal ledger account balances.

From the above information the financial statements which follow will be prepared.

SMALDINO COMPANY

Income statement

For Year Ended December 31, 2005

Sales	Br.480,000
Cost of goods sold	<u>280,000</u>
Gross margin on sales	Br.200,000
Operating expenses	<u>113,000</u>
Net income	<u>Br. 87,000</u>
Basic earnings per share of common stock	<u>Br. 5.80</u>

SMALDINO COMPANY

Statement of Retained Earnings

For Year Ended December 31, 2005

Retained earnings, beginning of year	Br. 70,000
Add: Net income	<u>87,000</u>
Subtotal	Br.157,000
Less: Dividends (Br.2.67 per share)	<u>40,000</u>
Retained earnings, end of year	<u>Br.117,000</u>

SMALDINO COMPANY

Balance sheet

December 31, 2005

Assets

Cash	Br.30,000
Trade accounts receivable (net)	57,000
Inventories	60,000
Equipment	Br.150,000

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Less: Accumulated depreciation	10,000	140,000
Total assets		<u>Br.287,000</u>

Liabilities and Stockholder's Equity

Liabilities		
Trade accounts payable		Br.20,000
Stockholders' equity		
Common stock, Br.10 par, 15,000 shares authorized issued, and outstanding	Br.150,000	
Retained earnings	117,000	267,000
Total liabilities and stockholders' equity		<u>Br.287,000</u>



Home office Adjusting and Closing Entries and Branch Closing Entries

The home office's equity-method adjusting and closing entries for branch operating results and the branch's closing entries on December 31, 2005, are as follows (explanations for the entries are omitted):

Adjusting and Closing Entries (Perpetual Inventory System)

Home Office Accounting Records			Mason Branch Accounting Records		
Adjusting and Closing Entries			Closing Entries		
None			Sales	80,000	
			Cost of Goods Sold		45,000
			Operating Expenses		23,000
			Income Summary		12,000
Investment in Mason Branch	12,000		Income Summary Home Office	12,000	12,000
Income: Mason Branch		12,000			
Investment Mason Branch Income Summary	12,000	12,000	None		



Billing of Merchandise to Branches at Prices above Home Office Cost

As stated earlier the home offices of some business enterprises bill merchandise shipped to branches at home office cost plus a markup percentage (or alternatively at branch retail selling). Because both these methods involve similar modifications of accounting procedures, a single example illustrates the key points involved, using the illustration for Smaldino Company discussed above with one changed assumption: the home office bills merchandise shipped to mason branch at a markup of 50% above home office cost, or 33¹/₂% of billed price.

Under this assumption, the journal entries for the first year's events and transactions by the home office and Mason Branch are the same as those presented above except for the journal entries for

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shipments of merchandise from the home office to Mason Branch. These shipments (Br.60, 000 cost + 50% markup on cost = Br.90,000) are recorded under the perpetual inventory system as follow:

Journal Entries for Shipments to Branch At Prices above Home Office Cost
(perpetual Inventory System)

Home Office Accounting records		Masson branch Accounting Records		
Journal Entries		Journal Entries		
(2) Investment in Mason Branch Inventories	90,000	Inventories Home Office	90,000	90,000
Allowance for Overvaluation Of inventories: Mason Branch	0	60,000		
		30,000		

In the accounting records of the home office, the Investment in Mason Branch ledger account below has a debit balance of Br.56,000 before the accounting records are closed and the branch net income or loss is entered in the Investment in Mason Branch account. This account is Br.30,000 larger than the Br.26,000 balance in the prior illustration (page 118). The increase represents the 50% markup over cost (Br.60,000) of the merchandise shipped to Mason Branch.

Investment in Mason Branch					
Date	Explanation	Debit	Credit	Balance	
2005	Cash sent to branch	1,000		1,000	dr
	Merchandise billed to branch at markup of 50% over home office cost, or 33 ¹ / ₂ % of billed price	90,000		91,000	dr
	Equipment acquired by branch, carried in home office accounting records		500		
	cash received from branch		37,500	90,500	dr
	operating expenses billed to branch	3,000		53,000	dr
				56,000	dr

accounting records of mason Branch, the Home office ledger account now has a credit balance of Br.56,000, before the accounting records are closed and the branch net income or is entered in the Home office account, as illustrated below:

Home Office				
Date	Explanation	Debit	Credit	Balance
2005	Cash received from home office		1,000	1,000 cr
	Merchandise received from home office		90,000	91,000 cr
	Equipment acquired	500		90,500 cr

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	Cash sent to home office	37,500		53,000 cr
	Operating expenses billed by home office		3,000	56,000 cr

Mason branch recorded the merchandise received from the home office at billed prices of Br.90,000; the home office recorded the shipment by credits of Br.60,000 to Inventories and Br.30,000 to Allowance for Overvaluation of Inventories: Mason Branch. Use of the allowance account enables the home office to maintain a record of the cost of merchandise shipped to Mason Branch as well as the amount of the unrealized gross profit on the shipments.

At the end of the accounting period, Mason Branch reports its inventories (at billed prices) at Br.22,500. The cost of these inventories is Br.15,000 ($\text{Br.22,500} \div 1.50 = \text{Br.15,000}$). In the home office accounting records, the required balance of the Allowance for Overvaluation of Inventories: Mason branch ledger account is Br.7,500 ($\text{Br.22,500} - \text{Br.15,000} = \text{Br.7,500}$); thus, this account balance must be reduced from its present amount of Br.30,000 to Br.7,500. The reason for this reduction is ***that the 50% markup of billed prices over cost has become realized gross profit to the home office with respect to the merchandise sold by the branch.*** Consequently, at the end of the year the home office reduces its allowance for overvaluation of the branch inventories to the Br.7,500 excess valuation contained in the ending inventories. The debit adjustment of Br.22,500 in the allowance account is offset by a credit to the Realized gross profit: Mason Branch Sales account, because it represents additional gross profit of the home office resulting from sales by the branch.



Working Paper When Billings to Branches Are at Prices above cost

When a home office bills merchandise shipments to branches at prices above home office cost, preparation of the working paper for combined financial statements is facilitated by an analysis of the flow of merchandise to a branch, such as the following for Mason branch of Smaldino Company:

SMALDINO COMPANY

Flow of Merchandise for Mason Branch
During 2005

	Billed price	Home Office Cost	(Markup)
Beginning inventories	0	0	0

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Add: shipments from home office	<u>Br.90,000</u>	<u>Br.60,000</u>	<u>Br.30,000</u>
Available for sale	Br.90,000	Br.60,000	Br.30,000
Less: Ending inventories	<u>22,500</u>	<u>15,000</u>	<u>7,500</u>
Cost of goods sold	<u>Br.67,500</u>	<u>Br.45,000</u>	<u>Br.22,500</u>

The Markup column in the foregoing analysis provides the information needed for the Eliminations column in the working paper for combined financial statements below.

Dear students, how do you think the working paper of this section differ from we saw earlier?

SMALDINO COMPANY Working Paper for Combined Financial Statement of Home and Mason Branch For Year Ended December 31, 2005 (perpetual Inventory System: Billings above Cost)				
	Adjusted Trial Balances		Eliminations	Combined
	Home Office	Mason branch		
	Dr (Cr)	Dr (Cr)	Dr (Cr)	Dr (Cr)
Income Statement				
Sales	(400,000)	(80,000)		(480,000)
Cost of goods sold	235,000	67,500	(a) (22,500)	280,000
Operating expenses	90,000	23,000		113,000
Net income (loss) (to statement of retained earnings below)	75,000	(10,500)	(a) 22,500	87,000
Totals	<u>-0-</u>	<u>-0-</u>		<u>-0-</u>
Statement of Retained Earnings				
Retained earnings, beginning of year	(70,000)			(70,000)
Net (income) loss (from income statement above)	(75,000)		(b) (22,500)	(87,000)
Dividends declared	40,000	10,500		40,000
Retained earnings, end of year (to balance sheet below)				117,000
Total				<u>-0-</u>
Balance Sheet				
Cash	25,000	5,000		30,000
Trade account receivable (net)	39,000	18,000		57,000
Inventories	45,000	22,500	(a) (7,500)	60,000
Investment in Mason Branch	56,000		(c) (56,000)	
Allowance for overvaluation of inventories: Mason Branch	(30,000)		(a) 30,000	
Equipment	150,000			150,000
Accumulated depreciation of statement	(10,000)			(10,000)
Trade accounts payable	(20,000)			(20,000)
Home office		(56,000)	(c) 56,000	
Common stock, Br.10 par	(150,000)			(150,000)
Retained earnings (from statement of retained earnings above)				<u>(117,000)</u>

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60	61	62	63	64	65	66	67	68	69	70	71	72	73	74	75	76	77	78	79	80	81	82	83	84	85	86	87	88	89	90	91	92	93	94	95	96	97	98	99	100	101	102	103	104	105	106	107	108	109	110	111	112	113	114	115	116	117	118	119	120	121	122	123	124	125	126	127	128	129	130	131	132	133	134	135	136	137	138	139	140	141	142	143	144	145	146	147	148	149	150	151	152	153	154	155	156	157	158	159	160	161	162	163	164	165	166	167	168	169	170	171	172	173	174	175	176	177	178	179	180	181	182	183	184	185	186	187	188	189	190	191	192	193	194	195	196	197	198	199	200	201	202	203	204	205	206	207	208	209	210	211	212	213	214	215	216	217	218	219	220	221	222	223	224	225	226	227	228	229	230	231	232	233	234	235	236	237	238	239	240	241	242	243	244	245	246	247	248	249	250	251	252	253	254	255	256	257	258	259	260	261	262	263	264	265	266	267	268	269	270	271	272	273	274	275	276	277	278	279	280	281	282	283	284	285	286	287	288	289	290	291	292	293	294	295	296	297	298	299	300	301	302	303	304	305	306	307	308	309	310	311	312	313	314	315	316	317	318	319	320	321	322	323	324	325	326	327	328	329	330	331	332	333	334	335	336	337	338	339	340	341	342	343	344	345	346	347	348	349	350	351	352	353	354	355	356	357	358	359	360	361	362	363	364	365	366	367	368	369	370	371	372	373	374	375	376	377	378	379	380	381	382	383	384	385	386	387	388	389	390	391	392	393	394	395	396	397	398	399	400	401	402	403	404	405	406	407	408	409	410	411	412	413	414	415	416	417	418	419	420	421	422	423	424	425	426	427	428	429	430	431	432	433	434	435	436	437	438	439	440	441	442	443	444	445	446	447	448	449	450	451	452	453	454	455	456	457	458	459	460	461	462	463	464	465	466	467	468	469	470	471	472	473	474	475	476	477	478	479	480	481	482	483	484	485	486	487	488	489	490	491	492	493	494	495	496	497	498	499	500	501	502	503	504	505	506	507	508	509	510	511	512	513	514	515	516	517	518	519	520	521	522	523	52
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- (a) To reduce ending inventories and cost of goods sold of branch to cost, and to eliminate unadjusted balance of Allowance Overvaluation of Inventories: mason Branch ledger account.
- (b) To increase income of home office by portion of merchandise markup that was realized by branch sales.
- (c) To eliminate ledger account balance.

Combined Financial Statements

Home Office Adjusting and Closing Entries and Branch Closing Entries

Home office Accounting Records Adjusting and Closing Entries

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Realized gross profit: mason Branch Sales To reduce allowance to amount by which ending inventories of branch exceed cost:				office general ledger use
Realized Gross Profit: Mason Branch Sales Income: Mason Branch		22,500	10,500 12,000	
Realized Gross Profit: Mason Branch Sales				
To close branch net loss and realized gross profit to income summary ledger account. (Income tax effects are disregarded.)		Debit	Credit	Balance
2005	Realization of 50% markup on merchandise sold by branch during 2005		22,500	22,500
Investment in Mason Branch		22,500		cr
Date	Explanation	Debit	Credit	Balance
2005	Cash sent to branch	1,000		1,000 dr
	Merchandise billed to branch at markup of 50% over home office cost, or 33 ¹ / ₂ % of billed price	90,000		91,000 dr
	Equipment acquired by branch, carried in home office accounting records		500	
	Cash received from branch		37,500	90,500 dr
	Operating expenses billed to branch	3,000		dr
	Net loss for 2005 reported by branch		10,500	53,000 dr
				56,000 dr
				45,500 dr
				dr
Allowance for Overvaluation of Inventories: Mason Branch				
Date	Explanation	Debit	Credit	Balance
2005	Markup on merchandise shipped to Branch during 2005 (50% of cost)		30,000	30,000 cr
	Realization of 50% markup on merchandise sold by branch during 2005	22,500		
				7,500 cr

Income: mason Branch				
Date	Explanation	Debit	Credit	Balance
2005	Net loss for 2005 reported by branch Closing entry	10,500	10,500	10,500 dr -0-

In the separate balance sheet for the home office, the Br.7,500 credit balance of the Allowance of Overvaluation of Inventories: mason Branch ledger account is deducted from the Br.45,500 debit balance of the Investment in Mason Branch account, thus reducing the carrying amount of the investment account to a cost basis with respect to shipments of merchandise to the branch. In the separate income statement for the home office, the Br.22,500 realized gross profit on Mason Branch sales may be displayed following gross margin on sales, Br.165,000 (Br.400,000 sales – Br.235,000 cost of goods sold = Br.165,000). The closing entries for the branch at the end of 2005 are as follows:

Mason Branch Accounting Records
Closing Entries

Sales	80,000	
Income Summary	10,500	
Cost of Goods Sold		67,500
Operating Expenses		23,000
To close revenue and expense ledger accounts.		

Home office Income Summary To close the net loss in the income Summary account to the home office account.	10,500	10,500
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After these closing entries have been posted by the branch, the following Home Office ledger account in the accounting records of Mason Branch has a credit balance of Br.45,500, the same as the debit balance of the Investment in Mason Branch account in the accounting records of the home office.

Compare this Ledger Account with Investment in Mason Branch Account

Home Office				
Date	Explanation	Debit	Credit	Balance
2005	Cash received from home office		1,000	1,000
	Merchandise received from home office		90,000	cr
	Equipment acquired	500		91,000
	Cash sent to home office	37,500		cr
	Operating expenses billed by home office		3,000	90,500
	Net loss for 2005	10,500		cr
				53,000
				cr
				56,000
				cr
				45,500
				cr

Treatment of Beginning Inventories

Priced above Cost

Dear students, hope that you are able to easily relate the effect that overvaluing has on balance sheet and income statement. This section try to address the issues related to the treatment of beginning inventory in subsequent years where the merchandise was priced above cost. The working papers in the previous sections show the ending inventories and the related allowance for overvaluations of inventories were handled. However, because 2005 was the first year of operations for Mason Branch, no beginning inventories were involved.

Perpetual inventory system

Under the perpetual inventory system, no special problems arise when the beginning inventories of the branch include an element of unrealized gross profit. The working paper eliminations would be similar to those illustrated earlier

Periodic Inventory System

The illustration of a second year operations (2006) of Smaldino Company demonstrates the handling of beginning inventories carried by mason Branch at an amount above home office cost. However, assume that both the home office and Mason Branch adopted the periodic inventory system in 2006. When the periodic inventory system is used, the home office credits Shipments to branch (an offset account to Purchases) for the home office cost of merchandise shipped and Allowance for Overvaluation of inventories for the markup over home office cost. The branch debits Shipments from Home Office (analogous to a Purchases account) for the billed price of merchandise received.

The beginning inventories for 2006 were carried by Mason Branch at Br.22,500, or 150% of the cost of Br.15,000 ($\text{Br.15,000} \times 1.50 = \text{Br.22,500}$). Assume that during 2006 the home office shipped merchandise to Mason Branch that cost Br.80,000 and was billed at Br.120,000, and that Mason branch sold for Br.150,000 merchandise that was billed at Br.112,500. The journal entries (explanations omitted) to record the shipment and sales under the periodic inventory system are illustrated below:

Journal Entries for Shipments to branch at a price above Home Office Cost (Periodic Inventory System)

Home Office Accounting records			Mason Branch Accounting Records		
Journal Entries			Journal Entries		
Investment in Mason Branch	120,000		Shipments from Home office	120,000	
Shipments to Mason Branch		80,000	Home office		120,000
Allowance for Overvaluation of inventories: mason Branch		40,000			
None			Cash (or Trade Accounts Receivable)	150,000	
			Sales		150,000

The branch inventories at the end of 2006 amounted to Br.30,000 at billed prices, representing cost of Br.20,000 plus a 50% markup on cost ($\text{Br.20,000} \times 1.50 = \text{Br.30,000}$). The flow of merchandise for mason branch during 2006 is summarized as follows.

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During 2006

SMALDINO COMPANY

Flow of Merchandise for Masson Branch

	Billed price	Home Office Cost	Markup (50% of Cost; 33¹/₃% of Billed price)
Beginning inventories (from Earlier section)	Br.22,500	Br.15,000	Br.7,500
Add: Shipments from home office	<u>120,000</u>	<u>80,000</u>	<u>40,000</u>
Available fir inventories	Br.142,500	Br.95,000	Br.47,500
Less: Ending inventories	<u>(30,000)</u>	<u>(20,000)</u>	<u>(10,000)</u>
Cost of goods sold	<u>Br.112,500</u>	<u>Br.75,000</u>	<u>Br 37,500</u>

The activities of the branch for 2006 and end-of-period adjusting and closing entries are reflected in the four home office ledger accounts below.

End-of-Period Balances in Accounting Records of Home Office

Investment in Mason Branch

Date	Explanation	Debit	Credit	Balance
2006	Balance, Dec. 31, 2005 (from page 128)			45,5000
	Realized gross profit on Mason Branch Sales			dr
Date	Explanation	Debit	Credit	Balance
	33 ¹ / ₃ % of billed price	120,000		
	Cash received from branch		113,000	165,500
	Operating expenses billed to branch	4,500		dr
	Net income for 2006 reported by branch	10,000		52,500 dr
				57,000 dr
				67,000 dr

Allowance for Overvaluation Inventories: Mason Branch

Date	Explanation	Debit	Credit	Balance
2006	Balance, Dec. 31, 2005 (from page 128)			7,500 cr
	Markup on merchandise shipped to branch during 2006 (50% of cost)		40,000	47,5000 cr
	Realization of 50% markup on Merchandise sold by branch during 2006	37,500		10,000 cr

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2006	Realization of 50% markup on End-of-Period Balance by Accounting Records of Home Office. 2006 Closing entry	37,500	37,500	37,500 cr -0-
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Income: Mason Branch

Date	Explanation	Debit	Credit	Balance
2006	Net income for 2006 reported by Branch Closing	10,000	10,000	10,000 cr -0-

In the accounting records of the home office at the end of 2006, the balance required in the Allowance for Overvaluation of Inventories: Mason Branch ledger account is Br.10,000, that is, the billed price of Br.30,000 less cost of Br.20,000 for merchandise in the branch's ending inventories. Therefore, the allowance account balance is reduced from Br.47,500 to Br.10,000. This reduction of Br.37,500 represents the 50% markup on merchandise above cost that was realized by Mason Branch during 2006 and is credited to the Realized Gross profit: Mason Branch Sales account.

The Home Office account in the branch general ledger shows the following activity and closing entry for 2006:

Home Office				
Date	Explanation	Debit	Credit	Balance
2006	Balance, Dec. 31, 2005 (from page 129)			45,500 cr
	Merchandise received from home office		120,000	165,500
	Cash sent to home office	113,000		cr
	Operating expenses billed by home office		4,500	52,500
	Net income for 2006		10,000	cr
				57,000
				cr
				67,000
				cr

The working paper for combined financial statement under the periodic inventory system, which reflects pre-adjusting and pre-closing balance for the reciprocal ledger accounts and the Allowance for overvaluation of Inventories: Mason Branch account below.

