Summary

-Financial Accounting and Reporting-

CH1: Financial Reporting and Accounting Standards

Global Financial Markets and their relation to financial reporting

Due to globalization and the intertwining of world markets, a revolution is occurring in financial reporting with the entry of a single set of rules: **The International Financial Reporting Standards** (IFRS)

Essential characteristics of accounting:
(1) the identification, measurement, and communication of financial information about (2) economic entities to (3) interested parties.

Financial Accounting: the process that culminates in the preparation of financial reports on the enterprise for use by both internal and external parties.

Managerial Accounting: process of identifying, measuring, analysing, and communicating financial information needed by management to plan, control, and evaluate a company's operations.

Financial statements: (1) statement of financial position, (2) the income statement, (3) the statement of cash flows, (4) the statement of changes in equity.

Capital Allocation Process: Financial Reporting → Users (present and potential) → capital allocation

Efficient use of scarce resources: accounting provides reliable, relevant and timely information to managers, investors and creditors to allow resource allocation to the most efficient enterprises.

High-quality standards: a single, widely accepted set of high-quality accounting standards is a necessity to ensure adequate comparability.

The Objective 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.

General-purpose financial statements: provide financial reporting information to a wide variety of users (provide the most useful information, at the least cost)

Entity perspective: companies are viewed as separate and distinct from their owners

Decision-usefulness approach: financial reporting provides information that is useful for making decisions

Accrual-basis accounting: a company records events in the periods in which events occur, rather than in the periods in which it receives or pays cash (cash-basis accounting)

Bovemij Crowe EY Grant Thornton KPMG pwc

Major policy-setting bodies and their role in the standard-setting process
(p.1-9, illustration 1.4)
International Accounting Standards Board (IASB): international standard-setting organization, issues IFRS, is composed of the following four organizations:
1. The IFRS Foundation (provides oversight to the other three organizations)
2. The IASB (develops a single set of standards for general-purpose financial statements)
3. The IFRS Advisory Council (provides advice and counsel to the IASB on major policies and technical issues)
4. The IFRS Interpretations Committee (assists the IASB with the development of the IFRS)

The characteristics of the IASB (Membership, Autonomy, Independence, Voting) reinforce the importance of and open, transparent and independent due process.

International Organization of Securities Commissions (IOSCO): association of organizations that regulate the world's securities and futures markets (does not set accounting standards)

Conceptual Framework for Financial Reporting: sets forth the fundamental objective and concepts that the IASB uses in developing future standards of financial reporting.

Challenges facing Financial Reporting
1) **IFRS in a political environment:** user groups often target the IASB to pressure it to change existing rules and develop new ones.
2) **The expectations GAP:** due to the size and number of fraudulent reporting cases, some question whether the accounting profession is doing enough
3) **Financial reporting issues related to key performance measures:** (1) non-financial measurements, (2) forward-looking information, (3) soft assets, (4) timeliness
4) **Ethics in Accounting**
5) **International Convergence:** further convergence of accounting principles

Bovemij Crowe EY GrantThornton KPMG pwc

Usefulness of a conceptual framework and the objective of financial reporting

The conceptual framework: establishes the concepts that underlie financial reporting and enables the IASB to issue more useful and consistent pronouncements over time.

(1) builds on and relates to an established body of concepts and objectives, (2) provides a framework for solving new and emerging practical problems, (3) increases financial statement users' understanding of and confidence in financial reporting and (4) enhances comparability among companies' financial statement.

The conceptual framework

1th level: (Why?) Objective of financial reporting: provides financial information about the reporting entity that is useful to present and potential equity investors, lenders and other creditors.

2nd level: (Bridge) Qualitative characteristics of accounting information / Elements of financial statements

3rd level: (How?) Recognition, measurement and disclosure concepts

Qualitative characteristics of accounting information and the basic elements of financial statements

Decision-usefulness: is derived by:

1. Relevance: (1) predictive value (value as input for predictive processes), (2) confirmatory value (helps confirm or correct prior expectations), (3) Materiality (omitting it or misstating it could influence decisions)
2. Faithful representation: (1) free from error, (2) neutrality, (3) completeness

Enhancing qualities of useful information:

1. Comparability: information that is measured and reported in a similar manner
2. Verifiability: independent measurers, using the same methods, obtain similar results
3. Timeliness: having information available before it loses its capacity to influence decisions
4. Understandability: quality of information that lets reasonably informed users see its significance

Basic elements of financial statements: (1) assets, (2) liabilities, (3) equity, (4) income, (5) expenses.

The basic assumption of accounting

Five basic assumptions underlying financial accounting are:

1. Economic Entity (activity of a company can be kept separate and distinct from its owners)
2. Going Concern (company will have a long life)
3. Monetary Unit (company's common denominator is money)
4. Periodicity (the economic activities can be divided into artificial time periods)
5. Accrual basis (transactions are recorded in the periods in which events occur)

The application of the basic principles of accounting

1. Measurement principle (historical cost or fair value)
2. Revenue Recognition principle (recognize revenue when it satisfies a performance obligation)
3. Expense Recognition principle / Matching (recognize expenses when the service or product actually makes its contribution to revenue)
4. Full disclosure principle (provide information that is of sufficient importance to influence the judgment and decisions of an informed user)

Bovemij Crowe EY GrantThornton KPMG pwc

Basic accounting information system

An accounting information system: collects and processes transaction data and then disseminates the financial information to interested parties

Key accounting concepts: event / transaction / account / real and nominal accounts / ledger / journal / posting / trial balance / adjusting entries / financial statements / closing entries

Double-entry rules: For every debit, there must be a credit and vice versa. Debit (Dr) and Credit (Cr) mean left and right, respectively and describe where a company makes entries in the recording process. An account shows a debit balance if the total of the debit amounts exceeds the credits and shows a credit balance if the credit amounts exceed the debits.

- For asset and expense accounts, debiting the account means an increase and credit a decrease
- For liability, equity and revenue accounts, debiting the account means a decrease and crediting means an increase

↳ $Assets = Liabilities + Equity$

Basic steps: (1) identify and measure transactions and other events, (2) journalize, (3) post, (4) prepare an unadjusted trial balance, (5) make adjusting entries, (6) prepare an adjusted trial balance, (7) prepare financial statements, (8) close

Different Statements:

Income statement	***Retained Earnings Statement***	***Statement of Financial Position***
Revenues	*Beginning retained earnings*	*Assets*
- Expenses	*+ Net income*	*Liabilities*
Net income or loss	*- Dividends*	*Equity (share capital)*
	Ending retained earnings	*(retained earnings)*

Recording and summarizing basic transactions

Chronologically list transactions and events expressed in terms of debits and credits to particular accounts. Items entered in a general journal must be transferred to the general ledger. Prepare an unadjusted trial balance at the end of a given period.
Example as how the general journal and the general ledger are intertwined.

General Journal **J1**

Date	Account Titles and Explanation	Ref.	Debit	Credit
	Account Title Explanation	X		

Account Title **no. X**

Date	Explanation	Ref.	Debit	Credit

Bovemij Crowe EY GrantThornton KPMG pwc

	Explanation			

Explained:
J1: Journal entry nr 1
Date: of event / journal entry
Ref: reference number of journal entry in general ledger for a specific account

Transaction analysis: identify the type of account involved and determine whether to make a debit or a credit to the account

Trial Balance: a list of accounts and their balances at a given time (in order in which they appear in the ledger) - left debit accounts, on the right credit accounts.

Identifying and preparing adjusting entries
Adjusting entries: achieve a proper recognition of revenues and expenses.
Major types of adjusting entries: **deferrals** (prepaid expenses, unearned revenues) and **accruals** (accrued revenues, accrued expenses)

Deferrals
Deferrals: expenses or revenues that are recognized at a date later than the point when cash was originally exchanged.
1. **Prepaid expenses:** assets paid for and recorded before a company uses them
2. **Unearned revenues:** cash received before services are performed

Depreciation: process of allocating the cost of an asset to expense over its useful life in a rational and systematic manner

Contra asset account: offsets an asset account on the statement of financial position (for example accumulated depreciation) Its normal balance is a credit.

Book value / carrying value: difference between the cost of any depreciable asset and its related accumulated depreciation.

Accruals
Accruals: to record revenues for services performed and expenses incurred in the current accounting period. Accruals will increase both a statement of financial position and an income statement account.
1. **Accrued Revenues:** Revenues for services performed but not yet recorded, billed nor collected
2. **Accrued Expenses:** expenses incurred, but not yet paid or recorded

↳ Recognizing revenues as a firm sells goods/services (or delivers them) *independent* of the time when it receives cash

Bad debts: expense of the period in which a company records revenue for services performed instead of the period in which the company writes off the accounts or notes

Bovemij Crowe EY GrantThornton KPMG pwc

Preparing financial statements from the adjusted trial balance and prepare closing entries (p.3-21)

Adjusted Trial Balance: proves the equality of the total debit balances and the total credit balances in the ledger after all adjustments. Financial statements can be prepared directly from the adjusted trial balance.

The income statement is prepared from the revenue and expense accounts.

The retained earning statement is prepared from the retained earnings account, dividends and net income.

The statement of financial position is prepared from the asset, liability and equity accounts

The closing process reduces the balance of nominal accounts to zero in order to prepare the accounts for the next period's transactions.

Post-Closing Trial Balance: third trial balance after posting the closing entries to prove the equality of the permanent account balances that the company carries forward into the next accounting period.

Reversing entries: reverse certain adjusting entries at the beginning of the next accounting period. (not required in the accounting cycle)

Summarizing the Accounting Cycle:

1. Enter the transactions of the period in appropriate journals
2. Post from the journals to the ledger
3. Prepare an unadjusted trial balance
4. Prepare adjusting journal entries and post to the ledger
5. Prepare a trial balance after adjusting
6. Prepare the financial statements from the adjusted trial balance
7. Prepare closing journal entries and post to the ledger
8. Prepare a trial balance after closing
9. Prepare reversing entries (optional) and post to the ledger

Preparing financial statements for a merchandising company

The financial statements for a merchandiser differ from those for a service company, as a merchandiser must account for gross profit on sales. The accounting cycle, however, is performed the same.

