



## **SCHOOL BUSINESS AND ECONOMICS**

**DEPARTMENT OF ACCOUNTING AND FINANCE**

# **INTERMEDIATE FINANCIAL ACCOUNTING I (ACFN 3021)**

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# **CHAPTER ONE**

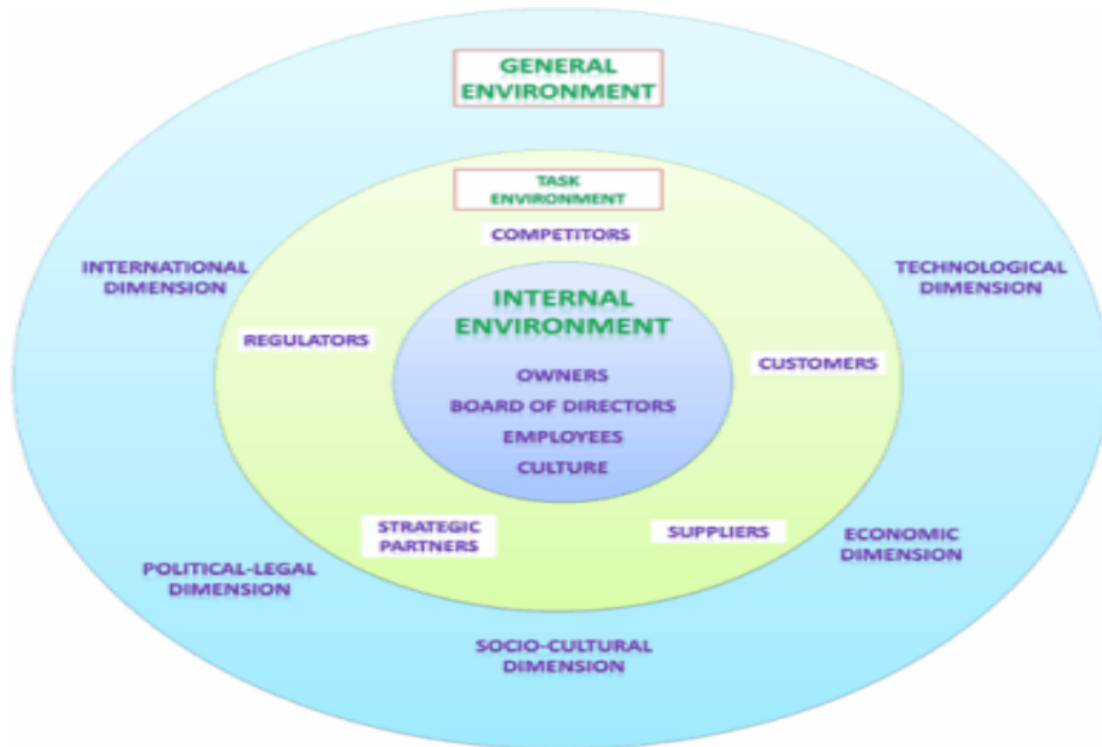
## **1. DEVELOPMENT OF ACCOUNTING PRINCIPLES AND PROFESSIONAL PRACTICE**

The American Accounting Association defines accounting as "the process of identifying, measuring, and communicating. This information is primarily financial—stated in money terms. Accounting, then, is a measurement and communication process used to report on the activities of profit-seeking business organizations and not-for-profit organizations. As a measurement and communication process for business, accounting supplies information that permits informed judgments and decisions by users of the data.

The accounting process provides financial data for a broad range of individuals whose objectives in studying the data vary widely. Bank officials, for example, may study a company's financial statements to evaluate the company's ability to repay a loan. Prospective investors may compare accounting data from several companies to decide which company represents the best investment. Accounting also supplies management with significant financial data useful for decision making. Reliable information is necessary before decision makers can make a sound decision involving the allocation of scarce resources. Accounting information is valuable because decision makers can use it to evaluate the financial consequences of various alternatives. Accountants eliminate the need for a crystal ball to estimate the future.

### **1.1.The Accounting Environment**

By the word “environment” we understand the surrounding or conditions in which a particular activity is carried on. And we know that organization is a social entity that has a hierarchical structure where all necessary items are put together and they act within it to reach the collective goal. Organization or more specifically business organization and its activities are always being affected by the environment. In an organization, every action of management body is influenced by the environment.



Organizations have an external and internal environment;

1. External Environment.
2. Internal Environment.

In this post, we will look at the elements of organizations environment.

### **External Environment of Organization**

In a simple way factors outside or organization are the elements of the external environment. The organization has no control of how the external environment elements will shape up. The external environment can be subdivided into 2 layers: the general environment and the task environment.

1. General Environment
2. Task Environment

### **General Environment of Organization**

The general environment consists of factors that may have an immediate direct effect on operations but nevertheless influences the activities of the firm. The dimensions of the general environment are broad and non-specific whereas the dimensions of the task environment are composed of the specific organization.

Let's see the elements or dimensions of the general environment.

### **1. Economic Dimension**

The economic dimension of an organization is the overall status of the economic system in which the organization operates. The important economic factors for business are inflation, interest rates, and unemployment. These factors of the economy always affect the demand for products. During inflation, the company pays more for its resources and to cover the higher costs for it, they raise commodity prices. When interest rates are high, customers are less willing to borrow money and the company itself must pay more when it borrows. When unemployment is high, the company is able to be very selective about whom it hires, but customers' buying power is low as fewer people are working.

### **2. Technological Dimension**

It denotes to the methods available for converting resources into products or services. Managers must be careful about the technological dimension. Investment decision must be accurate in new technologies and they must be adaptable with them.

### **3. Socio-cultural dimension**

Customs, mores, values and demographic characteristics of the society in which the organization operates are what make up the socio-cultural dimension of the general environment. The socio-cultural dimension must be well studied by a manager. It indicates the product, services, and standards of conduct that the society is likely to value and appreciate. The standard of business conduct varies from culture to culture and so does the taste and necessity of products and services.

### **4. Political-Legal Dimension**

The politico-legal dimension of the general environment refers to the government law of business, business-government relationship and the overall political and legal situation of a country. Business laws of a country set the dos and don'ts of an organization. A good business-government relationship is essential to the economy and most importantly for the business. And the overall situation of law implementation and justices in a country indicates that there is a favorable situation in of business in a country.

### **1. International Dimension**

Virtually every organization is affected by the international dimension. It refers to the degree to which an organization is involved in or affected by businesses in other countries. Global society concept has brought all the nation together and modern network of communication and transportation technology, almost every part of the world is connected.

## **Task Environment of Organization**

The task environment consists of factors that directly affect and are affected by the organization's operations. These factors include suppliers, customers, competitors, regulators and so on. A manager can identify environmental factors of specific interest rather than having to deal with a more abstract dimension of the general environment. The different elements of task environment may be discussed as under:

### **1. Competitors**

Policies of the organization are often influenced by the competitors. A competitive marketplace companies are always trying to stay and go further ahead of the competitors. In the current world economy, the competition and competitors in all respects have increased tremendously. The positive effect of this is that the customers always have options and the overall quality of products goes high.

### **2. Customers**

“Satisfaction of customer” is the primary goal of every organization. The customer is who pays money for organization's product or services. They are the peoples who hand them the profit that the companies are targeting. Managers should pay close attention to the customers' dimension of the task environment because its customers purchase that keeps a company alive and sound.

### **3. Suppliers**

Suppliers are the providers of production or service materials. Dealing with suppliers is an important task of management.

A good relationship between the organization and the suppliers is important for an organization to keep a steady follow of quality input materials.

### **4. Regulators**

Regulators are units in the task environment that have the authority to control, regulate or influence an organization's policies and practices. Government agencies are the main player of the environment and interest groups are created by its members to attempt to influence organizations as well as government. Trade unions and chamber of commerce are the common examples of an interest group.

### **5. Strategic Partners**

They are the organization and individuals with whom the organization is to an agreement or understanding for the benefit of the organization. These strategic partners in some way influence the organization's activities of in various ways.

## **Internal Environment of Organization**

Forces or conditions or surroundings within the boundary of the organization are the elements of the internal environment of the organization.

The internal environment consists mainly of the organization's owners, the board of directors, employees and culture.

### **1. Owners**

Owners are people who invested in the company and have property rights and claims on the organization. Owners can be an individual or group of person who started the company; or who bought a share of the company in the share market.

They have the right to change the company's policy at any time.

### **2. Board of Directors**

The board of directors is the governing body of the company who are elected by stockholders, and they are given the responsibility for overseeing a firm's top managers such as the general manager.

### **3. Employees**

Employees or the workforce, the most important element of organization's internal environment, who performs the tasks of the administration. Individual employees and also the labor unions they join are important parts of the internal environment.

If managed properly they can positively change the organization's policy. But ill-management of the workforce could lead to a catastrophic situation for the company.

### **4. Culture**

Organizational culture is the collective behavior of members of an organization and the values, visions, beliefs, habits that they attach to their actions. An organization's culture plays a major role in shaping its success because culture is an important determinant of how well their organization will perform. As the foundation of the organization's internal environment, it plays a major role in shaping managerial behavior.



The environment irrespective of its external or internal nature, a manager must have a clear understanding of them. Normally, you would not go for a walk in the rain without an umbrella, because you understand the environment and you know when it rains you can get wet.

Similarly, if a manager does not know and understand the environment of the organization, he or she will definitively get wet or dry and the organization also in today's fast and hyper-moving organizational environment.

## **1.2.Financial reporting requirements in Ethiopia**

### **A. Applicable Financial Reporting Standards**

1. issued by the International Accounting stands Board or is successor or issued by the international Public sector Accounting Standards Board or its successor, as adopted, adapted or amended by the Board:
  - a) International financial reporting standards; or
  - b) International financial reporting standards for small and medium enterprises;
  - c) International Public Sector Accounting standards applicable to charities and societies,
2. Any public interest entity shall, without prejudice the provision or sub article 1 (c) or this Article, be required to comply with international financial reporting standards referred to in sub-article (1) (a) of this Article.
3. The Board shall specify, in the financial reporting standards, the minimum requirements for recognition, measurement, presentation, and disclosure in annual financial statements, group annual financial statements.

### **B. Financial Statements of Reporting Entities Incorporated outside Ethiopia**

Where the Board is satisfied that:

1. The financial statements of a reporting entity that is incorporated outside Ethiopia comply with the requirements of the law in force in the country where the reporting entity is incorporated or constituted; and
2. The requirements of the country of incorporation are substantially the same as those provided for in this Proclamation; the financial statements shall be taken to comply with the applicable financial reporting standards under this Proclamation.

### **C. Financial Statements of Groups Incorporated outside Ethiopia**

Where the Board is satisfied that:

1. The consolidated financial statement of a reporting entity representing a group that is incorporated outside Ethiopia comply with the law in force in the country where the reporting entity is incorporated; and
2. The requirements of the country of incorporation are substantially the same as those of this Proclamation; the consolidated financial statement shall be taken to comply with the applicable financial reporting standards under this Proclamation.

#### **D. Obligation to Submit Financial Reports**

1. Any reporting entity shall submit to the Board its financial report in accordance with the schedule to be set by the Board.
2. The provisions of sub-article (1) of this Article shall not preclude reporting entities from submitting their financial reports to the competent public bodies in accordance with other laws.
3. The financial report to be submitted to the competent public body in accordance with other laws shall be the original copy of the financial report submitted to the Board pursuant to sub-article (1) of this Article.

#### **E. Obligation to Audit Financial Statements and Consolidated Financial Statements**

1. The Director of a reporting entity shall ensure that the financial statements of the reporting entity and the consolidated financial statements, if the reporting entity is required to prepare consolidated financial statements, are audited.
2. The audit on the financial statement shall be conducted and the auditor's report on the financial statements or consolidated financial statements shall be prepared according to the International Standards for Auditing approved by the Board or in the case of reporting entities constituted or incorporated outside Ethiopia, pursuant to auditing standards applicable in the country where those reporting entities are incorporated or constituted so long as it is substantially the same with this Proclamation.

### **Conceptual framework (FASB vs. IFRS)**

#### **FASB Financial Accounting Standards Board - FASB**

The Financial Accounting Standards Board (FASB) is a seven-member independent board consisting of accounting professionals who establish and communicate standards of financial accounting and reporting in the United States. FASB standards, known as generally accepted

accounting principles (GAAP), govern the preparation of corporate financial reports and are recognized as authoritative by the Securities and Exchange Commission (SEC).

### **Breaking Down 'Financial Accounting Standards Board - FASB'**

Accounting standards are crucial in an efficient market, as information must be transparent, credible and understandable. The FASB sets out to improve corporate accounting practices by enhancing guidelines set out for accounting reports, identifying and resolving issues in a timely manner, and creating a uniform standard across the financial markets.

The FASB was established in 1973 as the designated organization for championing the financial standards that govern accounting practices and the preparation of financial reports in the private sector. In fact, it is the SEC itself that gives the FASB its governing authority. The SEC technically has statutory authority to establish and manage financial reporting standards under the Securities Exchange Act of 1934 but has chosen to give that power to the privately held FASB to self-manage the private sector.

### **The Mission of the FASB**

The stated mission of the FASB is to establish and improve financial accounting and reporting standards and to provide useful information to investors and other people who use financial reports. The FASB seeks to actively achieve this mission by facilitating an open and independent reporting process that allows broad participation from company stakeholders. The mission and activity of the FASB are overseen by the Financial Accounting Foundation's (FAF) Board of Trustees. As of 2016, the current and primary priority of the FASB is to integrate U.S. GAAP with the International Financial Reporting Standards (IFRS). This allows for more transparent and translatable financial practices internationally. Specifically, the FASB aims to address the differences in reporting between revenue recognition, leases, financial instruments and insurance.

### **The Overall Structure of the Entity**

The FASB is part of a larger, nonprofit, private institution that is independently structured from all other business entities and professional organizations. The overall structure is comprised of the FASB, the FAF, the Financial Accounting Standards Advisory Council (FASAC), the Governmental Accounting Standards Board (GASB) and the Governmental Accounting Standards Advisory Council (GASAC). The FAF is responsible for all the oversight, administration and finances of the FASB and the GASB. The FAF's advisory board is also

responsible for the council of the FASAC and the GASAC. The FAF's primary responsibilities include protecting the standards setting process and appointing members of the other organizations. The FASAC was created to advise the FASB on issues, agendas and priorities. The FASAC is integral to the successful operations of the FASB and is comprised of more than 30 members. Both the GASB and the GASAC are geared toward governmental oversight. Independent, reliable funding safeguards the ability of the FASB and the GASB to set standards in an environment free from real or perceived conflicts of interest. The current funding mechanisms for our standard-setters means they don't have to try to raise money from the very organizations that are subject to accounting standards.

The work of the Financial Accounting Foundation (FAF), the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB) is funded by a combination of subscription and publication revenue, accounting support fees, and investment income. The largest share of financial support for the standard-setting boards comes from accounting support fees. Those fees are paid by publicly traded companies (for the FASB) and municipal bond brokers and dealers (for the GASB).

### **International Financial Reporting Standards (IFRS Standards)**

The International Accounting Standards Board (the Board) was established in 2001 and is the independent standard-setting body of the IFRS Foundation, an independent, private sector, not-for-profit organization working in the public interest. Its principal objectives are:

- To develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted international financial reporting standards (IFRS Standards) based upon clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets and other users of financial information make economic decisions;
- to promote the use and rigorous application of those standards;
- in fulfilling the objectives associated with (1) and (2), to take account of, as appropriate, the needs of a range of sizes and types of entities in diverse economic settings; and

- To promote and facilitate adoption of IFRS Standards, being the standards and interpretations issued by the Board, through the convergence of national accounting standards and IFRS Standards.

The governance and oversight of the activities undertaken by the IFRS Foundation and its standard-setting body rests with a geographically and professionally diverse body of Trustees, who are also responsible for safeguarding the independence of the Board and ensuring the financing of the organization. The Trustees are publicly accountable to a Monitoring Board of public authorities. The Board is an independent group of experts with an appropriate mix of recent practical experience in setting accounting standards; in preparing, auditing, or using financial reports; and in accounting education. Broad geographical diversity is also required. Members are appointed by the Trustees through an open and rigorous process that includes advertising vacancies and consulting relevant organizations. The IASB has 14 full-time members. The Board develops and maintains a set of accounting requirements collectively referred to as International Financial Reporting Standards (IFRS Standards). IFRS Standards are a set of high quality, understandable, enforceable and globally accepted Standards based up on clearly articulated accounting principles. The Board has no authority to impose those Standards. However, entities that wish, or are required by a particular jurisdiction, to assert compliance with IFRS Standards must comply with all of the individual IFRSs Standards and IFRS Interpretations (Interpretations) issued by the Board. IFRS Standards generally contain principles and accompanying application guidance, both of which are mandatory and carry equal weight. Some Standards also include illustrative examples or implementation guidance, neither of which is part of IFRS Standards. They are therefore not mandatory. Each Standard and Interpretation has a basis for conclusions that explains the Board's reasons for developing the particular requirements. The basis for conclusions is not part of IFRS Standards and is therefore also not mandatory. Additionally, the Board has a Conceptual Framework for Financial Reporting (the Framework). This Framework is designed to help the Board develop IFRS Standards. The Framework is also designed to help those applying IFRS Standards address matters not covered by IFRS Standards. However, the Framework is not a Standard and the accounting requirements in an IFRS Standards take precedence over the Framework. The Board develops IFRS Standards in the public interest. Through the Board's due process, it consults and engages with investors,

regulators, business leaders and the global accountancy profession at every stage of the process, whilst maintaining collaborative efforts with the worldwide standard-setting community. In developing IFRS Standards and Interpretations the Board publishes and seeks public comment on Discussion Papers and Exposure Drafts. Those documents are not part of IFRS Standards. The IFRS Interpretations Committee is the interpretative body of the Board. The Interpretations Committee has 14 voting members appointed by the Trustees, and its members are drawn from a variety of countries and professional backgrounds. The Interpretations Committee's mandate is to review on a timely basis widespread accounting issues that have arisen within the context of current IFRS Standards and to provide authoritative guidance (IFRIC Interpretations) on those issues. The Interpretations Committee also develops proposals for narrow scope amendments to IFRS Standards on behalf of the Board. In developing Interpretations and narrow scope amendments, the Interpretations Committee follows a transparent, thorough and open due process. However, it is the Board that issues Interpretations and narrow scope amendments and the Board that considers and votes on each Interpretation and narrow scope amendment before it is issued. As well as IFRS Standards, the Board has issued an IFRS Standard for SMEs, to meet the needs and capabilities of small and medium-sized entities (SMEs) and users of their financial statements. Any company of any size is eligible to use the IFRS Standard for SMEs, provided it does not have public accountability. An entity has public accountability if it is publicly traded, or if it is a financial institution or similar entity. The IFRS Standard for SMEs is based on IFRS Standards but is much less complex.