4.3.5 Reconciliation of Reciprocal Ledger Accounts

At the end of an accounting period, the balance of the Investment in Branch ledger account in the accounting records of the home office may not agree with the balance of the Home office account in the accounting records of the branch because certain transactions may have been recorded by one office but not by the other. The situation is comparable to that of reconciling the

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ledger account for Cash in Bank with the balance in the monthly bank statement. The lack of agreement between the reciprocal ledger account balances causes no difficulty during an accounting period, but at the end of each period the reciprocal account balances must be brought into agreement before combined financial statements are prepared.

As an illustration of the procedure for reconciling reciprocal ledger account balances at year-end, assume that the home office and branch accounting records of Mason Company on December 31, 2005, contain the data below.

SMALDINO COMPANY				
Working paper for combined Financial Statements of Home Office and Mason Branch				
For year Ended December 31, 2006				
(Periodic Inventory System: Billings above Cost)				
	Adjusted Trial Balance		Elimination s	Combine d
	Home Office	Mason Branch		
	Dr (Cr)	Dr (Cr)	Dr (Cr)	Dr (Cr)

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Income Statement				
Sales	(500,000)	(150,000)		(650,000)
Inventories, Dec. 31, 2005	45,000	22,500	(b)	60,000
Purchases	400,000		(7,500)	400,000
Shipments to Mason Branch	(80,000)			
Shipments from home office		120,000	(a) 80,000	
Inventories, Dec. 31, 2006	(70,000)	(30,000)	(a) (120,000)	(90,000)
Operating expenses	120,000	27,500		147,500
Net income (to statement of retained earnings below)	85,000	10,000	(c) 10,000	132,500
Totals	-0-	-0-		-0-
Statement of Retained Earnings				
Retained earnings, beginning of year (from page 126)	(117,000)			(117,000)
Net (income) (from income statement above)	(85,000)	(10,000)		(132,500)
Dividends declared	60,000			60,000
Retained earnings, end of year (to balance Sheet below)			(d) (37,500)	189,500
Total				-0-
Balance Sheet				
Cash	30,000	9,000		30,000
Trade accounts receivable (net)	64,000	28,000		92,000
Inventories, Dec. 31, 2006	70,000	30,000		90,000
Allowance for overvaluation of inventories: Mason Branch	(47,500)			
Investment in Mason Branch	57,000		(c) (10,000)	
Equipment	158,000			158,000
Accumulated depreciation of equipment	(15,000)		(a) 40,000	(15,000)
Trade accounts payable	(24,500)		(b) 7,500	(24,500)
Home office		(57,000)	(e)	
Common stock, Br.10 par	(150,000)		(57,000)	(150,000)
Retained earnings (from statement of retained earnings above)				(189,500)
Total	-0-	-0-		-0-
			(e) 57,000	
			-0-	

- (a) To eliminate reciprocal ledger account for merchandise shipments.
- (b) To reduce beginning inventories of branch to cost.
- (c) To reduce ending inventories of branch to cost.
- (d) To increase income of home office by portion of merchandise markup that was realized by branch sales.
- (e) To eliminate reciprocal ledger account balances.

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Reciprocal Ledger Accounts before Adjustments

Investment in Arvin Branch (in accounting records of Home Office)				
Date	Explanation	Debit	Credit	Balance
2006				
Nov.	Balance,			62,500 dr
30	Cash received from branch		20,000	42,500 dr
Dec. 10	Collection of branch trade accounts Receivable		1,000	41,500 dr
27	Merchandise shipped to branch	8,000		49,500 dr
29				

Investment in Arvin Branch (in accounting records of Home Office)				
Date	Explanation	Debit	Credit	Balance
2006				
Nov.	Balance,			62,500 cr
30	Cash sent to home office	20,000		42,500 cr
Dec. 7	Acquired equipment	3,000		39,500 cr
28	Collection of home office trade accounts receivable		2,000	41,500 cr
30				

Comparison of the two reciprocal ledger accounts discloses four reconciling item, described as follows:

- 1. A debit of Br.8,000 in the Investment in Arvin branch ledger account without a related credit in the Home office account.**

On December 29, 2005, the home office shipped merchandise costing Br.8,000 to the branch. The home office debits its reciprocal ledger account with the branch on the date merchandise is shipped, but branch credits its reciprocal account with the home office when the merchandise is received a few days later. The required journal entry on December 31, 2005, in the **branch accounting records**, assuming use of the perpetual inventory system, appears below.

Branch Journal Entry For merchandise in Transit from Home Office

Inventories in Transit	8,000	
Home Office		8,000
To record shipment of merchandise in transit from home office.		

In taking a physical inventory on December 31, 2005, the branch personal must add to the inventories on hand the Br.8,000 of merchandise in transit. When the merchandise is received in 2006, the branch debits Inventories and credits Inventories in Transit.

2. A credit of Br.1,000 in the Investment in Arvin Branch ledger account without a related debit in the Home Office account

On December 27, 2005, trade accounts receivable of the branch was collected by the home office. The collection was recorded by the home office by a debit to Cash and a credit to Investment in Arvin Branch. No journal entry had been made Arvin Branch: therefore, the following journal entry is required *in the accounting records of Arvin Branch* on December 31, 2005:

Branch Journal Entry for Trade Accounts Receivable Collected by Home Office

Home Office	1,000	
Trade Accounts Receivable		1,000
To record collection of accounts receivable by home office.		

3. A debit of Br.3,000 in the Home Office ledger account without a related credit in the Investment in Arvin Branch account.

On December 28, 2005, the branch acquired equipment for Br.3,000. Because the equipment used by the branch is carried in the accounting records of the home office, the journal entry made by the branch was a debit to Home Office and a credit to Cash. No journal entry had been made by the home office; therefore, the following journal entry is required on **December 31, 2005, in the accounting records of the home office:**

Home Office journal Entry for Equipment Acquired by Branch

Equipment: Arvin Branch	3,000	
Investment in Arvin Branch		3,000
To record equipment acquired by branch.		

4. A credit of Br.2,000 in the Home Office ledger account without a related debit in the Investment in Arvin Branch account.

On December 30, 2005, trade accounts receivables of the home office were collected by Arvin Branch. The collection was recorded by Arvin Branch by a debit to Cash and accredit to Home Office. No journal entry had been made by the home office; therefore, the following journal entry is required in the accounting records of the home office on December 31, 2005:

Home office Journal Entry for trade Account Receivable Collected by Brach

The	Investment in Arvin Branch	2,000	
	Trade Accounts Receivable		2,000
To record collection of accounts receivable by Arvin Branch.			

effect of the foregoing end-of-period journal entries is to update the reciprocal ledger accounts, as shown by the following reconciliation:

MERCER COMPANY –HOME OFFICE AND ARVIN BRANCH

Reconciliation of Reciprocal Ledger Accounts

December 31, 2005

Investment in Arvin Account	Home office Account (in home office in branch Accounting records)	Branch Accounting records)
Balances before adjustments	Br.49,500 dr	Br.41,500 cr
Add: (1) Merchandise shipped to Branch by home office		8,000
(4) Home office trade accounts Receivable collected by branch		2,000
Less: (2) branch trade accounts receivable collected home office	(1,000)	
(3) Equipment acquired by Branch	<u> </u>	<u>(3,000)</u>
Adjusted balance	<u>Br.48,500 dr</u>	<u>Br.48,500 cr</u>

4.3.6 Transaction between Branches

Efficient operations may on occasion require that merchandise of other assets be transferred from one branch to another. Generally, a branch does not carry a reciprocal ledger account with another branch but records the transfer in the Home Office ledger account. For example, if Alba Branch debits home office and credits Inventories (assuming that the perpetual inventory system is used). On receipt of the merchandise, Boro Branch debits Inventories and credits Home Office. The home office records the transfer between branches by a debit to Investment in Boro branch and a credit to Investment in Alba Branch.

The transfers of merchandise from one branch to another dose justify increasing the carrying amount of inventories by the freight costs incurred because of the indirect routing. The amount of freight costs properly included in inventories at a branch is limited to the cost of shipping the merchandise **directly** from the home office to its present location. Excess freight costs are recognized as expenses of the home office.

To illustrate the accounting for excess freight costs on interbranch transfers of merchandise, assume the following data. The home office shipped merchandise costing Br.6,000 to Dana Branch and paid freight costs of Br.400. Subsequently, the home office instructed Dana Branch to transfer this merchandise to Evan Branch. Freight costs of Br.300 were paid by Dana Branch to carry out this order. If the merchandise had been shipped directly from the home office to Evan Branch, the freight costs would have been Br.500. The journal entries required in the three sets of accounting records (assuming that the perpetual inventory system is used) are as follows:

In Accounting Records of Home Office:

Investment in Dana Branch	6,400	
Inventories		6,000
Cash		400
To record shipment of merchandise and payment of freight cost.	6,500	

Investment in Evan Branch	200	
Excess Freight Expense—interbranch Transfers		6,700
Investment in Dana Branch		
To record transfer of merchandise from Dana Branch to Evan Branch under Instruction of home office. Interbranch freight of Br.300 paid by Dana Branch caused total freight costs on this merchandise to exceed direct Shipment costs by Br.200 (Br.400 + Br.300 – Br.500 = Br.200).		

In Accounting Records of Dana Branch:

Freight in (of inventories)	400	
inventories	6,000	
Home Office		6,400
To record receipt of merchandise from home with freight cost paid In advance by home office.		

Home Office	6,700	
inventories		6,000
freight in (or inventories)		400
Cash		300
To record transfer of merchandise from Dana Branch under instruction of home office and payment of freight costs of Br.300.		

In Accounting Records of Evan Branch:

Inventories	6,000	
Freight in (or inventories)	500	
Home Office		6,500
To record receipt of merchandise from Dana Branch transferred under instruction of home office and normal freight costs billed by home office.		

Recognizing excess freight costs on merchandise transferred from one branch to another as expenses of the home office is an example of the accounting principle that expenses and losses should be given prompt recognition. The excess freight costs from such shipments generally result from inefficient planning of original shipments and should not be included in inventories. In recognizing freight cost of interbranch transfers as expenses attributable to the home office, the assumption was that the home office makes the decisions directing all shipments, if branch managers are given authority to order transfers of merchandise between branches, the excess freight costs are recognized as expenses attributable to the branches whose managers authorized the transfers.

Chapter Four: Business Combinations

4.1. Definition of Business Combination

A *Business combination* occurs when an entity acquires net assets that constitute a business or acquires equity interests of one or more other entities and obtains control over that entity or entities. The most important elements of this definition include; **entity, business, and control** which are further explained as follows:

Entity:	<i>A business enterprise, a new entity formed to complete a business combination, or a mutual enterprise-an entity, not investor-owned, that provides dividends, lower costs, or other economic benefits directly to its owners, members, or participants.</i>
Business:	<i>An asset group that constitutes a business</i>
Control:	<i>Ownership by one company, directly or indirectly, of the outstanding voting shares of another company. Putting it in short business combinations are often referred to as mergers and acquisitions.</i>

In reading on business combination we usually use the following terms and terminologies which need to be used consistently.

Combined Enterprise:	<i>Refers to the accounting entity that results from a business combination.</i>
Constituent Companies:	<i>Refer to business enterprises that enter into a business combination.</i>
Combinor:	<i>Refers to a constituent company entering into a business combination whose owners as a group ends up with control of the ownership interests in the combined enterprise</i>
Combinee:	<i>Refers to constituent company other than the combinator in a business combination.</i>

Business combinations may be divided into two classes as *friendly takeovers* and *hostile takeovers*. In a *friendly takeover*, the boards of directors of the constituent companies generally work out the terms of the business combination amicably and submit the proposal to stockholders of all constituent companies for approval. A target combine in a *hostile takeover* typically resists the proposed business combination by resorting to one or more defensive tactics.

4.2. Reasons for Business Combinations

Although a number of reasons have been cited, probably the overriding one for *combinors* has been *growth*. Business enterprises have major operating objectives other than growth, but that goal increasingly has motivated combinator managements to undertake business combinations. Advocates of this *external* method of achieving growth point out that it is much more rapid than growth through *internal* means. They add that expansion and diversification of product lines, or enlarging the market share for current products, is achieved readily through a business combination with another enterprise.

Other reasons, often advanced, in support of business combinations are obtaining new management strength or better use of existing management and achieving manufacturing or other operating economies. In addition, a business combination may be undertaken for the income tax advantages available to one or more parties to the combination. The rationales for business combination is said to include the following as well:

- *Cost advantage*
- *Lower risk*
- *Fewer operating delays*
- *Avoidance of takeovers*
- *Acquisition of intangible assets*
- *Other: business and other tax advantages, personal reasons*
- *'Empire building'*

However, some criticize that the foregoing reasons attributed to the "urge to merge" (business combinations) do not apply to hostile takeovers. These critics complain that the "sharks" who engage in hostile takeovers, and the investment bankers and attorneys who counsel them, are motivated by the prospect of substantial gains resulting from the sale of business segments of a combine following the business combination.

4.3. Methods of Arranging Business Combinations

Business combinations may be arranged in various ways but the four common methods for carrying out a business combination are statutory merger, statutory consolidation, acquisition of common stock, and acquisition of assets discussed as follows.

4.3.1. Statutory Merger

As its name implies, a *statutory merger* is executed under provisions of applicable state laws. In a statutory merger, the boards of directors of the constituent companies approve a plan for the exchange of voting common stock (and perhaps some preferred stock, cash, or long-term debt) of one of the corporation's (the *survivor*) for all the outstanding voting common stock of the other

corporations. Stockholders of all constituent companies must approve the terms of the merger. The survivor corporation issues its common stock or other consideration to the stockholders of the other corporations in exchange for all their holdings, thus acquiring ownership of those corporations. The other corporations ***then are dissolved and liquidated and thus cease to exist as separate legal entities***, and their activities often are continued as *divisions* of the survivor, which now owns the *net assets* (assets minus liabilities), rather than the outstanding common stock, of the liquidated corporations.

4.3.2. Statutory Consolidation

In a consolidation type of business combination a *new corporation is formed to issue its common stock* for the outstanding common stock of two or more existing corporations, *which then go out of existence*. The new corporation thus acquires the net assets of the defunct corporations, whose activities may be continued as divisions of the new corporation. .

4.3.3. Acquisition of Common Stock

One corporation (the *investor*) may issue preferred or common stock, cash, debt instruments, or a combination thereof, to acquire from present stockholders a controlling interest in the voting common stock of another corporation (the *investee*). If a controlling interest in the combinee's voting common stock is acquired, that corporation becomes ***affiliated*** with the combinator ***parent company*** as a ***subsidiary***, ***but is not dissolved and liquidated and remains a separate legal entity***. Business combinations arranged through common stock acquisitions require authorization by the combinator's board of directors and may require ratification by the combine's stockholders. Most hostile takeovers are accomplished by this means.

4.3.4. Acquisition of Assets

A business enterprise may acquire from another enterprise all or most of the gross assets or the net assets of the other enterprise for cash, debt instruments, preferred or common stock, or a combination thereof. The transaction generally must be approved by the boards of directors and stockholders or other owners of the constituent companies. The selling enterprise ***may continue its existence as a separate entity or it may be dissolved and liquidated***; but it does not become an ***affiliate*** of the combinator.

An important early step in planning a business combination is deciding on an appropriate price to pay. The amount of cash or debt securities, or the number of shares of preferred or common stock, to be issued in a business combination generally is determined by variations of the following methods:

- *Capitalization of expected average annual earnings of the combinee at a desired rate of return.*
- *Determination of current fair value of the combine's net assets (including goodwill).*

In a part to follow we will see how the methods will be applied under the purchase method.

4.4. Method of Accounting for Business Combinations

Earlier to the year 2001, business combinations had been accounted using either **the Pooling-of-Interest Method** or **the Purchase Method**. The use of these alternative methods has created a problem to users of financial statements especially in comparing financial statements.

Initial Recognition:	<i>Assets are commonly acquired in exchange transactions that trigger the initial recognition of the assets acquired and any liabilities assumed.</i>
Initial Measurement:	<i>Like other exchange transactions generally, acquisitions are measured on the basis of the fair values exchanged.</i>
Allocating Cost:	<i>Acquiring assets in groups requires not only ascertaining the cost of the asset (or net asset) group but also allocating that cost to the individual assets (or individual assets and liabilities) that make up the group.</i>
Accounting after Acquisition:	<i>The nature of an asset and not the manner of its acquisitions determines an acquiring entity's subsequent accounting for the asset.</i>

The foregoing four bases provide the foundation for applying the purchase method of accounting for business combinations. Because the carrying amounts of the net assets of the combinator are not affected by a business combination, the combinator must be accurately identified. For combinations effected by the issuance of equity securities, consideration of all the facts and circumstances is required to identify the combinator. However, a common theme is that the combinator is the constituent company whose stockholders as a group retain or receive the largest portion of the voting rights of the combined enterprise and thereby can elect a majority of the governing board of directors or other group of the combined enterprise.

Once accountants are clear with which company is a combinator, they have to work out the cost of a business combination/ amount of value exchanged. The **cost of a combine** in a business combination accounted for by the purchase method is the total of:

- (1) *The **amount of consideration** paid by the combinator,*
- (2) *The combinator's **direct** "out-of-pocket" costs of the combination, and*
- (3) *Any **contingent consideration** that is determinable on the date of the business combination.*

1) Amount of Consideration. This is the total amount of cash paid, the current fair value of other assets distributed, the present value of debt securities issued, and the current fair (or market) value of equity securities issued by the combinator.

2) Direct Out-of-Pocket Costs. Included in this category are some legal fees, some accounting fees, and finder's fees. A **finder's fee** is paid to the investment banking firm or other organization or individuals that investigated the combinee, assisted in determining the price of the business combination, and otherwise rendered services to bring about the combination. Costs of registering stocks issued and issuing *debt securities* in a business combination are debited to Bond Issue Costs; they are not part of the cost of the combinee. *Indirect* out-of-pocket costs of the combination, such as salaries of officers of constituent companies involved in negotiation and

completion of the combination, are recognized as expenses incurred by the constituent companies.

3) Contingent Considerations are additional cash, other assets, or securities that may be issuable in the future, contingent on future events such as a specified level of earnings or a designated market price for a security that had been issued to complete the business combination. Contingent consideration that is **determinable** on the consummation date of a combination is recorded as part of the cost of the combination; contingent consideration **not determinable** on the date of the combination is recorded when the contingency is resolved and the additional consideration is paid or issued (or becomes payable or issuable).

Once accountants compute the cost of a combinee in a business combination, they need to allocate to assets (other than goodwill) acquired and liabilities assumed based on their estimated **fair values** on the date of the combination. Any excess of total costs over the amounts thus allocated is assigned to goodwill. The question that remains to be answered at this point is how much the **FAIR VALUE** is. Methods for determining fair values included present values for receivables and most liabilities; net realizable value less a reasonable profit for work in process and finished goods inventories; and appraised values for land, natural resources, and nonmarketable securities. In addition, the following combinee intangible assets were to be recognized individually and valued at fair value:

- *Assets arising from contractual or legal rights, such as patents, copyrights, and franchises*
- *Other assets that are separable from the combinee entity and can be sold, licensed, exchanged, and the like, such as customer lists and unpatented technology.*

In a business combination it is often a case that the cost of the combinee differs from the amount allocated to net asset value. In such instances, a good would be recognized along with the assets acquired. Goodwill frequently is recognized in business combinations because the total cost of the combinee exceeds the current fair value of identifiable net asset of the combinee. The amount of goodwill recognized on the date the business combination is consummated may be adjusted subsequently when contingent consideration becomes issuable.