Bovemij Crowe EY GrantThornton KPMG pwc

Uses and limitations of an income statement

The incomes statement: (statement of income, statement of earnings) measures the success of company operations for a given period of time. Provides with information that helps predict the *amounts, timing and uncertainty* of future cash flows.

Uses of the income statement: (1) Provides with information that helps predict the amounts timing and uncertainty of future cash flows. (2) Helps users determine the risk (level of uncertainty) of not achieving particular cash flows. (3) Evaluates past performance.

Limitations of the income statement: (1) Does not include many items that contribute to general growth and well-being of a company. (2) Income numbers are often affected by the accounting methods used. (3) Income measures are subject to estimates.

Quality of earnings: affected by earnings management if it distorts the information in a way that is less useful for predicting future earnings and cash flows.

Content and format of the income statement

The transaction approach: a method of income measurement, focuses on the income-related activities that have occurred during a given period.

Content of the income statement:

1. Sales / revenue
2. Cost of goods sold
3. Selling expenses
4. Administrative / general expenses
5. Other income and expense
6. Financing costs
7. Income tax
8. Discontinued operations
9. Non-controlling interest
10. Earnings per share

Income statement format
1. Sales or Revenue
2. Cost of Goods Sold
Gross Profit
3. Selling Expenses
4. Administrative or General Expenses
5. Other Income and Expense
Income from Operations
6. Financing costs
Income before Income Tax
7. Income Tax
Income from Continuing Operations
8. Discontinued Operations
Net Income
9. Non-Controlling Interest
10. Earnings Per Share

Illustration 4.1 **Income statement format**

Condensed income statements include only totals of components in the statement of income

Net income: revenues - expenses (but also classify various revenues and expenses in order to report useful subtotals within the income statement such as gross profit, income from operations, income before income tax and net income)

↳ $Net\ income = revenue - expenses$

Earnings per share: $\frac{(Net\ income - Preference\ Dividends)}{Weighted\ average\ of\ ordinary\ shares\ outstanding}$

Expenses: are classified by nature or by function

Unusual and non-recurring items: reported in income from operations

Financing costs: separate from operating revenues and expenses

Bovemij Crowe EY GrantThornton KPMG pwc

Discontinued operations: a component of an entity that either has been disposed of, or is classified as held for-sale and: (1) represents a major line of business or geographical area of operations, or (2) is part of a single, coordinated plan to dispose of a major line of business or geographical area of operations, or (3) is a subsidiary acquired exclusively with a view to resell.

Non-controlling interest: the portion of equity interest in a subsidiary not attributable to the parent company.

Tax expense: related to specific items on the income statement (intraperiod tax allocation)

Intraperiod tax allocation: relates the income tax expense for the fiscal period to income from continuing operations and discontinued operations

Calculating net income:
Income before income tax
<u>- Income Tax</u>
Income from continuing operations
+ Gain on discontinued operations
<u>- Applicable income tax</u>
Net income

<u>Reporting accounting changes and errors</u>
Changes and corrections of errors are adjusted to retained earnings.
Changes in accounting principle: recognized by making a retrospective adjustment to the financial statements.

- *Example: changing inventory pricing from FIFO to average-cost.*

Changes in Accounting Estimates:

- *Example: changing residual value or useful live of depreciable assets*

Correction of errors are treated as prior period adjustments. Correction take place in the year in which it is discovered

<u>Related equity statements</u>
The retained earnings statement: discloses net income, dividends, adjustments due to changes in accounting principles, error corrections, and restrictions of retained earnings.

Comprehensive income statement: all changes in equity during a period, except those resulting from investments by owners and distributions to owners. (These are other comprehensive income)

Comprehensive income = net income + other comprehensive income
Comprehensive income = income – expenses + other comprehensive income

Statement of changes in equity: includes (1) accumulated other comprehensive income, (2) contributions and distributions to owners (3) reconciliation

Bovemij Crowe EY GrantThornton KPMG pwc

CH5: Statement of Financial position and Statement of Cash Flows

Uses, Limitations, and content of the statement of financial position

The statement of financial position (balance sheet)

Uses: provides information about the nature and amounts of investments in a company's resources, obligations and equity.

Contributions to financial reporting: (1) computing rates of return, (2) evaluating the capital structure of the enterprise, (3) assessing the liquidity, solvency and financial flexibility of the enterprise

Limitations: (1) generally does not reflect fair value due to the use of historical costs, (2) companies must use judgements and estimates to determine certain amounts, (3) omits many items that are of financial value to the business but cannot be recorded objectively

Classification of items: companies should report separately: (1) assets and liabilities with different general liquidity characteristics, (2) assets that differ in their expected function, (3) liabilities that differ in their amounts, nature and timing.

General elements:

(1) Assets: resource controlled by the entity as a result of past events, from which future economic benefits are expected to flow to the entity

a. Non-current assets: (long-term investments, property, plant, and equipment, intangible assets)
b. Long-term assets
c. Intangible assets
d. Other assets
e. Current assets: cash and other assets a company expects to convert into cash, sell, or consume either in one year or in the operating cycle, whichever is longer (inventories, receivables, prepaid expenses, short-term investments, cash)

(2) Equity: residual interest in the assets of the entity after deducting all its liabilities (share capital, share premium, retained earnings)

(3) Liabilities: present obligation of the entity arising from past events in which an outflow of resources is expected for the company (non-current and current liabilities)

Preparing a classified statement of financial position

The statement of financial position:

Assets | **Equity and Liabilities**

Non-current assets | Equity

Current assets

Non-current Liabilities

Current liabilities

Or:

(EU format)

Assets

Non current assets

Assets	Equity and liabilities
Non-current assets	Equity – Share capital – Share premium – Retained earnings – Accumulated other comprehensive income – Non-controlling interest
	Non-current liabilities
Current assets	Current liabilities

Bovemij Crowe EY Grant Thornton KPMG pwc

Current assets
Equity
Equity
Liabilities
Non-current liabilities
Current liabilities

Explaining the purpose, content, and preparation of the statement of cash flows

The statement of cash flows: detailed summary of all of the cash inflows and outflows, or the sources and uses of cash during the period. Shows where the cash comes from, what is was used for, and the change in the cash balance.

Purpose: provide relevant information about a company's cash receipts and cash payments during a period for creditors and investors.

Content: classifying the period's cash receipts and cash payments into three different activities:
1. Operating activities: cash effects of transactions that determine net income
2. Investing activities: making and collecting loans, acquiring and disposing investments
3. Financing activities: liability and equity items (capital from owners and providing them with a return on investment and borrowing money from creditors and repaying the amounts borrowed)

Preparate the statement of cash flows: use the comparative statements of financial position, the current income statement and selected transaction data. After, determine:
1. The net cash provided by operating activities
2. The net cash provided by investing and financing activities
3. The change in cash during the period
4. Reconcile the change in cash with the beginning and ending cash balance

Noncash activities: not all of a company's significant activities involve cash, for example:
- Issuance of ordinary shares to purchase assets
- Conversion of bonds into ordinary shares
- Issuance of debt to purchase assets
- Exchanges of long-lived assets

Describing additional types of information provided

Additional reporting in the notes:
1. Accounting policies (principles, bases, conventions, rules and practices applied)
2. Expanded disclosures and detailed schedules related to items

Two methods to disclose pertinent information:
1. Parenthetical explanations (additional information or description of the item)
2. Cross-reference and contra items (direct relationship between an asset and a liability on the statement of financial position)

Other guidelines
1. Offsetting (assets / liabilities, income / expense are reported separately)

Bovemij Crowe EY GrantThornton KPMG pwc

2. Consistency (for comparability)
3. Fair Presentation

Statement of cash flows
– Cash flows from operating activities
– Cash flows from investing activities
– Cash flows from financing activities
Net change in cash and cash equivalents = net increase or decrease in cash

Shown at the Cash Flows Statement

Cash at the begining of the year
Cash at the end of the year

Shown at the Balance Sheet

CH7: Cash and Receivables

Reporting Cash and Related Items

Cash: an asset readily available for the payment of current obligations and free from contractual restrictions that limit its use in satisfying debts.

- Examples; coins / currency / available funds on deposits at the bank / money orders / certified checks / cashier's checks / personal checks / bank drafts / savings accounts

Related Items:

1. Restricted cash (compensating balances against short-term borrowing among the cash and cash equivalents items)
2. Bank overdrafts (current liabilities - accounts payable)
3. Cash equivalents (cash and cash equivalents)

Receivables and accounting issues related to their recognition

Receivables: Claims held against customers and others for money, goods, or services. Ideally they are measured by their present value.

Receivables are classified into three types:

1. Current or non-current (short or long-term)
2. Trade or non-trade
3. Accounts receivable or notes receivable

Accounting issues related to their recognition:

1. Availability of discounts (trade discounts / cash discounts)
2. Length of time between the sale and the payment due dates (interest element)

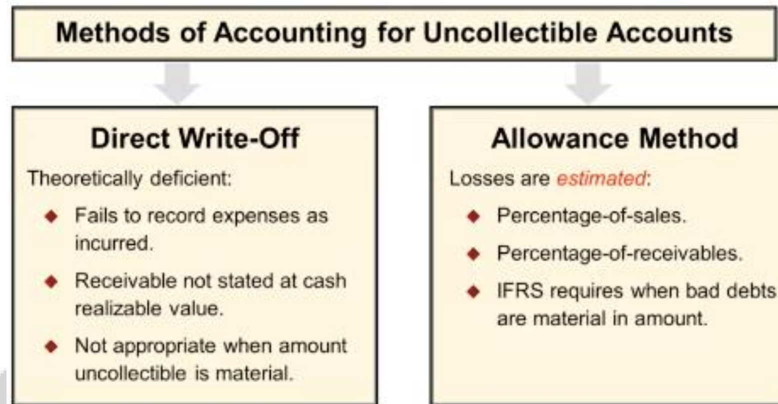
Accounts receivable; oral promises of the purchaser to pay for the goods/services sold
Notes receivable; written promises to pay a certain sum of money on a specified future date
Companies classify receivables as either current (short-term) or non-current (long-term). Companies expect to collect current receivables within a year or during the current operating cycle, whichever is longer. They classify all other receivables as non-current.

Transaction price: amount of consideration that a company expects to receive from a customer in exchange for transferring goods or services.