### **Assessment Methodology**

As part of the Reports on the Observance of Standards and Codes (ROSC) initiative, the World Bank has established a program to assist its member countries in implementing international accounting and auditing standards for strengthening the financial reporting regime. The objectives of this program are two-fold:

- Analyze comparability of national accounting and auditing standards with international standards, determine the degree with which applicable accounting and auditing standards are complied, and assess strengths and weaknesses of the institutional framework in supporting high-quality financial reporting.

- Assist the country in developing and implementing a country action plan for improving institutional capacity with a view to strengthening the country's corporate financial reporting regime.

### **1.3.The IASB and its governance structure**

At its meeting on 11 July 2006, the Economic and Financial Affairs Council (ECOFIN) adopted conclusions on funding of the International Accounting Standards Board (IASB). The Council welcomed the current private sector efforts to create a broad-based voluntary financing system for the IASB and recognized the need to finalize the financing system in order to prevent any disruption to the operations of the IASB. In addition, ECOFIN stressed the importance of improvements in the IASB governance structure and encouraged the IASB to continue to:

(1)strengthen its governance structure, with a view to ensuring that adequate account is taken of public interest issues, including financial stability aspects;

(2)strengthen its due process with stakeholders - including work planning and setting of standards as well as their interpretations - in particular relating to consultation, so that views of all International Financial Reporting Standards (IFRS) users and investors are fully taken into account; in this context, impact assessments, field testing and reasoning behind any actions should be developed; and cooperation with other standard setting bodies should involve stakeholders using IFRS; as well as

(3) ensure that stakeholders are adequately represented in the International Accounting Standards Committee Foundation (IASCF), IASB and International Financial Reporting Interpretations Committee (IFRIC) governing bodies;

This report highlights the following main areas where further improvement is desirable:

- Firstly, concerning the governance structure of the IASCF/IASB, the Commission believes that further amendments would improve the accountability of the Board and of the Trustees to their constituents, in particular those jurisdictions which apply IFRS.

- Secondly, as regards the IASB's due process with stakeholders, strengthened consultation procedures are necessary, in particular for IFRIC. In particular, the IASB should explain, preferably in writing, the reasons for not taking into account comments made by stakeholders. In addition, the credibility of standards would be further enhanced by impact assessment and field testing procedures.

It is important that the IASB evaluates the practical impact of new standards and the cost of possible changes in practice at an early stage of development in order to assess how the proposed standards or interpretations may affect businesses.

Meetings between world standard-setters and the IASB take place regularly. Certain projects are also carried out jointly by the IASB and national standard-setters. Nonetheless, the IASB could usefully intensify its informal liaison relationships with national standards setters and preparers. Some projects are carried out jointly between standard setters.

The IASB and FASB apply a so called "modified joint project" approach. Under this approach, one standard setter takes the lead and the other follows with consultation taking place once the main research is done.

It is of the utmost importance that for joint and modified joint projects there is a proper consultation of all interested parties and jurisdictions and that any concerns which are raised are properly discussed and satisfactorily resolved before standards are finalized.

- Thirdly, on the issue of adequate representation of stakeholders in governing bodies of the IASCF/IASB, the composition of these bodies should ensure adequate representation and experience from countries and regions committed to use of IFRS.

#### **1.3.1. Governance structure**

Significant improvements have been made in the IASC/IASB governance structures, in particular:

- strengthening of the IASCF Constitution to define the involvement of Trustees in reviewing operating procedures, consultative arrangements and due process of the IASB,
- introduction of a formalized framework for evaluating the effectiveness of the oversight function of the IASCF Trustees including a specific section in the IASCF Annual Report on how the Trustees fulfill this function,
- More transparent election procedures for Trustees including a new Trustees Appointments Advisory Group,



- Regular reviews of operating procedures and the Constitution, and
- Strengthened role of the Standards Advisory Council. On the other hand further improvement is needed in particular.
- To take proper account of public interest considerations, including financial stability.

### **1.3.2. Objective of financial reporting**

An evaluation of company financial reporting requires some agreement on its objectives. Financial reporting is not an end in itself but is a means to certain objectives. The objectives of financial reporting and financial statements have been discussed for a long time. While there is no final statement on objectives, to which all parties (of financial reporting) have agreed, some consensus has been developing on the objectives of financial reporting.

**At present, the following may be described as the primary objectives of financial reporting:**

- (a) Investment Decision-making.
- (b) Management Accountability.

#### **(a) Investment Decision-making.**

The True-blood Committee stated that “...the basic objective of financial statements is to provide information useful for making economic decisions.” Recently, the FASB (USA) in its Concept No. 1 also concluded that financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions.

It is essential to have an understanding of the investment decision process applied by external users in order to provide useful information to them. The investors seek such investment which will provide the greatest total return with an acceptable range of risk. Investment return is comprised of future interest or dividends and capital appreciation (or loss). The investors while making investment decisions aim to determine the amount and certainty of a company’s future earning power in order to estimate their future cash return in dividends and capital appreciation. Earning power is the ability of a business firm to produce continuous earnings from the operating assets of the business over a period of years, which may differ from accounting net income.

**(b) Management Accountability:**

A second basic objective of financial reporting is to provide information on management accountability to judge management's effectiveness in utilizing the resources and running the enterprise.

Management of an enterprise is periodically accountable to the owners not only for the custody and sale-keeping of enterprise resources, but also for their efficient and profitable use and for protecting them to the extent possible from unfavorable economic impacts of factors in the economy such as technological changes, inflation or deflations.

Management accountability is of very great interest not only to existing shareholders and other users but also to potential shareholders, creditors and users. A company generally offers shares; debentures etc., to the prospective investing public and therefore it should accept accountability responsibilities to prospective investors also. Certainly annual and other financial statements are intended to play a major role in this regard.

- To provide useful information to the users of financial reports. The information should be useful from a number of perspectives, such as whether to provide credit to a customer, whether to lend to a borrower, and whether to invest in a business. The information should be comprehensible to those with a reasonable grounding in business, which means that it should not be laced with jargon or burdened with so much detail that it is impossible to extract the essentials about a business from its financial statements.
- To provide information about the cash flows to which an entity is subjected, including the timing and uncertainty of cash flows. This information is critical for determining the liquidity of a business, which in turn can be used to evaluate whether an organization can continue as a going concern.
- To disclose the obligations and economic resources of an entity. There should be an emphasis on the changes in liabilities and resources, which can be used to predict future cash flows.

## **1.4. Qualitative Characteristics of accounting information**

The primary decision-specific qualities that make accounting information useful are relevance and reliability. Both are critical. No matter how reliable, if information is not relevant to the decision at hand, it is useless. Conversely, relevant information is of little value if it cannot be relied on. Let's look closer at each of these two characteristics, including the components that make those qualities desirable. We also consider two secondary qualities—comparability and consistency.

### **Relevance**

To make a difference in the decision process, information must possess predictive value and/or feedback value. Generally, useful information will possess both qualities. For example, if net income and its components confirm investor expectations about future cash-generating ability, then net income has feedback value for investors. This confirmation can also be useful in predicting future cash-generating ability as expectations are revised.

### **Timeliness**

Timeliness is an important component of relevance. Information is timely when it is available to users early enough to allow its use in the decision process. The need for timely information requires that companies provide information to external users on a periodic basis. The SEC requires its registrants to submit financial statement information not only on an annual basis, but also quarterly for the first three quarters of each fiscal year.

### **Reliability**

Reliability is the extent to which information is verifiable, representational faithful, and neutral. Verifiability implies a consensus among different measurers. For example, the historical cost of a piece of land to be reported in the balance sheet of a company is usually highly verifiable. The cost can be traced to an exchange transaction, the purchase of the land. However, the market value of that land is much more difficult to verify. Appraisers could differ in their assessment of market value. The term objectivity often is linked to verifiability. The historical cost of the land is objective but the land's market value is subjective, influenced by the measurer's past experience and prejudices. A measurement that is subjective is difficult to verify, which makes it more difficult for users to rely on.

**Representational faithfulness** exists when there is agreement between a measure or description and the phenomenon it purports to represent. For example, assume that the term inventory in a balance sheet of a retail company is understood by external users to represent items that are intended for sale in the ordinary course of business. If inventory includes, say, machines used to produce inventory, then it lacks representational faithfulness.

### **FedEx Corporation**

Reliability assumes the information being relied on is neutral with respect to parties potentially affected. In that regard, neutrality is highly related to the establishment of accounting standards. You learned earlier that changes in accounting standards can lead to adverse economic consequences to certain companies, their investors and creditors, and other interest groups. Accounting standards should be established with overall societal goals and specific objectives in mind and should try not to favor particular groups or companies.

## **1.5. Elements of Financial Statements of Business Enterprise**

The Financial Accounting Standards Board (FASB) has defined the following elements of financial statements of business enterprises: assets, liabilities, equity, revenues, expenses, gains, losses, investment by owners, distribution to owners, and comprehensive income. According to FASB, the elements of financial statements are the building blocks with which financial statements are constructed. These FASB definitions, articulated in its "Elements of Financial Statements of Business Enterprises," are as follows:

- **Assets** are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
- **Comprehensive income** is the change in equity (net assets) of an entity during a period from transactions and other events and circumstances from no owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

- **Distributions to owners** are decreases in net assets of a particular enterprise resulting from transferring assets, rendering services, or incurring liabilities to owners. Distributions to owners decrease ownership interest or equity in an enterprise.
- **Equity** is the residual interest in the assets of an entity that remains after deducting its liabilities. In a business entity, equity is the ownership interest.
- **Expenses** are outflows or other uses of assets or incurring of liabilities during a period from delivering or producing goods or rendering services, or carrying out other activities that constitute the entity's ongoing major or central operation.
- **Gains** are 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 owner.
- **Investments by owners** are increases in net assets of a particular enterprise resulting from transfers to it from other entities of something of value to obtain or increase ownership interest (or equity) in it.
- **Liabilities** are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.
- **Losses** are 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.
- **Revenues** are inflows or other enhancements of assets of an entity or settlement of its liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

## 1.6.Summary

Development of accounting principles and professional practice. The accounting process provides financial data for a broad range of individuals whose objectives in studying the data vary widely. Bank officials, for example, may study a company's financial statements to evaluate the company's ability to repay a loan. Prospective investors may compare accounting data from

several companies to decide which company represents the best investment. Accounting also supplies management with significant financial data useful for decision making. Reliable information is necessary before decision makers can make a sound decision involving the allocation of scarce resources.

- To provide useful information to the users of financial reports. The information should be useful from a number of perspectives, such as whether to provide credit to a customer, whether to lend to a borrower, and whether to invest in a business. The information should be comprehensible to those with a reasonable grounding in business, which means that it should not be laced with jargon or burdened with so much detail that it is impossible to extract the essentials about a business from its financial statements.
- To provide information about the cash flows to which an entity is subjected, including the timing and uncertainty of cash flows. This information is critical for determining the liquidity of a business, which in turn can be used to evaluate whether an organization can continue as a going concern..
- To disclose the obligations and economic resources of an entity. There should be an emphasis on the changes in liabilities and resources, which can be used to predict future cash flows.

The primary decision-specific qualities that make accounting information useful are relevance and reliability. Both are critical. No matter how reliable, if information is not relevant to the decision at hand, it is useless. Conversely, relevant information is of little value if it cannot be relied on. Let's look closer at each of these two characteristics, including the components that make those qualities desirable. We also consider two secondary qualities comparability and consistency.

An evaluation of company financial reporting requires some agreement on its objectives. Financial reporting is not an end in itself but is a means to certain objectives. The objectives of financial reporting and financial statements have been discussed for a long time. While there is no final statement on objectives, to which all parties (of financial reporting) have agreed, some consensus has been developing on the objectives of financial reporting.

The governance and oversight of the activities undertaken by the IFRS Foundation and its standard-setting body rests with a geographically and professionally diverse body of Trustees, who are also responsible for safeguarding the independence of the Board and ensuring the

financing of the organization. The Trustees are publicly accountable to a Monitoring Board of public authorities. The Board is an independent group of experts with an appropriate mix of recent practical experience in setting accounting standards; in preparing, auditing, or using financial reports; and in accounting education. Broad geographical diversity is also required. Members are appointed by the Trustees through an open and rigorous process that includes advertising vacancies and consulting relevant organizations. The IASB has 14 full-time members. The Board develops and maintains a set of accounting requirements collectively referred to as International Financial Reporting Standards (IFRS Standards). IFRS Standards are a set of high quality, understandable, enforceable and globally accepted Standards based up on clearly articulated accounting principles. The Board has no authority to impose those Standards. However, entities that wish, or are required by a particular jurisdiction, to assert compliance with IFRS Standards must comply with all of the individual IFRSs Standards and IFRS Interpretations (Interpretations) issued by the Board.

### 1.7.Exercise

1. Each year the accountant for Northeast Real Estate Company adjusts the recorded value of each asset to its market value. Using these market value figures on the balance sheet violates the
  - A. accounting equation
  - B. stable-dollar assumption
  - C. business entity concept
  - D. cost principle
2. The entry to allocate net income among partners requires a
  - A. debit to each partner's capital account
  - B. credit to each partner's capital account
  - C. credit to income summary
  - D. credit to retained earnings
3. On December 31, 2023, the accounting records of Queens Corporation contain the items below. What is the amount of Cash owned by Sky on December 31, 2023?

Accounts Payable	\$16,000
Accounts Receivable	\$40,000
Land	240,000
Cash -----	
Capital Stock	260,000
Equipment	120,000
Building	180,000

Notes Payable                      190,000  
Retained Earnings                      160,000

- A. \$46,000
  - B. \$86,000
  - C. \$94,000
  - D. \$686,000
4. Which of the following is a characteristic of a corporation?
- A. Declaration of a dividend by the stockholders
  - B. Appointment of officers by the stockholders
  - C. Transferability of shares of stock
  - D. Unlimited liability
5. Which of the following statements best describes the concept of adequate disclosure?
- A. The accounting department of a business must inform management of the accounting practices used to prepare the financial statements.
  - B. The company must inform users of any significant facts necessary for proper interpretation of the financial statements, including events occurring after the financial statement date.
  - C. The independent auditors must disclose in the financial statements any and all errors detected in the company's accounting records.
  - D. The financial statements must include a comprehensive list of each transaction that occurred during the year.
6. What accounting principle governs the timing of revenue recognition?
- A. Realization principle
  - B. Materiality principle
  - C. Matching principle
  - D. Depreciation principle
7. What is the correct order of the accounts in the adjusted trial balance?
- A. Revenues, expenses, assets, liabilities, owner's equity
  - B. Liabilities, assets, revenues, owner's equity, expenses
  - C. Assets, liabilities, owner's equity, revenues, expenses
  - D. Expenses, liabilities, revenues, assets, owner's equity
8. In preparing bank reconciliation, a service charge shown on the bank statement should be
- A. added to the balance per the bank statement
  - B. deducted from the balance per the bank statement
  - C. added to the balance per the depositor's records
  - D. deducted from the balance per the depositor's records
9. Which of the following credit terms is most advantageous to the buyer?
- A. 1/10, n/30
  - B. 5/10, n/60
  - C. 2/10, n/30
  - D. 5/10, n/20
10. A purchasing agent wants to know the dollar amount of inventory purchased on account during the year from a particular supplier. Where is the easiest place to find this information?
- A. Inventory subsidiary ledger
  - B. Accounts payable controlling account
  - C. Inventory controlling account



- D. Accounts payable subsidiary ledger
11. A company uses a perpetual inventory system. At year-end the Inventory account has a balance of \$275,000, but a complete year-end physical inventory shows goods on hand costing \$269,000. What should the company do?
- E. Reduce its cost of goods sold by \$6,000
  - F. Record a \$6,000 current liability
  - G. Reduce the balance in its Inventory controlling account and inventory subsidiary ledger by \$6,000
  - H. Reduce the balance in its Inventory controlling account and record a current liability, both in the amount of \$6,000
12. . Which statement correctly describes the tax advantage of raising money by issuing bonds instead of common stock?
- A. The amount paid by the corporation to redeem bonds at maturity date is deductible in computing income subject to corporate income tax.
  - B. Interest payments are deductible in determining income subject to corporate income tax; dividends are not deductible.
  - C. A corporation must pay tax on the sales price of stock issued, but is not taxed on the amount received when bonds are issued.
  - D. Both interest and dividends paid are deductible in computing taxable income, but since interest must be paid annually, the corporation usually receives a larger tax deduction over the life of the bonds payable.
13. Sally enters into a partnership by contributing the following: Cash \$15,000; Accounts Receivable \$4,500; machinery that cost \$3,000 and has a fair market value of \$2,125; and Accounts Payable of \$1,200. What amount will be recorded in her capital account?
- A. \$20,425
  - B. b. \$21,300
  - C. c. \$21,625
  - D. d. \$22,500
14. A store that sells expensive custom-made jewelry is most likely to determine its cost of goods sold using
- A. LIFO
  - B. FIFO
  - C. Specific identification
  - D. Average cost
15. The collection of accounts receivable is recorded by a
- A. Credit to Cash and a credit to Accounts Receivable
  - B. Debit to Cash and a debit to Accounts Receivable
  - C. Credit to Cash and a debit to Accounts Receivable
  - D. Debit to Cash and a credit to Accounts Receivable
16. On November 1, Delphi Corporation sold merchandise in return for a 7%, 90-day note receivable in the amount of \$30,000. What does the proper adjusting entry at December 31 (the end of Delphi's fiscal year) include?
- A. Credit to Interest Revenue of \$350
  - B. Credit to Notes Receivable of \$525
  - C. Debit to Cash of \$350
  - D. Debit to Interest Receivable of \$175

17. At the beginning of the current year, Wilson Corporation had 200,000 shares of \$1 par common stock outstanding and had retained earnings of \$4,800,000. During the year, the company earned \$1,675,000 and paid a year-end cash dividend of \$3 per share. What was Wilson's retained earnings at the end of the year?
- A. \$4,800,000
  - B. \$5,875,000
  - C. \$6,275,000
  - D. \$6,475,000
18. When stock that was issued by a corporation is later reacquired it is classified as
- A. Treasury stock
  - B. non-participating preferred stock
  - C. restricted stock
  - D. issued shares

## **CHAPTER TWO**

### **IFRS-BASED FINANCIAL STATEMENTS**

#### **2.1.Summary of the accounting cycle (process)**

International Financial Reporting Standards (IFRS) is a set of accounting standards developed by an independent, not-for-profit organization called the International Accounting Standards Board (IASB). It is a single standard will also provide investors and auditors with a cohesive view of finances. Most agree that there is a need for one set of international accounting standards. Here is why:

Multinational corporations. Today's companies view the entire world as their market. For example, large companies often generate more than 50% of their sales outside their own boundaries.