In some business combinations (known as **bargain purchases**), the current fair signed to the identifiable net assets acquired exceed the total cost of the combine. A bargain purchase is most likely to occur for a combinee with a history of losses or when common stock prices are extremely low. The excess of the current fair values over total cost is applied pro rata to reduce (but not below zero) the amounts initially assigned to all the acquired assets except financial assets other than investments accounted for by the equity method; assets to be disposed of by sale; deferred tax assets; prepaid assets relating to pension or other postretirement benefits; and any other current assets. If any excess of current fair values over cost of the combinee's net asserts remains after the foregoing reduction, it is recognized as an extraordinary gain by the combinator.

Illustration 4 - 1: Purchase Accounting for Statutory Merger, with Goodwill

On December 31, 2005, **Mason Company** (the combinator) was merged into **Saxon Corporations** (the combinator or survivor). Both companies used the same accounting principles for assets,

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liabilities, revenue, and expenses and both had a December 31 fiscal year. **Saxon** issued 150,000 shares of its Br. 10 par common stock (current fair value Br. 25 a share) to **Mason's** stockholders for all 100,000 issued and outstanding shares of **Mason's** no-Par Br. 10 stated value common stock. In addition, **Saxon** paid the following out-of-pocket costs associated with the business combination:

Combinor's Out-of-Pocket Costs of Business Combination	
Accounting Fees:	
For investigation of Mason Company as prospective combinee	Br. 5,000
For Registration statement for Saxon common stock	60,000
Legal Fees:	
For the business combination	10,000
For Registration statement for Saxon common stock	50,000
Finder's fee	51,250
Printing charges for printing securities and registration statement	23,000
Registration statement fee	750
Total out-of-pocket costs of business combination	<u>Br. 200,000</u>

There was no contingent consideration in the merger contract. Immediately prior to the merger, Mason Company's condensed balance sheet was as follows:

MASON COMPANY (Combinee)	
Balance Sheet (prior to business combination)	
December 31, 2005	
Assets	
Current assets	Br. 1,000,000
Plant assets (net)	3,000,000
Other assets	600,000
Total assets	<u>Br. 4,600,000</u>
Liabilities and Stockholders' Equity	
Current liabilities	Br. 500,000
Long-term debt	1,000,000
Common stock, no par, Br. 10 stated value	1,000,000
Additional paid-in capital	700,000
Retained earnings	1,400,000
Total liabilities and stockholders' equity	<u>Br. 4,600,000</u>

For this illustration purpose the following figures have been assumed about:

	Current Fair Values
Current assets	Br. 1,150,000
Plant assets	3,400,000
Other assets	600,000
Current liabilities	(500,000)
Long-term debt (present value)	(950,000)
Identifiable net assets of combinee	<u>Br. 3,700,000</u>

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The condensed journal entries that follow are required for Saxon Corporation (the combinator) to record the merger with Mason Company on December 31, 2005, as a business combination. Saxon uses an investment ledger account to accumulate the total cost of Mason Company prior to assigning the cost to identifiable net assets and goodwill.

SAXON CORPORATION (Combinor)			
Journal Entries			
December 31, 2005			
Investment in Mason Company Common Stock ($150,000 \times \text{Br. } 25$).....	3,750,000		
Common Stock ($150,000 \times \text{Br. } 10$)		1,500,000	
Paid-in Capital in Excess of Par.....		2,250,000	
<i>To record merger with Mason Company.</i>			
Investment in Mason Company Common Stock ($\text{Br. } 5,000 + \text{Br. } 10,000 + \text{Br. } 51,250$)....	66,250		
Paid-in Capital in Excess of Par ($\text{Br. } 60,000 + \text{Br. } 50,000 + \text{Br. } 23,000 + 750$)	133,750		
Cash.....		200,000	
<i>To record payment of out-of-pocket costs incurred in merger with Masson Company. Accounting, legal, and finder's fees in connection with the merger are recognized as an investment cost; other out-of-pocket costs are recorded as a reduction in the proceeds received from issuance of common stock.</i>			
Current Assets.....	1,150,000		
Plant Assets.....	3,400,000		
Other Assets.....	600,000		
Discount on long-Term Debt.....	50,000		
Goodwill.....	116,250		
Current Liabilities.....		500,000	
Long-Term Debt.....		1,000,000	
Investment in Mason Comp Common Stock ($\text{Br. } 3,750,000 + \text{Br. } 66,250$).....		3,816,250	
<i>To allocate total cost of liquidated mason Company to identifiable assets and liabilities, with the remainder to goodwill.</i>			
Amount of goodwill is computed as follows:			
Total cost of mason Company($\text{Br. } 3,750,000 + \text{Br. } 66,250$).....			Br. 3,816,250
<u>Less:</u> Carrying amount of Mason's identifiable net Assets			
($\text{Br. } 4,600,000 - \text{Br. } 1,500,000$).....		Br. 3,100,000	
Excess (deficiency) of Current fair values of Identifiable net assets Over carrying amounts:			
Current assets.....	150,000		
Plant assets.....	400,000		
Long-term debt.....	50,000		
			<u>3,700,000</u>
Amount of goodwill.....			<u>Br. 116,250</u>

Note that no adjustments are made in the foregoing journal entries to reflect the current fair values of **Saxon's** identifiable net assets or goodwill, **because Saxon is the combinator in the business combination**. The combinee on the other hand has to record the above transaction in a way that reflects the liquidation.

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MASON COMPANY (combinee)

Journal Entries

December 31, 2005

Current Liabilities.....	500,000	
Long-Term Debt.....	1,000,000	
Common Stock, Br. 10 stated value	1,000,000	
Paid-in Capital in Excess of Stated Value.....	700,000	
Retained Earnings.....	1,400,000	
Current Assets.....		1,000,000
Plant Assets (net).....		3,000,000
Other Assets.....		600,000
<i>To record liquidation of company in conjunction with merger with Saxon corporation.</i>		

The above entry wipes out the records of **Mason company** (the Combinee) as posting the above entry to the respective accounts makes their balances zero.

Illustration of Purchase Accounting for Acquisition of Net Assets, with Bargain-Purchase Excess

The foregoing illustration assumes that the combinator paid more than the net asset value and the difference is assigned to unidentified intangible assets; a goodwill as commonly practiced. It is also possible for the combinator to pay less than the net asset value of the combinee. On December 31, 2005, **Davis Corporation** acquired all the net assets of **Fairmont Corporation** directly from **Fairmont** for Br. 400,000 cash, in a business combination. **Davis** paid legal fees of Br. 40,000 in connection with the combination. The condensed balance sheet of **Fairmont** prior to the business combination, with related current fair value data, is presented below:

FAIRMONT CORPORATION (combinee)

Balance Sheet (prior to business combination)

December 31, 2005

	Carrying Amounts	Current Fair Values
Assets		
Current assets	Br. 190,000	Br. 200,000
Investment in marketable debt securities(held to maturity)	50,000	60,000
Plant assets (net)	870,000	900,000
Intangible assets(net)	90,000	100,000
Total assets	<u>Br. 1,200,000</u>	<u>Br. 1,260,000</u>
Liabilities and Stockholders' Equity		
Current liabilities	Br. 240,000	Br. 240,000
Long-term debt	500,000	520,000
Total liabilities	<u>Br. 740,000</u>	<u>Br. 760,000</u>
Common stock, Br.1 par	Br. 600,000	
Deficit	(140,000)	
Total stockholders' equity	<u>Br. 460,000</u>	
Total liabilities and stockholders' equity	<u>Br. 1,200,000</u>	

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Thus, Davis acquired identifiable net assets with a current fair value of Br. 500,000 (Br. 1,260,000 – Br. 760,000 = Br. 500,000) for a total cost of Br. 440,000 (Br. 400,000 + Br. 40,000 = Br. 440,000). The Br. 60,000 excess of current fair value of the net assets over their cost to Davis (Br. 500,000 – Br. 440,000 = Br. 60,000) is prorated to the plant assets and intangible assets in the ratio of their respective current fair values, as follows:

Allocation of Excess of Current Fair Value over Cost of Identifiable Net Assets of Combinee			
To plant assets:	$\text{Br. } 60,000 \times (\text{Br. } 900,000 \div \text{Br. } 1,000,000)$	=	Br. 54,000
To Intangible assets:	$\text{Br. } 60,000 \times (\text{Br. } 100,000 \div \text{Br. } 1,000,000)$	=	<u>6,000</u>
Total excess of current fair value of identifiable net assets over cost combinator's cost			<u>Br. 60,000</u>

Remember that no part of the Br. 60,000 bargain-purchase excess is allocated to current assets or to the investment in marketable securities.

The journal entries below record **Davis Corporation's** acquisition of the net assets of **Fairmont Corporation** and payment of Br. 40,000 legal fees:

DAVIS CORPORATION (combinor)			
Journal Entries			
December 31, 2005			
Investment in Net Assets of Fairmont corporation	400,000		
Cash		400,000	
<i>To record acquisition of net assets of Fairmont Corporation.</i>			
Investment in net Assets of Fairmont Corporation.....	40,000		
Cash.....		40,000	
<i>To record payment of legal fees incurred in acquisition of net assets of Fairmont corporation.</i>			
Current Assets.....	200,000		
Investments in marketable Debt securities.....	60,000		
Plant Assets (Br. 900,000 – Br. 54,000).....	846,000		
Intangible Assets (Br. 100,000 – Br. 6,000)	94,000		
Current Liabilities		240,000	
Long-Term		Debt	500,000
Premium on long-Term Debt (Br. 520,000 – Br. 500,000)			20,000
Investment in net Assets of Fairmont Corporation (Br. 400,000 + Br. 40,000)			440,000
<i>To allocate total cost of net assets acquired to identifiable net assets, with excess of current fair value of net assets over their cost prorated to noncurrent assets other than investment in marketable debt securities. (Income tax effects are disregarded.)</i>			

Chapter Five: Consolidation on Date of Acquisition

5.1. Nature of Consolidated Financial Statements

Consolidated financial statements are somewhat similar to the combined financial statements that consists a home office and its branches. In a consolidated financial statement, assets, liabilities, revenue, and expenses of the parent company and its subsidiaries are *totaled*; intercompany transactions and balances are *eliminated*; and the final consolidated amounts are reported in the consolidated balance sheet, income statement, statement of stockholders' equity, and statement of cash flows.

The consolidated financial statements are pooled from the separate legal entity status of the parent and subsidiary corporations which necessitates eliminations that generally are somewhat complex. It must be made clear that the investor need not consolidate all subsidiaries where it holds more than 50% of the shares.

Consolidation is normally appropriate where one company (parent) controls another company (subsidiary). An unconsolidated subsidiary should be reported as an investment on the parent's balance sheet. However, unconsolidated subsidiaries are relatively rare. A subsidiary can be excluded from consolidation in only two situations:

- *Control is likely to be temporary.*
- *Control does not rest with the majority owner.*

5.2. Methods of Accounting for Investment in Other Firms

Before the consolidation balances can be determined, the parent's investment account must be adjusted to reflect application of way investment has been accounted. Accountants can follow one of the following methods:

➤ The Equity Method

- ***The Cost Method***
- ***The Partial Equity Method***

The methods differ in the way/time of accounting and reporting the following facts and events of the subsidiary:

- a) *Accounting for the net income/loss reported by the investee*
- b) *Dividend declared and paid*
- c) *Recognition and reporting excess expense due to disparity between carrying amounts and Fair value of assets/liabilities.*

In this section, we will see how the three methods differ in regard to the above issues.

a) The Equity Method

In applying the equity method, we have to account for the investment in subsidiary by:

1. *Recording the Investment in Sub on the acquisition date at cost of consideration given up.*
2. *Recognizing the receipt of dividends from the subsidiary reducing the investment.*
3. *Recognizing a share of the sub's income (loss) as addition to or reduction from the investment balance.*
4. *Adjusting the assets and liabilities to reflect the Fair value methods.*

b) The Cost Method

If the **cost method** is used by the parent company to account for the investment, then the consolidation entries will change only slightly. The difference between the cost method and the equity method includes:

1. *No adjustments are recorded in the **Investment account** for current year operations, dividends paid by the subsidiary, or amortization of purchase price allocations.*
2. *Dividends received from the subsidiary are recorded as **Dividend Revenue**.*

c) The Partial Equity Method

The **Partial Equity Method** slightly differs from the Equity method in that the adjustment to the **Fair value balances** of assets and liabilities.

To summarize the above differences in the accounting methods for the investment account and the income from the investment under the three methods, we have the following table:

METHOD	INVESTMENT ACCOUNT	INCOME ACCOUNT

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EQUITY	Continually Adjusted to Reflect Ownership of Acquired Company.	Income Accrued As Earned; Amortization And Other Adjustments Are Recognized.
COST	Remains at Initially Recorded Cost.	Cash Received Recorded As Dividend Income.
PARTIAL EQUITY	Adjusted Only for Accrued Income and Dividends Received from Acquired Company.	Income Accrued as Earned; No Other Adjustments Recognized.

5.3. Consolidation of Wholly Owned Subsidiary on Date of Business Combination

Once you have grasped the basics of how the investment account will be affected with the passage of time, we will next see the consolidation of financial statements. To begin with, we consider the consolidation of financial statements from the parent and subsidiary as of the date of business combination where the parent holds 100% of the subsidiary's stocks. There is no question of *control* of a wholly owned subsidiary.

Thus, to illustrate consolidated financial statements for a parent company and a wholly owned subsidiary, assume that on December 31, 2005, **Palm Corporation** issued 10,000 shares of its Br. 10 par common stock (current fair value Br. 45 a share) to stockholders of **Starr Company** for all the outstanding Br. 5 par common stock of Starr. There was no contingent consideration. Out-of-pocket costs of the business combination paid by **Palm** on December 31, 2005, consisted of the following:

<i>Finder's and legal fees relating to business combination</i>	<i>Br. 50,000</i>
<i>Costs associated with registration</i>	<u><i>35,000</i></u>
<i>Total out-of-pocket costs of business combination</i>	<u><u><i>Br85,000</i></u></u>

Assume also that **Starr Company** was to continue its corporate existence as a wholly owned subsidiary of **Palm Corporation**. Both constituent companies had a December 31 fiscal year and used the same accounting principles and procedures; thus, no adjusting entries were required for either company prior to the combination.

Financial statements of **Palm Corporation** and **Starr Company** for the year ended December 31, 2005, prior to consummation of the business combination, follow:

PALM CORPORATION AND STARR COMPANY Separate Financial Statements (prior to business combination) For Year Ended December 31, 2005		
PALM CORPORATION AND STARR COMPANY Income Statements (prior to business combination) For Year Ended December 31, 2005		
	Palm Corporation	Starr Company
<i>Revenue:</i>		

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Net sales	Br. 990,000	Br. 600,000
Interest revenue	<u>10,000</u>	<u>-</u>
Total revenue	<u>Br. 1,000,000</u>	<u>Br. 600,000</u>
Costs and expenses:		
Cost of goods sold	Br. 635,000	Br. 410,000
Operating expenses	158,333	73,333
Interest expense	50,000	30,000
Income taxes expense	<u>62,667</u>	<u>34,667</u>
Total costs and expenses	<u>Br. 906,000</u>	<u>Br. 548,000</u>
Net income	<u>Br. 94,000</u>	<u>Br. 52,000</u>

PALM CORPORATION AND STARR COMPANY Statements of Retained Earnings (prior to business combination) For Year Ended December 31, 2005

	Palm Corporation	Starr Company
Retained earnings, beginning of year	Br. 65,000	Br. 100,000
Add: Net income	<u>94,000</u>	<u>52,000</u>
Subtotals	Br. 159,000	Br. 152,000
Less: Dividends	<u>25,000</u>	<u>20,000</u>
Retained earnings, end of year	<u>Br. 134,000</u>	<u>Br. 132,000</u>

PALM CORPORATION AND STARR COMPANY Balance Sheets (prior to business combination) December 31, 2005

	Palm Corporation	Starr Company
Assets		
Cash	Br. 100,000	Br. 40,000
Inventories	150,000	110,000
Other current assets	110,000	70,000
Receivable from Starr Company	25,000	----
Plant assets (net)	450,000	300,000
Patent (net)	<u>----</u>	<u>20,000</u>
Total assets	<u>Br. 835,000</u>	<u>Br. 540,000</u>
Liabilities and Stockholders' Equity		
Payables to Palm Corporation	----	Br. 25,000
Income taxes payable	Br. 26,000	10,000
Other liabilities	325,000	115,000
Common stock, Br10 par	300,000	----
Common stock, Br5 par	----	200,000
Additional paid-in capital	50,000	58,000
Retained earnings	<u>134,000</u>	<u>132,000</u>
Total liabilities and stockholders' equity	<u>Br. 835,000</u>	<u>Br. 540,000</u>

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The December 31, 2005, current fair values of Starr Company's identifiable assets and liabilities were the same as their carrying amounts, except for the three assets listed below:

	Current Fair Values, December 31, 2005
<i>Inventories</i>	Br. 135,000
<i>Plant assets (net)</i>	365,000
<i>Patent (net)</i>	25,000

Because **Starr** was to continue as a separate corporation and current generally accepted accounting principles do not sanction write-ups of assets of a going concern, **Starr** did not prepare journal entries for the business combination. **Palm Corporation** recorded the combination on December 31, 2005, with the following journal entries:

PALM CORPORATION (COMBINOR)			
Journal Entries			
December 31, 2005			
Investment in Star Company Common Stock (10,000 x Br. 45)	450,000		
Common Stock (10,000 x Br. 10).....		100,000	
Paid-in Capital in Excess of par		350,000	
<i>To record the issuance of 10,000 shares of common stock for all the outstanding common stock of Starr Company in a business combination.</i>			
Investment in star company common stock	50,000		
Paid-in Capital in Excess Par.....	35,000		
Cash.....			85,000
<i>To record payment of out-of-pocket costs of business combination with Starr Company.</i>			

Unlike the journal entries for a merger illustrated in the previous unit the foregoing journal entries do not include any debits or credits to record individual assets and liabilities of **Starr Company** in the accounting records of **Palm Corporation**. The reason is that **Starr** was not liquidated as in a merger; it remains a separate legal entity.

After the foregoing journal entries have been posted, the affected ledger accounts of **Palm Corporation** (the combinator) are as follows:

Investment in Starr Company Common Stock				
Date	Explanation	Debit	Credit	Balance
2005				
Dec. 31	Balance forward			100,000 dr
31	Out-of-pocket costs of business combination		85,000	15,000 dr

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Date	Explanation	Debit	Credit	Balance
2005				
Dec. 31	Issuance of common stock in business combination	450,000		450,000 dr
31	Direct out-of-pocket costs of business combination	50,000		500,000 dr

Preparation of Consolidated Balance Sheet without a Working Paper

Accounting for the business combination of **Palm Corporation** and **Starr Company** requires a **fresh start** for the consolidated entity. This reflects the theory that a business combination that involves a parent company-subsidary relationship is an **acquisition of the combinee net assets** (assets less liabilities) by the combinator. The operating results of **Palm** and **Starr** prior to the date

Common Stock, Br10 Par				
Date	Explanation	Debit	Credit	Balance
2005				
Dec. 31	Balance forward			300,000 cr
31	Issuance of common stock in business combination		100,000	400,000 cr

Paid-in Capital in Excess of Par				
Date	Explanation	Debit	Credit	Balance
2005				
Dec. 31	Balance forward			50,000 cr
31	Issuance of common stock in business combination		350,000	400,000 cr
31	Costs of issuing common stock in business combination	35,000		365,000 cr

of their business combination are those of two separate **economic** - as well as **legal** - entities. Accordingly, a consolidated balance sheet is the only **consolidated** financial statement issued by **Palm** on December 31, 2005, the date of the business combination of **Palm** and **Starr**.