Bovemij Crowe EY GrantThornton KPMG pwc

Accounting issues related to valuation of accounts receivable

Companies value and report short-term receivables at cash realizable value (the net amount expected to be received in cash), which is not necessarily the amount legally receivable (due to estimating uncollectible receivables)



Direct-write off method for uncollectible accounts: charge the loss to bad debt expense (bad debt expense only shows actual losses from uncollectibles)

Dr Bad Debt expense
Cr Accounts Receivable

> Example;
>
> When a company determines a particular account to be uncollectible, it charges to loss to Bad Debt Expense
>
> On December 10th Cruz Ltd. Writes off as uncollectible Yusado's $8,000,000 balance;
>
> | | Dr | Cr |
> |---|---|---|
> | Bad Debt Expense (E) | 8,000,000 | |
> | Accounts Receivable (A) | | 8,000,000 |

However, the direct write-off method is not considered appropriate, except when the amount uncollectible is immaterial.

Allowance method for uncollectible accounts: estimate uncollectible accounts at the end of each period, debit estimated increases in uncollectibles to Bad Debt Expense and credit them to Allowance for Doubtful Accounts through an adjusting entry at the end of each period

Dr Bad Debt Expense
Cr Allowance for Doubtful Accounts

> Example;
>
> Assume that Brown Furniture in 2022, its first year of operations, has credit sales of £1,800,000. Of this amount £150,000 remains uncollected at December 31th. The credit manager estimates that £10,000 of these sales will be uncollectible. The adjusting entry to record the estimated uncollectibles (assuming a zero balance in the allowance account) is;
>
> | | Dr | Cr |
> |---|---|---|
> | Bad Debt Expense (E) | 10,000 | |
> | Allowance for Doubtful Accounts (CA) | | 10,000 |

Bovemij Crowe EY GrantThornton KPMG pwc

Accounting issues related to recognition and valuation of notes receivable

Short-term notes are recorded at face value, long-term notes at present value of the cash they expect to collect. When the stated rate differs from the effective rate, a company records the receivable net of the discount or premium

Note receivable: supported by a formal promissory note (a written promise to pay a certain sum of money at a specific future date) They are usually classified as interest-bearing or non-interest bearing notes.

Basic issues:

1. Recognition: at the present value of the cash expected to be collected
2. Valuation
3. Derecognition

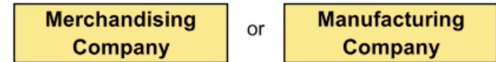
Face Value = Present Value + interest (if stated rates and the market rate are the same)
PV = FV * [1 + (1+i)^n]

Accounting issues related to accounts and notes receivables

Derecognition of receivables: transferring receivables to another company for cash to accelerate the receipt of cash from receivables by (1) Sales of receivables, and (2) Secured Borrowing

Reporting and analysis: Companies should report receivables with appropriate offset of valuation accounts against receivables, classify the receivables and disclose the credit risk inherent in the receivables

Bovemij Crowe EY GrantThornton KPMG pwc



Inventory classifications and inventory systems

Merchandiser: has one inventory account (inventory)

Manufacturer: three inventory accounts: raw materials, work in process and finished goods. (COGS = Cost of goods manufactured = Raw materials + labor + overhead)

Merchandising Company

Carrefour
Statement of Financial Position (Balance Sheet)

Current assets (in millions)	
Inventories	€ 3,168
Trade receivables	4,856
Contract assets	1,875
Prepaid expenses and accrued income	1,024
Current income tax assets	227
Other financial assets	243
Current financial assets	612
Cash and cash equivalents	6,261
Total current assets	€18,266

Manufacturing Company

Nissan
Statement of Financial Position (Balance Sheet)
March 31, 2019

Current assets (in millions)	
Cash on hand and in banks	¥ 1,219,588
Trade notes and accounts receivable	512,164
Sales finance receivables	7,665,603
Securities	139,470
Merchandise and finished goods	827,289
Work in process	64,386
Raw materials and supplies	366,248
Other	945,449
Allowance for doubtful accounts	(127,092)
Total current assets	¥11,613,105

Perpetual inventory system: maintains a continuous record of inventory changes in the inventory account. (Report changes when they occur)

Periodic inventory system: determine the quantity of inventory only periodically. (Debit purchases account, but COGS = cost of goods available for sale - ending inventory)

Modified perpetual inventory system: provides detailed inventory records of increases and decreases in quantities only (not currency amounts)

Perpetual Inventory System			Periodic Inventory System		
Beginning inventory, 100 units at $6					
The inventory account shows the inventory on hand at $600.			The inventory account shows the inventory on hand at $600.		
Purchase 900 units at $6					
Inventory	5,400		Purchases	5,400	
Accounts Payable		5,400	Accounts Payable		5,400
Sale of 600 units at $12					
Accounts Receivable	7,200		Accounts Receivable	7,200	
Sales Revenue		7,200	Sales Revenue		7,200
Cost of Goods Sold (600 at $6)	3,600		(No entry)		
Inventory		3,600			
End-of-period entries for inventory accounts, 400 units at $6					
No entry necessary.			Inventory (ending, by count)	2,400	
The Inventory account shows the ending balance of $2,400 ($600 + $5,400 − $3,600).			Cost of Goods Sold	3,600	
			Purchases		5,400
			Inventory (beginning)		600

The entries marked in red indicates where the methods differ from each other.

Bovemij Crowe EY GrantThornton KPMG pwc

Goods and cost included in inventory

Recording purchases of inventory: are done when companies obtain legal title to the goods. When this passes, depends on the Shipping terms.

Consigned goods: goods are left in the possession of a third party to sell

Special sales agreements: Sales with repurchase agreement / sales with high return rates

Product costs: costs attached to the inventory (recorded in the inventory account): (1) cost of purchase, (2) cost of conversion, (3) other costs

Period costs: indirectly related to the acquisition or production of goods (selling expense, general and administrative expenses)

Gross versus net Method for Purchase discounts:

Gross Method			Net Method		
Purchase cost $10,000, terms 2/10, net 30					
Purchases	10,000		Purchases	9,800	
Accounts Payable		10,000	Accounts Payable		9,800
Invoices of $4,000 are paid within discount period					
Accounts Payable	4,000		Accounts Payable	3,920	
Purchase Discounts		80	Cash		3,920
Cash		3,920			
Invoices of $6,000 are paid after discount period					
Accounts Payable	6,000		Accounts Payable	5,880	
Cash		6,000	Purchase Discounts Lost	120	
			Cash		6,000

Cost flow assumptions used to account for inventories

Specific identification: only in situations when inventory turnover is low, unit price is high or inventory quantities are small

Example (Specific Identification);

Call-Mart Inc's 6,000 units of inventory consists of;

- 1,000 units from the March 2 purchase (€4.00)
- 3,000 units from the March 15 purchase (€4.40)
- 2,000 units from the March 30 purchase (€4.75)

Date	No. of Units	Unit Cost	Total Cost
March 2	1,000	€4.00	€ 4,000
March 15	3,000	4.40	13,200
March 30	2,000	4.75	9,500
Ending inventory	6,000		€26,700

Cost of goods available for sale (computed in previous section)	€43,900
Deduct: Ending inventory	26,700
Cost of goods sold	€17,200

Bovemij Crowe EY GrantThornton KPMG pwc

Average cost-prices items: price items on the basis of the average cost of all similar goods available during the period

Example (Weighted-Average Method);

Date of Invoice	No. Units	Unit Cost	Total Cost
March 2	2,000	€4.00	€ 8,000
March 15	6,000	4.40	26,400
March 30	2,000	4.75	9,500
Total goods available	10,000		€43,900

Weighted-average cost per unit $\frac{€43,900}{10,000} = €4.39$

Inventory in units 6,000 units

Ending inventory 6,000 × €4.39 = €26,340

Cost of goods available for sale	€43,900
Deduct: Ending inventory	26,340
Cost of goods sold	€17,560

First-in-first-out: use goods in the order in which they are purchased.

Example (FIFO - Periodic Inventory System);

Date	No. Units	Unit Cost	Total Cost
March 30	2,000	€4.75	€ 9,500
March 15	4,000	4.40	17,600
Ending inventory	6,000		€27,100

Cost of goods available for sale	€43,900
Deduct: Ending inventory	27,100
Cost of goods sold	€16,800

Last-in-First-out: matches the cost of the last goods purchased against the revenue

<u>Effects of inventory errors on the financial statements</u>

Misstating ending inventory:

1. In the statement of financial position, the inventory and retained earnings will be misstated (so, miscalculation of the working capital and current ratio)
2. In the income statement, the cogs and net income will be misstated

Misstating purchases:

Bovemij Crowe EY GrantThornton KPMG pwc

1. Statement of financial position, the inventory and accounts payable will be misstated (so, miscalculation of the current ratio)
2. In the income statement, purchases and ending inventory will be misstated

CH10: Acquisition and Disposition of property, plant and equipment

Property, Plant, and equipment and its related costs

Property, land and equipment *are mostly valued by using historical cost and are recognized when the cost of the asset can be measured reliably and it is probable that the company will obtain future economic benefits.*

Property, land and equipment:

1. *Are acquired for use in operations (and not for resale)*
2. *Are long-term in nature and usually subject to depreciation*
3. *Possess physical substance.*

Includes:

- Land,
- Building structures (offices, factories, warehouses), and
- Equipment (machinery, furniture, tools).

Cost of Land: all expenditures made to acquire land and to ready it for use. Costs include:

(1) The purchase price
(2) Closing costs (title to the land, attorney's fees, recording fees
(3) Cost incurred in getting the land in condition for its intended use (grading, filling, draining, clearing
(4) Assumption of any liens, mortgages or encumbrances on the property
(5) Any additional land improvements that have an indefinite live

If a company purchases land with an old building on it, then the cost of demolition less its residual value is a cost of getting the land ready for its intended use and relates to the land rather than to the new building

Cost of buildings: all expenditures related directly to their acquisition or construction

(1) Materials, labor, overhead costs incurred during construction
(2) Professional fees and building permits

Cost of equipment: purchase price, freight and handling charges incurred, insurance on the equipment while in transit, cost of special foundations, assembling and installation costs, cost of conducting trial runs

Self-constructed assets: indirect costs of manufacturing create special problems because companies cannot easily trace these costs directly to work and material orders related to the constructed assets. Handle these costs by:

(1) Assigning no fixed overhead to the cost of the constructed asset
(2) Assigning a portion of all overhead to the construction process.