Mergers and acquisitions. The mergers between Fiat/Chrysler and Vodafone/Mannesmann suggest that we will see even more such business combinations in the future.

Information technology. As communication barriers continue to topple through advances in technology, companies and individuals in different countries and markets are becoming more comfortable buying and selling goods and services from one another.

Financial markets. Financial markets are of international significance today. Whether it is currency, equity securities (shares), bonds, or derivatives, there are active markets throughout the world trading these types of instruments.

#### **2.1.1 Brief History of the IASB and Its Standards (IFRS)**

- IASC (predecessor of IASB) was established in 1973.
- The IASC was a consortium of national CPA organizations, and committee members served part time while maintaining their connections with their firms and their clients.
- The early IASC standards were just a compilation of the diverse accounting practices from around the world with some expression of a preferred alternative but no coherent conceptual foundation.

- The original standards of the IASC were, and are, called International Accounting Standards (IAS). The body of standards issued by the IASC/IASB is now referred to as *IFRS* whether the label is IAS or IFRS.
- All during the 1990s, the IASC worked to eliminate the large number of alternative accounting treatments allowable under IAS and also to improve the overall quality of the standards.
- The immediate goal of the IASC was to have its set of standards endorsed by the International Organization of Securities Commission (IOSCO), which includes the U.S. Securities and Exchange Commission

#### Basic Accounting Equation

- Provides the underlying framework for recording and summarizing economic events.
- Assets must equal the sum of liabilities and equity.

#### **2.1.2 Generally Accepted Accounting Principles (GAAP)**

Generally Accepted Accounting Principles, generally called GAAP, are a set of rules and practices having substantial authoritative support. GAAP is the standards that companies use to compile their financial statements such as the income statement, balance sheet, and statement of cash flows. Now a day because of it limitation of different reason the GAAP has been replaced by IFRS.

Financial statements are compiled using GAAP primarily for the benefit of the financial markets and investors in the financial markets. Investors need to know the information they are looking at in different companies' annual reports is in some sort of standardized form. That is what GAAP is for. It makes sure that companies present the same information in the same format, while leaving room for managerial judgment.

There are several regulatory and standard-setting bodies that administer GAAP standards in consultation with the business community and professionals in accounting:

1. Securities and Exchange Commission: This is the body that regulates the U.S. financial markets and accounting standard-setting bodies.

2. Public Company Accounting Oversight Board: This body reviews auditing boards and determines auditing standards.
3. Financial Accounting Standards Board: This board sets the accounting standards for firms in the U.S.
4. International Accounting Standards Board: This board issues accounting standards for firms in many countries outside the U.S.

## **2.2. IFRS ( International financial Reporting Standard )**

Over the past decade, this global discussion has intensified. In 2001, the International Accounting Standards Board (IASB) adopted the first iteration of International Financial Reporting Standards (IFRS) to serve as a possible pathway for establishing uniform global accounting standards. Since then, IFRS has been adopted or become accepted in over 100 countries. Over this same period, the Financial Accounting Standards Board (FASB) and the IASB have begun an effort to converge IFRS and the Generally Accepted Accounting Principles in the United States (US GAAP), essentially working to make the two sets of accounting standards increasingly similar to each other. More recently, some market participants have raised the possibility of transitioning entirely from US GAAP to IFRS for public company financial reporting in the United States.

In the coming years, critical decisions will need to be made regarding the use of global accounting standards in the United States. Market participants will be called upon to determine whether achieving a uniform set of high-quality global accounting standards is feasible, what sort of investments would be required to achieve that outcome, and whether it is a desirable goal in the first place. This dialogue will be critical to the future of financial reporting and of fundamental importance to the long-term strength and stability of the global capital markets.

### **2.2.1 Accounting regulation, the meaning of IFRS, their application and role**

All of the currently adopted accounting standards can be conditionally grouped in the following categories pursuant to the degree of standardization of accounting: national standards, the application of which is statutory in a specific country; national standards, the application of which is statutory in countries of specific regions; international financial reporting standards which are developed for application in countries worldwide. In parallel to the process of

accounting standardization at the regional level, the common international accounting system is also developed. The generally accepted accounting principles form the basis of the international accounting system, and there are common financial accounting and reporting standards established to enable the comparability of enterprise operations worldwide. The purpose of establishing the international financial reporting standards is the harmonization of national accounting and reporting systems in order to improve the quality of use of the company financing, and particularly of the trans-national companies.

IFRS are created at the international level and they are drafted by the International Accounting Standards Board. At present these international standards are named 'International Financial Reporting Standards'. The international standards (IFRS):

- reflect the peculiarities of the market economy; have acquired wide international recognition;
- are relatively simple compared to known national standards; require less cost for the development and enforcement of own (national) standards;
- Open for amendments - there is a possibility to influence their development by participating in the working process of professional organizations. According to substance IFRS: comprise accounting and presentation of reports for tangible and intangible assets, financial instruments, liabilities, reserves, issued capital, revenues and expenses; regulate the preparation of reports in circumstances of hyperinflation;
- provide with the methods for preparation of consolidated financial statements in accordance with the different enterprise merger techniques;
- offer accounting for impairment of asset value; reflect accounting for contingencies;
- provide for winding-up of enterprise operations;
- Provide solutions for several other reporting issues.

## **2.3. Cash flow and net income measurement**

### **2.3.1 Cash flow statement**

In financial accounting, a cash flow statement, also known as *statement of cash flows*, is a financial statement that shows how changes in balance sheet accounts and income affect cash

and cash equivalents, and breaks the analysis down to operating, investing and financing activities. Essentially, the cash flow statement is concerned with the flow of cash in and out of the business. The statement captures both the current operating results and the accompanying changes in the balance sheet. As an analytical tool, the statement of cash flows is useful in determining the short-term viability of a company, particularly its ability to pay bills. International Accounting Standard (IAS 7) is the International Accounting Standard that deals with cash flow statements.

### **Purpose**

The cash flow statement was previously known as the flow of funds statement. The cash flow statement reflects a firm's liquidity.

The statement of financial position is a snapshot of a firm's financial resources and obligations at a single point in time, and the income statement summarizes a firm's financial transactions over an interval of time. These two financial statements reflect the accrual basis accounting used by firms to match revenues with the expenses associated with generating those revenues. The cash flow statement includes only inflows and outflows of cash and cash equivalents; it excludes transactions that do not directly affect cash receipts and payments. These non-cash transactions include depreciation or write-offs on bad debts or credit losses to name a few. The cash flow statement is a cash basis report on three types of financial activities: operating activities, investing activities, and financing activities. Non-cash activities are usually reported in footnotes.

The cash flow statement is intended to

1. provide information on a firm's liquidity and solvency and its ability to change cash flows in future circumstances
2. provide additional information for evaluating changes in assets, liabilities and equity
3. improve the comparability of different firms' operating performance by eliminating the effects of different accounting methods
4. indicate the amount, timing and probability of future cash flows

### **2.3.2 Income Statement**

An income statement or profit and loss account (also referred to as a *profit and loss statement* (P&L), *statement of profit or loss*, *revenue statement*, *statement of financial performance*, *earnings statement*, *operating statement*, or *statement of operations*) is one of the financial statements of a company and shows the company's revenues and expenses during a particular period. It indicates how the revenues (money received from the sale of products and services before expenses are taken out, also known as the "*top line*") are transformed into the net income (the result after all revenues and expenses have been accounted for, also known as "*net profit*" or the "*bottom line*"). The purpose of the income statement is to show managers and investors whether the company made or lost money during the period being reported.

One important thing to remember about an income statement is that it represents a period of time like the cash flow statement. This contrasts with the balance sheet, which represents a single moment in time.

### **Income Statement Uses**

Analysts use the income statement for data to calculate financial ratios such as return on equity (ROE), return on assets (ROA), gross profit, operating profit, earnings before interest and taxes (EBIT), and earnings before interest taxes and amortization (EBITDA). The income statement is often presented in a common-sized format, which provides each line item on the income statement as a percent of sales. In this way, analysts can easily see which expenses make up the largest portion of sales. Analysts also use the income statement to compare year-over-year (YOY) and quarter-over-quarter (QOQ) performance. The income statement typically provides two to three years of historical data for comparison.

Cash flow and net income statements are different in most cases, because there is a time gap between documented sales and actual payments. The situation is under control if the invoiced customers pay in cash during the next period. If the payments are postponed further, there is a larger difference between net income and operative cash flow statements. If the trend does not change, the annual report may demonstrate equally low total cash flow and net income.

Given these descriptions of net income and net cash flow, the key differences between net income and net cash flow are:



- Expense accruals. Expenses are included in the calculation of net income for which no cash payments may have yet been made.
- Prepaid expenses. Cash payments for costs incurred may be recorded as assets instead of expenses, since they have not yet been consumed.
- Deferred revenues. Revenues are excluded from the calculation of net income, because they have not yet been earned, even though the related cash may have already been received (perhaps as a customer deposit).
- Sales on credit. Revenues are included in the calculation of net income, because they have been earned, even though the related cash receipts may not yet have been received.

## 2.4. Summary

This chapter GAAP is rule-based, meaning publicly traded US companies are lawfully required to follow its directives. On the other hand, IFRS is standard-based, meaning no one is required to follow its guideline though it's recommended. As a result, the theoretical framework and principles of IFRS leave more room for interpretation and sometimes require lengthy disclosures on financial statements.

**Source and scope.** GAAP is US-based, while IFRS is used worldwide. The IASB, which sets IFRS, is globally influential; its accounting standards are adapted to accounting rules in countries worldwide. The US, where the Securities and Exchange Commission requires American companies to use GAAP when preparing their financial statements, is the only exception. There are other notable differences in how GAAP and IFRS handle specific elements of various financial documents, including:

### 1. Inventory valuation methods

Inventory valuation is figuring out how much your inventory is worth. There are three standard accounting methods for doing this: the first in, first out (FIFO) method, which assumes that the first (or oldest) items in your inventory will be the first to sell; the last in, first out (LIFO) method, which assumes that the last (or newest) items in your inventory will be the first to sell; and the weighted average method, which uses the amount earned from selling a portion of your inventory to determine the value of the remaining portion.

Here's how GAAP and IFRS differ when it comes to inventory valuation methods:

GAAP. GAAP allows companies to use any of the three inventory valuation methods. When using FIFO, GAAP uses “net asset value”—the total value of a company’s assets minus the total value of its liabilities—to determine inventory valuation.

IFRS. IFRS allows the FIFO and weighted average method but does not allow the LIFO method, because LIFO can be manipulated to distort a company’s earnings to lower tax liability. When using FIFO, IFRS uses “net realizable value,” which considers how much an asset might generate when sold, minus an estimate of costs, fees, and taxes associated with the sale.

## 2. Cash flow statement

A cash flow statement is a financial statement that shows precisely how cash and cash equivalents enter and exit a business over a specific reporting period. GAAP and IFRS handle cash flow statements differently, particularly in how they classify interest and dividends:

GAAP. With GAAP, interest paid and received, and received dividends are listed under the operating section, while dividends paid are listed in the financing section.

IFRS. With IFRS, all interest and dividends can be listed under the operating or financing section.

## 3. Balance sheet

A balance sheet is a financial statement that summarizes a company’s assets, liabilities, and shareholder equity at a given point in time. It’s essential to know how to organize your balance sheet so that your investors and other interested parties can quickly and accurately read it. GAAP and IFRS differ in how categories are arranged on a balance sheet:

GAAP. GAAP requires assets in order of liquidity, with the most liquid assets listed first—that is, current assets, non-current assets, current liabilities, non-current liabilities, and owners’ equity.

IFRS. IFRS suggests putting assets in the opposite order of liquidity, with the least liquid assets listed first—that is, non-current assets, current assets, owners’ equity, non-current liabilities, and current liabilities.

## 4. Asset revaluation

The value of a company’s assets may fluctuate over a given period, meaning they need to be re-evaluated (i.e., reappraised). Asset revaluation is crucial because it can help you save for replacement costs of fixed assets once they’ve run through their useful lives, and gives investors

a more accurate understanding of your business. Asset revaluation can also reduce your debt-to-equity ratio, which can paint a healthier financial picture of your company.

GAAP and IFRS have different approaches to asset revaluation:

GAAP. GAAP only allows the revaluation of fair market value for marketable securities (i.e., investments and stocks).

IFRS. IFRS allows for the revaluation of more assets, including plant, property, and equipment (PPE), inventories, intangible assets, and investments in marketable securities.

#### 5. Inventory write-down reversals

A company's inventory may lose value over time. An asset may, for example, lose value because of market or technological factors, which classifies it as a "loss on impairment." GAAP and IFRS require that businesses write down their inventory as soon as its cost exceeds its net realizable value (i.e., how much the inventory is expected to generate when sold). While a loss is often permanent, the value of an asset may increase again if the impairing factor is no longer present. GAAP doesn't allow companies to re-evaluate the asset to its original price in these cases. In contrast, IFRS allows some assets to be evaluated up to their original price and adjusted for depreciation.

### 2.5.Exercise

1. What is IFRS?
2. What is the IASB?
3. How widespread is the adoption of IFRS around the world?
4. What is the possibility of the Securities and Exchange Commission substituting IFRS for GAAP?
5. What are the advantages of converting to IFRS?
6. What could be the disadvantages of converting to IFRS?
7. What is the difference between convergence and adoption?
8. Who are the key players in the United States regarding the development and adoption of IFRS?
9. Have any major U.S. companies begun transitioning to IFRS?
10. When comparing IFRS and GAAP, what are some overall key differences I should be aware of?

11. What are some of the most important specific differences between IFRS and U.S. GAAP?
12. Is the possible conversion to IFRS from U.S. GAAP solely a financial reporting issue?
13. What other areas of the profession will IFRS affect?
14. What are the likely costs of converting to IFRS?
15. What should I do now?
16. If the United States mandates IFRS for publicly traded companies, will private companies and not-for-profit organizations be required to adopt IFRS?
17. What actions are being taken that could allow private companies to follow IFRS?
18. What might make some private companies in the United States adopt IFRS?
19. Delta is an entity which prepares financial statements to 31 March each year. During the year ended 31 March 2014 the following events affected Delta:
  - A. On 1 April 2012, Delta had granted share appreciation rights to 200 senior executives. Each executive will receive 2,000 rights on 31 March 2015 provided he or she continues to be employed by Delta at that date. On 1 April 2012, the directors estimated that all the executives would remain employed by Delta for the three-year period ending on 31 March 2015. However, 10 executives left in the year ended 31 March 2013 and at 31 March 2013 the directors believed that a further 10 executives would leave in the following two years. Five executives actually left in the year ended 31 March 2014 and the directors now believe that seven more directors will leave in the year ended 31 March 2015. Since 1 April 2012, the fair value of the share appreciation rights has fluctuated as follows:
20. IFRS 2 – Share-based Payment – defines a share-based payment transaction as one in which an entity receives goods or services from a third party (including an employee) in a share-based payment arrangement. A share-based payment arrangement is an agreement between an entity and a third party which entitles the third party to receive either: – Equity instruments of the entity (equity-settled share-based payments); or – Cash or other assets based on the price of equity instruments of the entity (cash-settled share-based payments). Share-based payment arrangements are often subject to vesting conditions which must be satisfied over a vesting period. Required: For both cash-settled AND equity-settled share-based payment arrangements, explain:

- (i) The basis on which the arrangements should be measured;
  - (ii) The criteria which are used to allocate the total value of the arrangement to individual accounting periods;
  - (iii) The accounting entries (debit and credit) required during the vesting period.
21. Kappa prepares financial statements to 31 March each year. The following share-based payment arrangements were in force during the year ended 31 March 2015:
- (i) On 1 April 2013, Kappa granted options to 500 employees to subscribe for 400 shares each in Kappa on 31 March 2017, providing the employees still worked for Kappa at that time. On 1 April 2013, the fair value of each option was \$1.50. In the year ended 31 March 2014, ten of these employees left Kappa and at 31 March 2014, Kappa expected that 20 more would leave in the three-year period from 1 April 2014 to 31 March 2017. Kappa's results for the year ended 31 March 2014 were below expectations and at 31 March 2014 the fair value of each option had fallen to 25 cents. Therefore, on 1 April 2014 Kappa amended the exercise price of the original options. This amendment caused the fair value of these options to rise from 25 cents to \$1.45. During the year ended 31 March 2015, five of the employees left and at 31 March 2015, Kappa expected that ten more would leave in the two-year period from 1 April 2015 to 31 March 2017. The results of Kappa for the year ended 31 March 2015 were much improved and at 31 March 2015, the fair value of a re-priced option was \$1.60.