The preparation of a consolidated balance sheet for a parent company and its wholly owned subsidiary may be accomplished without the use of a supporting working paper. The parent company's investment account and the subsidiary's stockholder's equity accounts do not appear

in the consolidated balance sheet because they are essentially **reciprocal** (intercompany) accounts. The parent company (combinor) assets and liabilities (other than intercompany ones) are reflected at **carrying amounts**, and the subsidiary (combinee) assets and liabilities (other than intercompany ones) are reflected at **current fair values**, in the consolidated balance sheet. Goodwill is recognized to the extent the cost of the parent's investment in 100% of the subsidiary's outstanding common stock exceeds the current fair value of the subsidiary's **identifiable** net assets, both tangible and intangible.

Applying the foregoing principles to the **Palm Corporation** and **Starr Company** parent-subsidiary relationship, the following consolidated balance sheet is produced:

PALM CORPORATION AND SUBSIDIARY			
Consolidated Balance Sheet			
December 31, 2005			
Assets			
Current assets:			
Cash (Br. 15,000 + Br. 40,000)		Br.	55,000
Inventories (Br. 150,000 + Br. 135,000)			285,000
Other (Br. 110,000 + Br. 70,000)			<u>180,000</u>
Total current assets		Br.	520,000
Plant assets (net) (Br. 450,000 + Br. 365,000)			815,000
Intangible assets:			
Patent (net) (Br. 0 + Br. 25,000)	Br. 25,000		
Goodwill	<u>15,000</u>		<u>40,000</u>
Total assets			<u>Br. 1,375,000</u>
Liabilities and Stockholders' Equity			
Liabilities:			
Income taxes payable (Br. 26,000 + Br. 10,000)		Br.	36,000
Other current liabilities (Br. 325,000 + Br. 115,000)			<u>440,000</u>
Total liabilities		Br.	476,000
Stockholders' equity:			
Common stock, Br. 10 par	Br. 400,000		
Additional paid-in capital	365,000		
Retained earnings	<u>134,000</u>		<u>899,000</u>
Total liabilities and stockholders' equity			<u>Br. 1,375,000</u>

The following are significant aspects of the consolidated balance sheet:

1. The first amounts in the computations of consolidated assets and liabilities (except goodwill) are the parent company's carrying amounts; the second amounts are the subsidiary's current fair values.

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Elimination of Intercompany Accounts	<i>Retained Earnings - Starr</i>	132,000	
	<i>Investment in Starr Company</i>	<u>390,000</u>	500,000

The footing of Br. 390,000 of the debit items of the foregoing partial elimination represents the **carrying amount** of the net assets of **Starr Company** and is Br. 110,000 less than the Office reciprocal account credit item of Br. 500,000, which represents the cost of **Palm Corporation's** investment in *company* accounts of Starr. As indicated on earlier, part of the Br. 110,000 difference is attributable to the excess of current fair values over carrying amounts of certain **identifiable** tangible and intangible assets of **Starr**. This excess is summarized as follows (the current fair values of all other assets and liabilities are equal to their carrying amounts):

Differences between Identifiable Assets Current Fair Values and Carrying Amounts of Combinee's Identifiable Assets			
	Current Fair Values	Carrying Amounts	Difference
<i>Inventories</i>	Br. 135,000	Br. 110,000	Br. 25,000
<i>Plant assets (net)</i>	365,000	300,000	65,000
<i>Patent (net)</i>	<u>25,000</u>	<u>20,000</u>	<u>5,000</u>
<i>Total</i>	<u>Br. 525,000</u>	<u>Br. 430,000</u>	<u>Br. 95,000</u>

Generally accepted accounting principles do not presently permit the write-up of a going concern's assets to their current fair values. Thus, to conform to the requirements of purchase accounting for business combinations, the foregoing excess of current fair values over carrying amounts must be incorporated in the consolidated balance sheet of **Palm Corporation and subsidiary** by means of the elimination.

Increases in assets are recorded by **debits**; thus, the elimination for **Palm Corporation and subsidiary** begun above is *continued* as follows (in journal entry format):

Use of Elimination to Reflect Current Fair Values of Combinee's Identifiable Assets	<i>Common Stock - Starr</i>	200,000	
	<i>Additional Paid-in Capital - Starr</i>	58,000	
	<i>Retained Earnings - Starr</i>	132,000	
	<i>Inventories - Starr (Br. 135,000 - Br. 110,000)</i>	25,000	
	<i>Plant Assets (net) - Starr (Br. 365,000 - Br. 300,000)</i>	65,000	
	<i>Patent (net) - Starr (Br. 25,000 - Br. 20,000)</i>	5,000	
		<u>485,000</u>	
	<i>Investment in Starr Company Common Stock-Palm</i>		500,000

The revised footing of Br. 485,000 of the debit items of the foregoing partial elimination is equal to the **current fair value** of the **identifiable** tangible and intangible net assets of **Starr Company**.

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Thus, the Br. 15,000 difference (Br. 500,000 – Br. 485,000 = Br. 15,000) between the cost of **Palm Corporation's** investment in **Starr** and the current fair value of Starr's identifiable net assets represents **goodwill of Starr**, in accordance with purchase accounting theory for business combinations. Consequently, the December 31, 2005, elimination for **Palm Corporation** and subsidiary is completed with a Br. 15,000 *debit* to Goodwill-Starr.

Completed Elimination and Working Paper for Consolidated Balance Sheet

The completed elimination for **Palm Corporation** and subsidiary (in journal entry format) and the related working paper for consolidated balance sheet are as follows:

PALM CORPORATION AND SUBSIDIARY Working Paper Elimination December 31, 2005				
Completed Working Paper Elimination for Wholly Owned Purchased Subsidiary on date of Business Combination	(a)	Common Stock - Starr	200,000	
		Additional Paid-in Capital - Starr	58,000	
		Retained Earnings – Starr	132,000	
		Inventories - Starr (Br. 135,000 – Br. 110,000)	25,000	
		Plant Assets (net) - Starr (Br. 365,000 – Br. 300,000)	65,000	
		Patent (net) - Starr (Br. 25,000 – Br. 20,000)	5,000	
		Goodwill-starr (Br. 500,000 – Br. 485,000)	15,000	
		Investment in Starr Company Common Stock-Palm		500,000
To eliminate intercompany investment and equity accounts of subsidiary on date of business combination; and to allocate excess of cost over carrying amount of identifiable assets acquired, with remainder to goodwill. (Income tax effects are disregarded.)				
PALM CORPORATION AND SUBSIDIARY Working Paper for Consolidated Balance Sheet December 31, 2005				
	Palm Corporation	Starr Company	Eliminations Increase (Decrease)	Consolidated
Assets				
Cash	15,000	40,000	-----	55,000
Inventories	150,000	110,000	(a) 25,000	285,000
Other current assets	110,000	70,000	----	180,000
Intercompany receivable (payable)	25,000	(25,000)	--	-0-
Investment in Starr Company Common Stock	500,000		(a) (500,000)	-0-
Plant assets (net)	450,000	300,000	(a) 65,000	815,000
Patent (net)		20 000	(a) 5,000	25,000
Goodwill			(a) 15,000	15,000
Total assets	1,250,000	515,000	(390,000)	1,375,000
Liabilities and Stockholders' Equity				
Income taxes payable	26,000	10,000		36,000
Other liabilities	325,000	115,000		440,000
Common stock, Br10 par	400,000			400,000

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Common stock, Br5 par		200,000	(a) (200,000)	
Additional paid-in capital	365,000	58,000	(a) (58,000)	365,000
Retained earnings	134,000	132,000	(a) (132,000)	134,000
Total liabilities and stockholders' equity	1,250,000	515,000	(390,000)	1,375,000

Dear student, you do not have to be worried by the complexity of the working paper. All you need to emphasize are the following points:

1. The elimination is not entered in either the parent company's or the subsidiary's accounting records; it is only a part of the working paper for preparation of the consolidated balance sheet.
2. The elimination is used to reflect differences between current fair values and carrying amounts of the subsidiary's identifiable net assets because the subsidiary did not write up its assets to current fair values on the date of the business combination.
3. The Eliminations column in the working paper for consolidated balance sheet reflects **increases** and **decreases**, rather than **debits** and **credits**. Debits and credits are not appropriate in a working paper dealing with **financial statements** rather than **trial balances**.
4. **Intercompany receivables** and **payables** are placed on the same line of the working paper for consolidated balance sheet and are combined to produce a consolidated amount of zero.
5. The respective corporations are identified in the working paper elimination.
6. The consolidated paid-in capital amounts are those of the parent company only. Subsidiaries' paid-in capital amounts **always** are eliminated in the process of consolidation.
7. Consolidated retained earnings on the date of a business combination include only the retained earnings of the parent company. This treatment is consistent with the theory that purchase accounting reflects a fresh start in an acquisition of net assets (assets less liabilities).
8. The amounts in the consolidated column of the working paper for consolidated balance sheet reflect the financial position of a **single economic entity** comprising **two legal entities**, with all **intercompany** balances of the two entities eliminated.

Consolidated Balance Sheet

The amounts in the '**Consolidated**' column of the working paper for consolidated balance sheet are presented in the customary fashion in the **Consolidated Balance Sheet** of **Palm Corporation and subsidiary** that follows:

PALM CORPORATION AND SUBSIDIARY	
Consolidated Balance Sheet	
December 31, 2005	
Assets	
Current assets:	
Cash	Br. 55,000
Inventories	285,000
Other	180,000
Total current assets	Br. 520,000
Plant assets (net)	815,000
Intangible assets:	

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Patent (net)	Br. 25,000	
Goodwill	<u>15,000</u>	<u>40,000</u>
Total assets		<u>Br. 1,375,000</u>
Liabilities and Stockholders' Equity		
Liabilities:		
Income taxes payable		Br. 36,000
Other current liabilities		<u>440,000</u>
Total liabilities		Br. 476,000
Stockholders' equity:		
Common stock, Br. 10 par	Br. 400,000	
Additional paid-in capital	365,000	
Retained earnings	<u>134,000</u>	<u>899,000</u>
Total liabilities and stockholders' equity		<u>Br. 1,375,000</u>

Dear student in the above illustration we have seen a case where the parent is the exclusive owner of a subsidiary. It is also possible for the parent to own just part of the shares and still control the subsidiary which requires consolidation by the parent. The consolidation of a parent company and its **partially owned** subsidiary differs from the consolidation of a wholly owned subsidiary in one major respect-the recognition of minority interest. **Minority interest**, or **non-controlling interest**, is a term applied to the claims of stockholders other than the parent company (the **controlling interest**) to the net income or losses and net assets of the subsidiary. The minority interest in the subsidiary's net income or losses is displayed in the consolidated income statement, and the minority interest in the subsidiary's net assets is displayed in the consolidated balance sheet.

Nature of Minority Interest

The appropriate classification and presentation of minority interest in consolidated financial statements has been a perplexing problem for accountants, especially because it is recognized **only in the consolidation process** and does not result from a business transaction or event of either the parent company or the subsidiary. Two concepts for consolidated financial statements have been developed to account for minority interest-the **parent company concept** and the **economic unit concept**. The FASB has described these two concepts as follows:

The parent company concept emphasizes the interests of the parent's shareholders. As a result, the consolidated financial statements reflect those stockholders' interests in the parent itself, plus their undivided interests in the net assets of the parent's subsidiaries. The consolidated balance sheet is essentially a modification of the parent's balance sheet with the assets and liabilities of all subsidiaries substituted for the parent's investment in subsidiaries.

... [T]he stockholders' equity of the parent company is also the stockholders' equity of the consolidated entity. Similarly, the consolidated income statement is essentially a modification of the parent's income statement with the revenues, expenses, gains, and losses of subsidiaries substituted for the parent's income from investment in the subsidiaries.

The economic unit concept emphasizes control of the whole by a single management. As a result, under this concept (sometimes called the entity theory in the accounting literature), consolidated financial statements are intended to provide information about a group of legal entities—a parent company and its subsidiaries—operating as a single unit. The asset, liabilities, revenues, expenses, gains, and losses of the various component entities are the assets, liabilities, revenues, expenses, gains, and losses of the consolidated entity. Unless all subsidiaries are wholly owned, the business enterprise's proprietary interest (its residual owners' equity—assets less liabilities) is divided into the controlling interest (stockholders or other owners of the parent company) and one or more non-controlling interests in subsidiaries. Both the controlling and the non-controlling interests are part of the proprietary group of the consolidated entity, even though the non-controlling stockholders' ownership interests relate only to the affiliates whose shares they own.

The major difference in the two concepts could be summarized as follows:

The **parent company concept** of consolidated financial statements apparently treats the minority interest in net assets of a subsidiary as a **liability**. This liability is increased each accounting period subsequent to the date of a business combination by an **expense** representing the minority's share of the subsidiary's net income (or decreased by the minority's share of the subsidiary's net loss). Dividends declared by the subsidiary to minority stockholders decrease the liability to them. Consolidated net income is **net** of the minority's share of the subsidiary's net income.

In the **economic unit concept**, the minority interest in the subsidiary's net assets is displayed in the stockholders' equity section of the consolidated balance sheet. The consolidated income statement displays the minority interest in the subsidiary's net income as a **subdivision of total consolidated net income**, similar to the division of net income of a partnership.

Chapter Six: Consolidation Subsequent to Acquisition

6.1. Consolidated Financial Statements: Subsequent to Date of Business Combination

In the equity method of accounting, the parent company recognizes its share of the subsidiary's net income or net loss, adjusted for depreciation and amortization of differences between current fair values and carrying amounts of a subsidiary's identifiable net assets on the date of the business combination, as well as its share of dividends declared by the subsidiary.

In the cost method of accounting, the parent company accounts for the operations of a subsidiary only to the extent that dividends are declared by the subsidiary. Dividends declared by the subsidiary from net income subsequent to the business combination are recognized as revenue by the parent company; dividends declared by the subsidiary in excess of post combination net income constitute a reduction of the carrying amount of the parent company's investment in the subsidiary.

Net income or net loss of the subsidiary is ***not recognized*** by the parent company when the cost method of accounting is used.

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Dear student at this point you have to appreciate how complex the consolidation process can get as we add on cases and assumptions about the methods. To make life easier and give you the basics of the process, we will limit the illustration of the subsequent date of purchase choosing one method of accounting for the investment - The Equity method and where the subsidiary is a wholly owned one. To make ends meet, we will continue to use the example seen above.

Assume that **Palm Corporation** had appropriately accounted for the December 31, 2005, business combination with its wholly owned subsidiary, **Starr Company** and that **Starr** had a net income of Br. 60,000 for the year ended December 31, 2006. Assume further that on December 20, 2006, **Starr's** board of directors declared a cash dividend of Br. 0.60 a share on the 40,000 outstanding shares of common stock owned by **Palm**. The dividend was payable January 8, 2007, to stockholders of record December 29, 2006.

Starr's December 20, 2006, journal entry to record the dividend declaration is as follows:

2006 December	20	Dividends Declared (40,000 x Br. 0.60)	24,000	
		Intercompany Dividends Payable		24,000
To record declaration of dividend payable January 8, 2007, to stock- holders of record December 29, 2006.				

Starr's credit to the *Intercompany Dividends Payable* ledger account indicates that the liability for dividends payable to the parent company **must be eliminated** in the preparation of consolidated financial statements for the year ended December 31, 2006.

Under the equity method of accounting, **Palm Corporation** prepares the following journal entries to record the dividend and net income of **Starr** for the year ended December 31, 2006:

2006 December	20	Intercompany Dividends Receivable	24,000	
		Investment in Starr Company Stock		24,000
To record dividend declared by Starr company, payable January 8, 2007, to stockholders of record Dec, 29, 2006.				
	31	Investment in Starr Company Common Stock	60,000	
		Intercompany Investment Income		60,000
To record 100% of Starr Company's net income for the year ended Dec. 31, 2006.				

The parent's first journal entry records the dividend declared by the subsidiary in the Intercompany Dividends Receivable account and is the counterpart of the subsidiary's journal entry to record the declaration of the dividend. The credit to the Investment in Starr Company Common Stock account in the first journal entry reflects an underlying premise of the equity method of accounting: dividends declared by a subsidiary represent a return of a portion of the parent company's investment in the subsidiary.

The parent's second journal entry records the parent's 100% share of the subsidiary's net income for 2006. The subsidiary's net income *accrues* to the parent company under the equity method of accounting, similar to the accrual of interest on a note receivable or an investment in bonds.

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In addition to the two foregoing journal entries, **Palm** must prepare a third equity-method journal entry on December 31, 2006, to adjust **Starr's** net income for depreciation and amortization attributable to the differences between the current fair values and carrying amounts of **Starr's** identifiable net assets on December 31, 2005, the date of the **Palm-Starr** business combination.

Because such differences were not recorded by the subsidiary, the subsidiary's 2006 net income **is overstated** from the point of view of the consolidated entity.

Assume that the December 31, 2005 (date of business combination), differences between the current fair values and carrying amounts of Starr Company's net assets were as follows:

<i>Difference between Current Fair Values and Carrying Amounts of Wholly Owned Subsidiary's Assets on Date of Business Combination</i>	<i>Inventories (first-in, first-out cost)</i>	<i>Br. 25,000</i>
	<i>Plant assets (net):</i>	
	<i>Land</i>	<i>Br. 15,000</i>
	<i>Building (economic life 15 years)</i>	<i>30,000</i>
	<i>Machinery (economic life 10 years)</i>	<i><u>20,000</u> 65,000</i>
	<i>Patent (economic life 5 years)</i>	<i>5,000</i>
	<i>Goodwill (not impaired as of December 31, 2006)</i>	<i><u>15,000</u></i>
	<i>Total</i>	<i><u><u>Br. 110,000</u></u></i>

Palm Corporation prepares the following additional equity-method journal entry to reflect the effects of depreciation and amortization of the differences between the current fair values and carrying amounts of Starr Company's **identifiable** net assets on Starr's net income for the year ended December 31, 2006:

<i>2006 December</i>	<i>31</i>	<i>Intercompany Investment Income</i>	<i>30,000</i>	
		<i>Investment in Starr Company Stock</i>		<i>30,000</i>
		<i>To amortize differences between current fair values and carrying amounts of Starr Company's net assets on Dec. 31, 2005, as follows:</i>		
	<i>31</i>	<i>Inventories-to cost of goods sold</i>	<i>Br. 25,000</i>	
		<i>Building-depreciation (Br30,000 ÷ 15)</i>	<i>2,000</i>	
		<i>Machinery-depreciation (Br20,000 ÷ 10)</i>	<i>2,000</i>	
		<i>Patent-amortization (Br5,000 ÷ 5)</i>	<i><u>1,000</u></i>	
		<i>Total amortization applicable to 2006</i>	<i><u><u>Br. 30,000</u></u></i>	
		<i>(Income tax effects are disregarded.)</i>		

Dear student after been introduced to how the investment account be affected with passage of as a result of events of the Investee and facts that prevail on the date of business combination , we will next show you what must be done to facilitate the consolidation. The first step to be done is preparing the elimination entries.

In our Illustration, the investor, **Palm Corporation's** use of the equity method of accounting for its Investment in **Starr Company** results in a balance in the Investment account that is a mixture of two components:

- 1) *The carrying amount of Starr's identifiable net assets, and*
- 2) *The excess on the date of business combination of the current fair values of the subsidiary's net assets (including goodwill) over their carrying amounts, net of depreciation and amortization.*

Working Paper for Consolidated Financial Statements

We continue to apply the equity method to illustrate the preparation of consolidated financial statements using a work paper. The work paper follows the discussion of the components and their computation.

We start with the balance sheet of a year ago that we used from **Palm Corporation** and **Starr Company**.

The intercompany receivable and payable is the Br. 24,000 dividend payable by **Starr** to **Palm** on December 31, 2006. (The advances by **Palm** to **Starr** that were outstanding on December 31, 2005, were repaid by **Starr** on January 2, 2006.)