The accounting problems associated with interest capitalization

Three approaches to account for interest:

(1) Capitalize no interest charges during construction
(2) Charge construction with all costs of funds employed (identifiable or not)

Bovemij Crowe EY GrantThornton KPMG pwc

(3) Capitalize only the actual interest costs during construction

To implement the interest capitalization approach, companies should consider:
(1) Qualifying assets (assets must require a substantial period of time to get them ready for their intended use or sale)
(2) Capitalization period (period of time during which a company must capitalize interest, this period of time continues as long as (1) expenditures for the asset are being incurred, (2) activities that are necessary to get the asset ready are in progress, and (3) interest cost is being incurred).
(3) Amount to capitalize (is limited to the lower of actual interest cost incurred during the period or avoidable interest)

Avoidable interest: amount of interest cost during the period that a company could theoretically avoid if it had not made expenditures for the asset

Amount to capitalize: use the weighted-average accumulated expenditures (weight the construction expenditures by the amount of time)

$Capitalization\ rate: \frac{Total\ Interest}{Total\ Principal}$

$Weighted - Average\ Accumulated\ Expenditures\ = Expenditures * Current - Year\ Capitalization\ Period$

$Avoidable\ Interest\ = Weighted - Average\ Accumulated\ Expenditures * Interest\ Rate$

Accounting issues related to acquiring and valuing plant assets

The following issues relate to acquiring and valuing plant assets:
(1) **Cash discounts** (reduction in the cost of the asset)
(2) **Deferred-payment contracts** (account for assets purchased on long-term credit contracts at PV of the consideration exchanged between the contracting parties at the date of construction)
(3) **Lump-sum purchase** (Allocate the total cost among the various assets on the basis of their relative FV)
(4) **Issuance of shares** (if shares are actively traded: market price of the shares issued is a fair indication of the cost of the property acquired. If the market price of the ordinary shares exchanged is not determinable, establish the FV of the property and use this as basis for recording the asset and issuance of the ordinary shares)
(5) **Exchanges of non-monetary assets** (depends on whether the exchange has commercial substance, if it has: recognize gains and losses immediately, if it has not, defer gains and losses
(6) **Grants** (Record at FV of the asset received, and credit deferred revenue or the appropriate asset in most cases)

The accounting treatment for costs subsequent to acquisition

Types of expenditures:

Additions: companies capitalize any addition to plant assets because a new asset is created.

Improvements / Replacement: remove cost of and accumulated depreciation on old asset, recognize any gains / loss. Capitalize cost of improvement / replacement.

Rearrangement / Reorganization: expense costs as expense

Bovemij Crowe EY GrantThornton KPMG pwc

Repairs: (a) ordinary: expense cost of repairs when incurred. (b) Major: remove cost and accumulated depreciation of old asset, recognize any gain or loss. Capitalize cost of major repair.

The accounting treatment for the disposal of property, plant, and equipment

Take depreciation up to the date of disposition and remove all accounts related to the retired asset. Gains or losses on the retirement of plant assets are shown in the income statement along with other items that arise from customary business activities.

Involuntary conversion: fire, flood, theft, or condemnation: report difference between amount recovered and the asset's book value as a gain or loss.

CH11: Depreciation, Impairments, and Depletion

Depreciation concepts and methods of depreciation

Depreciation: allocates the cost of tangible assets to expense in a systematic and rational manner to those periods expected to benefit from the use of the asset. Here, important factors are:

(1) Determining the depreciable base for the asset (Original cost - residual value)
(2) Estimating service lives (= not physical life!)
(3) Selecting a method of cost apportionment (depreciation)

Original cost	€10,000
Less: Residual value	1,000
Depreciation base	€ 9,000

Methods of depreciation:

(1) Activity method: depreciation as function of use (life of the asset in the output or input it provides)

$$Depreciation\ Charge = \frac{Depreciable\ base * Hours\ used\ this\ year}{Total\ Estimated\ Hours}$$

(2) Straight-line method: depreciation as function of time $Depreciation\ Charge = \frac{Depreciable\ base}{Estimated\ service\ life}$

(3) Decreasing-charge method: higher depreciation cost in the earlier years (asset is most productive in early years)

Example;

Cost of crane	$500,000
Estimated useful life	5 years
Estimated salvage value	$ 50,000
Productive life in hours	30,000 hours

Activity method; $\frac{(\$500{,}000 - \$50{,}000) \times 4{,}000}{30{,}000} = \$60{,}000$

Straight-line method; $\frac{\$500{,}000 - \$50{,}000}{5} = \$90{,}000$

Other depreciation issues

IFRS Requirements for other depreciation issues are:

Bovemij Crowe EY GrantThornton KPMG pwc

(1) Component depreciation: each component that is significant to the total cost of the asset must be depreciated separately.
(2) Partial Periods: in computing depreciation expense for partial periods, companies must determine depreciation expense for the full year and then prorate between the periods.
(3) Replacement of property, plant and equipment: depreciation does not provide funds for replacement (it's a non-cash expense)
(4) Revision of depreciation rates: companies report a change in estimate in the current and prospective period. It does not adjust opening balances nor attempt to "catch up" for prior periods.

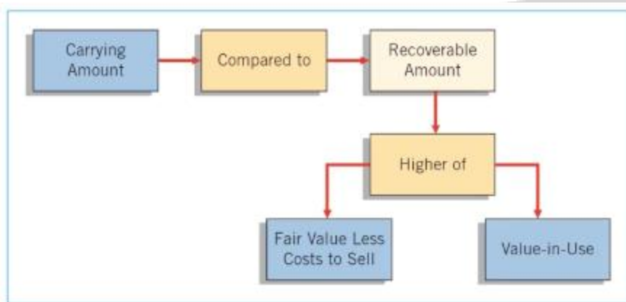
Bovemij Crowe EY GrantThornton KPMG pwc

Accounting issues related to asset impairment

The process of asset impairment:

(1) Review events and changes in circumstances for indicators of impairment
(2) If impairment indicators are present, an impairment test must be conducted

The impairment test: compares the asset's recoverable amount (the higher of FV - cost to sell or value-in-use) with its carrying amount. If the carrying amount is higher, the difference is an impairment loss, if the recoverable amount is higher, no impairment is recorded.



Recording an impairment loss: if a loss is recorded, the reduced carrying amount of the long-lived asset is its new cost basis. Impairment losses may be reversed as long as the write-up is never to an amount greater than the carrying amount before impairment

Assets held for disposal: are not depreciated.

Accounting procedures for depletion of mineral resources

Depletion: the reduction in the cost of mineral resources: a function of the number of units withdrawn during the period. (Total cost - residual value)/number of units estimated

To account for depletion of mineral resources:

(1) Establish the depletion base
(2) Write off resource cost

Three types of cost are considered in establishing the depletion base:

(a) Pre-exploratory costs (write off with units-of-production method)
(b) Exploration and evaluation costs
(c) Development costs (tangible equipment costs and intangible development costs)

$Depletion\ cost\ per\ unit: \frac{Total\ Cost - Residual\ Value}{Total\ Estimated\ Units\ Available}$

Accounting for revaluations

Long-lived asset: value at cost or at FV

At fair value: there is accounted for the change in the FV by adjusting the appropriate asset account and by recording an unrealized gain on the revalued long-lived tangible asset, which is recorded in other comprehensive income

Reporting and analyzing property, plant, equipment, and mineral resources

$Asset\ Turnover: \frac{Net\ Sales}{Average\ Total\ Assets}$

Bovemij Crowe EY GrantThornton KPMG pwc

$Profit\ Margin\ on\ Sales: \frac{Net\ income}{Net\ Sales}$

$Return\ on\ Assets\ = Profit\ Margin\ on\ Sales * Asset\ Turnover\ = \frac{Net\ Income}{Average\ Total\ Assets}$

CH12: Intangible Assets

Characteristics, Valuation and amortization of intangible assets

Characteristics of intangible assets:

(1) They are identifiable
(2) They lack physical existence
(3) They are not monetary assets

Valuation of intangible assets: Intangibles are recorded at cost. (all acquisition costs and expenditures needed to make the intangible asset ready for its intended use)

(1) Acquired in exchange for shares or other assets: cost is the FV of the consideration given or of the intangible received.
(2) "Basket purchase": allocate the cost on the basis of relative FV

Amortization of intangible assets: Intangibles have either a limited useful life or an indefinite useful live. Only limited-life intangibles are amortized. Amortize by systematic charges to expense over their useful life (in which they contribute to cash flows)

Impairment test: compare recoverable amount to carrying value

Accounting for various types of intangible assets

Types of intangible assets:

(1) Marketing-related intangibles (trademark or trade name)
(2) Customer-related intangibles (result from interactions with outside parties)
(3) Artistic-related intangibles (copyright)
(4) Contract-related intangibles (franchise, licenses, permits)
(5) Technology-related intangibles (product or process patents)
(6) Goodwill

Accounting issues for recording goodwill

Goodwill: arises from business combinations, is a 'going concern' valuation and is recorded only when an entire business is purchased. (Goodwill generated internally should not be capitalized). The future benefits of goodwill may have no relationship to the costs incurred in the development of that goodwill. Goodwill may exist even in the absence of specific costs to develop it.

Recording goodwill: compare the FV of the net tangible and identifiable intangible assets with the purchase price of the acquired business. The difference is considered goodwill.