## **CHAPTER THREE**

### **3. REVENUE RECOGNITION**

#### **3.1.Introduction**

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 customer who enters into a mobile phone contract with a company such as Verizon. 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, customers may pay for these services in a variety of ways, possibly receiving a discount on the handset, 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 Verizon? The answer is not obvious.

#### **3.1. Guidelines for Revenue Recognition**

Revenue arises from ordinary operations and is referred to by various names such as sales, fees, rent, interest, royalties, and service revenue. Gains, on the other hand, may or may not arise in the normal course of operations. Typical gains are gains on sale of noncurrent assets or unrealized gains related to investments or noncurrent assets. The primary issue related to revenue recognition is when to recognize the revenue.

In general, the guidelines for revenue recognition are quite broad. On top of the broad guidelines, certain industries have specific additional guidelines that provide further insight into when revenue should be recognized. The revenue recognition principle provides that companies should recognize revenue<sup>4</sup> (1) when it is realized or realizable, and (2) when it is earned.<sup>5</sup> Therefore, proper revenue recognition revolves around three terms: Revenues are realized when a company exchanges goods and services for cash or claims to cash (receivables). Revenues are realizable when assets a company receives in exchange are readily convertible to known amounts of cash or claims to cash. Revenues are earned when a company has substantially accomplished what it must do to be entitled to the benefits represented by the revenues—that is, when the earnings process is complete or virtually complete.

Four revenue transactions are recognized in accordance with this principle:

1. Companies recognize revenue from selling products at the date of sale. This date is usually interpreted to mean the date of delivery to customers.
2. Companies recognize revenue from services provided, when services have been performed and are billable.
3. Companies recognize revenue from permitting others to use enterprise assets, such as interest, rent, and royalties, as time passes or as the assets are used.

4. Companies recognize revenue from disposing of assets other than products at the date of sale. The preceding statements are the basis of accounting for revenue transactions. Yet, in practice there are departures from the revenue recognition principle. Companies sometimes recognize revenue at other points in the earning process, owing in great measure to the considerable variety of revenue transactions.

### **Departures from the Sale Basis**

An FASB study found some common reasons for departures from the sale basis. One reason is a desire to recognize earlier than the time of sale the effect of earning activities. Earlier recognition is appropriate if there is a high degree of certainty about the amount of revenue earned. A second reason is a desire to delay recognition of revenue beyond the time of sale. Delayed recognition is appropriate if the degree of uncertainty concerning the amount of either revenue or costs is sufficiently high or if the sale does not represent substantial completion of the earnings process.

This chapter focuses on two of the four general types of revenue transactions described earlier: (1) selling products and (2) providing services. Both of these are sales transactions. (In several other sections of the textbook, we discuss the other two types of revenue transactions—revenue from permitting others to use enterprise assets, and revenue from disposing of assets other than products.) Our discussion of product sales transactions in this chapter is organized around the following topics:

1. Revenue recognition at point of sale (delivery).
2. Revenue recognition before delivery.
3. Revenue recognition after delivery

### **3.2.1 Revenue recognition at point of sale**

According to the FASB's Concepts Statement, companies usually meet the two conditions for recognizing revenue (being realized or realizable and being earned) by the time they deliver products or render services to customers. Therefore, companies commonly recognize revenues from manufacturing and selling activities at point of sale (usually meaning delivery). Implementation problems, however, can arise. We discuss some of these problematic situations on the following pages.

#### **Sales with Discounts**

Any trade discounts or volume rebates should reduce consideration received and reduce revenue earned. In addition, if the payment is delayed, the seller should impute an interest rate for the difference between the cash or cash equivalent price and the deferred amount. In essence, the seller is financing the sale and should record interest revenue over the payment term.

#### **Sales with Right of Return**

Whether cash or credit sales are involved, a special problem arises with claims for returns and allowances. However, certain companies experience such a high rate of returns—a high ratio of returned merchandise to sales—that they find it necessary to postpone reporting sales until the return privilege has substantially expired.

For example, in the publishing industry, the rate of return approaches 25 percent for hardcover books and 65 percent for some magazines. Other types of companies that experience high return rates are perishable food dealers, distributors who sell to retail outlets, recording-industry companies, and some toy and sporting goods manufacturers. Returns in these industries are frequently made either through a right of contract or as a matter of practice involving “guaranteed sales” agreements or consignments. Three alternative revenue recognition methods are available when the right of return exposes the seller to continued risks of ownership. These are (1) not recording a sale until all return privileges have expired; (2) recording the sale, but reducing sales by an estimate of future returns; and (3) recording the sale and accounting for the returns as they occur. The FASB concluded that if a company sells its product but gives the buyer the right to return it, the company should recognize revenue from the sales transactions at the time of sale only if all of the following six conditions have been met.

1. The seller's price to the buyer is substantially fixed or determinable at the date of sale.
2. The buyer has paid the seller, or the buyer is obligated to pay the seller, and the obligation is not contingent on resale of the product.
3. The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product.
4. The buyer acquiring the product for resale has economic substance apart from that provided by the seller.
5. The seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer.



6. The seller can reasonably estimate the amount of future returns.

What if the six conditions are not met? In that case, the company must recognize sales revenue and cost of sales either when the return privilege has substantially expired or when those six conditions subsequently are met, whichever occurs first. In the income statement, the company must reduce sales revenue and cost of sales by the amount of the estimated returns.

### **3.2. Income statement**

The **income statement** is the report that measures the success of company operations for a given period of time. (It is also often called the statement of income or statement of earnings.) The business and investment community uses the income statement to determine profitability, investment value, and creditworthiness. It provides investors and creditors with information that helps them predict the **amounts, timing, and uncertainty of future cash flows**.

#### **3.2.1 Usefulness of the Income Statement**

The income statement helps users of financial statements predict future cash flows in a number of ways. For example, investors and creditors use the income statement information to:

**1. Evaluate the past performance of the company.** Examining revenues and expenses indicates how the company performed and allows comparison of its performance to its competitors. For example, analysts use the income data provided by **Ford** to compare its performance to that of **Toyota**.

**2. Provide a basis for predicting future performance.** Information about past performance helps to determine important trends that, if continued, provide information about future performance. For example, **General Electric** at one time reported consistent increases in revenues. Obviously past success does not necessarily translate into future success. However, analysts can better predict future revenues, and hence earnings and cash flows, if a reasonable correlation exists between past and future performance.

**3. Help assess the risk or uncertainty of achieving future cash flows.** Information on the various components of income—revenues, expenses, gains, and losses—highlights the relationships among them. It also helps to assess the risk of not achieving a particular level of cash flows in the future. For example, investors and creditors often segregate **IBM**'s operating performance from other nonrecurring sources of income because IBM primarily generates revenues and cash through its operations. Thus, results from continuing operations usually have greater significance for predicting future performance than do results from nonrecurring activities and events. In summary, information in the income statement—revenues, expenses, gains, and losses—helps users evaluate past performance. It also provides insights into the likelihood of achieving a particular level of cash flows in the future.

In summary, information in the income statement—revenues, expenses, gains, and losses—helps users evaluate past performance. It also provides insights into the likelihood of achieving a particular level of cash flows in the future.

### 3.2.2 Limitations of the Income Statement

Because net income is an estimate and reflects a number of assumptions, income statement users need to be aware of certain limitations associated with its information. Some of these limitations include:

- 1. Companies omit items from the income statement that they cannot measure reliably.** Current practice prohibits recognition of certain items from the determination of income even though the effects of these items can arguably affect the company's performance. For example, a company may not record unrealized gains and losses on certain investment securities in income when there is uncertainty that it will ever realize the changes in value.
- 2. Income numbers are affected by the accounting methods employed.** One company may depreciate its plant assets on an accelerated basis; another chooses straight-line depreciation. Assuming all other factors are equal, the first company will report lower income. In effect, we are comparing apples to oranges.
- 3. Income measurement involves judgment.** For example, one company in good faith may estimate the useful life of an asset to be 20 years while another company uses a 15-year estimate for the same type of asset. Similarly, some companies may make optimistic estimates of future warranty costs and bad debt write-offs, which results in lower expense and higher income. In summary, several limitations of the income statement reduce the usefulness of its information for predicting the amounts, timing, and uncertainty of future cash flows.

### 3.3. Alternative Forms of Income Statement

The manner in which accounting information is displayed in an income statement can influence the reader's interpretation of the information.

Except for three specific items (extra ordinary items, discontinued operations, and effects of changes in accounting principles), GAAP does not require a standard format for organizing and presenting the firm's revenues, expenses, gains, and losses. These income statement elements are organized in one of two general ways: a single-step format and a multiple-step format.

#### Single-Step Format

The single-step format uses only two broad section classifications: (1) a revenue and gains section, and (2) an expenses and losses section. It is a single step statement because only one step is involved in computing and displaying operating income.

The single-step form of income statement is presented below:

**Nice Corporation**  
**Income Statement**  
**For the Year ended Dec. 31, 1990.**

**Revenue:**

Net sales -----	Br. 18,108
Investment income -----	420
Gain on disposal of equipment -----	50
<b>Total revenue .....</b>	<b>18,578</b>

**Costs and Expenses:**

Cost of goods sold -----	Br. 11,988
Selling Expenses -----	2640
General and administrative Expense -----	1620
Interest Expense -----	230
Income taxes expense -----	1,043
<b>Total costs and expenses .....</b>	<b>(17,521)</b>
Net income -----	<b><u>Br. 1,057</u></b>

**Multiple-Step Format**

The multiple-step format provides for several classifications and intermediate subtotal measures of income. It typically distinguishes among various operations and activities that affect income. The multiple-step form is more likely to be found in more detailed income statements prepared for the use of management bankers and other creditors.

The multiple-step form of income statement is presented below:

NICE Corporation  
Income Statement  
For the year ended December 31, 1990  
(In thousands of Birrs)

Sales (net of discounts, returns, and allowances) -----	Br. 18,108
Cost of goods sold:	
Inventories Jan 1, 1990 -----	Br. 1,000
Purchases (net of discounts, returns, and allowances) -----	10,302
Freight-in -----	<u>1,266</u> 11,568
Cost of goods available for sale -----	<u>12,568</u>
Less: Inventories Dec. 31, 1990 -----	580
Cost of goods sold -----	<u>11,988</u>
Gross profit on sales -----	6,120
Operating expenses:	
Selling expenses:	
Sales salaries -----	Br. 1260
Advertising and promotion -----	880
Building occupancy (including depreciation and property taxes on building) -----	420
Other -----	<u>80</u> Br. 2,640
General and administrative expenses:	
Salaries -----	1,160
Property tax -----	308
Depreciation on equipment -----	80
Other -----	<u>721620</u>
Total operating expenses -----	Br. <u>4260</u>
Income from operation -----	Br. 1,860
Other revenue (Expenses):	
Investment income -----	Br. 420
Gain on disposal of equipment -----	50
Interest expense -----	<u>(230)240</u>
Income before income taxes -----	Br. 2,100
Income taxes expense (including Br. 20 differed) -----	<u>1,043</u>
Net income -----	Br. <u>1057</u>
Earnings per share of common stock -----	Br. <u>1.2</u>

### **3.4. Statement of retained earnings**

A statement of retained earnings often presented as a supplement to the financial statements. The purpose of statements of retained earnings is to reconcile the beginning and ending balances of retained earnings, showing all changes in retained earnings, during the accounting period, and to provide connecting ink between the income statement and the balance sheet.

The ending balance of retained earnings is reported on the balance sheet as one element of owners' equity. Major components of a statement of retained earnings are:

1. Prior period adjustments
2. Net income or loss for the period
3. Dividends – both stock dividends and cash dividends
4. On special accounting changes, retroactive effects of accounting principle change.

Disclosure of cash dividends per share also is made in the statement of retained earnings.

#### **3.4.1 Prior Period Adjustments**

Prior period adjustments are correction of errors in the financial statements from a prior period that affect retained earnings. Material errors in the financial statements might include arithmetical mistakes, the misuse or omissions of information, mistakes in the application of accounting principles and failure to interpret properly the accounting aspects of transactions.

In the financial statements for the current accounting period, a prior period adjustment is reported as a correction to the beginning balance of retained earnings.

The format of the statement of retained earnings is presented below:

**NICE Corporation**

**Statement of Retained Earnings**  
**For the year ended December 31, 1990**

Retained earnings, beginning of the year, as originally reported -----	Br. 2,800
Less: Prior period adjustment (correction of error), net of income tax effect of Br. 240 -----	<u>360</u>
Retained Earnings, beginning of year, as restated -----	Br. 2,440
Add: Net income -----	<u>1,057</u>
Subtotal -----	3, 497
Less: Cash dividends on preferred stock -----	Br. 57
Cash dividends on common stock -----	<u>400 457</u>
Retained Earnings, end of year -----	<u>3,040</u>

**3.5. Revenue recognition.**

The objective of any business enterprise is to generate income that will provide owners with a return on their investment. The major source of income for most enterprises is from its operation - the process of generating revenue by providing goods and services to outsiders. Operations involve the incurring of costs and expenses, and unless a satisfactory level of revenue is generated a loss or a low level of income will result, no matter how carefully costs and expenses are controlled. Consequently, the meaning of revenue and the criteria for its recognition are important not only to accountants but also to enterprise and to the users of its financial statements.

In today's more complex and uncertain business environment, accountants are faced with two tasks relating to revenue i.e. to determine when revenue is realized and the birr amount at which it is recognized in the accounting records. Because of new and frequently complex ways of structuring business transactions, and because of the many new products and services developed in recent years, revenue recognition has become one of the most challenging problems in financial accounting.

SFAC No 5 defines recognition as the recording of an item in the accounts and financial statements as an asset, liability, revenue, expense, gain, or loss. Recognition includes depiction

of an item in both words and numbers, with the amount included in the summarized figures reported in the financial statements

Four fundamental criteria must be met before an item can be recognized. These are definition (the item or the event must meet the definition of one of the financial statement elements (asset, revenue, expense etc), measurability (the item or event must have a relevant attribute that is reliably measurable, that is, a characteristic, trait, or aspect that can be quantified and measured. Examples are historical cost, current cost, market value etc), Relevance (information about the item or event is capable of making a difference in users decisions), Reliability (information about the item is representational faithful, verifiable, and neutral).

In addition to the above four general recognition criteria, the revenue principle provides that revenue should be recognized in the financial statements when it is earned and it is realized or realizable.

Revenues are earned when the company has substantially accomplished all that it must do to be entitled to receive the associated benefits of the revenue. In general, revenue is recognizable when the earning process is completed or virtually completed.

Earning process is the profit – directed activities of a business enterprise through which revenue is earned; such activities may include purchasing, manufacturing, selling, rendering services, delivering and servicing products sold, allowing others to use enterprise resources, etc.

Revenue is realized when cash is received for the goods or services sold. Revenue is considered realizable when claims to cash (for example, non-cash assets such as accounts or notes receivable) are received that are determined to be readily convertible into known amount of cash. This criteria is also met if the product is a commodity, such as gold or wheat, for which there is a public market in which essentially unlimited amounts of the product can be bought or sold at the known market price. In the measurement of revenue, realization generally means that a measurable transaction (such as sale) or an event (such as the rendering of services) has been completed or is sufficiently finalized to warrant the recording of earned revenue in the accounting records. The selection of the critical event indicating that revenue has been realized (earned) is the foundation of the revenue realization principle. In addition, revenue to be recognized collection of the claims from customers and clients who have purchased goods and services should be reasonably assured.

In general, revenues are recognized (formally recorded in the accounting records) as soon as all criteria are met. An accounting issue is to determine when the criteria are met for different types of revenue – generating transactions.

In making many revenue & expense recognition decisions, accountants may rely on estimates and professional judgments. For example, the amount spent for material, labor, and other services may be measured objectively, however, the continuous transformation of these cost inputs into more valuable outputs is an internal process that requires estimates based on subjective judgment. In tracing the effect of this process and portraying it in terms of birr, accountants do not have objective external evidence supporting market transactions as a basis for measurement and recording.

However, generally accepted accounting principles provide few guidelines for making estimates and for exercising professional judgment in specific revenue & expense recognition situations.

### **Stages at which revenues are recognized**

The delivery of goods or services to a customer is a significant event that occurs in virtually all revenue – generating transitions. Given this fact, three broad timing categories of revenue recognition can be identified:

1. Revenue recognized on delivery of the product or service (the point of sale)
2. Revenue recognized before delivery of the product or service.
3. Revenue recognized after delivery of the product or service.

For most companies and for most goods and services, however, revenue is recognized at the time of delivery of the goods or services to the customer: Revenue is then considered both earned and realized or realizable when the product or service is delivered.

Revenue is sometimes recognized before delivery when the earning process extends over several accounting periods and it is considered important (i.e. relevant) to provide revenue information before the earning process is complete. For example, when there is a contract to produce a product for a known birr amount that will be received when the product is delivered (i.e. it is realizable), revenue can be recognized as it is earned, before the product is delivered to the customer.

Revenue is sometimes recognized after delivery when there are concerns about the amount of revenue that will be realized. Revenue has been earned, but recognition is delayed until the



amount realizable is determined. In these situations, providing reliable revenue information is considered more important than early, potentially more relevant but less reliable, revenue information.

#### **4.5.1 Revenue Recognized at Delivery (Point of Sale)**

The conditions for revenue recognition are usually met at the time goods or services are delivered. Thus, revenue from the sale of goods is usually recognized at the date of sale, which is the date the goods are delivered to the customer. Revenue from services rendered is likewise recognized when the services have been performed. This is the point – of – sale method, sometimes called the sales method or the delivery methods of revenue recognition.

Some costs associated with servicing a product or service sold with a guarantee or warranty may be incurred after delivery. When these cost can be reasonably estimated, revenue is still recognized at the date of sale, with a provision made for future warranty cost. In this case, revenue is considered earned and realizable.

One may question why accountants choose so late a stage in the earning process to recognize revenue and thus net income.