The following aspects of the working paper for consolidated financial statements of **Palm Corporation and subsidiary** should be emphasized:

1. The intercompany receivable and payable, placed in adjacent columns on the same line, are offset without a formal elimination.
2. The elimination cancels all intercompany transactions and balances not dealt with by the offset described in 1 above.
3. The elimination cancels the subsidiary's retained earnings balance **at the beginning of the year** (the date of the business combination), so that each of the three basic financial statements may be consolidated in turn. (**All** financial statements of a parent company and a subsidiary are consolidated for accounting periods subsequent to the business combination.)
4. The first-in, first-out method is used by **Starr Company** to account for inventories; thus, the Br. 25,000 difference attributable to **Starr's** beginning inventories is allocated to cost of goods sold for the year ended December 31, 2006.
5. Income tax effects are ignored in the process.
6. One of the effects of the elimination is to reduce the differences between the current fair values and the carrying amounts of the subsidiary's net assets, excepting land and goodwill, on the business combination date. The effect of the reduction is as follows:

Total difference on date of business combination (Dec. 31, 2005)	Br. 110,000
<u>Less: Reduction in elimination (a) (Br. 29,000 + Br. 1,000)</u>	<u>30,000</u>
Unamortized difference, Dec, 31, 2006 (Br. 61,000 + Br. 4,000 + Br. 15,000)	<u>Br. 80,000</u>

The joint effect of **Palm Corporation's** use of the equity method of accounting and the annual elimination will be to extinguish Br. 50,000 of the Br. 80,000 difference above through **Palm's** Investment in **Starr Company** Common Stock ledger account. Remember that *the Br. 15,000 balance applicable to Starr's land will not be extinguished; the Br.15,000 balance applicable to Starr's goodwill will be reduced only if the goodwill in subsequently impaired.*

7. The parent company's use of the equity method of accounting results in the equalities described below:

Parent company net income = consolidated net income

Parent company retained earnings = consolidated retained earnings

8. The equalities exist when the equity method of accounting is used and intercompany profits and sales are ignored. Despite the equalities indicated above, **consolidated financial statements** are superior to **parent company financial statements** for the presentation of financial position and operating results of parent and subsidiary companies. The effect of the consolidation process for **Palm Corporation and subsidiary** is to **reclassify Palm's Br. 30,000 share of its subsidiary's adjusted net income to the revenue and expense components of that net income.** Similarly, Palm's Br. 506,000 investment in the subsidiary is **replaced by the assets and liabilities comprising the subsidiary's net assets.**
9. Purchase accounting theory requires the exclusion from consolidated retained earnings of a subsidiary's retained earnings on the date of a business combination. **Palm Corporation's** use of the equity method of accounting meets this requirement. **Palm's** ending retained earnings amount in the working paper, which is equal to consolidated retained earnings, includes only **Palm's** Br. 30,000 share of the subsidiary's adjusted net income for the year ended December 31, 2006, the first year of the parent- subsidiary relationship.

Equity Method: Wholly Owned Subsidiary Subsequent to Date of Business Combination

PALM CORPORATION AND SUBSIDIARY Working Paper for Consolidated Financial Statements For Year Ended December 31, 2006				
	Palm Corporation	Starr Company	Elimination Increase (Decrease)	Consolidated
Income Statement				
Revenue:				
Net sales	1,100,000	680,000	----	1,780,000
Inter-company Investment Income	30,000		(a) (30,000)	----
Total revenue	1,130,000	680,000	(30,000)	1,780,000
Costs and expenses:				
Cost of Goods sold	700,000	450,000	(a) 29,000	1,179,000
Operating expenses	217,667	130,000	(a) 1,000	348,667
Interest expense	----	49,000	----	49,000
Income taxes expense	53,333			
Total costs and exp	1,020,000	620,000	30,000*	1,670,000
Net income	110,000	60,000	(60,000)	110,000
Statement of Retained Earnings				

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Beginning Retained earnings	134,000	132,000	(a) (132,000)	134,000
Net Income	110,000	60,000	(60,000)	110,000
Sub total	244,000	192,000	(192,000)	244,000
Dividends declared	30,000	24,000	(a) (24,000)**	30,000
Ending Retained earnings	214,000	168,000	(168,000)	214,000
Balance Sheet				
Assets				
Cash	15,900	72,100		88,000
Intercompany receivable (payable)	24,000	(24,000)	----	----
Inventories	136,000	115,000		251,000
Other current assets	88,000	131,000		219,000
Investment in Starr Co. Common Stock	506,000	----	(a) (506,000)	----
Plant assets (net)	440,000	340,000	(a) 61,000	841,000
Patent (net)		16,000	(a) 4,000	20,000
Goodwill			(a) 15,000	15,000
Total assets	1,209,900	650,100	(426,000)	1,434,000
Liabilities and Stockholder's Equity				
Income taxes payable	40,000	20,000	----	60,000
Other liabilities	190,900	204,100	----	395,000
Common stock, Br. 10 par	400,000			400,000
Common stock, Br. 5 par		200,000	(a) (200,000)	
Additional Paid-in Capital	365,000	58,000	(a) (58,000)	365,000
Retained earnings	214,000	168,000	(168,000)	214,000
Total Liabilities and Stockholders' Equity	1,209,900	650,100	(426,000)	1,434,000
* an increase in total costs and expenses and a decrease in net income				
**a decrease in dividends and an increase in retained earnings				

The consolidated income statement, statement of retained earnings, and balance sheet of Palm Corporation and subsidiary for the year ended December 31, 2006, are as follow. The amounts in the consolidated financial statements are taken from the consolidated column of the above working paper.

PALM CORPORATION AND SUBSIDIARY	
Consolidated Income Statement	
For Year Ended December 31, 2006	
Net sales	Br. 1,780,000
Costs and expenses:	
Cost of goods sold.....	Br. 1,179,000
Operating expenses	348,667
Interest expense	49,000
Income taxes expense.....	<u>93,333</u>
Total costs and expenses	<u>1,670,000</u>
Net income	<u>Br. 110,000</u>
Basic Earnings per share of common stock (40,000 shares outstanding)	<u>Br. 2.75</u>
PALM CORPORATION AND SUBSIDIARY	
Consolidated Statement of Retained Earnings	
For Year Ended December 31, 2006	

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Retained earnings, beginning of year		Br. 134,000
Add: Net income		<u>110,000</u>
Subtotal		Br. 244,000
Less: Dividends (Br. 0.75 a share)		<u>30,000</u>
Retained earnings, end of year		<u>Br. 214,000</u>
PALM CORPORATION AND SUBSIDIARY		
Consolidated Balance Sheet		
December 31, 2006		
Assets		
Current assets:		
Cash		Br. 88,000
Inventories		251,000
Other		<u>219,000</u>
Total current assets		Br. 558,000
Plant assets (net)		841,000
Intangible assets:		
Patent (net)	Br. 20,000	
Goodwill	<u>15,000</u>	<u>35,000</u>
Total assets		<u>Br. 1,434,000</u>
Liabilities and Stockholders' Equity		
Liabilities:		
Income taxes payable		Br. 60,000
Other current liabilities		<u>395,000</u>
Total liabilities		Br. 455,000
Stockholders' equity:		
Common stock, Br. 10 par	Br. 400,000	
Additional paid-in capital	365,000	
Retained earnings	<u>214,000</u>	<u>979,000</u>
Total liabilities and stockholders' equity		<u>Br. 1,434,000</u>

Chapter Sven: The Effects of Changes in Foreign Exchange Rates

7.1. Foreign Currency Transactions and Accounting Fluctuations

In most countries, a foreign country's currency is treated as though it were a **commodity**, or a **money-market instrument**. In Ethiopia, for example, foreign currencies are bought and sold by the international banking departments of commercial banks. These foreign currency transactions are entered into on behalf of the banks' multinational enterprise customers, and for the banks' own account.

An exchange rate is the ratio between a unit of one currency and the amount of another currency for which that unit can be exchanged at a particular time. For example daily newspaper might quote exchange rates for the Ethiopian birr and United States Birr, British pound, Euro, Chinese Yuan, etc.

The buying and selling of foreign currencies as though they were commodities result in variations in the **exchange rate** between the currencies of two countries.

These exchange rates are subject to variations due a number of factors including:

- a) *The balance of payment which reveals the demand and supply of foreign currency*
- b) *Relative Inflation rate difference between economies of the two currencies*
- c) *Relative interest rate difference between economies of the two currencies*

A multinational (or transnational) enterprise is a business enterprise that carries on operations in more than one nation, through a network of branches, divisions, influenced investees, joint ventures, and subsidiaries. Multinational enterprises obtain material and capital in countries where such resources are plentiful. Multinational enterprises manufacture their products in nations where wages and other operating costs are low, and they sell their products in countries that provide profitable markets.

Use of historical exchange rates shields financial statements from foreign currency translation gains or losses. The use of current rates causes translation gains or losses.

We need to distinguish between translation gains and losses and transaction gains and losses both of which are considered exchange gains and losses. A realized (or settled) transaction creates a real gain or loss. This is a gain or loss that should be reflected immediately in income. A gain or loss on a settled transaction arises whenever the exchange rate used to book the original transaction differs from the rate used at settlement.

To illustrate the application of exchange rates, assume that an Ethiopian business enterprise required €10,000 (10,000 Euros) to pay for merchandise acquired from a Germany supplier. At the Br. 16, selling spot rate, the Ethiopian multinational enterprise would pay Br. 160, 000 ($€10,000 \times \text{Br. } 16 = \text{Br. } 160,000$) for the 10,000 Euros. If on the date of settlement the exchange rate between Birr and Euro differs from the Br. 16 per Euro it will result in exchange rate gain or loss.

Let's illustrate the exchange rate variation and its accounting treatment from the side of Ethiopian multinational firm (buyer in this case).

Case A. Exchange rate between Birr and Euro is 17.

<i>Date of purchase</i>	<i>Merchandise</i>	<i>160,000</i>	
	<i>Account payable</i>		<i>160,000</i>
<i>Date of settling the bill</i>	<i>Account payable</i>	<i>160,000</i>	
	<i>Loss on Foreign exchange fluctuation</i>	<i>10,000</i>	
	<i>Cash</i>		<i>170,000</i>

Case B. Exchange rate between Birr and Euro is 15.

<i>Date of purchase</i>	<i>Merchandise</i>	<i>160,000</i>	
	<i>Account payable</i>		<i>160,000</i>
<i>Date of settling the bill</i>	<i>Account payable</i>	<i>160,000</i>	
	<i>Cash</i>		<i>150,000</i>

	Gain on Foreign exchange fluctuation	10,000
--	--------------------------------------	--------

7.2. The Mechanics of Exchange Rates

An exchange rate is a measure of how much of one currency may be exchanged for another currency. These rates may be in the form of either **direct** or **indirect quotes** made by commercial banks. A **direct quote** measures how much of the **domestic currency** must be exchanged to receive **a unit of the foreign currency** (1 FC).

Direct quotes allow the party using the quote to understand the price of the foreign currency in terms of its own “base” or domestic currency. *Indirect quotes*, also known as *European terms*, measure how many units of **foreign currency** will be received for **a unit of the domestic currency**. Thus, if the direct quote for a foreign currency (FC) is Br. 0.25, then one FC would cost Br. 0.25. The indirect quote would be the reciprocal of the direct quote, or 4 FC per Birr (Br. 1.00 divided by Br. 0.25).

Exchange Rate Quotes	
Direct Quote	Indirect Quote
1 FC = Br. 0.25	Br. 1 = 4 FC

The business news often reports that a currency has strengthened (gained) or weakened (lost) relative to another currency. Assuming a direct quote system, such changes measure the difference between the new rate and the old rate, as a percentage of the old rate. For example, if the Birr strengthened or gained 20% against a foreign currency (FC) from its previous rate of Br. 0.25, the Birr would now command more FC (i.e., the FC would be cheaper to buy). To be exact, the new exchange rate would be Br. 0.20 [Br. 0.25 - (20% × 0.25)]. Therefore, *the strengthening currency would be evidenced by a reduction in the directly quoted amount and an increase in the indirectly quoted amount.*

The opposite would be true for a weakening of the domestic currency. The reaction to a strengthening or weakening of a currency depends on what type of transaction is contemplated. For example, an Ethiopian exporter would want a weaker Birr because the foreign importer would need fewer of its currency units to acquire a Birr’s worth of Ethiopian goods. Thus, Ethiopian goods would cost less in terms of the foreign currency. If the Birr strengthened so that one could acquire more foreign currency units for a Birr, importers would benefit. Therefore, Ethiopian companies and citizens would have to spend fewer Ethiopian Birr to buy the imported goods.

Changes Relative to Another Currency	
A Strengthening Birr	A Weakening Birr
Before: 1 FC = Br. 0.25	Before: 1 FC = Br. 0.25
After: 1 FC = Br. 0.20	After: 1 FC = Br. 0.30
Result: The Birr gained 20%.	Result: The Birr lost 20%.
(Br. 0.25 - Br. 0.20 = Br. 0.05;	(Br. 0.25 - Br. 0.30 = -Br. 0.05;

Br. 0.05 + Br. 0.25 = 20%)

-Br. 0.05 + Br. 0.25 = -20%)

Exchange rates often are quoted in terms of a buying rate (the bid price) and a selling rate (the offered price). The buying and selling rates represent what the currency broker (normally a large commercial bank) is willing to pay to acquire or sell a currency. The difference or spread between these two rates represents the broker's commission and is often referred to as the points. The spread is influenced by several factors, including the supply of and demand for the currency, the number of transactions taking place, currency risk, and the overall volatility of the market. For example, assume a currency broker agrees to pay Br. 0.20 to a holder of a foreign currency and agrees to sell that currency to a buyer of foreign currency for Br. 0.22. In this case, the broker will receive a commission of Br. 0.02 (Br. 0.22 - Br. 0.20). In Ethiopia, rates generally are quoted between the Ethiopian Birr and a foreign currency. However, rates between two foreign currencies are also quoted and are referred to as **cross rates**.

Exchange rates fall into two primary groups: **spot rate** and **forward rate**. A **spot rate** is the rate of exchange for a currency with immediate delivery, selling, or buying of the currency normally occurring within two business days. In addition to exchange rates governing the immediate delivery of currency, **forward rates** apply to the exchange of different currencies at a future point in time, such as in 30, 60, 90, or 180 days. Although not all currencies are quoted in forward rates, virtually all major trading nations have forward rates.

	Types of Exchange Rates			
	Buying Rate		Selling Rate	
	Spot Rate	Forward Rate	Spot Rate	Forward Rate
<i>Exchange:</i>	Within 2 days	In the future (e.g., 30 days)	Within 2 days	In the future (e.g., 30 days)

An agreement to exchange currencies at a specified price with delivery at a specified future point in time is a **forward contract**. A forward contract is a derivative instrument whose underlying value is a foreign currency exchange rate. Forward exchange contracts may be held as an investment or held as part of a strategy to reduce or hedge against exchange rate risk associated with another transaction. A forward contract, used to hedge against the risk associated with changing exchange rates, specifies the future exchange date and the forward rate of exchange. Although future exchange dates typically are quoted in 30-day intervals, contracts may be written to cover any number of days. To illustrate a forward contract, assume the forward rate to buy a FC to be delivered in 90 days is Br. 1.650. This means that, after the specified time from the inception of the contract date (90 days), one FC will be exchanged for Br. 1.650, regardless of what the spot rate is at that time.

Inception of Contract	← 90 Days →	Settlement of Contract
Forward Rate		Exchange Rate
1 FC = Br. 1.650		1 FC = Br. 1.650

Spot Rate	(Regardless of what the spot rate is on that day.) Spot Rate
1 FC = Br. 1.640	1 FC = Br. 1.655

Several aspects of spot rates and forward rates are noteworthy. First, typically both rates are constantly changing. Spot rates are revised daily; as they change, forward rates for the *remaining time* covered by a given forward contract also change even though the forward rate at inception is fixed.

When there is no more remaining time, the current forward rate becomes the spot rate. Therefore, the value of a forward contract changes over the forward period. For instance, in the above example, if the forward rate is 1 FC = Br. 1.652 with 30 days remaining, the right to *buy* FC at the original fixed forward rate of 1 FC = Br. 1.650 suggests that the value of the forward contract has increased. Rather than paying a forward rate of Br. 1.652 to acquire FC in 30 days, the holder of the original forward contract must only pay the fixed rate of Br. 1.650. Second, the ultimate value of the forward contract must be assessed by comparing the fixed forward rate against the spot rate at the settlement date. In the above example, at the settlement date, the holder of the contract will pay the fixed rate of 1 FC = Br. 1.650 to buy an FC rather than the spot rate of 1 FC = Br. 1.655.

The total change in value is represented by the difference between the original fixed forward rate and the spot rate at settlement date. Finally, the difference between a forward rate and a spot rate represents a premium or discount which is traceable to a number of factors. This difference between the spot and forward rate represents the time value of the forward contract.

If the forward rate is greater than the spot rate at inception of the contract, the contract is said to be at a **premium** (as in the above example). The opposite situation results in a **discount**. Quoting premiums or discounts (known as *forward differentials*), rather than forward rates, is a common industry practice.

Forward Rates	
Employ a Forward Exchange Contract	
At a Premium	At a Discount
Forward Rate > Spot Rate (At inception of contract)	Forward Rate < Spot Rate (At inception of contract)

At inception, the difference between the forward and spot rates represents a contract expense or income to the purchaser of the forward contract. A number of factors influence forward rates and, thus, account for the difference between a forward rate and a spot rate. A primary factor is the interest rate differential between holding an investment in foreign currency and holding an investment in domestic currency over a period of time. It is for this reason that the difference between a forward rates is referred to as the **time value** of the forward contract. For example, if a broker sold a contract to deliver foreign currency in 30 days, the interest differential would be the difference between

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- 1) the interest earned on investing foreign currency for the 30 days prior to delivery date, and
- 2) the 30 days of interest lost on the domestic currency that was not invested but was used to acquire the foreign currency needed for delivery.

Assume that the spot rate is 1 FC = Br. 0.60 and that you want to determine a 6-month forward rate. Further, assume that the Birr could be invested at 4.5% and the FC could be invested at 7.25%. The forward rate would be calculated as follows:

	Ethiopian Birr	Foreign Currency (FC)
Value today	Br. 600.00	1,000 FC
Interest rate	4.5%	7.25%
Six months of interest	Br. 13.50	36.25 FC
Value in six months	Br. 613.50	1036.25 FC
6-month forward rate = Br. 613.50 + 1036.25 FC = 1 FC = Br. 0.592		

The forward rate for a currency can also be derived by the following formula:

Forward rate = Direct spot rate at the beginning of period $t \times \frac{1 + \text{Interest rate for domestic investment during period } t}{1 + \text{Interest rate for foreign country investment during period } t}$
--

Using the formula to solve the previous example results in the following, based on 6-month interest rates:

Forward rate of Br. 0.592 = Br. 0.60 $\times \frac{1 + 0.02250}{1 + 0.03625}$

If the interest yield on the FC is greater than the yield on the Ethiopian Birr, the forward rate will be less than the spot rate (contract sells at a discount). The forward contract will sell at a premium if the opposite is true. The forward rate based on interest differentials will be slightly different than the quoted forward rate because the quoted rate includes a commission to the foreign currency broker. Furthermore, other factors in addition to interest differentials could be incorporated into the forward rate. These other factors include the volatility of the spot rates, the time period covered by the contract, expectations of future exchange rate changes, and the political and economic environments of a given country.

As previously mentioned, changes in exchange rates represent an additional business risk when transactions are denominated in a foreign currency. The accounting for foreign currency transactions measures this risk and demonstrates the use of both spot and forward rates.