$Goodwill\ = FV\ of\ the\ net\ tangible\ and\ identifiable\ intangible\ assets\ -\ their\ purchase\ price$

Impairment procedures and presentation requirements for intangible assets

Impairment procedures:

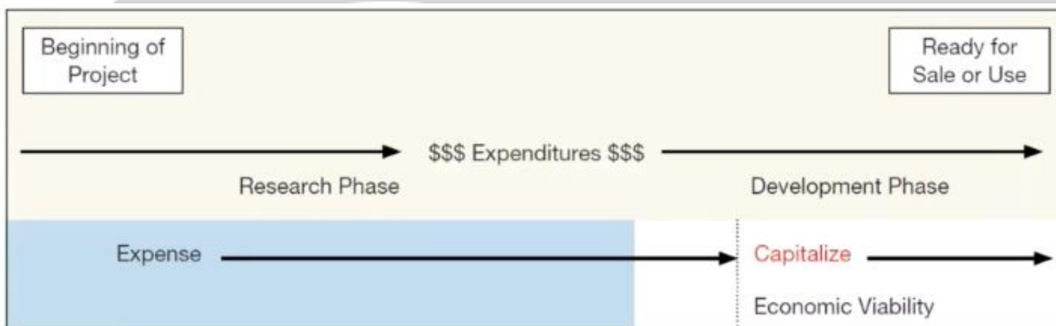
(1) Impair when a company is not able to recover the asset's carrying amount either through using it or by selling it.
(2) Limited life intangibles are reviewed annually (if there are impairment indicators, an impairment test is performed)

Bovemij Crowe EY GrantThornton KPMG pwc

(3) Indefinite-life intangibles, including goodwill, must be tested for impairment every year
(4) An impairment loss is recorded in net income if the recoverable amount of an intangible asset < its carrying value

Presentation requirements:
(1) Report all intangible assets other than goodwill as a separate item
(2) Contra accounts are not normally shown
(3) If goodwill is present, it should be reported as a separate item
(4) On the income statement, companies should report amortization expense and impairment losses in operating income

<u>Accounting and presentation for research and development and similar costs</u>
R&D costs: are not intangible assets, but R&D activities frequently result in the development of something a company patents or copyrights



Difficulties in accounting for R&D expenditures:
(1) Identifying the costs associated with particular activities, projects, or achievements
(2) Determining the magnitude of the future benefits and length of time over which a company may realize such benefits
R&D costs are expensed as incurred.

Accounting for R&D Activities
(1) Materials, equipment and facilities (expense entire costs, unless the items have alternative future uses)
(2) Personnel (expense as incurred salaries, wages and other related costs)
(3) Purchased intangibles (recognise and measure at FV)
(4) Contract services (expense the costs of services as incurred)
(5) Indirect costs (include a reasonable allocation of indirect costs, except for general and administrative costs)
Costs similar to R&D costs

Bovemij Crowe EY Grant Thornton KPMG pwc

1. Start-up costs for a new operation
2. Initial operating losses
3. Advertising costs

Bovemij Crowe EY GrantThornton KPMG pwc

The nature, valuation and reporting of current liabilities

Current liabilities: a present obligation, arises from past events which results in an outflow of resources. A current liability is generally reported if:
(1) The liability is expected to be settled within its normal operating cycle, and / or
(2) The liability is expected to be settled within 12 months after the reporting date.

Typical current liabilities:
1. Accounts payable
2. Notes payable
3. Current maturities of long-term debt
4. Short-term obligations expected to be refinanced
5. Dividends payable
6. Customer advances and deposits
7. Unearned revenues
8. Sales and value-added taxes payable
9. Income taxes payable
10. Employee-related liabilities

Liabilities: should be measured b the PV of the future outlay of cash required to liquidate them (usually their full maturity value)

Short-term debt expected to be refinanced: a short-term obligation is excluded from current liabilities if both of the following conditions are met:
(1) The company must intend to refinance the obligation on a long-term basis
(2) It must have an unconditional right to defer settlement of the liability for at least 12 months after reporting date

Employee-related liabilities: (Covered in Salaries and Wages expense)
(1) Payroll deductions
(2) Compensated absences
(3) Bonus agreements

Accounting for different types of provisions

Provisions: liability of uncertain timing or amount. May be reported either as current or non-current depending on the date of expected payment. Common types are:
(1) Litigation obligations (lawsuits)
(2) Warranty obligations (product guarantee)
(3) Consideration payable
(4) Environmental obligations
(5) Onerous obligations (contracts in which the unavoidable costs of meeting the obligations exceed the economic benefits expected to be received)
(6) Restructuring obligations

Expenses are accrued if:
(1) A company has a present obligation 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
(3) A reliable estimate can be made of the amount of the obligation
If any of these conditions is not met, no provision is recognized

Bovemij Crowe EY GrantThornton KPMG pwc

Accounting for loss and gain contingencies

Contingent: not recognized in financial statements due to uncertainty in timing or amount

Contingent liabilities: are not recognized in the financial statements because they are a possible obligation or they are present obligations but it is not probable that payment will be necessary or a reliable estimate of the obligations can not be made.

Contingent assets: are not recognized on the statement of financial position. If realization of the contingent asset is virtually certain, it is no longer considered a contingent asset and is recognized as an asset. (Probability >90%)

Present and analyze liability-related information

Current liabilities: usually recorded and reported in financial statements at full maturity value and presented after non-current liabilities in the statement of financial position.

Current ratio: $\frac{Current\ Assets}{Current\ Liabilities}$

Acid-test ratio: $\frac{Cash + Short\ Term\ investments + Net\ receivables}{current\ liabilities}$

Bovemij Crowe EY GrantThornton KPMG pwc

Nature of bonds and accounting for bond issuances

Incurring long term debt: usually require approval by the board of directors and the shareholders before bonds can be issued or long-term debt arrangements can be made

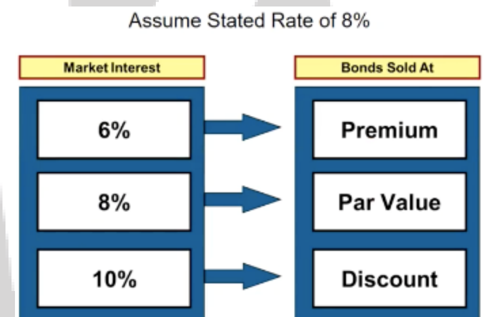
Bond issues:

(1) Secured and unsecured bonds
(2) Term, serial, callable bonds
(3) Convertible, commodity-backed, deep-discount bonds
(4) Registered and bearer (coupon) bonds
(5) Income and revenue bonds

Issuing bonds: a bond arises from a bond indenture (a contract) and 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 (FV)

Valuing a bond: based on the PV of its future cash flows (interest + principal)

- Interest rate: provides an acceptable return on an investment commensurate with the risk characteristics. (stated, coupon or nominal rate)
- The issuer of the bonds sets the rate and expresses it as a percentage of the Face (or par) Value
- The PV can differ from the FV if the rate employed by the buyers differs from the stated rate. (This is the discount if sold for < FV or the premium if sold >FV)



The discount (premium): is amortized and charged (credited) to interest expense over the life of the bonds using the **effective-interest method**:

(1) Bond interest expense is computed by multiplying the carrying value of the bonds at the beginning of the period by the effective interest rate, then
(2) The bond discount or premium amortization is determined by comparing the bond interest expense with the interest to be paid.

$$Amortization\ amount = Bond\ interest\ expense - Bond\ interest\ paid$$
$$Bond\ interest\ Expense = Carrying\ Value\ of\ Bonds\ at\ Beginning\ of\ Period * Effective\ interest\ rate$$
$$Bond\ Interest\ Paid = Face\ Amount\ of\ Bonds * Stated\ Interest\ Rate$$

Accounting for long-term notes payable

Accounting procedures for notes and bonds are similar.

Long-term notes: valued at PV of its expected future interest and principal cash flows, with any discount or premium being similarly amortized over the life of the note.

Notes Issued for Property, Goods or Services: interest rate is fair, unless:

(1) No interest rate is stated

Bovemij Crowe EY GrantThornton KPMG pwc

(2) The stated interest rate is unreasonable
(3) The stated face amount of the debt instrument is materially different from the current cash sales price for the same or similar items or from the current fair value of the debt instrument

Accounting for the extinguishment of non-current liabilities

Extinguish by:

(1) Paying cash
(2) Transferring non-cash assets and / or granting of an equity interest
(3) Modification of terms.

At the time of extinguishment, any unamortized premium or discount must be amortized up to the reacquisition date.

Reacquisition price: amount paid on extinguishment or redemption before maturity, including any call premium and expense of reacquisition

Loss from extinguishment: excess of the reacquisition price over the carrying amount

Gain from extinguishment: excess of the carrying amount over the reacquisition price.
Gains and Losses are recognized currently in income.

Present and analyze non-current liabilities:

Fair Value option: Companies have the option to record fair value in their accounts for most financial assets and liabilities. → provides more relevant and understandable information than amortized cost. Non-current liabilities are recorded at fair value, with unrealized holding gains or losses reported as part of net income.

Unrealized holding gain or loss: net change in the FV of the liability from one period to another, exclusive of interest expense recognized but not recorded.

Off-balance-sheet financing arrangements: attempt to borrow funds in such a way as to prevent recording obligations, such as: (1) non-consolidated subsidiaries and (2) special purpose entities.

Presentation: companies that have large amounts and numerous issues of non-current liabilities frequently report only one amount in the statement of financial position and support this with comments and schedules in the accompanying notes.
If a debt is refinanced, converted into shares or retired from a bond retirement fund, it should continue to report it as non-current, as long as the refinancing is completed by the end of the period.

Analysis:

Debt to assets = Total Liabilities / Total Assets
Times interest earned: (Net income + Interest Expense + Income Tax Expense) / Interest Expense

Bovemij Crowe EY GrantThornton KPMG pwc

The corporate form and the issuance of shares

Specific characteristics of the corporate form:

(1) Influence of corporate law
(2) Use of the share system
(3) Development of a variety of ownership interests

Issuance of shares: accounting problems involved are:

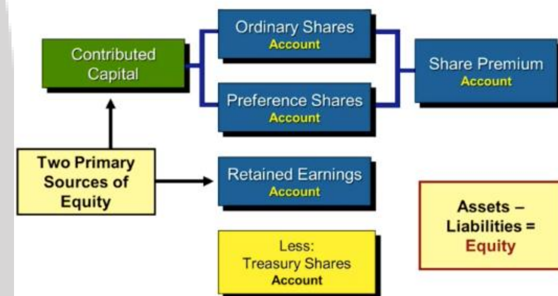
(1) Accounting for par value shares
(2) Accounting for no-par shares
(3) Accounting for shares issued in combination with other securities
(4) Accounting for shares issued in non-cash transactions
(5) Accounting for costs of issuing shares

In the absence of restrictive provisions: each ordinary share carries the right to share proportionately in:

(1) Profits and losses
(2) Management
(3) Corporate assets upon liquidation
(4) Any new issues of shares of the same class (preemptive right)

Categories of equity:

(1) Contributed capital (total amount paid in as share capital)
   (a) Par value of all outstanding shares
   (b) Premiums less discounts on issuance
(2) Earned capital (develops if the business operates profitably)



Accounting problems in the issuance of shares:

Accounts for Par value shares:

(a) Share capital - Preference / Share capital - Ordinary
(b) Share Premium - Preference / Share Premium - Ordinary

Accounts for no par shares:

(a) Share Capital - Ordinary / Share Capital - Ordinary and Share Premium - Ordinary

Shares issued in combination with other securities (lump-sum sales):

Methods of allocation are:

(a) The proportional method
(b) The incremental method

Preference shares: possess (1) preference to dividend, (2) preference as to assets in the event of liquidation, (3) convertible into ordinary shares, (4) callable at the option of the corporation, (5) non voting

The accounting and reporting for treasury shares

Cost method: maintain the Treasury Shares Account at the cost of the shares purchased. Debit Treasury Shares account for the cost of the shares acquired and credits this same cost upon reissuance.