The answer comes in two parts: (1) At any point prior to sale, the expected selling price of a product and the ability to sell it at a profit may be so uncertain that they do not constitute sufficient evidence to justify an upward valuation of the product, and (2) for most business enterprises the actual sale of a product is the most important step – the critical event – in the earning process. Until a sale is made and the product is delivered to and accepted by the customer, the future stream of revenue is both uncertain and unearned.

Shipment of goods on consignment does not constitute sales. In a consignment, goods are transferred to another party (the consignee), who acts as an agent for the owner of the goods (the consignor). Title to the goods remains with the owner until the agent sells the goods to ultimate customers, at which time a sales transaction takes place and revenue is recognized by the consignor.

#### **1. Installment method:**

Business enterprises that sell goods on the installment plan may use the installment method of accounting only when accrual accounting is not considered appropriate. The installment method

is widely used for income tax purposes because it postpones the payment of income taxes until installment receivables are collected. However, the installment method is not acceptable for financial accounting unless considerable doubt exists as to the collectibles of the receivables and a reasonable estimate of doubtful accounts expense can't be made.

Under the installment method, the seller recognizes gross profit on sales in proportion to the cash collected. If the rate of gross profit on installment sales is 40%, each birr of cash collected on the installment receivables represents 40 cents of gross profit and 60 cents of cost recovery.

Repossessions are common under the installment sales method because this method is used only when there is substantial uncertainty of collection.

### **Revenue Recognition when Right of Return Exists**

Even when a sale occurs, the recognition of revenue may be delayed because of unusual terms surrounding the sales transaction. For example, in the recorded music and book publishing industries it is common practice to give retail stores the right to return products sold and delivered to them if they cannot resell these products. When such a right of return exists, the seller continues to be exposed to the usual risks of ownership, and revenue is recognized on the date of sale only if all of the following conditions are met.

1. The seller's price to the buyer is substantially fixed or determinable on the date of sale.
2. The buyer has paid the seller, or is obligated to pay the seller and the obligations not contingent on resale of the product.
3. The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product.
4. The buyer acquiring the product for resale has economic substance apart from that provided by the seller.
5. The seller does not have significant obligations for future performance to bring about resale of the product by the buyer.
6. The amount of future returns can be reasonably estimated.

If these conditions are met and sales are recorded, provision for any costs or losses that may be expected in connection with any returns is made on the date of sale. The sales and cost of goods sold in the income statement exclude the portion for which returns are expected, and the allowance for estimated returns is deducted from trade accounts receivable in the balance sheet.

Transactions for which revenue recognition is postponed are record as sales when the return privilege expires.

### **Sales on installment plan**

A sale of goods or services on the installment plan generally provides for a cash down payment and a series of additional monthly payments. Because payments extend over a long period, the seller customarily charges interest and carrying charges on the unpaid balance of installment receivables. Revenue from installment sales is recorded in the same manner as from regular sales, unless the collection of the installment receivable is not assured and there is no reasonable basis for estimating the probability of collection. If the accrual basis of accounting is not considered appropriate, an alternative method of revenue recognition such as the installment method or the recovery method which will be discussed later must be used.

#### **4.5.2 Revenue Recognition Before Delivery**

In some instances the earning process extends over several accounting periods. Delivery of the final products may occur years after the initiation of the product. Examples are construction of large ships, bridges, office buildings, and development of space exploration equipment. Contracts for these projects often provide for progress billings at various points in the construction process.

If the builder (seller) waits until the construction is completed to recognize revenue, the information on revenue and expense included in the financial statements will be reliable, but may not be relevant for decision making because the – information is not timely. In such instances, it often is worthwhile to trade – off reliability in order to provide more timely, relevant earnings information. This is the case for a company engaging in long – construction contracts.

GAAP provides two methods of accounting for revenue on long – term constructs:

1. Completed – contract method: under this method revenues, expenses, and gross profit are recognized only when the contract is completed. As construction costs are incurred they are accumulated in an inventory account (construction in progress). Progress billings are not recorded as revenues but are accumulated in a contra inventory account (billings on construction progress. At the completion of the contract, all the accounts are closed and the entire gross profit from the construction project is recognized.

2. Percentage – of – completion method: Under this method revenue, expenses and gross profit are recognized each accounting period based on the estimate of the percentage of completion of the construction project.

The percentage of – completion method recognizes revenue on a long – term project as the contract is being completed, thus timely information is provided. However, it contains estimates and is not as reliable as information in the completed – contract method.

Management of a company has little freedom of choice in deciding between these alternative methods of accounting for long – term contracts. When estimate of costs to complete and extent of progress toward completion of long-term construction contracts are reasonably dependable, the percentage – of - completion method is preferable. When lack of dependable estimates or inherent hazards cause forecasts to be doubtful, the completed – contract method is preferable.

Measuring progress toward completion of a long – term construction project is accomplished with input measures or output measures.

### **1. In put measures:**

The effort devoted to a project to date is compared with the total effort expected to be required in order to complete the project. Examples are cost incurred to date compared with total estimated costs for the project and labor hours worked compared with total estimated labor required to complete the project. Among input measures, the cost – to – cost method is the most common. The cost – to - cost method measures the percentage completed by the ratio of the costs incurred to date to the current estimate of the total cost required to complete the project:

$$\text{Percent complete} = \frac{\text{Total costs incurred to date}}{\text{Most recent estimate of total costs of the project}}$$

The most recent estimate of total project costs is the sum of the total costs incurred to date plus the estimated costs yet to be incurred to complete the project. Once the percentage completed has been computed, the amount of revenue to be recognized in the current period is determined as:

$$\text{Current period revenue} = (\text{percent complete} \times \text{total revenue from contract}) - \text{total revenue Recognized in prior periods}$$

### **2. Output measures:**

Results to date are compared with total results when the project is completed. Examples are number of stories to be built and miles of highway completed compared with total miles to be completed.

**Illustration:** FENOTE construction company engaged into contract with a municipality to construct a 10 kilometer highway. Total contract price is Br. 900,000.

<u>Additional data:</u>	<u>Year 1</u>	<u>year 2</u>	<u>year 3</u>
Construction costs incurred during the year .....	Br.125,000	Br. 495,000	Br. 145,000
Estimated cost to complete the project			
at the end of the year .....	Br.625,000	Br. 155,000	0
Operating costs incurred (selling , Administrative)	Br. 15,000	Br. 30,000	12,000

**Required :** using the above data compute the realized profit on contract revenue for each year under the following methods of accounting for construction – type contracts:

- (a) Percentage - of –completion method (cost – to cost)
- (b) Completed – contract method.

**Solution:**

(a) Percentage – of – completion method

- ◆ Revenue recognized to date =  $\frac{\text{Actual cost incurred to date}}{\text{Newly estimated total cost to complete the projects}} \times \text{contract price}$
- ◆ revenue recognized for = Revenue recognized – Revenue recognized until the end of the previous year a particular year to date

**Therefore,**

$$\begin{aligned} \text{Revenue recognized for year 1} &= \frac{125,000}{750,000} \times 900,000 \\ &= \text{Br. } \underline{150,000} \end{aligned}$$

$$\begin{aligned} \text{Revenue recognized for year 2} &= \frac{620,000}{775,000} \times 900,000 - 150,000 \\ &= 720,000 - 150,000 \\ &= \text{Br. } \underline{570,000} \end{aligned}$$

$$\begin{aligned} \text{Revenue recognized for year 3} &= \frac{765,000}{765,000} \times 900,000 - (150,000 + 570,000) \\ &= \text{Br. } \underline{180,000} \end{aligned}$$

**Fenote Construction Company**

**Realized Gross Profit On Contract Revenue – Percentage Of Completion Method.  
For Years 1,2 And 3**

	<u>YEAR 1</u>	<u>YEAR 2</u>	<u>YEAR 3</u>
Contract Revenue	Br. 150,000	Br. 570,000	Br. 180,000
Costs Incurred	<u>125,000</u>	<u>495,000</u>	<u>145,000</u>
Realized Gross Profit On Contract Revenue	Br. 25,000	Br. 75,000	Br. 35,000
Operating Expenses	<u>15,000</u>	<u>30,000</u>	<u>12,000</u>
Net Income	Br. <u>10,000</u>	Br. <u>45,000</u>	Br. <u>23,000</u>

(B) Completed – contract method.

	<u>YEAR 1</u>	<u>YEAR 2</u>	<u>YEAR 3</u>
Contract revenue	Br.0	Br.0	Br. 0
construction costs incurred.....	<u>0</u>	<u>0</u>	<u>0</u>
Gross profit	Br. 0	Br. 0	Br. 0
Operating expenses	Br. <u>15,000</u>	Br. <u>30,000</u>	Br. <u>12,000</u>
Net income	Br. <u>(15,000)</u>	Br. <u>(30,000)</u>	Br. <u>(123,000)</u>

Some additional methods that have been proposed, and generally rejected, for the realization of revenue prior to delivery of the product are production, accretion, discovery, receipt of order, and billing.

The recognition of revenue prior to delivery generally is viewed as a departure from the revenue realization principle. Recognition of revenue on construction – type contracts under the percentage – Of completion or on completion of “special order” goods has considerable theoretical and practical support.

In general, when a sale of goods is not considered to result in revenue realization, the revenue might be recognized at the following stages of the productive (earning) process prior to delivery of goods to customers:

1. Prior to production.
2. During production
3. on completion of production
4. At some other stage based, for example, on production, accretion, discovery, receipt of orders from customers, or billing of customers.

### **4.5.3 Revenue Recognition After Delivery**

Under some circumstances the revenue recognition criteria are not met until some time after delivery of the goods or service to the customer. Such is the case when :

1. The substance of the transaction is different from the form, such as in product – financing arrangements.

2. The ultimate collectability of the sales price is highly uncertain, such as with some long – term installment sales

In such instance revenue may be recorded under the installment method, the cost recovery method , or some other method based on cash collection.

## **2. Cost Recovery method.**

The cost recovery method is sometimes called the sunk cost method. Under this method a company recovers all the related costs incurred (the sunk costs) before it recognizes any profit. The cost recovery method is used only for highly speculative transactions when the ultimate realization of revenue or profit is unpredictable. The cost recovery method is also justified when there is uncertainty regarding the ultimate collectability of an installment sale.

Under the cost recovery method, no profit is recognized until the cost of the products sold is fully recovered. In the period of sale, the cost of the products is deducted from sales (net of the deferred gross profit) in the income statement. The deferred gross profit also is deducted from the related receivable in the balance sheet. Collections of principal reduce the receivable, and any collections of interest are credited to the deferred gross profit ledger account. Deferred gross profit subsequently recognized as earned is presented as a separate item of revenue in the income statement.

**Illustration:** For installment method and cost recovery method.

On June 1, 2021, Booker productions sells a large amount of unusual merchandise to a retailer. The demand for the merchandise is unknown, the retailer is of questionable financial strength, and thus it is highly uncertain as to whether Booker will ever be paid the full sales price. The facts regarding the transaction and subsequent events are:

Sales price for merchandise	Br. 140,000	100%
Cost of merchandise sold	<u>84,000</u>	60%
Gross margin	Br. 56,000	
Cash Collected in 2021	Br. 40,000	
Cash collected in 2022	Br. 55,000	
Cash collected in 2023	Br. <u>15,000</u>	
Total cash inflows	Br. <u>110,000</u>	

At December 31, 2023, it is determined that no more cash will be collected from this transaction.

**Required:**

1. Show the entries to account for this transaction using the installment sales method.
2. Show the entries to account for this transaction using the cost recovery method
3. Show summary comparative income statements for all three years for both methods.

**Solution:**

Requirements 1 and 2 are shown in side –by – side columns to illustrate the difference between the two methods. Entries that differ between the two methods are shown in bold face.

	<u>Installment Method</u>	<u>Cost recovery method</u>
To record sales and cost of sales:		
Installment sales receivable	140,000	140,000
Installment sales	140,000	140,000
Cost of installment sales	84,000	84,000
Merchandise inventory	84,000	84,000
To record cash payments received during 2021:		
Cash	40,000	40,000
Installment sales receivable	40,000	40,000

At December 31, 2021, to record deferred gross margin and amount of realized gross margin during 2021 , and to close temporary accounts:

	<u>Installment Method</u>	<u>Cost recovery method</u>
Installment sales	\$ 140,000	\$ 140,000
Cost of installment sales	84,000	84,000
Deferred gross margin	56,000	56,000
Deferred gross margin(Br. 40,000 X 0.4)	<b>16,000</b>	
Realized gross margin	<b>16,000</b>	

2022 entries to record cash received and to record realized gross margin

	<u>Installment Method</u>	<u>Cost Recovery Method</u>
Cash	55, 000	55.000
I/sales receivable	55,000	55,000
D/Gross Margin(55,000*40%)	22,000	55,000
Rea/Gross margin	22, 000	55, 000

2023 entries to record cash received and to record realized gross margin

	<u>Installment Method</u>	<u>Cost recovery Method</u>
Cash	15,000	15,000
Installment sales receivable	15,000	15,000
Deferred gross margin	<b>6,000+</b>	<b>15,000*</b>
Realized gross margin	<b>6,000</b>	<b>15,000</b>

+ Br. 15,000 X 0.4 =Br.6,000

\* Since all costs have been recurred, the full amount of cash represents realized gross margin.

To record write off of amount not expected to be collected.

Deferred gross, margin	<b>12,000+</b>	<b>30,000*</b>
------------------------	----------------	----------------



Loss on write –off of installment sale receivable **18,000**                      **- 0 -**

    Installment sales receivable    **30,000**                      **30,000**

+Under the installment sales method, the remaining deferred gross margin at the time of the write –off is Br.56,000 – 16,000 – Br.22,000 – Br.6000 = Br.12,000.

\*Under the cost recovery method, the remaining deferred gross margin at the time of the write – off is Br.56,000 – Br. 0 – Br. 11,000 – Br.15,000 = 30,000

    In both cases the balance in the installment accounts receivable is Br.30,000 (Br. 140,000 – Br.55,000 – 15,000)

3. Comparative income statement under the two methods are :

(In all cases, for years ending December 31).

(amount in thousands)	<u>Installment Method</u>				<u>Cost Recovery Method</u>			
	2021	2022	2023	Total	2021	2022	2023	Total
Installment sales	Br.140,000	0	0	140,000	140,000	0	0	140,000
Cost of sales	84,000	0	0	84,000	84,000	0	0	84,000
Gross margin	56,000	0	0	56,000	56,000	0	0	56,000
Less: Deferred margin	(56,000)	0	0	(56,000)	(56,000)	0	0	(56,000)
Add: Realized gross margin	16000	22000	6000	44000	0	11000	15000	26000
Income (before write – off)	16000	22000	6000	4400	0	11000	15000	26000
Write-off of uncoll/receivable	-	-	(18000)	(18000)	0	0	0	0
Income	Br. 16000	22000	(12000)	26000	11000	15000	26000	

In general, revenue recognition under the installment and cost recovery methods of accounting is based to a considerable extent on the timing of cash receipts.

### **3. Cash Collection method.**

The recognition of revenue may be delayed beyond the point of sale until additional evidence confirms the sales transaction. For example, a significant degree of uncertainty may exist as to the collectibles of receivables resulting from revenue transactions, or a sales transaction may be lacking in economic substance and therefore may after inadequate evidence of revenue realization. Under these circumstances revenue is recognized as cash is collected, and costs incurred are either recognized as expense or deferred, as considered appropriate in a specific situation. An extreme application of this test of revenue realization is the cash basis of accounting described in chapter 3.

### **3.5. Revenue recognition for service sales.**

For companies that provide services rather than products, revenue recognition follows procedures similar to those for tangible goods transactions. The four methods of revenue recognition for service sales are:

1. Specific performance
2. Proportional performance
3. Completed performance
4. Cash Collection method

### **Specific performance.**

The specific performance method is used to account for service revenue that is earned by performing a single act. For example, a real estate broker earns sales commission revenue on completion on a real estate transaction, a dentist earns revenue on completion of a tooth filling; a laundry earns revenue on completion of the cleaning.

Franchise revenue: SFAS No 45, "Accounting for Franchise Fee Revenue" deals with a particular type of service sale, franchises. It prescribes the specific performance method to account for franchise fee revenue, which a franchisor earns by selling a franchise. For revenue recognition purposes, it is often difficult to determine the point at which the franchisor has "substantially performed" the service required to earn the franchise fee revenue.

Example: Assume that on April 1, 2021, Chicago Pizza Corporation (franchisor) sold a franchise to Arthur Wilson (franchisee) for Br. 20,000 cash down and received a note that required five annual payments of Br. 8,739 beginning on March 31, 2022. The interest rate is 14% and the note therefore has a present value of Br. 30,000.

### **Two situations are examined:**

**Case A.** If no additional services are to be performed by the franchisor and collectability is reasonably assured, Chicago pizza should recognize the entire amount (the Br. 20,000 cash payment and Br. 30,000 note receivable)

As revenue on April 1, as follows:

Cash-----	20,000
Notes receivable -----	30,000
Franchise fee revenue -----	50,000

**Case B.** If Chicago pizza has additional services to perform for the franchisee, such as outfitting the new pizza restaurant, no franchise fee revenue would be recognized on April 1, 2021.

Rather, the entry would be:

Cash -----	20,000
Notes receivable -----	30,000
Deferred franchise fee revenue -----	50,000

On December 31, 1997, Chicago pizza would make the following entry to accrue interest on the notes receivable:

Note receivable-----	3150
Deferred franchise fee revenue (Br.30,000 X ).14 X 9/12) -----	3150

Assume that Chicago completes its obligations to the franchisee in January 1998, after having spent Br.2000 in the process. The entry to record this expenditure and recognize revenue would be:

Deferred franchise fee revenue-----	50,000
Franchise service expense -----	2,000
Franchise fee revenue -----	50,000
Prepaid expense, franchise services -----	2,000

Expenditures in 2021 by the franchisor related to the franchise would be deferred as prepaid expenses until the associated franchise fee is recognized until the associated franchise fee is recognized, in conformity with the matching principle.