7.3. Accounting for Foreign Currency Transactions

Assume an Ethiopian Company sells mining equipment to an Indian Company and the equipment must be paid for in 30 days with Ethiopian Birr. This transaction is denominated in Birr and will be measured by the Ethiopian Company in Birr. Changes in the exchange rate between the Ethiopian Birr and the Indian Rupee from the transaction date to the settlement date will not expose the Ethiopian Company to any risk of gain or loss from exchange rate changes. Now assume that the same transaction occurs except that the transaction is to be settled in Indian Rupees. Because this transaction is denominated in Rupees and will be measured by the Ethiopian Company in Birr, changes in the exchange rate subsequent to the transaction date expose the Ethiopian Company to the risk of an exchange rate loss or gain. If the Ethiopian Birr strengthens, relative to Rupee, the Ethiopian Company will experience a loss because it is holding an asset (a receivable of Indian Rupees) whose price and value have declined. If the Birr weakens, the opposite effect would be experienced. Whether a transaction is settled in Birr versus a foreign currency is a matter that is negotiated between the transacting parties and is influenced by a number of factors. A bank wire transfer is generally used to transfer currency between parties in different countries. For one of the parties, the currency will be a foreign currency; for the other party, the currency will be its domestic currency.

To summarize, *changes in exchange rates do not affect transactions that are both denominated and measured in the reporting entity's currency.* Therefore, these transactions require no special accounting treatment. However, *if a transaction is denominated in a foreign currency and measured in the reporting entity's currency, changes in the exchange rate between the transaction date and settlement date result in a gain or loss to the reporting entity.* These gains or losses are referred to as exchange gains or losses, and their recognition requires special accounting treatment.

Effect of Rate Changes	
No Exchange Gain or Loss	Exchange Gain or Loss
Transactions are denominated and measured in the reporting entity's currency.	Transactions are denominated in the foreign currency and measured in the reporting entity's currency.

Originally, two methods were proposed for the treatment of exchange gains or losses arising from foreign currency transactions. After considering the merits of these two methods, the FASB adopted the **two-transaction method** which views the initial foreign currency transaction as one transaction. The effects of any subsequent changes in the exchange rates and the resulting exchange gain or loss are viewed as a second transaction. Therefore, the initial transaction is recorded independently of the settlement transaction. This method is consistent with accepted accounting techniques, which normally account for the financing of a transaction as a separate and distinct event. *(The required two-transaction method is used in all instances with one exception. The exception relates to a hedge on a foreign currency commitment that is discussed later in this unit. Therefore, unless otherwise stated, the two-transaction method will be used throughout this unit.)*

In order to illustrate the two-transaction method, assume that an Ethiopian Company sells mining equipment on June 1, 200X4, with the corresponding receivable to be paid or settled on July 1, 20X4. The equipment has a selling price of Br. 306,000 and a cost of Br. 250,000. On June 1, 20X4, the Indian Rupee (denoted here as Rs) is worth Br. 1.70, and on July 1, 20X4, rupee is worth Br. 1.60. Illustrations 7-1 and 7-2 present the entries to record the sale of the mining

equipment, assuming that the transaction is denominated in Birr (Br. 306,000) and then in Rupees (Rs. 180,000). Note that, when the transaction is denominated in Birr (in Illustration 6–1), the Ethiopian Company does not experience an exchange gain or loss. However, because the Indian Company measures the transaction in Rupees but denominates the transaction in Birr, it experiences an exchange loss.

In substance, the value of the Indian Company's accounts payable changed because it was denominated in a foreign currency (Birr, in this case), that is, in a currency other than its own. In order to emphasize that the value of certain asset or liability balances is not fixed and will change over time, these changing accounts are identified in boldface type throughout these illustrations. When the transaction is denominated in Rupees, as in Illustration 7–2, the Ethiopian Company experiences an exchange loss (or gain). The exchange loss (or gain) is accounted for separately from the sales transaction and does not affect the Ethiopian Company's gross profit on the sale. This separately recognized exchange gain or loss is not viewed as an extraordinary item, but should be included in determining income from continuing operations for the period and, if material, should be disclosed in the financial statements or in a note to the statements. Finally, it is important to note in Illustration 7–2 that the Indian Company does not experience an exchange gain or loss. This is because the Indian Company both measured and denominated the transaction in Rupees.

in Rupees:

Illustration 7–1

Transaction Denominated in Birr: Two–Transaction Method

Ethiopian Company (Birr)			Indian Company (Rs.)		
June 1, 20X4					
Accounts Receivable	306,000		Equipment.....	180,000*	
Sales Revenue.....		306,000	Accounts Payable—FC.		180,000
Cost of Goods Sold	250,000				
Inventory.....		250,000			
July 1, 20X4					
Cash	306,000		Accounts Payable—FC.....	180,000	
Accounts Receivable.....		306,000	Exchange Loss	11,250	
			Cash.....		191,250**
Note: The Ethiopian Company experienced no exchange gain or loss because its transaction was both denominated and measured in Birr. However, under the two-transaction method, the Indian Company did experience an exchange loss since its transaction was measured in Rupees and denominated in Birr. The decrease in the value of the Indian Rupee relative to the Ethiopian Birr means more Rupees must be paid to cover the liability. *(Br. 306,000 ÷ Br. 1.70 = Rs. 180,000) ** (Br. 306,000 ÷ Br. 1.60 = Rs. 191,250)					

Illustration 7–2

Transaction Denominated in Rupees: Two–Transaction Method

Ethiopian Company (Birr)			Indian Company (Rupees)		
June 1, 20X4					
Accounts Receivable—FC.....	306,000		Equipment.....	180,000	
Sales Revenue.....		306,000	Accounts Payable.....		180,000
Cost of Goods Sold.....	250,000				
Inventory.....		250,000			
July 1, 20X4					
Cash	288,000*		Accounts Payable.....	180,000	
Exchange Loss.....	18,000**		Cash.....		180,000
Accounts Receivable—FC....		306,000			

Note: The loss is considered to be part of a separate financing decision and unrelated to the original sales transaction.

**The company received Rs. 180,000 when the exchange rate was 1 rupee = Br. 1.60 (Rs. 180,000 × Br. 1.60 = Br. 288,000). Normally, the company would not physically receive Rupees but would have the Birr equivalent wired to its bank account. Through the use of a bank wire transfer, the Indian Company's account would be debited for the number of Rupees, and the Ethiopian company's bank account would be credited for the applicable number of Birr, given the exchange rate.*

***The decrease in the value of the Indian Rupee from Br. 1.70 to Br. 1.60 results in an exchange loss to the Ethiopian Company since the Rupees it received are less valuable than they were at the transaction date [180,000 × (Br. 1.60 - Br. 1.70) = -Br. 18,000].*

7.4. Foreign Currency Translations

In the previous unit, we prepared consolidated financial statements from the constituent firms, parent and subsidiary companies. The assumption is that the financial statements are prepared using same accounting principles and currencies. Accountants are often faced with the problem of consolidating financial statements where the parent and subsidiaries operate using two different currencies and follow different accounting principles. In this section we discuss how a foreign subsidiary's financial statements are translated to equivalent amounts of parent company's financial statement. Once the financial statements from both parent and subsidiary are expressed in same currencies, the usual consolidation process follows.

Foreign currency translation is the process of expressing amounts denominated or measured in foreign currencies into amounts measured in the reporting currency of the domestic entity. Foreign currency translation is complicated by the reality that the foreign financial statements may have been prepared using accounting principles that are different from those of the domestic reporting entity. Thus, prior to translation, the statements of a foreign entity must be adjusted to reflect the principles employed by the domestic reporting entity.

7.4.1. Methods of Foreign Currency Translation

- a. **Current-non-current** method—translates current accounts at current exchange rates and non-current accounts at historical rates;
- b. **Monetary-non-monetary** method—translates monetary items at current exchange rates and non-monetary items at historical exchange rates;
- c. **Temporal method** (This method will be seen later)
- d. **Current rate method**—translates all assets and liabilities at the current exchange rate.

Under the temporal method, translation is a function of whether a balance sheet account measures current values or historical costs. Accounts measured by the foreign entity at current values will be translated using the current spot rate at the date of the financial statement. Balance sheet accounts that are measured by the foreign entity at historical cost are to be translated at the spot rates that existed at the date of the original transaction.

If a foreign entity acquired equipment by paying 100,000 Foreign Currency on July 1, 2008 the equipment would be translated into Birr using the spot rate that existed on July 1, 2008. Equity account balances also represent historical costs and are to be translated at the historical spot rates that existed at the date of the equity transaction.

Income statement accounts that do not represent the amortization of historical costs should be translated at the spot rate that existed at the date of the revenue or expense transaction. The use of such specific spot rates produces a practical dilemma which is resolved through the use of weighted average exchange rates for the period covered by the income statement. Revenues and expenses that result from the amortization of assets or liabilities are translated at the historical spot rates used to translate the underlying historical costs being amortized.

The translation of trial balance accounts at different spot rates results in an inequality which represents the translation exchange gain or loss. Under the temporal method, this gain or loss is included as a component of net income.

The summary may be presented as follows:

Trial Balance Items	Spot Rate for Temporal Method
Assets and Liabilities	
<i>Measured at current values</i>	<i>Current rates</i>
<i>Measured at historical cost</i>	<i>Historical rates</i>
Equity Accounts	
<i>Other than retained earnings</i>	<i>Historical rates</i>
<i>Retained Earnings</i>	<i>Translated beginning balance plus translated net income less dividends translated at historical rates.</i>
Revenue and Expenses	
<i>Representing amortization of historical amounts</i>	<i>Historical Rate</i>
<i>Not representing amortization of historical amounts</i>	<i>Weighted average rate</i>
<i>Translation gain or loss</i>	<i>A balancing amount included as a component of current net income.</i>

7.4.2. Translation of a Foreign Entity's Financial Statements

If a foreign entity's financial statement amount are expressed in a functional currency other than the Ethiopian birr, those amounts must be translated to birr (the Ethiopian company reporting currency) by the current rate method. The following sections illustrate translation of the financial statements of a foreign influenced investee and a foreign subsidiary.

7.4.2.1. Translation of Financial Statements of Foreign Influenced Investee

To illustrate the translation of the financial statement of a foreign investee whose functional currency is its local currency, assume that on May 31, 2005, the end of a fiscal year, **Colossus Company**, an Ethiopian multinational company, acquired 30% of the outstanding common stock of a corporation in Venezuela, which is termed as **Venezuela Investee**. Although the investment of **Colossus** enabled it to exercise influence (but not control) over the operations and financial

policies of **Venezuela Investee**, that entity's functional currency was the *Bolívar* (B). **Colossus** acquired its investment in **Venezuela Investee** for B 600, 000, which **Colossus** acquired at a selling spot rate of B1 = Br. 0.25, for a total cost of Br. 150,000. Out-of-pocket costs of the investment may be disregarded. Stockholders' equity of **Venezuela Investee** on May 31, 2005, was as follows:

Common Stock	B 500,000
Additional Paid-in Capital	600,000
Retained Earnings	<u>900,000</u>
Total Stockholders' Equity	<u>B 2,000,000</u>

There was no difference between the cost of **Colossus Company's** investment and its equity in the net assets of Venezuela investee ($B\ 2,000,000 \times 0.30 = B\ 600,000$, the cost of the investment). The exchange rates for the *Bolívar* were as follows:

May 31, 2005	Br. 0.25
May 31, 2006	0.27
Average for the year ended May 31, 2006	<u>0.26</u>

Translation of Venezuela investee's financial statements from the functional currency to the Ethiopian birr **reporting currency** for the fiscal year ended May 31, 2006, is illustrated as follows:

Venezuela Investee Translation of Financial Statements to Ethiopian Birr For Year Ended May 31, 2006			
	Venezuelan Bolivars	Exchange Rates	Ethiopian Birr
Income Statement			
Net Sales	B 6,000,000	Br. 0.26(1)	Br. 1,560,000
Costs and expenses	<u>4,000,000</u>	0.26(1)	<u>1,040,000</u>
Net income	<u>B 2,000,000</u>		<u>Br. 520,000</u>
Statement of Retained Earnings			
Retained Earnings, Beginning of Year	B 900,000	0.25(2)	Br. 225,000
Add: Net Income	<u>2,000,000</u>		<u>520,000</u>

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Subtotal	B 2,900,000		Br. 745,000
<i>Less: Dividends*</i>	<u>600,000</u>	0.27(3)	<u>162,000</u>
Retained Earnings, End of Year	<u>B 2,300,000</u>		<u>Br. 583,000</u>
Balance Sheet			
Assets			
Current Assets	B 200,000	0.27(3)	Br. 54,000
Plant Assets (net)	4,500,000	0.27(3)	1,215,000
Other Assets	<u>300,000</u>	0.27(3)	<u>81,000</u>
Total Assets	<u>B 5,000,000</u>		<u>Br. 1,350,000</u>
Liabilities and Stockholders' Equity			
Current Liabilities	B 100,000	0.27(3)	Br. 27,000
Long-term Debt	1,500,000	0.27(3)	405,000
Common Stock	500,000	0.25(2)	125,000
Additional Paid-in Capital	600,000	0.25(2)	150,000
Retained Earnings	2,300,000		583,000
Foreign Currency Translation Adjustments	<u>.</u>		<u>60,000[†]</u>
Total Liabilities and Stockholders' Equity	<u>B 5,000,000</u>		<u>Br. 1,350,000</u>
* = dividends were declared on May 31, 2006 † = income tax effects are disregarded (1)= average rate for year ended May 31, 2006 (2)= historical rate (on May 31, 2005, date of investment) (3)= current rate (on May 31, 2006)			

In a review of the illustration of the foreign investee's financial statements illustrated above, the following features may be emphasized:

1. All assets and liabilities are translated at the current rate.
2. The paid-in capital amounts and the beginning retained earnings are translated at the historical rate on the date of Colossus Company's acquisition of its investment in Venezuela Investee.
3. The average rate for the year ended May 31, 2006, is used to translate all revenue and expenses in the income statement.
4. A balancing amount labeled **foreign currency translation adjustments**, which is **not a ledger account**, is used to reconcile total liabilities and stockholders' equity with total assets in the translated balance sheet of Venezuela Investee. Foreign currency translation adjustments are displayed in the accumulated other comprehensive income statement of the translated balance sheet.

Following the translation of *Venezuela Investee's* financial statements from *bolivars* (the **functional currency** of *Venezuela Investee*) to the Ethiopian birr (the **reporting currency** of *Colossus Company*), on May 31, 2006, *Colossus* prepares the following journal entries in the Ethiopian birr under the equity method of accounting for an investment in common stock:

Investor Company's Journal Entries under Equity Method Accounting	
Investment in Venezuela Investee Common Stock (Br. 520,000 × 0.30).....	156,000

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<i>Investment Income</i>	156,000
<i>To record 30% of net income of Venezuela Investee. (Income tax effects are disregarded.)</i>	
<i>Investment in Venezuela Investee Common Stock (Br. 60,000 × 0.30)</i>	18,000
<i>Foreign Currency Translation Adjustments</i>	18,000
<i>To record 30% of other comprehensive income component of Venezuela Investee's stockholders' equity. (Income tax effects are disregarded.)</i>	
<i>Dividends Receivable (Br. 162,000 × 0.30)</i>	48,600
<i>Investment in Venezuela Investee Common Stock (Br. 520,000 × 0.30)</i>	48,600
<i>To record dividends receivable from Venezuela Investee.</i>	

After the foregoing journal entries are posted, the investment ledger account of *Colossus Company* (in birr) is as follows:

Investment in Venezuela Investee Common Stock				
Date	Explanation	Debit	Credit	Balance
2005				
May 31	Acquisition of 30% of common stock	150,000		150,000 dr
2006				
May 31	Share of net income	156,000		306,000 dr
31	Share of other comprehensive income	18,000		324,000 dr
31	Share of dividends		48,600	275,400 dr

The Br. 275,400 balance of the Investment account is equal to *Colossus Company's* share of the total stockholders' equity, **including foreign currency translation adjustments**, in the translated balance sheet of *Venezuela Investee* [(Br. 125,000 + Br. 150,000 + Br. 583,000 + Br. 60,000) × 0.30 = Br. 275,400]. Foreign currency translation adjustments, which are not operating revenues, gains, expenses, or losses, do not enter into the measurement of the translated **net income** or dividends of *Venezuela Investee*; however, the investor's share of the translation adjustments is reflected in the investor's Investment ledger account as **other comprehensive income**. Foreign currency translation adjustments are displayed in accumulated other income in the stockholders' equity section of *Venezuela Investee's* translated balance sheet until sale or liquidation of all or part of *Colossus Company's* investment in *Venezuela Investee*. At that time, the appropriate amount of the foreign currency translation adjustments is included in the measurement of the gain or loss on sale or liquidation of the investment in *Venezuela Investee*.

7.4.2.2. Translation and Consolidation of Financial Statements of Foreign Subsidiary

To illustrate the translation and consolidation of financial statements of a foreign subsidiary whose functional currency is its local currency, assume that on August 31, 2005, the end of a fiscal year, **SP Corporation**, an Ethiopian enterprise with no other subsidiaries, acquired at the selling spot rate of ₧1 = Br. 0.52 a draft for 500,000 Kenyan Shilling (denoted as ₧), which it used to acquire all 10,000 authorized shares of ₧50 par common stock of newly organized **Anan, Ltd.**, a Kenyan enterprise. The out-of-pocket costs of the acquisition were immaterial and thus recognized as expense by **SP**, which prepared the following journal entry for the investment:

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Journal Entry for Investment in Foreign Subsidiary			
2005			
August 31	Investment in Anan, Ltd., Common Stock ($\text{₡ } 500,000 \times \text{Br. } 0.52$)	260,000	
	Cash		260,000
To record acquisition of 10,000 shares of ₡50 par common stock of Anan, Ltd.			

Anan, Ltd., was self-contained in Kenya, where it conducted all its operations. Thus, the functional currency of **Anan** was the Kenyan Shilling (₡). Further, to enhance **Anan's** growth, the board of directors of **SP** decided that **Anan** should pay no dividends to **SP** in the foreseeable future.

For the fiscal year ended August 31, 2006, **Anan** prepared the following income statement and balance sheet (a statement of cash flows is disregarded):

Anan, Ltd. Income Statement For Year Ended August 31, 2006		
Revenue		
Net Sales		₡ 240,000
Other		60,000
Total Revenue		₡ 300,000
Costs and Expenses:		
Cost of Goods Sold	₡ 180,000	
Operating Expenses and Income Tax Expense	96,000	
Total Costs and Expenses		276,000
Net Income (Retained Earnings, End of Year)		<u>₡ 24,000</u>

Anan, Ltd. Balance Sheet August 31, 2006		
Assets		
Cash		₡ 10,000
Trade Accounts Receivable (net)		40,000
Inventories		180,000
Short-term Prepayments		4,000
Plant Assets (net)		320,000
Intangible Assets (net)		20,000
Total Assets		<u>₡ 574,000</u>
Liabilities and Stockholders' Equity		
Notes Payable	₡ 20,000	
Trade Accounts Payable	30,000	
Total Liabilities	₡ 50,000	
Common Stock, ₡ 50 par	₡ 500,000	
Retained Earnings	24,000	

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Total Stockholders' Equity	<u>₺ 524,000</u>
Total Liabilities and Stockholders' Equity	<u><u>₺ 574,000</u></u>

The exchange rates for the Kenyan Shilling were as follows:

August 31, 2005	Br. 0.52
August 31, 2006	0.50
Average for the year ended August 31, 2006	<u>0.51</u>

Translation of the financial statements of **Anan, Ltd.**, from the functional currency to the Ethiopian birr **reporting currency** for the fiscal year ended August 31, 2006, is illustrated below:

Anan, Ltd.