The par value method: records all transactions in treasury shares at their par value and reports the treasury shares as a deduction from share capital only

Bovemij Crowe EY GrantThornton KPMG pwc

Outstanding shares: number of issued shares that shareholders own

Buying back shares:
(1) To provide tax-efficient distributions of excess cash to shareholders
(2) To increase earnings per share and return on equity
(3) To provide shares for employee compensation contracts or to meet potential merger
(4) To thwart takeover attempts or to reduce the number of shareholders
(5) To make a market in the shares

The accounting and reporting issues related to dividends

Considering declaring a dividend:
(1) Is the condition of the corporation such that the dividend is legally possible?
(2) Is the condition of the corporation such that a dividend is economically sound?

Dividends:
(1) Cash dividends
(2) Property dividends
(3) Liquidating dividends
(4) Share dividends

Example;
Roadway Freight Corp on June 10 declared a cash dividend of 50 cents a share on 1.8 million shares payable July 16 to all shareholders of record June 24.

Three dates:
a. Date of declaration
b. Date of record
c. Date of payment

At date of declaration (June 10)

	Debit	Credit
Retained earnings	900,000	
Dividends payable		900,000

At date of record (June 24)
No entry

At date of payment (July 16)

	Debit	Credit
Dividends payable	900,000	
Cash		900,000

Presenting and analysing equity

Equity section:
- Share capital
- Share premium
- Retained earnings
- Treasury shares
- Accumulated other comprehensive income or loss
- Minority interest

Return on ordinary share equity: $\frac{Net\ income - preference\ dividends}{average\ ordinary\ shareholders'\ equity}$

Bovemij Crowe EY GrantThornton KPMG pwc

Payout ratio: $\frac{Cash\ dividends}{Net\ income - Preference\ Dividends}$

Book value per share: $\frac{Ordinary\ shareholders'\ equity}{outstanding\ shares}$

CH17: Investments + consolidation

Accounting for debt investments

Financial assets: are accounted either at amortized cost or fair value

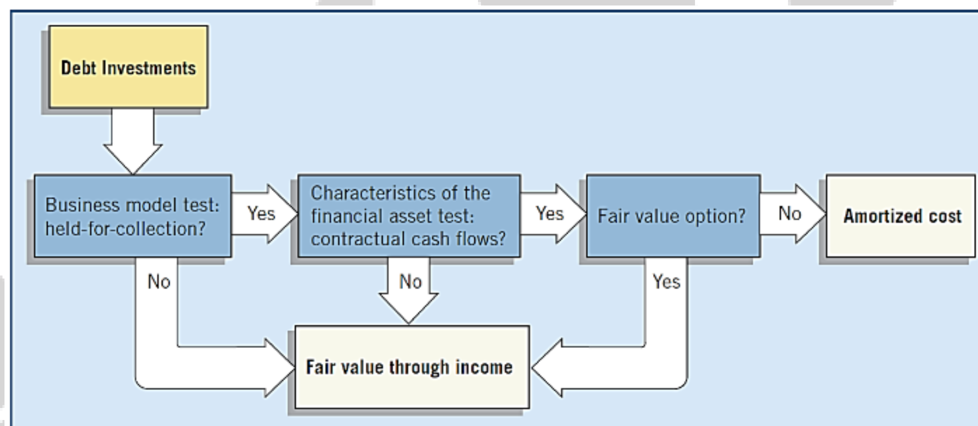
Debt investment:

(1) a business model related to holding assets in order to collect contractual cash flows, and

(2) contractual terms of the financial asset give specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding

For debt investments:

(1) Carry and report held-for-collection debt securities at amortized cost
(2) Value held-for-collection and selling debt securities at fair value (with unrealized holding gains or losses reported as other comprehensive income)
(3) Value trading debt securities for trading purposes at fair value (with unrealized holding gains or losses included in net income)



The fair value option: companies have the option to report most financial instruments at fair value. Generally available only at the time a company first purchases the financial asset or incurs a financial liability.

Amortized cost: initial recognition amount of the debt investment minus repayment plus or minus cumulative amortization and net of any reduction for uncollectibility.

Category	Valuation	Unrealized Gains or Losses	Other Income
Held-for-collection	Amortized cost	Not recognized	Interest when earned; gains and losses from sale.
Held-for-collection and selling	Fair value	Recognized as other comprehensive income and as a separate component of equity	Interest when earned; gains and losses from sale.
Trading securities	Fair value	Recognized in net income	Interest when earned; gains and losses from sale.

The effective-interest method: is used by companies to amortize premiums or discounts

Accounting for equity investments

Accounting treatment for the investment: is influenced by the degree to which one company acquires an interest in the ordinary shares of another company.

For equity investments:

(1) Holdings <20% at fair value (passive interest)
(2) Holdings between 20 / 50% by equity method (significant interest)
(3) Holdings >50% by consolidated statements (controlling interest)

Percentage of Ownership	0% ⟷ 20%	20% ⟷ 50%	50% ⟷ 100%
Level of influence	Little or None	Significant	Control
Valuation method	Fair Value Method	Equity Method	Consolidation

Unrealized Holding gains or losses: are only recognized in holdings <20%, trading options in net income, non-trading options in other comprehensive income.

Equity investment, holding less than 20%

Under the IFRS the presumption is that equity investments are trading:
General accounting and reporting rule for trading investments:

-dividends are recognized as revenue
-investments valued at fair value & unrealized gains and losses in included in net income

-> fair value adjustment, to unrealized holding gain or loss - income
Under IFRS allows companies to classify some equity investments as non-trading:
General accounting and reporting rule for non-trading investments:

-dividends are recognized as revenue
-investments valued at fair value & Record unrealized gains and losses in other comprehensive income

-> Fair value adjustment, to Unrealized holding gain or loss – Equity (OCI)

Fair value measurement: The total market value of all trading investments is compared to the most recent market-to-market price [cost of the investments]

Bovemij Crowe EY GrantThornton KPMG pwc

Category	Valuation	Unrealized Holding Gains or Losses	Other Income Effects
Holdings less than 20%			
1. Trading	Fair value	Recognized in net income	Dividends declared; gains and losses from sale.
2. Non-Trading Option	Fair value	Recognized in "Other comprehensive income" and as separate component of equity	Dividends declared; gains and losses from sale.
Holdings between 20% and 50%	Equity method	Not recognized	Proportionate share of investee's net income.
Holdings more than 50%	Consolidation	Not recognized	Not applicable.

<u>Equity method of Accounting (vs Fair value)</u>

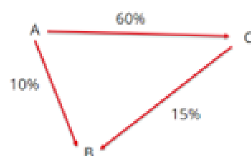
Equity method: investor and investee acknowledge a substantive economic relationship. (investment recorded at cost)

Equity vs Fair value method: (p.17-19, ill 17.20)

Equity investment, holdings between 20%-50% minority active investments

An investment (direct and/or indirect) of 20% 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", the investor must account for the investment using the equity method



Can Company A exert significant influence over company B?

Company A through C they can have more influence over company B

Ownership percentage equals or exceeds 20% is a guideline, it could be less than 20%

Real criterium for significant influence: the power to participate in the financial and operating policy decisions of the investee. However, no (legal) control or joint control over those policies.

<u>The key is the ability to influence management</u>: Representation on the board of directors, Participation in policy-making processes, Material intercompany transactions, Interchange of managerial personnel, Provision of essential technical information

<u>Criteria:</u> holdings between 20% and 50%: Investor can exert significant influence over another company (associate) and the investment represents a continuing ("non-trading") relationship between companies

Record the investment at cost

Subsequently, adjust the amount each period for the investor's proportionate share of the

Bovemij Crowe EY GrantThornton KPMG pwc

earnings (losses) & dividends received by the investor

Investment accounting approaches for debt investments: (see ill 17.21 for income effects)
(1) Held-for-collection: valuation at amortized cost
(2) Held-for-collection and selling: valuation at Fair Value
(3) Not Held-for-Collection, Trading: valuation at Fair Value
(4) Fair Value option: valuation at Fair Value

Investment accounting approaches for equity investments:
(1) Trading: valuation at Fair Value
(2) Non-trading: valuation at Fair Value
(3) Equity method: investment originally recorded at cost with periodic adjustments for the investor's share of the investee's income or loss, and decreased by all dividends received from the investee
(4) Consolidation: valuation by consolidated financial statements

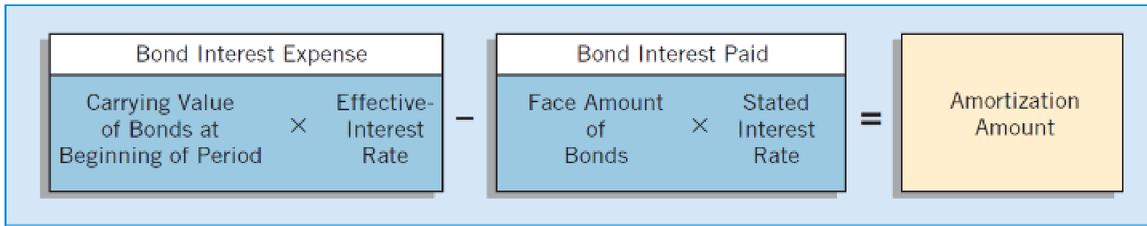
Debt investments
Debt investments are characterized by contractual payments on specified dates of principal and interest on the principal amount
Companies group debt investments into three categories:
1. held for collection: *Company has a business model whose objective is to hold assets in order to collect contractual cash flows. 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*
2. held for collection and selling: *Investments held with the objective to both collect contractual cash flows and sell financial assets*
3. trading (including held for collection and trading): *Company has a business model whose objective is to hold debt investments (bonds) as a trading investment. Active trading strategy for investments in debts (bonds)*

Classification	Valuation on the Balance Sheet	Income effects
1. Held-for-collection	Amortized cost	Interest is recognized as revenue.
2. Held-for-collection & Selling	Fair value	Interest is recognized as revenue. Unrealized holding gains and losses are included in other comprehensive income.
3. Held-for-collection & Trading	Fair value	Interest is recognized as revenue. Unrealized holding gains and losses are included in income.
4. Trading	Fair value	Interest is recognized as revenue. Unrealized holding gains and losses are included in income.