### **Proportional performance method.**

The proportional performance method is used to recognize service revenue that is earned by more than a single act and only when the service extends beyond one accounting period. Under this method, revenue is recognized based on the proportional performance of each act.

The proportional performance method of accounting for service revenue is similar to the percentage – of – completion method. Proportional measurement takes different forms depending on the type of service transaction.

- A. similar performance acts: an equal amount of service revenue is recognized for each such act (for example, processing of monthly mortgage payments by a mortgage banker).
- B. Dissimilar performance acts: service revenue is recognized in proportion to the server's direct costs to perform each act (for example, providing lessons, examinations, and grading by a correspondence school)
- C. Similar acts with a fixed period of performance: service revenue is recognized by the straight line method over the fixed period unless another method is more appropriate (for example, providing maintenance services on equipment for a fixed periodic fee)

### **Completed – Performance method.**

The completed performance method is used to recognize service revenue earned by performing a services of acts of which the last is so important in relation to the total service transaction that service revenue is considered earned only after the final act occurs. For example, a trucking firm earns service revenue only after delivery of freight, even though packing loading, and transporting preceded delivery. The method is similar to the completed – contract method used for long –term contracts.

### **Cash collection method**

The cash collection method is used to account for service revenue when the uncertainty of collection is so high or the estimates of expenses related to the revenues are so unreliable that the requirement of reliability is not satisfied. Revenue is recognized only when cash is collected. This method is similar to the cost recovery method used for product sales.

### **3.6. Expense Recognition.**

After the revenue of the accounting period is measured and recognized in conformity with the revenue principle, the matching principle is applied to measure and recognize the expenses of that period. The costs of those assets and services used up should be recognized and reported as expenses of the period during which the related revenue is recognized.

#### **Expenses can be classified into three categories:**

1. Direct expenses are expenses such as cost of goods sold that are associated directly with revenues. These expenses are recognized based on recognition of revenues that result directly and jointly from the same transactions or other events as the expenses. This is an example of applying the matching principle.
2. Period expenses are expenses such as selling and administrative salaries, which are not associated directly with revenues. These expenses are recognized during the period in which cash is spent or liabilities are incurred for goods and services that are used up either simultaneously at acquisition or soon after.
3. Allocated expense are expenses such as depreciation and insurance. These expenses are allocated by systematic and rational procedures to the periods during which the related assets are expected to provide benefits.

The principles that provide accountants with guidelines for the recognition of expenses are

#### **A. Association cause and Effect:**

Costs may be recognized as expenses based on a presumed direct association with specific revenue. Costs that appear to be related to specific revenue are recognized as expenses concurrently with the recognition of the related revenue. Examples of costs related to specific revenue include the direct cost of goods sold or service provided, sales commission, and direct costs incurred in relation to construction – type contracts.

### **B. Systematic and rational allocation.**

If a direct means is not available to associate cause and effect, costs may be recognized as expenses based on an orderly allocation to the accounting periods in which the costs appear to expire and presumably provide benefits received, because neither can be objectively measured.

### **C. Immediate recognition.**

Expenses are recognized in the current accounting period when

- i) Costs incurred in the accounting period are expected to provide any future benefit
- ii) Costs deferred as assets in earlier periods no longer provide benefits, and
- iii) Allocation of costs to revenue or to accounting periods is impractical or is considered to serve no useful purpose.

### **3.7. Recognition of gains and Losses.**

Gains and losses are distinguished from revenues and expenses in that they result from peripheral or incidental transactions, events, or circumstances.

Most gains and losses are recognized when the transaction is completed. Thus, gains and losses from disposal of operational assets, sale of investments, and early extinguishment of debt are recognized in the entry made to record the transaction. For example, an entry to record the disposal of a tract of land for cash would reflect a debit to cash, a credit to land for cash would reflect a debit to cash, a credit to land (for its recorded cost), and debit to loss (or a credit to gain) on disposal.

Estimated losses are recognized before their ultimate realization if they are both probable and can be reasonably estimated. Examples are losses on disposal of a segment of a business, pending litigation, and expropriation of assets. If both conditions are met, the nature and estimated amount of the contingent loss must be disclosed in as note to the financial statements.

In contrast, gains are almost never recognized before the completion of a transaction that establishes the existence and amount of the gain.

Accounting for gains and losses reflects a conservative approach. Losses may be recognized before they actually occur, but gains are recognized before a completed transaction or event.

### 3.8. Balance sheet and statements of cash flow

The balance sheet sometimes referred to as the statement of financial position, reports the assets, liabilities, and stockholders' equity of a business enterprise at a specific date. This statement provides financial information about the nature and amounts of investments in enterprise resources, obligation to creditors, and the owners' equity in net resources. It therefore helps in predicting the amount, timing, and uncertainty of future cash flows.

#### Usefulness

By providing information on assets, liabilities, and stockholders' equity, the balance sheet provides a basis for computing rates of return and evaluating the capital structure of the enterprise. Analysts also use information in the balance sheet to assess a company's risk and future cash flows. In this regard, analysts use the balance sheet to assess a company's liquidity, solvency, and financial flexibility.

**Liquidity:** describes “the amount of time that is expected to elapse until an asset is realized or otherwise converted into cash or until a liability has to be paid”.

Both short-term and long-term credit grantors are interested in such short-term ratios cash or near cash to current liabilities. Such ratio measure the enterprise's ability to meet current maturing obligations. Similarly, stockholders assess liquidity to evaluate the possibility of future cash dividends or the buyback of shares. In general, the greater a company's liquidity, the lower its risk of failure.

**Solvency** refers to the ability of a company to pay its debts as they mature. For example, when a company carries a high level of long-term debt relative to assets, it has lower solvency than a similar company with a low level of long-term debt. Companies with higher debt are relatively more risky because they will need more of their assets to meet their fixed obligations (interest and principal payments).

Liquidity and solvency affect a company's **financial flexibility**, which measures the “ability of an enterprise to take effective actions to alter the amounts and timing of cash flows so it can respond to unexpected needs and opportunities. A company with a high degree of financial flexibility is better able to survive bad times, to recover from unexpected setbacks, and to take advantage of profitable and unexpected investment opportunities. Generally, the greater an enterprise's financial flexibility, the lower its risk of failure.

### 3.8.1 Limitations of the balance sheet

Some of the major limitations of the balance sheet are:

1. Most assets and liabilities are reported at **historical cost**. As a result, the information provided in the balance sheet is often criticized for not reporting a more relevant fair value.
2. Companies use **judgments and estimates** to determine many of the items reported in the balance sheet. Examples include estimates of the amount of receivables that it will collect, the useful life of fixed assets and intangibles, and the number of units that will be returned under warranty.
3. The balance sheet necessarily **omits many items that are of financial value** but that a company cannot record objectively. For example, the knowledge and skill of employees in developing new ideas and products is arguably a company's most significant asset. However, because companies cannot reliably measure the value of its employees and other intangible assets (such as customer base, research superiority, and reputation), they do not recognize these items in the balance sheet

### 3.10. Classification in the balance sheet

Balance sheet accounts are **classified**. That is, balance sheets group together similar items to arrive at significant subtotals. Furthermore, the material is arranged so that important relationships are shown.

The FASB has often noted that the parts and subsections of financial statements can be more informative than the whole. Therefore, the FASB discourages the reporting of summary accounts alone (total assets, net assets, total liabilities, etc.). Instead, companies should report and classify individual items in sufficient detail to permit users to assess the amounts, timing, and uncertainty of future cash flows. Such classification also makes it easier for users to evaluate the company's liquidity and financial flexibility, profitability, and risk.

To classify items in financial statements, companies group those items with similar characteristics and separate items with different characteristics. For example, companies should report separately:

1. Assets that differ in their **type or expected function** in the company's central operations or other activities. For example, reporting merchandise inventories separately from property, plant, and equipment.
2. Assets and liabilities with **different implications for the company's financial flexibility**. For example, a company that uses assets in its operations should report those assets separately from assets held for investment and assets subject to restrictions, such as leased equipment.
3. Assets and liabilities with **different general liquidity characteristics**. For example, reporting cash separately from inventories.

The three general classes of items included in the balance sheet are assets, liabilities, and equity. Companies then further divide these items into several sub classifications. The following Illustration indicates the general format of balance sheet presentation.

<b>Assets</b>	<b>Liabilities and Owners' Equity</b>
Current assets	Current liabilities
Long-term investments	Long-term debt
Property, plant, and equipment	Owners' equity
Intangible assets	Capital stock
Other assets	Additional paid-in capital
	Retained earnings

### **Current Assets**

Current assets are 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. The operating cycle is the average time between when a company acquires materials and supplies and when it receives cash for sales of the product (for which it acquired the materials and supplies). The cycle operates from cash through inventory, production, receivables, and back to cash. When several operating cycles occur within one year (which is generally the case for service companies), a company uses the one year period. If the operating cycle is more than one year, a company uses the longer period.

Current assets are presented in the balance sheet in order of liquidity. The five major items found in the current assets section, and their bases of valuation, are shown in the following Illustration



<b>Item</b>	<b>Basis of Valuation</b>
Cash and cash equivalents	Fair value
Short-term investments	Generally, fair value
Receivables	Estimated amount collectible
Inventories	Lower of cost or market
Prepaid expenses	Cost

A company does not report these five items as current assets if it does not expect to realize them in one year or in the operating cycle, whichever is longer. For example, a company excludes from the current assets section cash restricted for purposes other than payment of current obligations or for use in current operations. Generally, if a company expects to convert an asset into cash or to use it to pay a current liability within a year or the operating cycle, whichever is longer, it classifies the asset as current.

### **Cash**

Cash is generally considered to consist of currency and demand deposits (monies available on demand at a financial institution). **Cash equivalents** are short-term highly liquid investments that will mature within three months or less. Most companies use the caption “Cash and cash equivalents,” and they indicate that this amount approximates fair value.

A company must disclose any restrictions or commitments related to the availability of cash. If a company restricts cash for purposes other than current obligations, it excludes the cash from current assets.

### **Short-Term Investments**

Companies group investments in debt and equity securities into three separate portfolios for valuation and reporting purposes:

**Held-to-maturity:** Debt securities that a company has the positive intent and ability to hold to maturity.

**Trading:** Debt and equity securities bought and held primarily for sale in the near term to generate income on short-term price differences.

**Available-for-sale:** Debt and equity securities not classified as held-to-maturity or trading securities.

A company should report trading securities (whether debt or equity) as current assets. It classifies individual held-to-maturity and available-for-sale securities as current or noncurrent depending on the circumstances. It should report held-to-maturity securities at amortized cost. All trading and available-for-sale securities are reported at fair value.

### **Receivables**

A company should clearly identify any anticipated loss due to uncollectible, the amount and nature of any nontrade receivables, and any receivables used as collateral. Major categories of receivables should be shown in the balance sheet or the related notes. For receivables arising from unusual transactions (such as sale of property, or a loan to affiliates or employees), companies should separately classify these as long-term, unless collection is expected within one year.

### **Inventories**

To present inventories properly, a company discloses the basis of valuation (e.g., lower-of-cost-or-market) and the cost flow assumption used (e.g., FIFO or LIFO). A manufacturing concern also indicates the stage of completion of the inventories.

### **Prepaid Expenses**

A company includes prepaid expenses in current assets if it will receive benefits (usually services) within one year or the operating cycle, whichever is longer. These items are current assets because if they had not already been paid, they would require the use of cash during the next year or the operating cycle. A company reports prepaid expenses at the amount of the unexpired or unconsumed cost.

### **Noncurrent Assets**

Noncurrent assets are those not meeting the definition of current assets. They include a variety of items, as we discuss in the following sections.

### **Long-Term Investments**

**Long-term investments** often referred to simply as investments, normally consist of one of four types:

1. Investments in securities, such as bonds, common stock, or long-term notes.
2. Investments in tangible fixed assets not currently used in operations, such as land held for speculation.

3. Investments set aside in special funds such as a sinking fund, pension fund, or plant expansion fund. This includes the cash surrender value of life insurance.
4. Investments in nonconsolidated subsidiaries or affiliated companies.

Companies expect to hold long-term investments for many years. They usually present them on the balance sheet just below “Current assets,” in a separate section called “Investments.” Realize that many securities classified as long-term investments are, in fact, readily marketable. But a company does not include them as current assets unless it **intends to convert them to cash in the short-term**—that is, within a year or in the operating cycle, whichever is longer. As indicated earlier, securities classified as available-for-sale are reported at fair value, and held-to-maturity securities are reported at amortized cost.

### **Property, Plant, and Equipment**

Property, plant, and equipment are tangible long-lived assets used in the regular operations of the business. These assets consist of physical property such as land, buildings, machinery, furniture, tools, and wasting resources (timberland, minerals). With the exception of land, a company either depreciates (e.g., buildings) or depletes (e.g., timberlands or oil reserves) these assets.

A company discloses the basis it uses to value property, plant, and equipment; any liens against the properties; and accumulated depreciation usually in the notes to the statements.

### **Intangible Assets**

Intangible assets lack physical substance and are not financial instruments. They include patents, copyrights, franchises, goodwill, trademarks, trade names, and customer lists. A company writes off (amortizes) limited-life intangible assets over their useful lives. It periodically assesses indefinite-life intangibles (such as goodwill) for impairment. Intangibles can represent significant economic resources, yet financial analysts often ignore them, because valuation is difficult.

### **Other Assets**

The items included in the section “Other assets” vary widely in practice. Some include items such as long-term prepaid expenses, prepaid pension cost, and noncurrent receivables. Other items that might be included are assets in special funds, deferred income taxes, property held for sale, and restricted cash or securities. A company should limit this section to include only unusual items sufficiently different from assets included in specific categories.

## **Liabilities**

Similar to assets, companies classify liabilities as current or long-term.

### **Current Liabilities**

Current liabilities are the obligations that a company reasonably expects to liquidate either through the use of current assets or the creation of other current liabilities. This concept includes:

1. Payables resulting from the acquisition of goods and services: accounts payable, wages payable, taxes payable, and so on.
2. Collections received in advance for the delivery of goods or performance of services, such as unearned rent revenue or unearned subscriptions revenue.
3. Other liabilities whose liquidation will take place within the operating cycle, such as the portion of long-term bonds to be paid in the current period or short-term obligations arising from purchase of equipment.

At times, a liability that is payable within the next year is not included in the current liabilities section. This occurs either when the company expects to refinance the debt through another long-term issue or to retire the debt out of noncurrent assets. This approach is used because liquidation does not result from the use of current assets or the creation of other current liabilities.

Companies do not report current liabilities in any consistent order. In general, though, companies most commonly list notes payable, accounts payable or short-term debt as the first item. Income taxes payable, current maturities of long-term debt or other current liabilities are commonly listed last.

Current liabilities include such items as trade and nontrade notes and accounts payable, advances received from customers, and current maturities of long-term debt. If the amounts are material, companies classify income taxes and other accrued items separately. A company should fully describe in the notes any information about a secured liability for example, stock held as collateral on notes payable to identify the assets providing the security.

The excess of total current assets over total current liabilities is referred to as working capital (or sometimes net working capital). Working capital represents the net amount of a company's relatively liquid resources. That is, it is the liquidity buffer available to meet the financial demands of the operating cycle.

Companies seldom disclose on the balance sheet an amount for working capital. But bankers and other creditors compute it as an indicator of the short-run liquidity of a company. To determine

the actual liquidity and availability of working capital to meet current obligations, however, requires analysis of the composition of the current assets and their nearness to cash.

### **Long-Term Liabilities**

Long-term liabilities are obligations that a company does not reasonably expect to liquidate within the normal operating cycle. Instead, it expects to pay them at some date beyond that time. The most common examples are bonds payable, notes payable, some deferred income tax amounts, lease obligations, and pension obligations. Companies classify long-term liabilities that mature within the current operating cycle as current liabilities if payment of the obligation requires the use of current assets.

**Generally, long-term liabilities are of three types:**

1. Obligations arising from specific financing situations, such as the issuance of bonds, long-term lease obligations, and long-term notes payable.
2. Obligations arising from the ordinary operations of the company, such as pension obligations and deferred income tax liabilities.
3. Obligations that depend on the occurrence or non-occurrence of one or more future events to confirm the amount payable, or the payee, or the date payable, such as service or product warranties and other contingencies.

Companies generally provide a great deal of supplementary disclosure for long-term liabilities, because most long-term debt is subject to various covenants and restrictions for the protection of lenders.

It is desirable to report any premium or discount separately as an addition to or subtraction from the bonds payable. Companies frequently describe the terms of all long-term liability agreements (including maturity date or dates, rates of interest, nature of obligation, and any security pledged to support the debt) in notes to the financial statements.

### **Owners' Equity**

The owners' equity (stockholders' equity) section is one of the most difficult sections to prepare and understand. This is due to the complexity of capital stock agreements and the various restrictions on stockholders' equity imposed by state corporation laws, liability agreements, and boards of directors. Companies usually divide the section into three parts:

1. **Capital Stock.** The par or stated value of the shares issued.
2. **Additional Paid-in Capital.** The excess of amounts paid in over the par or stated value.

**3. Retained Earnings.** The corporation's undistributed earnings.

For capital stock, companies must disclose the par value and the authorized, issued, and outstanding share amounts. A company usually presents the additional paid-in capital in one amount, although subtotals are informative if the sources of additional capital are varied and material. The retained earnings amount may be divided between the **inappropriate** (the amount that is usually available for dividend distribution) and **restricted** (e.g., by bond indentures or other loan agreements) amounts. In addition, companies show any capital stock reacquired (treasury stock) as a reduction of stockholders' equity.

The ownership or stockholders' equity accounts in a corporation differ considerably from those in a partnership or proprietorship. Partners show separately their permanent capital accounts and the balance in their temporary accounts (drawing accounts). Proprietorships ordinarily use a single capital account that handles all of the owner's equity transactions.