Translation of Financial Statements to Birr

For Year Ended August 31, 2006

	Kenyan Shilling	Exchange Rates	Ethiopian Birr
Income Statement			
Net Sales	₺ 240,000	Br. 0.51(1)	Br. 122,400
Other Revenue	<u>60,000</u>	0.51(1)	<u>30,600</u>
Total Revenue	<u>₺ 300,000</u>		<u>Br. 153,000</u>
Cost of Goods Sold	₺ 180,000	0.51(1)	Br. 91,800
Operating Expenses and Income Tax Expense	<u>96,000</u>	0.51(1)	<u>48,960</u>
Total Costs and Expenses	<u>276,000</u>		<u>Br. 140,760</u>
Net Income (Retained Earnings, End of Year)	<u><u>₺ 24,000</u></u>		<u><u>Br. 12,240</u></u>
Balance Sheet			
Cash	₺ 10,000	0.50(2)	Br. 5,000
Trade Accounts Receivable (net)	40,000	0.50(2)	20,000
Inventories	180,000	0.50(2)	90,000
Short-term Prepayments	4,000	0.50(2)	2,000
Plant Assets (net)	320,000	0.50(2)	160,000
Intangible Assets (net)	<u>20,000</u>	0.50(2)	<u>10,000</u>
Total Assets	<u><u>₺ 574,000</u></u>		<u><u>Br. 287,000</u></u>
Notes Payable	₺ 20,000	0.50(2)	Br. 10,000
Trade Accounts Payable	30,000	0.50(2)	15,000
Common Stock, ₺ 50 par	500,000	0.52(3)	260,000
Retained Earnings	24,000		12,240
Foreign Currency Translation Adjustments	<u>—</u>		<u>(10,240)*</u>
Total Liabilities and Stockholders' Equity	<u><u>₺ 574,000</u></u>		<u><u>Br. 287,000</u></u>

* Income tax effects are disregarded.

(1) Average for the year ended August 31, 2006

(2) Current rate (on August 31, 2006)

(3) Historical rate (on August 31, 2005, date of investment)

Following the translation of the financial statements of **Anan, Ltd.**, from Kenyan Shilling (the functional currency of **Anan**) to the Ethiopian birr (the reporting currency of **SP Corporation**), **SP** prepares the following journal entries in birr under the equity method of accounting for an investment in common stock:

2006	
August 31	Investment in Anan, Ltd., Common Stock 12,240

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	Intercompany Investment Income	12,240
	<i>To record 100% of net income of Anan, Ltd. (income tax effects are disregarded.)</i>	
31	Foreign Currency Translation Adjustments	10,240
	Investment in Anan, Ltd., Common Stock	10,240
	<i>To record 100% of other comprehensive income component of Anan, Ltd.'s stockholders' equity. (Income tax effects are disregarded.)</i>	

After the foregoing journal entries are posted, the balance of **SP's** Investment in **Anan, Ltd.**, Common Stock ledger account is Br. 262,000 (Br. 260,000 + Br. 12,240 – Br. 10,240), which is equal to the total stockholders' equity of **Anan, Ltd., including foreign currency translation adjustments**, in the translated balance sheet of **Anan** (Br. 260,000 + Br. 12,240 – Br. 10,240 = Br. 262,000). **SP Corporation** is now enabled to prepare the following working paper elimination (in journal entry format) and working paper for consolidated financial statements, as well as the consolidated financial statements presented below the working paper (other amounts for **SP Corporation** are assumed).

SP Corporation and Subsidiary Working Paper Elimination August 31, 2006

(a)	Common Stock – Anan	260,000	
	Intercompany Investment Income	12,240	
	Investment in Anan, Ltd., Common Stock – SP		262,000
	Foreign Currency Translation Adjustments– SP		10,240
	<i>To eliminate intercompany investment and equity accounts of subsidiary. (Income tax effects are disregarded.)</i>		

Equity Method: Wholly Owned Subsidiary Subsequent To Date of Business Combination

SP Corporation and Subsidiary Working Paper for Consolidated Financial Statements For Year Ended August 31, 2006

	SP Corporation	Anan, Ltd.	Eliminations Increases (Decreases)	Consolidated
Income Statement				
Revenue:				
Net Sales	840,000	122,400		962,400
Intercompany Investment Income	12,240		(a) (12,240)	
Other	120,000	30,600		150,600
Total Revenue	972,240	153,000	(12,240)	1,113,000
Costs and Expenses:				
Costs of Goods Sold	720,000	91,800		811,800
Operating Expenses and Income Tax Expenses	160,000	48,960		208,960
Total Costs and Expenses	880,000	140,760		1,020,760
Net Income	92,240	12,240	(12,240)	92,240
Statement of Retained Earnings				
Retained Earnings, Beginning of Year	480,000			480,000
Net Income	92,240	12,240	(12,240)	92,240
Subtotal	572,240	12,240	(12,240)	572,240
Dividends Declared	30,000			30,000

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<i>Retained Earnings, End of Year</i>	542,240	12,240	(12,240)	542,240
Balance Sheet				
Assets				
Cash	80,000	5,000		85,000
Trade Accounts Receivable (net)	270,000	20,000		290,000
Inventories	340,000	90,000		430,000
Short-term Prepayments	12,000	2,000		14,000
Investment in Anan, Ltd., Common stock	262,000		(a) (262,000)	
Plant Assets (net)	618,000	160,000		778,000
Intangible Assets (net)	80,000	10,000		90,000
Total Assets	1,662,000	287,000	(262,000)	1,687,000
Liabilities and Stockholders' Equity				
Notes Payable	50,000	10,000		60,000
Trade Accounts Payable	80,000	15,000		95,000
Long-term Debt	400,000			400,000
Common stock	600,000	260,000	(a) (262,000)	600,000
Retained Earnings	542,240	12,240	(12,240)	542,240
Foreign Currency Translation Adjustments	(10,240)	(10,240)	(a) (12,240)*	(10,240) [†]
Total Liabilities and Stockholders' Equity	1,662,000	287,000	(262,000)	1,687,000

* = A **decrease** in foreign currency translation adjustments an **increase** in equity
[†] = Income tax effects are disregarded

SP Corporation and Subsidiary Consolidated Income Statement For Year Ended August 31, 2006

Revenue:	
Net Sales	Br. 962,400
Other	<u>150,600</u>
Total Revenue	Br. 1,113,000
Costs and Expenses:	
Costs of Goods Sold	Br. 811,800
Operating Expenses and Income Tax Expenses	<u>208,960</u>
Total Costs and Expenses	<u>1,020,760</u>
Net Income	Br. <u>92,240</u>
Basic Earnings per share of common stock (60,000 shares outstanding)	Br. <u>1.54</u>

SP Corporation and Subsidiary Consolidated Statement of Comprehensive Income For Year Ended August 31, 2006

Net Income	Br. 92,240
Other Comprehensive Income: Foreign Currency Translation Adjustments	<u>(10,240)</u>
Comprehensive Income	Br. <u>82,000</u>

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SP Corporation and Subsidiary Consolidated Statement of Changes in Equity For Year Ended August 31, 2006

	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance, Beginning of Year.....	Br. 600,000	Br. 480,000		Br. 1,080,000
Add: Net Income.....		92,240		92,240
Other Comprehensive Income: Foreign Currency Translation Adjustments.....			Br. (10,240)	(10,240)
Comprehensive Income.....				Br. 82,000
Dividends Declared		(30,000)		(30,000)
Balances, End of Year.....	<u>Br. 600,000</u>	<u>Br. 542,240</u>	<u>Br. (10,240)</u>	<u>Br. 1,132,000</u>

SP Corporation and Subsidiary Consolidated Balance Sheet August 31, 2006

Assets	
Current Assets:	
Cash	Br. 85,000
Trade Accounts Receivable (net)	290,000
Inventories	430,000
Short-term Prepayments	14,000
Total Current Assets	Br. 819,000
Plant Assets (net)	778,000
Intangible Assets (net)	90,000
Total Assets	<u>Br. 1,687,000</u>
Liabilities and Stockholders' Equity	
Current Liabilities:	
Notes Payable	Br. 60,000
Trade Accounts Payable	95,000
Total Current Liabilities	Br. 155,000
Long-term Debt	
Total Liabilities	Br. 555,000
Stockholders' Equity:	
Common stock, Br. 10 par	Br. 600,000
Retained Earnings	542,240
Accumulated Other Comprehensive Income	(10,240)
Total Stockholders' Equity	1,132,000
Total Liabilities and Stockholders' Equity	<u>Br. 1,687,000</u>

The foregoing consolidated financial statements are in the formats required by the FASB.

Summary: Remeasurement and Translation

Financial Accounting and Reporting Module (include 4 courses)

Principal features of the foregoing discussions of remeasurement of a foreign entity's accounts and translation of a foreign entity's financial statements are summarized in the following table:

Comparison Remeasurement and Translation		
Features	Remeasurement	Translation
<i>Underlying concept</i>	<i>Foreign entity's accounts should reflect transactions and events as though recorded in the functional currency rather than the local currency.</i>	<i>Foreign entity's financial statements should reflect financial results and relationships created in the economic environment of the foreign operations.</i>
<i>When required</i>	(1) <i>Foreign entity's accounts are maintained in the local currency instead of the functional currency.</i> (2) <i>Foreign entity is operating in a highly inflationary economy.</i>	<i>Foreign entity's functional currency is not the reporting currency.</i>
<i>Method used</i>	<i>Monetary/nonmonetary method</i>	<i>Current method</i>
<i>Display of balancing amount</i>	<i>In income statement as transaction gain or loss</i>	<i>In balance sheet, stockholders' equity section, as part of accumulated other comprehensive income.</i>

Chapter Eight: Segment and Interim Financial Reporting

8.1. Segment Reporting

For various reasons, enterprises may develop a strategy which allows them to become involved in a variety of activities across various industries. Enterprises with such activities are referred to as being *horizontally integrated*. In other instances, the activities may be *vertically integrated*, which suggests that they relate to the sales and distribution of a final good or service. For example, a manufacturer of office and house furniture may also be involved in activities such as the growing and harvesting of timber. Enterprises may also become involved in activities which do not necessarily have a close relationship to their original core business but, rather, allow them to diversify their business. Such businesses are referred to as *conglomerates* or *diversified*

companies. For example, a single enterprise may be involved in such diverse activities as radio and television broadcasting, managed health-care facilities, development of software for engineering applications, and the manufacture of soups.

The traditional consolidated financial statements of a truly diversified enterprise would provide the user of these statements with limited information regarding the diversity of the enterprise's activities and the economic environments in which those activities function. For example, unless separate disclosures were present, it would not be possible to tell what portion of consolidated sales was traceable to various business activities. Certainly, the uncertainties affecting potential cash flows can be better understood if information related to an enterprise's products and services, as well as geographical areas of operation, is provided. Fortunately, special disclosures regarding the segments or activities of an enterprise are required and provide users with fundamental information through which they can better understand operating performance and prospects for future cash flows for both individual segments and the enterprise as a whole. Furthermore, such information will provide users with an improved basis for making comparisons between enterprises that are diversified with those that are not.

A number of professional groups, including the American Institute of Certified Public Accountants (AICPA), the Financial Executives Institute, the Financial Analysts Federation, the International Accounting Standards Committee, the Association for Investment Management and Research, and the FASB, have consistently emphasized the importance of segmental disclosures. In 1976, the FASB had issued Statement of Financial Accounting Standards No. 14, which also dealt with the topic of segmental disclosures. However, that statement had come under criticism from both reporting enterprises and users of the information.

The importance of segmental reporting, coupled with the criticisms directed toward earlier authoritative pronouncements, has resulted in a renewed interest globally, in establishing standards for segmental reporting. Of recent importance is the joint effort of the FASB and the Accounting Standards Board of the Canadian Institute of Chartered Accountants (CICA). The FASB and the CICA reached on the same conclusions regarding appropriate standards and have each issued new authoritative standards regarding segmental disclosures. In the case of the FASB, the authoritative standard is Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information* issued in 1997. FASB Statement No. 131, which replaces the earlier Statement No. 14, is applicable to public business enterprises. Although the statement does not apply to nonpublic enterprises or not-for-profit organizations, such enterprises or organizations are encouraged to adopt the requirements of the standard.

8.1.1. Definition of an Operating Segment

The FASB choose to define operating segments by emphasizing a “*management approach*” which focuses on how management organizes information for purposes of making operating decisions and assessing performance. The segments which emerge from an analysis of how management organizes information for decision-making purposes are called *operating segments* and are defined as a component of an enterprise:

- 1) *that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same enterprise),*
- 2) *whose operating results are regularly reviewed by the enterprise's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and*
- 3) *for which discrete (distinct) financial information is available.*

It is important to note that not all parts of an enterprise will necessarily qualify as an operating segment. For example, some parts may not earn revenues of an operating nature; such is the case with corporate headquarters. The chief operating decision maker who reviews a segment is one who assesses performance and allocates resources. This is a function which could be held by one individual, such as a chief executive officer (CEO) or chief operating officer (COO) or a group of individuals. One or more individuals typically have responsibility to account and report to the chief operating decision maker. This function is carried out by segment managers whose identification may also help identify operating segments.

Once operating segments have been identified, it is possible that some of the segments will appear to be similar due to similar economic characteristics. These segments may have virtually the same future prospects, and separate reporting of them may provide users with additional data of limited utility. Therefore, it may be possible to combine two or more of these segments into a single segment, if they are similar in each of the following areas:

- *The nature of the products or services.*
- *The nature of the production processes.*
- *The type or class of customer for their products and services.*
- *The methods used to distribute their products or provide their services.*
- *The nature of the regulatory environment (if applicable); for example, banking, insurance, or public utilities.*

8.1.2. Criteria for a Reportable Segment

Once segments have been identified and aggregated, if necessary, information should be disclosed about those segments which are deemed to be reportable. That is, even though there may be an operating segment, it may not be significant enough to require disclosure. A *reportable segment* is one which is deemed to be significant because of any of the following:

- (a) *Its reported revenue, including both sales to external customers and intersegment sales or transfers, is 10% or more of the combined revenue, internal and external, of all reported operating segments.*
- (b) *The absolute amount of its reported profit or loss is 10% or more of the greater, in absolute amount, of*
 - (i) *the combined profit of all operating segments that did not report a loss, or*
 - (ii) *the combined reported loss of all operating segments that did report a loss.*

(c) Its assets are 10% or more of the combined assets of all operating segments.

It is important to note that, even if a segment does not satisfy the above criteria, management may report information about that individual segment if they believe it to be material. For those operating segments which do not meet the above criteria, they will constitute a separate “all other” category for reporting purposes. It is possible that those segments which qualify as reportable do not represent a significant enough portion of the enterprise’s operating activities.

The total of **external revenues** for reportable segments must constitute at least 75% of the total consolidated revenue. If this is not the case, then additional operating segments must be designated as reportable even though they did not initially qualify as such. The goal of these guidelines is to reach a balance between providing users with information about a reasonable number of segments and yet not be excessive. In the latter regard, if the number of reportable segments exceeds 10 in number, consideration should be given to whether this number should be reduced by aggregating certain segments. The above criteria used to identify reportable segments and analyze the appropriate number of reportable segments are shown in Illustration 2-1.

Illustration 8-1

Reportable Segments: Demonstration of Criteria

Facts:

Wesson Corp. has classified its operations into segments and has provided the following data for each segment:

Segment	Revenues			Operating Profit (Loss)	Assets
	Unaffiliated Customers	Intersegment Sales	Total		
A	Br. 100,000	Br. 15,000	Br. 115,000	Br. 45,000	Br. 280,000
B	20,000		20,000	(10,000)	80,000
C	230,000	40,000	270,000	130,000	1,100,000
D	45,000	5,000	50,000	(60,000)	320,000
E	37,000	8,000	45,000	25,000	295,000
F	<u>140,000</u>	<u>14,000</u>	<u>154,000</u>	<u>85,000</u>	<u>760,000</u>
	Br. 572,000	Br. 82,000	Br. 654,000	Br. 215,000	Br. 2,835,000
Corporate level	<u>60,000</u>		<u>60,000</u>	<u>20,000</u>	<u>705,000</u>
Total	<u>Br. 632,000</u>	<u>Br. 82,000</u>	<u>Br. 714,000</u>	<u>Br. 235,000</u>	<u>Br. 3,540,000</u>

Analysis:

The determination of which segments are reportable requires the following evaluation, in which only combined data relating to the segments (not including corporate-level activity) are employed:

1. Total sales to unaffiliated customers	Br. 572,000
Total intersegment sales	<u>82,000</u>
Combined revenue	<u>Br. 654,000</u>

Segment revenue required to satisfy criterion (a): $\text{Br. } 654,000 \times 10\% = \text{Br. } 65,400$

Segment	Operating Profit	Operating Loss
A	Br. 45,000	—
B	—	Br. 10,000
C	130,000	—
D	—	60,000
E	25,000	—
F	<u>85,000</u>	<u>—</u>
Total	<u>Br. 285,000</u>	<u>Br. 70,000</u>

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Portion of absolute amount of the greater of the operating profit or the operating loss to satisfy criterion (b):

Br. 285,000 × 10% = **Br. 28,500**

3. Segment assets required to satisfy criterion (c): Br. 2,835,000 × 10% = **Br. 283,500**

Whether the criteria are satisfied is summarized as follows:

Segment	Revenue		Criterion Satisfied Operating Profit(Loss)		Identifiable Assets		Segment Reportable
A	Yes	(Br.115,000 > Br.65,400)	Yes	(Br. 45,000 > Br.28,500)	No	(Br.280,000 < Br.283,500)	Yes
B	No	(Br. 20,000 < Br.65,400)	No	(Br. 10,000 < Br.28,500)	No	(Br. 80,000 < Br. 283,500)	No
C	Yes	(Br.270,000 > Br.65,400)	Yes	(Br.130,000 > Br.28,500)	Yes	(Br.1,100,000 > Br.283,500)	Yes
D	No	(Br. 50,000 < Br.65,400)	Yes	(Br. 60,000 > Br.28,500)	Yes	(Br.320,000 > Br.283,500)	Yes
E	No	(Br. 45,000 < Br.65,400)	No	(Br. 25,000 < Br.28,500)	Yes	(Br.295,000 > Br. 283,500)	Yes
F	Yes	(Br.154,000 > Br.65,400)	Yes	(Br. 85,000 > Br.28,500)	Yes	(Br.760,000 > Br.283,500)	Yes

All of the segments are reportable except for Segment B.

(continued)

4. Significance of the reportable segments:

Consolidated revenue	Br. 632,000
Percentage requirement	<u>75%</u>
Dollar requirement	<u>Br. 474,000</u>
External revenue of reportable segments (all segments except Segment B)	<u>Br. 552,000</u>

The reportable segments represent a significant portion of the enterprise.

5. Reasonableness of the number of reportable segments:

The five reportable segments do not exceed the guideline number of 10.

8.1.3. Information about a Reportable Segment that must be Disclosed

Once the identification of reportable segments and the proper guidelines regarding the number of segments have been satisfied, various general and financial information regarding segments is required to be disclosed as part of a complete set of financial statements.

The factors used to identify reportable segments must be disclosed along with a discussion of how the segments are organized. For example, segments could be organized around products or services, geographical areas, marketing areas, or products within geographical areas. For each reportable segment, the type of products and/or services from which they derive their revenues should be disclosed. Certain information about profit or loss and assets must also be disclosed for each reportable segment, and then these amounts must be reconciled to corresponding enterprise consolidated amounts.

Information about Profit or Loss and Assets: The measure of profit or loss which is disclosed is a function of what information is reviewed by the chief operating decision maker of the

enterprise. For example, the measure could exclude items relating to the cost of capital, or the measure could include an allocation of general corporate overhead. It is important to note that the measure of profit or loss follows a management approach focusing on internal decision making rather than any strict definition of profit used by the enterprise for general purpose external reporting. Therefore, it is possible that segmental profit or loss may not necessarily incorporate the same generally accepted accounting principles (GAAP) as are employed at the consolidated level. For example, segment profit or loss may not include the effects of tax allocation or pension expense. The following items regarding profit or loss should be disclosed **only if** the items are included in the values reviewed by the chief operating decision maker: revenues from external customers, revenues from other operating segments, interest revenue, interest expense, depreciation, depletion, amortization expense, unusual items, equity in net income of investees accounted for under the equity method, income tax expense/benefit, extraordinary items, and other significant noncash items such as deferred tax expense. If a majority of a segment's revenues are from interest, such as those of a financial segment, and the decision-making process focuses on net interest (interest revenue less interest expense), then interest revenue may be reported net of interest expense.