Two criteria for companies to determine how to measure their financial assets:
1. The company's business model for managing its financial assets
2. The contractual cash flow characteristics of the financial asset

Bovemij Crowe EY GrantThornton KPMG pwc

Effective-interest method
Effective-interest method produces a periodic (bond) interest revenue (expense) equal to a constant percentage of the carrying value of the bonds.
Bond interest revenue (expense) = Carrying value of bonds at beginning of period x effective interest rate
Bond interest paid = Face amount of bonds x Stated interest rate
Amortization amount = Bond interest expense - Bond interest paid



Amortized cost
Effective-interest method produces a periodic (bond) interest revenue equal to a constant percentage of the carrying value of the bonds.
Cash received = (Bond) interest paid = Face amount of bonds x stated interest rate
Interest revenue = Carrying value of bonds at beginning of period x effective interest rate
Amortization amount = (Bond) interest received – (Bond) interest revenue

Fair value
Companies have the option to report most financial assets at fair value, with all gains and losses related to changes in fair value reported in the income statement.
Applied on an instrument-by-instrument basis.
Generally available only at the time a company first purchases the financial asset or incurs a financial liability.
Company must measure this instrument at fair value until the company no longer has ownership.

NOVUM FSV 1989 PECUNIA NON OLET

Bovemij Crowe EY GrantThornton KPMG pwc

CH18: Revenue Recognition not in the lecture 2022!!!

Fundamental concepts related to revenue recognition and measurement

New standard: *Revenue from contracts with customers* adopts an asset-liability approach as the basis for revenue recognition

Asset-liability approach: recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration that the company receives, or expects to receive, in exchange for these goods or services.

(1) Identify the contract with customers
(2) Identify the separate performance obligations in the contract
(3) Determine the transaction price
(4) Allocate the transaction price to the separate performance obligations
(5) Recognize revenue when each performance obligation is satisfied

Issues: possible fraudulent behaviour by company executives and employees / inadequate accounting guidelines.

The five-step revenue recognition process

1. Identify the contract with customers

↳ **Contract:** agreement between two or more parties that create enforceable rights or obligations. Revenue is only recognized when a valid contract exists.

2. Identify the separate performance obligations in the contract

↳ **Objective:** to determine whether the nature of the promise is to transfer individual goods and services to the customer or to transfer a combined item for which individual goods or services are inputs.

Bovemij Crowe EY GrantThornton KPMG pwc

3. Determine the transaction price

↳ **Transaction price:** amount of consideration that a company expects to receive. Can be altered by (1) variable consideration, (2) time value of money, (3) non-cash consideration, (4) consideration paid or payable to the customer.

4. Allocate the transaction price to the separate performance obligations

↳ **Fair Value:** here is the standalone selling price of the product.

5. Recognize revenue when the company satisfies its performance obligation

↳ **Summary:** p.18-29, ill 18.26

<u>**Presentation and disclosure regarding revenue**</u>

Contract assets:

(1) Unconditional rights to receive consideration because the company has satisfied its performance obligation with a customer

(2) Conditional rights to receive consideration because the company has satisfied one performance obligation but must satisfy another in the contract before it can bill the customer

Contract modifications: changes in the contract terms while it is ongoing

Separate Performance Obligation:

(1) Promised goods or services are distinct, and

(2) The company has the right to receive an amount of consideration that reflects the standalone selling price of the promised goods or services

Collectibility: refers to a customer's credit risk (risk that a customer will be unable to pay the amount of consideration in the contract

Revenue disclosures: (ill 18.32) To achieve understanding of the nature, amount, timing and uncertainty of revenue and cash flows, companies disclose qualitative and quantitative information about all of the following:

(1) Contracts with customers

(2) Significant judgements

(3) Assets recognized from costs incurred to fulfil a contract

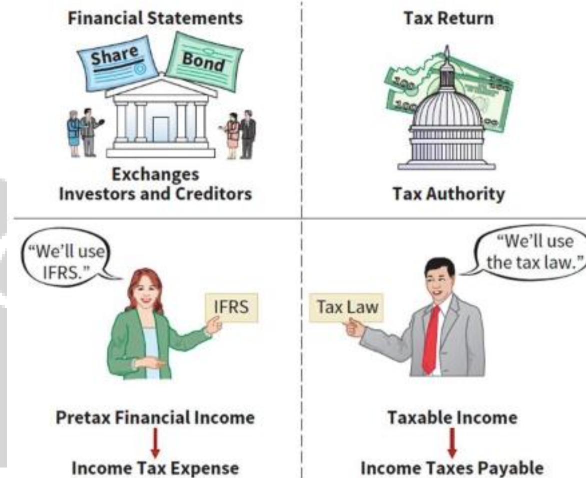
Bovemij Crowe EY GrantThornton KPMG pwc

Fundamentals of accounting for income taxes

Pretax financial income: income before taxes, income for financial reporting purposes, income for book purposes.

(1) Differences between pretax financial income and taxable income

(2) Temporary differences and future taxable amounts



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	Future Deductible 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.	**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.

Taxable amounts: increase taxable income in future years (deductible amounts decrease taxable income in future years)

Deferred tax liability: deferred tax consequences attributable to taxable temporary differences (represents the increase in taxes payable in future years as a result of taxable temporary differences existing at the end of the current year

(3) Temporary differences and future deductible amounts

Future deductible amounts: cause taxable income to be less than pretax financial income in the future as a result of an existing temporary difference.

Deferred tax asset: the deferred tax consequence attributable to deductible temporary differences. (increase in taxes refundable (or saved) in future years as a result of deductible temporary differences)

(4) Non-recognition of a deferred tax asset

A company should reduce a deferred tax asset if it is probable that it will not realize some portion or all of the deferred tax asset

Additional issues in accounting for income taxes

1) Presentation of income tax expense

Income Taxes Payable or Refundable +/- Change in deferred income taxes = total income tax expense or benefit

2) Temporary and permanent differences: differences that will result in taxable amounts in future years when the related assets are recovered

Temporary difference: initial difference between the book basis and the tax basis of an asset or liability, regardless of whether the tax basis of the asset or liability exceeds or is exceeded by the book basis

Reversing difference: occurs when eliminating a temporary difference that originated in prior periods and then removing the related tax effect from the deferred tax account

3) Tax rates and tax changes

Bovemij Crowe EY GrantThornton KPMG pwc

If tax rates are expected to change in the future, the **substantially enacted tax rate** expected should be applied.

Accounting for loss carrybacks and loss carryforwards

Loss carryback: carry the net operating loss back two years and receive refunds for income taxes paid in those years. Apply the loss to the first year and then to the second year.

Loss carryforward: offset future taxable income for up to 20 years.

Example;

Groh Inc. has no temporary or permanent differences. Groh experiences a net operating loss of $200.000 in 2022 and takes advantage of the carryforward provision. In 2022, the company records the tax effect of the $200.000 loss carryforward as a deferred tax asset of $40.000 ($200.000 x 0.20), assuming that the enacted future tax rate is 20%. Groh records the benefits of the carryforward in 2022 as follows;

2022;

Deferred Tax Asset	40.000	
Income Tax Expense (Loss Carryforward)		40.000

It is a deferred tax asset, because we use the $40.000 to reduce (save) taxes in the future and we anticipate that today.

Groh establishes a Deferred Tax Asset account for the benefits of future tax earnings. The account credited (Income Tax Expense (Loss Carryforward)) is a contra income tax expense item, which Groh presents on the 2022 income statement. The $40.000 is the deferred tax benefit of 2022, which results from an increase in the deferred tax asset

Groh Inc.
Income Statement (partial) for 2022

Operating loss before income taxes	$(200,000)
Income tax benefit	
Deferred	40,000*
Net loss	$(160,000)

*Carryforward ($200,000 × .20)

For 2023, assume that Groh returns to profitable operations and has taxable income of $250.000 (prior to adjustment for the NOL carryforward), subject to a 20% tax rate. Groh then realizes the benefits of the carryforward for tax purposes in 2023, which it recognized for accounting purposes in 2022. Groh computes the income taxes payable for 2023 as shown;

Taxable income prior to loss carryforward	$ 250,000
Loss carryforward deduction	(200,000)
Taxable income for 2023	50,000
Tax rate	× .20
Income taxes payable for 2023	$ 10,000

2023;

Income Tax Expense	50.000		(taxable income 2023)
Deferred Tax Asset		40.000	
Income Tax Payable		10.000	(50.000 – 40.000) (what we have to pay)

Bovemij Crowe EY GrantThornton KPMG pwc

The 2023 income statement does NOT report the tax effects of the loss carryforward because Groh had reported it previously

Groh Inc.
Income Statement (partial) for 2023

Income before income taxes		$250,000
Income tax expense		
Current	$10,000	
Deferred	40,000	50,000
Net income		$200,000

Presentation of deferred income taxes in financial statements

Presentation: deferred tax accounts are reported on the statement of financial position as assets and liabilities

Intraperiod tax allocation: allocate income tax expense to continuing operation, discontinued operations, other comprehensive income, and prior period adjustments

The components of income tax expense:
(1) Current tax expense
(2) Any adjustments recognized in the period for current tax of prior periods
(3) Amount of deferred tax expense relating to the origination and reversal of temporary differences
(4) Amount of deferred tax expense relating to changes in tax rates or the imposition of new taxes
(5) 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 expenses

Income Tax disclosures are required due to:
(1) Assessing quality of earnings
(2) Making better predictions of future cash flows
(3) Predicting future cash flows for operating loss carryforwards

The asset-liability method: (liability approach) recognize amount of taxes payable or refundable for the current year.