**Balance sheet formats**

One common arrangement that companies use in presenting a classified balance sheet is the **account form**. It lists assets, by sections, on the left side, and liabilities and stockholders' equity, by sections, on the right side. The main disadvantage is the need for a sufficiently wide space in which to present the items side by side. Often, the account form requires two facing pages. To avoid this disadvantage, the **report form, illustrated below**, lists the sections one above the other.

**Scientific Products, Inc.**

## Balance Sheet December 31, 2023

### Assets

#### Current assets

Cash		\$ 42,485
Available-for-sale securities—at fair value		28,250
Accounts receivable	\$165,824	
Less: Allowance for doubtful accounts	1,850	163,974
Notes receivable		23,000
Inventories—at average cost		489,713
Supplies on hand		9,780
Prepaid expenses		<u>16,252</u>
Total current assets		\$ 773,454

#### Long-term investments

Investments in Warren Co.	87,500
---------------------------	--------

#### Property, plant, and equipment

Land—at cost	125,000
Buildings—at cost	975,800
Less: Accumulated depreciation	341,200
Total property, plant, and equipment	759,600

#### Intangible assets

Goodwill	<u>100,000</u>
Total assets	<u>\$1,720,554</u>

### Liabilities and Stockholders' Equity

#### Current liabilities

Notes payable to banks	\$ 50,000
Accounts payable	197,532
Accrued interest on notes payable	500
Income taxes payable	62,520
Accrued salaries, wages, and other liabilities	9,500
Deposits received from customers	420
Total current liabilities	\$ 320,472

#### Long-term debt

Twenty-year 12% debentures, due January 1, 2020	<u>500,000</u>
Total liabilities	820,472

#### Stockholders' equity

Paid in on capital stock	
Preferred, 7%, cumulative	
Authorized, issued, and outstanding,	
30,000 shares of \$10 par value	\$300,000
Common—	
Authorized, 500,000 shares of	
\$1 par value; issued and	
Outstanding, 400,000 shares	400,000
Additional paid-in capital	37,500
Retained earnings	162,582
Total stockholders' equity	<u>900,082</u>
Total liabilities and stockholders' equity	<u>\$1,720,554</u>

### Statement of cash flows

The statement of cash flows reports cash receipts, cash payments, and net change in cash resulting from a company's operating, investing, and financing activities during a period.

The primary purpose of the **statement of cash flows** is to provide information about a company's cash receipts and cash payments during a period.

A secondary objective is to provide cash-basis information about the company's operating, investing, and financing activities.

### **Purpose of the Statement of Cash Flows**

The primary purpose of a statement of cash flows is to provide relevant information about the cash receipts and cash payments of an enterprise during a period.

To achieve this purpose, the statement of cash flows reports the following: (1) the cash effects of operations during a period, (2) investing transactions, (3) financing transactions, and (4) the net increase or decrease in cash during the period. Reporting the sources, uses, and net increase or decrease in cash helps investors, creditors, and others know what is happening to a company's most liquid resource.

Because most individuals maintain a check book and prepare a tax return on a cash basis, they can comprehend the information reported in the statement of cash flows.

The statement of cash flows provides answers to the following simple but important questions:

1. Where did the cash come from during the period?
2. What was the cash used for during the period?
3. What was the change in the cash balance during the period?

### **Classification of cash flows**

The statement of cash flows classifies cash receipts and cash payments by operating, investing, and financing activities.

1. **Operating activities** involve the cash effects of transactions that enter into the determination of net income, such as cash receipts from sales of goods and services, and cash payments to suppliers and employees for acquisitions of inventory and expenses.
2. **Investing activities** generally involve long-term assets and include (a) making and collecting loans, and (b) acquiring and disposing of investments and productive long-lived assets.
3. **Financing activities** involve liability and stockholders' equity items and include (a) obtaining cash from creditors and repaying the amounts borrowed, and (b) obtaining



capital from owners and providing them with a return on, and a return of, their investment.

The following illustration classifies the typical cash receipts and payments of a company according to operating, investing, and financing activities.

### **Operating**

#### Cash inflows:

From sales of goods or services.

From returns on loans (interest) and on equity securities (dividends).

#### Cash outflows

To suppliers for inventory.

To employees for services.

To government for taxes.

To lenders for interest.

To others for expenses.

### **Investing**

#### Cash inflows

From sale of property, plant, and equipment.

From sale of debt or equity securities of other entities.

From collection of principal on loans to other entities.

#### Cash outflows

To purchase property, plant, and equipment.

To purchase debt or equity securities of other entities.

To make loans to other entities.

### **Financing**

#### Cash inflows

From sale of equity securities.

From issuance of debt (bonds and notes).

#### Cash outflows

To stockholders as dividends.

To redeem long-term debt or reacquire capital stock.

The operating activities category is the most important. It shows the cash provided by company operations. This source of cash is generally considered to be the best measure of a company's ability to generate enough cash to continue as a going concern.

Note the following general guidelines about the classification of cash flows.

1. Operating activities involve income statement items.
2. Investing activities involve cash flows resulting from changes in investments and long-term asset items.
3. Financing activities involve cash flows resulting from changes in long-term liability and stockholders' equity items.

Companies classify some cash flows relating to investing or financing activities as operating activities. For example, companies classify receipts of investment income (interest and dividends) and payments of interest to lenders as operating activities. Why are these considered operating activities? Companies report these items in the income statement, where the results of operations are shown.

Conversely, companies classify some cash flows relating to operating activities as investing or financing activities. For example, a company classifies the cash received from the sale of property, plant, and equipment at a gain, although reported in the income statement, as an investing activity. It excludes the effects of the related gain in net cash flow from operating activities. Likewise, a gain or loss on the payment (extinguishment) of debt is generally part of the cash outflow related to the repayment of the amount borrowed. It therefore is a financing activity.

### **Format of the statement of cash flows**

The three activities we discussed above constitute the general format of the statement of cash flows. The operating activities section always appears first. It is followed by the investing activities section and then the financing activities section. The general format of the statement of cash flows presents the results of the three activities discussed previously—operating, investing, and financing.

**Company Name**  
**Statement of Cash Flows**  
**Period Covered**

Cash flows from operating activities

Net income		XXX
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
(List of individual items)	XX	XX
Net cash provided (used) by operating activities		XXX

Cash flows from investing activities

(List of individual inflows and outflows)	XX	
Net cash provided (used) by investing activities		XXX

Cash flows from financing activities

(List of individual inflows and outflows)	XX	
Net cash provided (used) by financing activities		XXX

Net increase (decrease) in cash XXX

Cash at beginning of period XXX

Cash at end of period

**Sources of information for the scf**

Important points to remember in the preparation of the statement of cash flows are these:

1. Comparative balance sheets provide the basic information from which to prepare the report. Additional information obtained from analyses of specific accounts is also included.
2. An analysis of the Retained Earnings account is necessary. The net increase or decrease in Retained Earnings without any explanation is a meaningless amount in the statement. Without explanation, it might represent the effect of net income, dividends declared, or prior period adjustments.
3. The statement includes all changes that have passed through cash or have resulted in an increase or decrease in cash.

4. Write-downs, amortization charges, and similar “book” entries, such as depreciation of plant assets, represent neither inflows nor outflows of cash, because they have no effect on cash. To the extent that they have entered into the determination of net income, however, the company must add them back to or subtract them from net income, to arrive at net cash provided (used) by operating activities.

### **Steps in preparation**

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 balance sheets.

**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 balance sheets as well as selected transaction data.

To arrive at net cash flow from operating activities, a company must determine revenues and expenses on a **cash basis. It does this by eliminating the effects of income statement transactions that do not result in an increase or decrease in cash.**

**Step 3. *Determine net cash flows from investing and financing activities.*** A company must analyze all other changes in the balance sheet accounts to determine their effects on cash.

### **Indirect Method**

The **indirect method** (or **reconciliation method**) starts with net income and converts it to net cash flow from operating activities. In other words, **the indirect method adjusts net income for items that affected reported net income but did not affect cash.**

To compute net cash flow from operating activities, a company adds back noncash charges in the income statement to net income and deducts noncash credits.

We determine net cash flows from operating activities by adding back to or deducting from net income those items that had no effect on cash.

Additions	Deductions
Depreciation expense	Amortization of bond premium
Amortization of intangibles and deferred charges	Decrease in deferred income tax liability
Amortization of bond discount	Income on investment in common stock using equity method
Increase in deferred income tax liability	Gain on sale of plant assets
Loss on investment in common stock using equity method	Increase in receivables
Loss on sale of plant assets	Increase in inventories
Loss on impairment of assets	Increase in prepaid expense
Decrease in receivables	Decrease in accounts payable
Decrease in inventories	Decrease in accrued liabilities
Decrease in prepaid expense	
Increase in accounts payable	
Increase in accrued liabilities	

**Tax Consultants Inc.**  
**Comparative Balance Sheets**  
**As of December 31**

			Change
Assets	2011	2010	Increase/Decrease
Cash	\$ 54,000	\$ 37,000	\$ 17,000
Accounts receivable	68,000	26,000	42,000
Inventories	54,000	—0—	54,000
Prepaid expenses	4,000	6,000	(2,000)
Land	45,000	70,000	25,000
Buildings	200,000	200,000	—0—
Accumulated depreciation—buildings (21,000)		(11,000)	10,000
Equipment	193,000	68,000	125,000
Accumulated depreciation—equipment (28,000)		(10,000)	18,000
Totals	<u>\$569,000</u>	<u>\$386,000</u>	
<b>Liabilities and Stockholders' Equity</b>			
Accounts payable	\$ 33,000	\$ 40,000	(\$ 7,000)
Bonds payable	110,000	150,000	(40,000)
Common stock (\$1 par)	220,000	60,000	160,000
Retained earnings	<u>206,000</u>	<u>136,000</u>	70,000
Totals	<u>\$569,000</u>	<u>\$386,000</u>	

**Tax Consultants Inc.**  
**Income Statement**  
**For The Year Ended December 31, 2011**

Revenues		\$890,000
Cost of goods sold	\$465,000	
Operating expenses	221,000	
Interest expense	12,000	
Loss on sale of equipment	<u>2,000</u>	<u>700,000</u>
Income from operations		190,000
Income tax expense		<u>65,000</u>
Net income		<u>\$125,000</u>

#### **Additional Information**

1. Operating expenses include depreciation expense of \$33,000 and expiration of prepaid expenses of \$2,000.
2. Land was sold at its book value for cash.
3. Cash dividends of \$55,000 were declared and paid.
4. Interest expense of \$12,000 was paid in cash.
5. Equipment with a cost of \$166,000 was purchased for cash. Equipment with a cost of \$41,000 and a book value of \$36,000 was sold for \$34,000 cash.
6. Bonds were redeemed at their book value for cash.
7. Common stock (\$1 par) was issued for cash.

#### **Step 1: Determine the Change in Cash**

The first step in the preparation of the statement of cash flows is to determine the change in cash. As the comparative balance sheets show, cash increased \$17,000 in 2011.

#### **Step 2: Determine Net Cash Flow from Operating Activities**

The adjustment to net income of \$125,000 is explained as follows.

***Increase in Accounts Receivable.*** The increase in accounts receivable of \$42,000 represents recorded accrual-basis revenues in excess of cash collections in 2011. The company deducts this increase from net income to convert from the accrual basis to the cash basis.

***Increase in Inventories.*** The \$54,000 increase in inventories represents an operating use of cash, not an expense. Tax Consultants therefore deducts this amount from net income, to arrive at net cash flow from operations. In other words, when inventory purchased exceeds inventory sold during a period, cost of goods sold on an accrual basis is lower than on a cash basis.

***Decrease in Prepaid Expenses.*** The \$2,000 decrease in prepaid expenses represents a charge to the income statement for which Tax Consultants made no cash payment in the current period. The company adds back the decrease to net income, to arrive at net cash flow from operating activities.

***Decrease in Accounts Payable.*** When accounts payable decrease during the year, cost of goods sold and expenses on a cash basis are higher than they are on an accrual basis. To convert net income to net cash flow from operating activities, the company must deduct the \$7,000 in accounts payable from net income.

***Depreciation Expense (Increase in Accumulated Depreciation).*** Accumulated Depreciation—Buildings increased \$10,000 (\$21,000 \_ \$11,000). The Buildings account did not change during the period, which means that Tax Consultants recorded depreciation expense of \$10,000 in 2011. Accumulated Depreciation—Equipment increased by \$18,000 (\$28,000 \_ \$10,000) during the year. But Accumulated Depreciation—Equipment decreased by \$5,000 as a result of the sale during the year. Thus, depreciation for the year was \$23,000. The company reconciled Accumulated Depreciation—Equipment as follows.

Beginning balance	\$10,000
Add: Depreciation for 2011	<u>23,000</u>
	33,000
Deduct: Sale of equipment	<u>5,000</u>
Ending balance	<u>\$28,000</u>

The company must add back to net income the total depreciation of \$33,000 (\$10,000 \_ \$23,000) charged to the income statement, to determine net cash flow from operating activities.

***Loss on Sale of Equipment.*** Tax Consultants Inc. sold for \$34,000 equipment that cost \$41,000 and had a book value of \$36,000. As a result, the company reported a loss of \$2,000 on its sale. To arrive at net cash flow from operating activities, it must add back to net income the loss on the sale of the equipment. The reason is that the loss is a noncash charge to the income statement. The loss did not reduce cash, but it did reduce net income. From the foregoing items, the company prepares the operating activities section of the statement of cash flows,

Cash flows from operating activities

Net income	\$125,000
------------	-----------

Adjustments to reconcile net income to

net cash provided by operating activities:

Depreciation expense	\$33,000
Loss on sale of equipment	2,000
Increase in accounts receivable	(42,000)
Increase in inventories	(54,000)
Decrease in prepaid expenses	2,000

Decrease in accounts payable	<u>(7,000)</u>	<u>(66,000)</u>
Net cash provided by operating activities		<u>59,000</u>

### **Step 3: Determine Net Cash Flows from Investing and Financing Activities**

By analyzing the remaining changes in the balance sheet accounts, Tax Consultants identifies cash flows from investing and financing activities.

**Land.** Land decreased \$25,000 during the period. As indicated from the information presented, the company sold land for cash at its book value. This transaction is an investing activity, reported as a \$25,000 source of cash.

**Equipment.** An analysis of the equipment account indicates the following.

Beginning balance	\$ 68,000
Purchase of equipment	<u>166,000</u>
	234,000
Sale of equipment	<u>41,000</u>
Ending balance	<u>\$193,000</u>

The company used cash to purchase equipment with a fair value of \$166,000—an investing transaction reported as a cash outflow. The sale of the equipment for \$34,000 is also an investing activity, but one that generates a cash inflow.

**Bonds Payable.** Bonds payable decreased \$40,000 during the year. As indicated from the additional information, the company redeemed the bonds at their book value. This financing transaction used \$40,000 of cash.

**Common Stock.** The common stock account increased \$160,000 during the year. As indicated from the additional information, Tax Consultants issued common stock of \$160,000 at par. This financing transaction provided cash of \$160,000.

**Retained Earnings.** Retained earnings changed \$70,000 (\$206,000 \_ \$136,000) during the year. The \$70,000 change in retained earnings results from net income of \$125,000 from operations and the financing activity of paying cash dividends of \$55,000.

**Tax Consultants Inc.**  
**Statement Of Cash Flows**  
**For The Year Ended December 31, 2011**



### Increase (Decrease) In Cash

Cash flows from operating activities		
Net income		\$125,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	\$ 33,000	
Loss on sale of equipment	2,000	
Increase in accounts receivable	(42,000)	
Increase in inventories	(54,000)	
Decrease in prepaid expenses	2,000	
Decrease in accounts payable	<u>(7,000)</u>	<u>(66,000)</u>
Net cash provided by operating activities		59,000
Cash flows from investing activities		
Sale of land	25,000	
Sale of equipment	34,000	
Purchase of equipment	<u>(166,000)</u>	
Net cash used by investing activities		(107,000)
Cash flows from financing activities		
Redemption of bonds	(40,000)	
Sale of common stock	160,000	
Payment of dividends	<u>(55,000)</u>	
Net cash provided by financing activities		<u>65,000</u>
Net increase in cash		17,000
Cash, January 1, 2011		<u>37,000</u>
Cash, December 31, 2011		<u><u>\$ 54,000</u></u>

### Usefulness of the statement of cash flows

The statement of cash flows provides information to help investors, creditors, and others assess the following

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, stockholders, 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, 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.

**The cash and noncash 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.

### **3.11. Summary**

This chapter Companies classify some cash flows relating to investing or financing activities as operating activities. For example, companies classify receipts of investment income (interest and dividends) and payments of interest to lenders as operating activities. Why are these considered operating activities? Companies report these items in the income statement, where the results of operations are shown.

Conversely, companies classify some cash flows relating to operating activities as investing or financing activities. For example, a company classifies the cash received from the sale of property, plant, and equipment at a gain, although reported in the income statement, as an investing activity. It excludes the effects of the related gain in net cash flow from operating activities. Likewise, a gain or loss on the payment (extinguishment) of debt is generally part of the cash outflow related to the repayment of the amount borrowed. It therefore is a financing activity.

One common arrangement that companies use in presenting a classified balance sheet is the account form. It lists assets, by sections, on the left side, and liabilities and stockholders' equity, by sections, on the right side. The main disadvantage is the need for a sufficiently wide space in which to present the items side by side. Often, the account form requires two facing pages. To avoid this disadvantage, the report form, illustrated below, lists the sections one above the other. Cash is generally considered to consist of currency and demand deposits (monies available on demand at a financial institution). Cash equivalents are short-term highly liquid investments that will mature within three months or less. Most companies use the caption "Cash and cash equivalents," and they indicate that this amount approximates fair value. A company must disclose any restrictions or commitments related to the availability of cash. If a company restricts cash for purposes other than current obligations, it excludes the cash from current assets.