In order to better evaluate a segment, it would be useful to disclose the assets which were employed to generate the profit or loss traceable to that segment. Therefore, those segment assets which are evaluated by the chief operating decision maker are also to be disclosed. The following items regarding assets should be disclosed **only if** the items are included in the values reviewed by the chief operating decision maker: the carrying basis of investments in investees measured under the equity method and total expenditures for additions to long-lived assets (other than financial instruments, long-term customer relationships of a financial institution, mortgage and other servicing rights, deferred policy acquisition costs, and deferred tax assets).

Because the measurement of segment profit or loss and assets follows a management approach, additional disclosures are necessary in order to assist users in understanding how these values are measured. For example, segment profit may not include the allocation of certain corporate-level expenses, or it may measure cost of sales using a method different from that used for consolidated purposes. Therefore, an enterprise should disclose, at a minimum, the following:

- 1) *The basis of accounting for any transactions between reportable segments.*
- 2) *The nature of any differences between the measurements of the reportable segments' profits or losses and the enterprise's consolidated income before income taxes, extraordinary items, discontinued operations, and the cumulative effect of changes in accounting principles (if not apparent from the reconciliations). Those differences could include accounting policies and policies for allocation of centrally incurred costs that are necessary for an understanding of the reported segment information.*
- 3) *The nature of any differences between the measurements of the reportable segments' assets and the enterprise's consolidated assets (if not apparent from the reconciliations). Those differences could include accounting policies and policies for allocation of jointly used assets that are necessary for an understanding of the reported segment information.*
- 4) *The nature of any changes from prior periods in the measurement methods used to determine reported segment profit or loss and the effect, if any, of those changes on the measure of segment profit or loss.*

5) *The nature and effect of any asymmetrical allocations to segments. For example, an enterprise might allocate depreciation expense to a segment without allocating the related depreciable assets to that segment.*

The various dollar amounts disclosed for reportable segments represent a significant portion of the respective consolidated dollar amounts. For example, the sum of profit or loss for all reportable segments will naturally represent a significant portion of consolidated profit or loss. However, all of the consolidated profit or loss will not be traceable to the reportable segments.

The difference between the sum of the reportable segment values and the respective consolidated value is most often due to the following:

1. *Not all segments are considered to be reportable. Therefore, some values are allocated to the category of segments known as “all other.”*
2. *Segment revenues, profits, and assets include the effect of intersegment transactions that are eliminated from consolidated amounts. Note that intersegment transactions that have not been realized through an exchange with an outside entity must be eliminated from consolidated amounts.*
3. *Certain values are not allocated to segments because they are not part of the information that is used by the chief operating decision maker as a basis for evaluating performance and allocating resources.*
4. *Certain values cannot be allocated to segments on a reasonable basis.*
5. *The accounting methods used to determine values for a reportable segment may be different from those used to prepare consolidated values. This is due to the focus on the management approach and the information used for internal rather than external reporting purposes.*

A requirement of segmental reporting is that the revenue, profit or loss, and asset amounts presented for reportable segments must be reconciled to the respective consolidated amounts for the enterprise as a whole. A reconciliation must also be made for other significant items presented by reportable segments. The reconciliation should be described in sufficient detail. Illustration 2-2 contains an example of the required segmental disclosures and the reconciliation to consolidated enterprise values.

Illustration 8-2 Presentation of Segmental Values							
	Auto Parts	Motor Vessels	Software	Electronics	Finance	All Other	Totals
Revenues from external customers	Br. 3,000	Br.5,000	Br. 9,500	Br.12,000	Br.5,000	Br.1,000 ^a	Br.35,500
Intersegment revenues...	—	—	3,000	1,500	—	—	4,500
Interest Revenue.....	450	800	1,000	1,500	—	—	3,750
Interest Expense	350	600	700	1,100	—	—	2,750
Net Interest Revenue ^b	—	—	—	—	1,000	—	1,000
Depreciation and Amortization.....	200	100	50	1,500	1,100	—	2,950

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Segment Profit.....	200	70	900	2,300	500	100	4,070
Other Significant Noncash Items:							
Cost in Excess of Billings on Long-term Contracts...	—	200	—	—	—	—	200
Segment Assets	2,000	5,000	3,000	12,000	57,000	2,000	81,000
Expenditures for Segment Assets.....	300	700	500	800	600	—	2,900

^a Revenue from segments below the quantitative thresholds are attributable to four operating segments of Diversified Company. Those segments include a small real estate business, an electronics equipment rental business, a software consulting practice, and a warehouse leasing operation. None of those segments has ever met any of the quantitative thresholds for determining reportable segments.

^b The finance segment derives a majority of its revenue from interest. In addition, management relies primarily on net interest revenue, not the gross revenue and expense amounts, in managing that segment. Therefore, only the net amount is disclosed.

Reconciliation of Segmental Values to Enterprise Consolidated Values

Revenues

Total revenues for reportable segments	Br. 34,500
Other revenues	1,000
Elimination of intersegment revenues	(4,500)
Total consolidated revenues	Br. 31,000

Profit or Loss

Total profit or loss for reportable segments	Br. 3,970
Other profit or loss.....	100
Elimination of intersegment profits	(500)
Unallocated amounts:	
Litigation settlement received	500
Other corporate expenses	(750)
Adjustment to pension expense in consolidation	(250)
Income before income taxes and extraordinary items	Br. 3,070

Assets

Total assets for reportable segments	Br. 79,000
Other assets	2,000
Elimination of receivables from corporate headquarters	(1,000)
Goodwill not allocated to segments	4,000
Other unallocated amounts	1,000
Consolidated Total	Br. 85,000

(continued)

Other Significant Items

	Segment Totals	Adjustments	Consolidated Totals
Interest revenue	Br. 3,750	Br. 75	Br. 3,825
Interest expense	2,750	(50)	2,700
Net interest revenue (finance segment only)	1,000	—	1,000
Expenditures for assets	2,900	1,000	3,900
Depreciation and amortization	2,950	—	2,950
Cost in excess of billing on long-term contracts	200	—	200

The reconciling item to adjust expenditures for assets is the amount of expenses incurred for the corporate headquarters building, which is not included in segment information. None of the other adjustments are significant.

Interim Period Disclosures: The current standard on segmental reporting addresses a criticism of the previous standard regarding interim reporting disclosures. The previous standard was criticized for not requiring segmental disclosures in interim reports. Interim information has become increasingly important, and users would find it even more useful if it included information regarding segments. Therefore, the new standard requires that *condensed* financial

statements for interim periods include the following for each reportable segment: revenues from both external customers and intersegment sales, profit or loss, a reconciliation of reportable segments' profit or loss to enterprise pretax net income from continuing operations, total assets which have materially changed from the values reported in the most recent annual report, and disclosure of any differences from the last annual report in terms of whether the basis for segmentation and/or measurement of segment profit or loss have changed. It is important to note that these disclosures are appropriate for only condensed financial statements of an interim period. If a complete set of financial statements is presented, then the more comprehensive disclosures discussed earlier would be appropriate. *Interim reporting* is discussed in detail later on under this unit.

8.1.4. Entity-wide disclosures

Because of the use of the management approach to defining segments, it is possible that segments may not necessarily be defined around product/service groups or geographical areas. For example, a segment may consist of several unrelated products because that is how information is structured for decision-making purposes. A company which produces beverages, produces snack foods, operates a chain of restaurants, and operates amusement parks may decide to include all but the amusement parks in a single segment. Segments may also be defined in such a way that a given segment includes activities which are occurring in more than one foreign geographical area. If information regarding product/service groups and/or geographical areas is not provided as part of the segmental disclosures, such information must be provided as an additional disclosure. These additional disclosures must be presented if practical; if it is not practical, that fact must be disclosed. These additional disclosures are presented on an enterprise-wide basis, not on a segmental basis. Furthermore, the disclosures are required even if there is only one reportable segment. The enterprise is required to:

- a. Report revenues from **external** customers for each product or service or each group of related products or services. The revenues are based on the information used for general purpose financial statements.
- b. Report revenues from **external** customers for the enterprise's country of domicile and all foreign countries in total. The revenues are based on the information used for general purpose financial statements. If material, revenues from separate foreign countries should be disclosed. Subtotals of revenue may also be disclosed by groups of foreign countries (e.g., South America). The basis used to allocate revenues to separate foreign countries must be disclosed. For example, revenues may be allocated based on where products are shipped or based on the location of customers.
- c. Report **long-lived** assets located in the enterprise's country of domicile and all foreign countries in total. The measurement of assets is based on the information used for general purpose financial statements. If material, assets traceable to separate foreign countries should be disclosed. Subtotals of assets may also be disclosed by groups of foreign countries (e.g., South America).

Disclosures Regarding Major Customers: Enterprises are also required to disclose information about major customers if revenues traceable to a single customer represent 10% or more of total enterprise revenues. For each such customer, the enterprise must disclose the total amount of

revenues and identify the segment or segments to which the revenues are traceable. The specific identity by name of the major customer need not be disclosed. For purposes of this disclosure, a group of entities under common control is considered to be a single customer. Federal, state, local, and foreign governments or agencies should each be considered as a single customer.

8.2. Interim Reporting

8.2.1. Approaches to Reporting Interim Data

Earlier forms of interim reporting provided the user of such data with various disclosures other than the computation of net income. However, as the importance of interim income statements became more apparent, different views of the interim period developed. One view of the interim period is that it represents a distinct, independent accounting period, separate from the annual accounting period. Therefore, interim net income should be determined by using the same principles and estimations as would be used if the interim period were an annual accounting period.

For example, annual research and development incurred during the interim period should be expensed in that period rather than deferred to future interim periods. Another view of the interim period is that it is an integral part of the annual period and does not stand as a distinct, independent period. Therefore, interim data should include appropriate adjustments and estimates so that they can be used to predict annual amounts. For example, assume annual income normally includes a year-end accrual for executive bonuses in the amount of Br. 120,000. If the interim statements are to serve as a predictor of annual values, it would seem appropriate that quarterly income statements should include a proportionate amount of this year end adjustment. Including a Br. 30,000 adjustment for bonuses in the quarterly income statement would allow one to predict annual bonuses in the amount of Br. 120,000. If this interim adjustment were not made, bonuses would be reflected only in the fourth quarter, and previous quarters would not have provided the user with a basis for predicting this annual amount. From this example, one can see that an interim period is viewed as an integral part of a larger annual period. This view of the interim period has been adopted as the underlying theory used to formulate interim accounting principles and practices.

Illustration of an Interim Liquidation of Inventory: In order to illustrate the special treatment given interim liquidations, assume a company's LIFO inventory available for sale during the third quarter consisted of beginning inventory of 1,200 units at a cost of Br. 20 each and current purchases of 2,000 units at a cost of Br. 30 each. Assume 2,500 units were sold during the quarter with the expectation that they would be replaced for Br. 32 a unit. Management anticipates that the annual ending inventory will be 1,100 units. Therefore, although the beginning inventory has been liquidated by 500 units, management expects to replenish 400 of these units by year-end. Assuming the company anticipates paying Br. 32 each to replenish the inventory, the third-quarter cost of sales would be calculated as follows:

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Current purchases (2,000 units @ Br. 30)	Br. 60,000
Prior inventory (500 units @ Br. 20 original cost)	
Excess replacement cost (400 units @ Br. 12)	10,000
	<u>4,800</u>
	<u>Br. 74,800</u>

The entry to record the third-quarter cost of sales would be as follows:

Cost of Sales	74,800
Inventory	70,000
Excess of Replacement Cost for Temporary Liquidation . . .	4,800
<i>To record cost of sales with a historical cost of Br. 70,000 and an excess of additional replacement cost equal to Br. 4,800 (Br. 12 × 400 units)</i>	

The Excess of Replacement Cost for Temporary Liquidation is classified as a current liability on the interim financial statements. When the 400 units are replenished in the fourth quarter at an assumed cost of Br. 32, the following entry is made:

Inventory	8,000	
Excess of Replacement Cost for Temporary Liquidation	4,800	
Accounts Payable (cash)		12,800
<i>To record replenishment of inventory previously liquidated</i>		

Notice that the 400 units replenish the inventory account at a cost of Br. 20 each as though no liquidation had occurred. That is, the inventory now consists of 1,100 units (700 at the end of the third quarter plus the 400 replenished) at a cost of Br. 20 each.

Illustration of Cost or Market for Interim Inventory: Assume at the end of the second quarter, ending inventory has a cost of Br. 380,000 and a fair value of Br. 350,000. The use of lower of cost or market would require a Br. 30,000 loss due to market declines to be recognized in the second quarter. At the end of the third quarter, the company has ending inventory with a cost of Br. 520,000 and a fair value of Br. 560,000. Of the Br. 40,000 excess of fair value over cost, the company can recognize Br. 30,000 of this amount as a recovery of the second-quarter loss. Therefore, the third quarter financial statements would include a Br. 30,000 gain due to market recoveries.

Reporting of Costs Unrelated to Inventory: In reporting costs and expenses that are not allocated to products sold or to services rendered but are charged against income in the interim period, the following standards apply:

a. *Costs and expenses other than product costs should be charged to income in interim periods as incurred or be allocated among interim periods based on an estimate of time expired, benefit received, or activity associated with the periods. Procedures adopted for assigning specific cost and expense items to an interim period should be consistent with the bases followed*

by the company in reporting results of operations at annual reporting dates. However, when a specific cost or expense item charged to expense for annual reporting purposes benefits more than one interim period, the cost or expense item may be allocated to those interim periods.

b. Some costs and expenses incurred in an interim period, however, cannot be readily identified with the activities or benefits of other interim periods and should be charged to the interim period in which they were incurred. Disclosure should be made as to the nature and amount of such costs unless items of a comparable nature are included in both the current interim period and in the corresponding interim period of the preceding year.

c. Arbitrary assignment of the amount of such costs to an interim period should not be made.

d. Gains and losses that arise in any interim period similar to those that would not be deferred at year-end should not be deferred to later interim periods within the same fiscal year.

To illustrate the above concepts, assume the following expenditures have occurred at the beginning of the second quarter:

- 1) A 12-month insurance premium was paid in the amount of Br. 1,200.
- 2) Research costs in the amount of Br. 18,000 were paid and are expected to benefit the company over the next 18 months.
- 3) A contribution in the amount of Br. 1,000 was made, although the benefits to subsequent quarters are uncertain.

The expenses to be recognized in the second quarter are as follows:

<i>Insurance expense (Br. 1,200 ÷ 12 × 3 months)</i>	<i>Br. 300</i>
<i>Research costs (Br. 18,000 ÷ 3 quarters—not to be deferred beyond year-end) ...</i>	<i>6,000</i>
<i>Contribution expense</i>	<i>1,000</i>
	<u>Br. 7,300</u>

Certain costs and expenses of an entity are subject to year-end adjustments, such as inventory shrinkage, allowance for uncollectible accounts, and year-end bonuses. These adjustments should not be recognized totally in the final interim period if they relate to activities of other interim periods. Therefore, to generate interim financial reports that contain a reasonable portion of annual expenses, a portion of estimated year-end adjustments should be allocated to each interim period on the basis of a revenue or a cost relationship. For example, a company that estimates an expected material year-end adjustment to its perpetual inventory, based on a physical inventory, should allocate a portion of that estimated adjustment to each interim period.

In this case, a portion of the annual estimated inventory shrinkage could be allocated to the quarter using a ratio of current quarter cost of sales to annual estimated cost of sales. Changes in earlier quarters' estimates should be accounted for in the current quarter.

The costs and expenses as well as revenues of some businesses are subject to seasonal variations. Since interim reports for such businesses must be considered as representative of the annual period, APB Opinion No. 28 states that

... such businesses should disclose the seasonal nature of their activities, and consider supplementing their interim reports with information for twelve-month periods ended at the interim date for the current and preceding years.

Adjustments Related to Prior Interim Period: By the definitions set forth in FASB Statement No. 16, *Prior Period Adjustments*, many items that were viewed previously as prior-period adjustments became elements of current operating income. However, certain items are treated as adjustments related to prior interim periods of the current fiscal year. These items include an adjustment or settlement of: litigation or similar claims, income taxes, renegotiation proceedings, or utility revenue under rate-making processes. Treating these items as prior-period adjustments is appropriate if all of the following criteria are met:

- a. *The effect of the adjustment or settlement is material in relation to income from continuing operations of the current fiscal year or in relation to the trend of income from continuing operations or is material by other appropriate criteria, and*
- b. *All or part of the adjustment or settlement can be specifically identified with and is directly related to business activities of specific prior interim periods of the current fiscal year, and*
- c. *The amount of the adjustment or settlement could not be reasonably estimated prior to the current interim period but becomes reasonably estimable in the current interim period.*

If such an item occurs in other than the first interim period of the current fiscal year and if all or part of the item is an adjustment related to prior interim periods of the current fiscal year, it should be reported as follows:

- a. *The portion of the item that is directly related to business activities of the enterprise during the current interim period, if any, shall be included in the determination of net income for that period.*
- b. *Prior interim periods of the current fiscal year shall be restated to include the portion of the item that is directly related to business activities of the enterprise during each prior interim period in the determination of net income for that period.*
- c. *The portion of the item that is directly related to business activities of the enterprise during prior fiscal years, if any, shall be included in the determination of net income of the first interim period of the current fiscal year.*

Disclosure also is required regarding adjustments related to prior interim periods of the current year in the period in which the adjustment occurs. Disclosures should be made for each prior

period of the current year setting forth both the effect on and actual adjusted amount of income from continuing operations, net income, and related per share amounts.

Finally, it is important to note that those adjustments that are related to prior interim periods do not include normal recurring corrections and adjustments that result from the use of estimates. For example, in the current interim period, the revision of estimates used to measure uncollectible accounts is not accounted for as an adjustment related to prior interim periods. Instead, this correction is accounted for in the current interim period and prospectively, as is the case with other changes in estimates.

8.2.2. Disclosures of Summarized Interim Data

To maintain the timeliness of interim data, companies frequently report summarized interim data rather than complete financial statements. When publicly traded companies report summarized interim data, the following disclosures are required, at a minimum:

1. *Sales or gross revenues, provision for income taxes, extraordinary items (including related income tax effects), cumulative effect of a change in accounting principles or practices, and net income.*
2. *Basic and diluted earnings-per-share data for each period presented, determined in accordance with the provisions of FASB Statement No. 128, Earnings per Share.*
3. *Seasonal revenue, costs, or expenses.*
4. *Significant changes in estimates or provisions for income taxes.*
5. *Disposal of a segment of a business and extraordinary, unusual, or infrequently occurring items.*
6. *Contingent items.*
7. *Changes in accounting principles or estimates.*
8. *Significant changes in financial position.*
9. *Information about reportable operating segments determined according to the provisions of FASB Statement No. 131, Disclosures about Segments of an Enterprise and Related Information, including provisions related to restatement of segment information in previously issued financial statements.*

The information in (9) above is more fully discussed in the following section of this chapter dealing with disclosures about segments of an enterprise.

In addition to providing this data for the current quarter, such data should be provided for the current year to date or the last 12 months to date, plus comparable data for the preceding year.

Frequently, companies do not issue separate fourth-quarter reports or provide fourth-quarter disclosure of summarized data because annual audited statements will be forthcoming. In such cases, a note to the annual financial statements should disclose the effect of the following items for the fourth quarter: disposals of a segment, extraordinary items, unusual or infrequently occurring items, and changes in accounting principles. Disclosure in the annual financial statements should also include the aggregate effect of year-end adjustments that are material to the fourth quarter results.