Basic principles:
(1) Recognize a current tax liability or asset for the estimated taxes payable or refundable on the tax return for the current year
(2) Recognize a deferred tax liability or asset for the estimated future tax effects attributable to temporary differences and carryforwards using the enacted tax rate
(3) Base the measurement of current and deferred tax liabilities and assets on provisions of the enacted tax law
(4) Reduce the measurement of deferred tax assets, if necessary, by the amount of any tax benefits that, based on available evidence, companies do not expect to realize

Bovemij Crowe EY GrantThornton KPMG pwc

The environment related to leasing transactions

Lease: a contract, part of a contract, that conveys the right to control the use of identified property, plant or equipment for a period of time in exchange for consideration.

↳ **Lessor;** obligation to provide lessee the right to use asset for entire lease duration
↳ **Lessee;** obligation to pay stipulated period fees (lease payments) to lessor during the lease term

Advantages lessees:
(1) 100% financing at fixed rate
(2) protection against obsolescence
(3) flexibility
(4) less costly financing

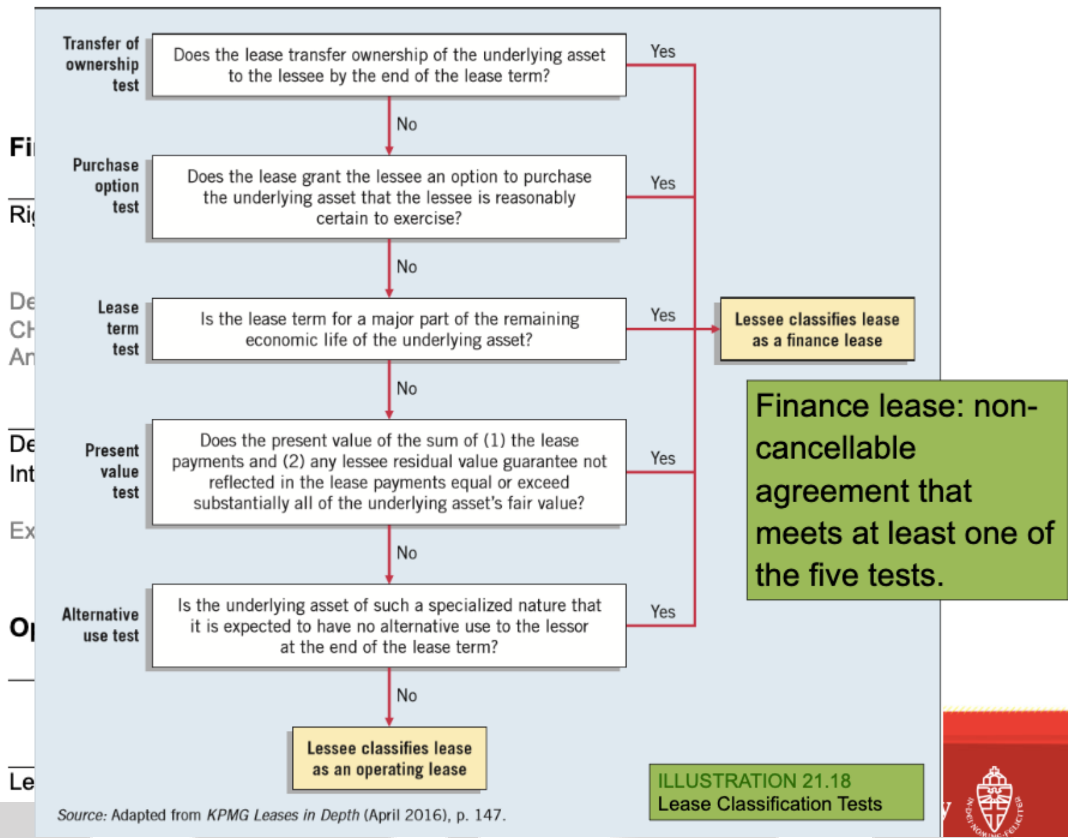
Advantages lessors: (banks, captive leasing companies, independents)
(1) profitable interest margins
(2) stimulation of product sales
(3) tax benefits and efficient tax sharing
(4) residual value profits.

For accounting purposes, IFRS 16 classifies all leases as either finance or operating leases

Finance lease;
Under the finance lease methods;
↳ The lessee is required to recognize a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments
↳ The lease liability is computed as the PV of the lease payments
↳ The lessee recognizes interest expense on the lease liability using the effective-interest method
↳ The lessee records depreciation expense on the right-of-use asset

Operating lease
Under the operating lease;
↳ The asset remains on the lessor's books
↳ The asset is depreciated over its economic life by the lessor

Bovemij Crowe EY GrantThornton KPMG pwc



ESV 1989 PECUNIA NON OLET

If the lease does not meet one of these tests, it is classified as a operating lease

Bovemij Crowe EY GrantThornton KPMG pwc

	Rent	Operating lease	Finance lease	Buy
Expenses	Rent expenses Gasoline costs	Lease expenses Gasoline costs	Interest expenses Depreciation expenses Executory costs	Depreciation expenses Insurance costs Maintenance expenses Gasoline costs
Journal entries	Rent expenses Gasoline costs To Cash and cash equivalents	Lease expenses Gasoline costs To Cash and cash equivalents	Right-of-use asset To Lease liability Depreciation expenses To Accumulated depreciation Lease liability Interest expenses Miscellaneous lease expense To Cash and cash equivalents	Asset To Cash and cash equivalents Depreciation expenses To Accumulated depreciation Insurance costs Maintenance expenses Gasoline costs To Cash and cash equivalents

Accounting for leases by lessees:
Lessee: lease liability is computed as the PV of the lease payments and uses the effective interest method
Ill 21.2: Views on laeasy capitalization
(1) Do not capitalize any leased assets
(2) Capitalize leases that are similar to instalment purchases
(3) Capitalize all long-term leases
(4) Capitalize firm leases where the penalty for non-performance is substantial

Lease payments include:
(1) Fixed payments
(2) Variable payments that are based on an index or a rate
(3) Amounts guaranteed by a lessee under a residual value guarantee
(4) Payments related to purchase or termination options that the lessee is reasonably certain to exercise
The IASB provided an exception to the required capitalization of all leases for (1) leases of underlying assets with low value and (2) short-term leases with a term of 12 months or less
Summary of lessee accounting:
(1) If it is probable that the expected residual value = equal to or greater than the guaranteed residual value, the lessee should not include the guaranteed residual value in the computation of the lease liability
(2) If it is probable that the expected residual value is less than the guaranteed residual value, the PV of the difference between both should be included in computation of the lease liability
(3) The lessee does not include the unguaranteed residual value in the computation of the lease liability

Lease receivable: PV of Rental Payments + PV of guaranteed and unguaranteed residual values

Accounting and Reporting or special features of lease agreements
Executory costs: normal expenses associated with owning a leased asset, such as property insurance and property taxes.

Lease Prepayments and incentives:
(1) Lease prepayments made by the lessee increase the right-of-use asset
(2) Lease incentive payments made by the lessor to the lessee reduce the right-of-use asset
(3) Initial direct costs incurred by the lessee increase the right of use asset

Bovemij Crowe EY GrantThornton KPMG pwc

Right-of-use Asset: Initial measurement of lease liability + Prepaid Lease Payments - lease incentives received + Initial Direct costs
(*Operating leases: lessor defers the initial direct costs and amortizes them as expenses over the term of the lease)*
(Finance leases: lessor expenses initial direct costs at lease commencement)

Bovemij Crowe EY GrantThornton KPMG pwc

Usefulness and format of the statement of cash flows

Usefulness of the statement of cash flows

(1) The entity's ability to generate future cash flows
(2) The entity's ability to pay dividends and meet obligations
(3) The reasons for the difference between net income and net cash flow from operating activities
(4) The cash and non-cash investing and financing transactions during the period

Classification of Cash Flows:

- Operating activities (cash effects of transactions that enter into the determination of net income)
- Investing activities (involve non-current assets and include making and collecting loans and acquiring and disposing of investments and productive long-lived assets
- Financing activities (liability and equity items including obtaining cash from creditors and repaying the amounts borrowed and obtaining capital from owners and providing them with a return)

Preparing a statement of cash flows

The information to prepare the statement comes from (1) comparative statements of financial position, (2) current income statement, (3) selected transaction data.

Preparing the statement of cash flows

1. Determine the change in cash
2. Determine the net cash flow from operating activities (examples:)
    a. Change in accounts receivable
    b. Change in prepaid expenses
    c. Change in inventories
    d. Change in accounts payable
    e. Depreciation expense
3. Determine net cash flows from investing and financing activities
    a. Change in land
    b. Change in buildings and related accumulated depreciation
    c. Change in equipment and related accumulated depreciation
    d. Change in bonds payable
    e. Change in retained earnings
    f. Change in share capital

Contrasting the direct and indirect methods of calculating net cash flow from operating activities

Direct method: reports cash receipts and cash disbursements from operating activities. Companies compute net cash provided by operating activities by adjusting each item in the income statement
Net cash provided by operating activities = Cash receipts - Cash Payments

Indirect method: not specified in text

Special problems in preparing a statement of cash flows

(1) Adjustments to net income (depreciation and amortization)
(2) Accounts receivable (net)
(3) Other working capital changes (some changes in working capital affect cash, but not net income)
(4) Net loss
(5) Disclosures (such as significant non-cash transactions)

Bovemij Crowe EY GrantThornton KPMG pwc

Disclaimer

ESV Nijmegen makes an effort to keep the content of this summary up to date and where needed complements it. Despite these efforts it is still possible that the content is incomplete or incorrect. The offered material is a supplement for studying next to the appointed literature. The material is offered without any guarantee or claim for correctness.
All rights of intellectual property concerning these summaries are owned by the ESV. Copying, spreading or any other use of this material is not allowed without written permission by the ESV Nijmegen, except and only to the extent provided in regulations of mandatory law, unless indicated otherwise.

Bovemij Crowe EY Grant Thornton KPMG pwc