### **3.12. Exercise**

#### **Multiple Choices**

1. The revenue recognition principle state that:
  - A. Expenses should be matched with revenues
  - B. Revenue should be recognized in the accounting period in which a performance obligation is satisfied
  - C. The fiscal year should correspond with the calendar year
  - D. The economic life of a business can be divided into artificial time periods.
2. Accumulated Depreciation is a(n):
  - Expense account.
  - Stockholders' equity account.
  - Liability account.
  - Contra asset account.
3. If a business has received cash in advance of services performed and credits a liability account, the adjusting entry needed after the services are performed will be:
  - Debit Unearned Service Revenue and credit Cash.
  - Debit Unearned Service Revenue and credit Service Revenue.
  - Debit Unearned Service Revenue and credit Prepaid Expense.
  - Debit Unearned Service Revenue and credit Accounts Receivable.

4. A law firm has billed their clients for services performed. They subsequently received payments from their clients. What entry will the law firm make upon receipt of the payments?
- Debit Unearned Service Revenue and credit Service Revenue
  - Debit Cash and credit Accounts Receivable
  - Debit Accounts Receivable and credit Service Revenue
  - Debit Cash and credit Service Revenue
5. The expense recognition principle matches:
- Customers with businesses.
  - Expenses with revenues.
  - Assets with liabilities.
  - Creditors with businesses.

## CHAPTER FOUR

### CASH AND RECEIVABLES

#### 4.1.Introduction

Cash is a medium of exchange that a bank will accept for deposit and immediate credit to the depositors account. To achieve efficient use of all resources, management of business enterprises frequently turns unproductive cash balances in to productive resources through the acquisition of short-term investments.

Cash refers to coin, currency and other items that are;

- A standard medium of exchange or acceptable by knowledgeable parties in exchange for goods or services
- The basis for measuring and accounting all other items
- Acceptable for deposit at face value by banks

**Criteria:** - An item to be reported as cash it must be

- Serve as a medium of exchange
- Readily available for the payment of current obligations
- It must be free from any contractual restriction that limits its use in satisfying debts.

Based on the criteria listed above we can classify negotiable instruments and other highly liquid items as cash and non-cash (cash equivalents).

Cash equivalents are short term, highly liquid investments that are both

- i. Readily convertible to known amounts of cash and
- ii. So near their maturity that they present insignificant risk of changes in interest rates.

If the item cannot be converted to coin or currency on short notice, it is separately classified as an investment, as a receivable, or as prepaid expenses. Cash that is not available for payment of currently maturing liabilities is segregated and classified in the long term assets section.

The following table summarizes the classification of cash related terms.

<u>Item</u>	<u>Classification</u>	<u>Comment</u>
Cash	Cash	If unrestricted, report as cash. If restricted, identify as current and noncurrent assets
Petty cash and change	Cash	Report as cash

funds

short term paper	Cash equivalents	Investments with maturity of less than 3 months
Short term paper	Temporary investments	Investments with maturity of 3 to 12 months
postdated checks and IOUs	Receivables	Assumed to be collectible
Travel advance	Receivables	Assume to be collected from employees or deducted from their salaries

Postage on hand (as stamps or in postage meters)	Prepaid Expenses	May also be classified as office supplies inventory
Bank Overdrafts	Current liability	if right of offset exists, reduce cash.
Compensating balances		
1. Legally restricted	Cash separately classified as a deposit maintained as compensating balance	Classify as current or non-current in the balance sheet
2. Arrangement without legal restriction	Cash with note disclosure	Disclose separately in notes details of the arrangement.

Based on the above criteria and table 1 items termed as cash like

- Coin and currency
- Negotiable instruments such as money orders, certified checks, personal checks, bank drafts, saving accounts, (if prior notice is rarely demanded by banks) are classified as cash because these items are readily available for the payment of current obligations and free from any contractual restrictions.

In addition petty cash funds, change funds and other funds, even though these funds are intended to be used for specific purposes they are used to meet current operating expenses and to liquidate current liabilities so that they are included in current assets as cash accounts.

However cash balances deposited and maintained in checking or saving accounts as a minimum requirements or compensating balances for borrowing are reported as follows. Legally restricted deposits held as compensating balances against:

- Short term borrowing arrangements to be stated separately among the cash and cash equivalent items in current assets

- Long term borrowing arrangements should be classified as noncurrent assets in the investment or other Assets sections. As "cash on Deposit maintained as compensating balance."
- In cases where compensating balance arrangements exist without legal restrictions, the arrangements and the amounts involved should be described in the notes.

Money market funds, money market savings certificates, certificates of deposit, short term papers that give an opportunity to earn high rates of interest are more appropriately classified as temporary investments (cash equivalents) than as cash. The reason is that these securities usually contain restrictions or penalties on their conversion to cash.

## **4.2. Cash Management and Control**

### **4.2.1. Cash management**

In any business enterprise management of cash is very important because cash is a means of acquiring goods and services and cash can be easily misappropriated or lost. The management of cash is centered on forecasting and internal controls.

The main objectives and responsibilities of management with respect to cash are

- To maintain liquidity (solvency) that is; to assure that there is sufficient cash to settle maturing obligations, pay for operating expenses and also to finance unexpected circumstances
- To invest any idle cash so as to maximize returns
- To prevent loss of cash due to theft, misuse or wastage

### **4.2.2. Control of cash**

In organizations internal control methods, procedures, rules and policies are adopted;

The main purpose of having internal control systems in organizations is

- To assure that assets that belong to business enterprise are received when tendered
- Protected while in the custody of the enterprise and
- Used only for authorized business purposes

Cash controlling consists of administrative control and accounting control

#### **Administrative controls**

- Promote operational efficiency ( to ensure no unauthorized transactions are entered into by officers or employees)

- Encourage adherence to prescribed managerial policies and achieving the objectives of the organization

### **Accounting Controls**

- Ensure the protection of assets for it is susceptible to improper diversion and use
- Ensure the accuracy and reliability of accounting data
- To have access to assets only in accordance with management's authorization
- To maintain accountability for assets

#### **4.2.2.1. Internal control procedures**

A system of internal control is not designed primarily to detect errors but rather to reduce the opportunity of errors or dishonesty to occur. Effective system of internal control procedures should consider the following points:

- Segregation of duties;** like separating one that works on custody with record keeper, purchaser or receiver of purchased item. Here the separation of duties enables to protect assets against either fraud or error. In addition the work of one helps to cross check the of the other
- Assignment of Responsibilities and Authorities;** giving a specific authority to a specific body helps a company to create responsibility and accountability in the actions of each party, department or division. For example, to set an internal control procedure for cash payments on enterprise could set a purchase procedure which gives responsibility to order and acquire goods to purchase department maintain a record and make payments for invoices to accounting and finance department and receive the purchased stocks to receiving department.
- Using mechanical devices and pre-numbered documents;** using cash registers, check protector holes and pre-numbered business forms are very helpful to ensure the accuracy and reliability of accounting data.
- Maintaining physical safeguarding tools;** for example safe boxes, drawers with lockers, having daily deposits etc.
- Implementing periodical performance evaluation methods;** evaluating helps to take periodical corrections and to take sure that regulations are properly implemented.
- Hiring competent employee and having computer help,** creates to have efficient and accurate record keeping and report preparation function



- vii. **Planning (budgeting):-** forecasting cash necessary for future operations such as through preparing periodic cash budgets

#### **4.2.2.2. Control over cash receipts**

Control over cash is required to safeguard all cash inflows or assure that all cash receivables by the enterprise is collected and recorded without loss.

It includes

- Immediate counting
- Daily recording
- Intact deposit

#### **4.2.2.3. Control over cash payments**

The main objective of control over cash payments is to ensure no unauthorized payments are made.

It includes;

- Verifying and approving payments for example by using voucher system.
- Making payments by checks
- Periodic preparation of Bank reconciliation

#### **1. Elements of internal control over cash payments.**

Cash is safeguarded by keeping it in a safe box, depositing it in banks and through use of special (imp rest) cash funds.

#### **i. Petty cash fund**

A petty cash fund refers to a fund of fixed amount used for small expenditures that are most conveniently paid in cash such as payments for taxi fare, postage stamps, minor amount of supplies etc.

##### **➤ Establishment**

- Estimate the required amount of payment to meet minor expenditures for specified period.

Journal Entry

Petty Cash fund	xx	
Cash		xx

##### **➤ Operation**

As each cash payment is made from the petty cash fund, prepare a voucher or other receipts

\* No Journal entry

##### **➤ Replenishment:** petty cash fund is replenished

- When it reaches a minimum cash balance and
- At the end of the accounting period to recognize the periodic expenses paid from the fund and to report the year end cash balance correctly.
- The vouchers or receipts will be reviewed and a check will be issued on the total amount of the vouchers to restore the petty cash fund to its original amount.

Journal Entries at the time of replenishment will be

Various expenses	xx	
Cash		xx

### Illustration:

On January 1, 2006 ABC Company established a petty cash fund to make payments for minor expenditures, for \$ 500. During January the petty cash vouchers indicate payments are made for the following transactions

Postage Expenses	189.60
Office Supplies	112.75
Minor repair Expenses	60.05
Miscellaneous expense	40.00

On January 28, the custodian requested replenishment for items paid to date and the cash balance in the petty cash box is \$ 95.20

Now let us see the record that ABC Company will have at the establishment of petty cash fund and at the replenishment of the fund respectively.

Petty cash funds	500	
Cash		500
Replenishment Entry		
Postage Expenses	189.60	
Office Supplies	112.75	
Minor repair Expenses	60.05	
Miscellaneous expense	40.00	
Cash short and over	2.40	
Cash	.....	404.80

The cash shortage and overage ledger account is classified as revenue when it has credit balance and as expense when it has a debit balance.

### ii. Cash Change Fund

A change fund is used to facilitate the collection of cash from customers

➤ **Establishment**

- Estimate the required types and amounts denominations.

Journal entry

Cash change fund	xx
Cash	xx

➤ **Operation**

Make the necessary changes and deduct the amount of the change fund from the total cash money on hand at the close of each business day to determine the daily collections.

\* No Journal entry will be required.

**iii. Bank checking account (Reconciliation of bank balances)**

Enterprises usually open checking account in a bank to have a daily deposits of all cash collections and to make payments from the bank by issuing checks. Periodically banks prepare bank statement, which is a summary of cash deposit and out lays made from each checking account of the depositor. Similarly the depositor will have a ledger account to record daily cash transactions in the bank account. Usually the cash balance in dictated in a bank statement seldom agrees with cash balance indicated by the depositors ledger account for the specific period.

**Bank reconciliation:** - is a schedule that analyzes and explains the difference between the ending balance of cash in a bank and bank statement.

The possible reasons for the difference between two balances could be

- Delay in recording transactions

For example: Deposit in transit (deposits made after the bank closes it records for the statement period), outstanding checks (checks issued but not presented for payment in the bank), bank service charges, collections made bank.

- Errors or omissions in recording transactions

Note that, adjustment entries are required for transactions and events that are not included in the depositor record and for the errors, which are made in recording by the depositor. However for transactions that are not recorded by bank and for the differences that are self-correcting such as, deposit in transit, outstanding checks, adjustment entries, will not be required. But for the errors made by the bank it should be called for correction by writing a memorandum to the bank.

The two commonly used forms of bank reconciliation are:

1. Reconcile both bank balance and depositors balance to correct cash balance (Direct method).
  2. Reconcile the bank balance to the balance in the depositor's record (Indirect method)
1. Reconcile both bank balance and depositors balance to correct cash balance.

**Illustration:**

On August 31, 2006 the cash ledger account in Awash international company shows a debit balance of Birr 82, 461 while the bank statement provided by Abyssinia bank indicates a balance of birr 110,632. A receipt of August 31, for 12,924 birr was not included in August bank statement. In addition the checks, which were issued but not paid by, bank during this month totals birr 11,458. Credit memorandums send by the bank indicated that notes receivable left with the bank for birr 10,200 had been collected and credited for 10,240 birr including interest revenue of birr 40. In addition the maturing value of Treasury bill birr 20,000 collected during this month. The bank acquired for Awash Company at a discount for birr 18,800 and had been recorded at cost in the short term investment ledger account by Awash Company. The bank statement included in debit memorandum includes birr 28 as a service charge for the month of August. A check for 521 birr drawn by ABC Company (Creditor) returned and marked as NSF. Check number 1334 issued for 328 birr had been recorded by bank as 382 birr.

**Required:**

- i) Prepare bank recondition schedule for Awash Company for the month of August.
  - ii) Make the necessary journal entries.
1. **Reconciling the bank balance and depositor's balance to correct cash balances (direct Method).**

Under this method reconciliation will be made to bring both unadjusted balance in a bank and a depositor's record to the adjusted or correct balances.

**Awash International Company**

**Bank Reconciliation**

**August 31, 2022**

Balance in depositor's record		Br 82,461
Add: Note and interest of Br.40 collected by bank	10,240	
: Proceeds from Treasury bill that had been		
Acquired for br.18, 800 and interest revenue.br 1,200	<u>20,000</u>	<u>30, 240</u>
Subtotal		112,701
Less: NSF checks drown by ABC company	521	
: Bank service charges for August	<u>28</u>	<u>549</u>
Correct cash balance		<u><b>112, 152</b></u>
Balance in bank statement		Br 110,632
Add: Deposit in transit	12,924	
Error in recording check number 1334	<u>54</u>	<u>12,978</u>
Subtotal		123,610
Less: Outstanding checks		<u>11,458</u>
Correct cash balance		<u><b>112,152</b></u>

Preparing the above bank reconciliation will have the following three functions.

1. It helps to determine the correct cash balance to be reported in the balance sheet.
2. To disclose errors made in recording cash transactions, either by the bank or by the depositor, and
3. To provide information necessary to bring the accounting records up to date.

After bank reconciliation statement is made, all items appearing in the reconciliation as additions to or deductions from the "balance in the depositor's record" must be included in the journal entry. The journal entry on August 31, 2022 to adjust the accounting records of Awash Company is shown below:

Cash	29,691	
Account Receivable	521	
Miscellaneous Expenses	28	
Interest revenue ( Br 40 + 1,200)		1,240
Notes Receivable		10,200
Short term investments (Treasury bill)		18,800

The cash at bank account in the depositor's record before the above adjustment has a debit balance for 82,461 Birr.

	Cash
	82,461
Adjustment →	29,691
	-----
	112, 152

And after the above journal entry is posted it will show the correct balance of 112,152 Birr.

## 2. Reconcile bank balance to the balance in the depositor's record (indirect method)

Steps to use this method;

1<sup>st</sup> Reconcile the bank balance to the unadjusted cash account balance in the general ledger.

- Include all items that are not included in the bank statement
- Add the items that were deducted in the bank statement but not in the depositor's cash account record.
- Deduct the items that were added in the bank statement but not in the depositor's cash account record.

2<sup>nd</sup> Enter the required adjustments in the bank reconciliation to the cash account in the depositor's record.

### Awash International Company Bank reconciliation August 31, 2022

Balance in Bank statement		Br 110,632
Add: Deposit in transit	12,924	
: Error in recording check no. 1334	54	
: NSF check drawn by ABC company	521	
: Bank service charges for August	<u>28</u>	<u>13,527</u>
Subtotal		124,159
Less: outstanding checks	11,458	
Note and interest of Br 40 collected by bank	10,240	
: Proceeds from treasury bill that had been acquired for br, 18,800 and interest revenue br 1,200	<u>20,000</u>	<u>41,698</u>
Balance in depositor's records; unadjusted		82,461
Add: Adjustment to cash ledger account (See the above journal entry)		<u>29,691</u>
Correct cash balance (adjusted)		<u><u>112,152</u></u>

## 4.5. ACCOUNTING FOR RECEIVABLES

**Receivables** are claims held against customers and others for money, goods, or services. For financial statement purposes, companies classify receivables as either **current** (short-term) or **noncurrent** (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 **noncurrent**. Receivables are further classified in the balance sheet as either trade or nontrade receivables.

Customers often owe a company amounts for goods bought or services rendered. A company may sub classify these **trade receivables**, usually the most significant item it possesses, into accounts receivable and notes receivable.

The basic issues in accounting for accounts and notes receivable are the same: **recognition**, valuation, and disposition.

### **Recognition of Accounts Receivable**

Accounts receivable are recognized only when the criteria for recognition are fulfilled. They are valued at the original exchange price between the firm and the outside party, less adjustments for cash discounts, sales returns and allowances, trade discounts and uncollectible accounts yielding an approximation to net realizable value, the amount of cash expected to be collected.

### **Trade Discounts**

Example: Assume an item priced Br. 50 is offered at a trade discount of 40 percent for order over 1000 units. The unit price for an order of 1,100 units is therefore Br. 30 (Br. 50 x 0.6). The percentage discount can be changed for different order quantities without changing the basic Br. 50 price.

### **Gross and Net Methods**

When cash discounts are offered, the receivable and sell is recorded either at the gross or net amount (gross invoice less available cash discount). The key distinction between the two is the treatment of sales discounts. The gross method record sells discounts only if the customer pays within the discount period. The net amount records sales discounts only if the customer fails to pay within the discount period.

To illustrate the two methods, assume that Cock Company sells merchandise to Ethio Company at a gross sales price of Br. 1000. Credit terms are 2/10, n/30. Cock company's entries for selected events follow.

Entry to record credit sale:

	<b>Gross method</b>	<b>Net method</b>
Accounts receivable	1000	Accounts receivable 980
Sales	1000	Sales 980

Cock Company's offer of a cash discount supports the net valuation of sales and accounts receivable. Cock Company is satisfied with Br. 980 if payment is made within 10 days of sale. Therefore, the additional Br.20 is a finance charge for delaying payment.

Entry to record collection within the 10-day discount period:

<b>Gross method</b>	<b>Net method</b>
Cash 9-----80	Cash -----980
Sales discount -----20	Accounts receivable ----980
Accounts receivable -----1000	

Sales discount is a contra account to sales, reducing net sales by the amount of cash discount taken. The gross method specifically identifies discounts taken by customers.

Entry to record collection after the 10-day discount period:

<b>Gross method</b>	<b>Net method</b>
Cash -----1000	Cash -----1000
Accounts receivable -----1000	Accounts receivable -----980
	Sales discount forfeited ---- 20

### **Measurement of uncollectible accounts receivable**

When credit is extended, some amount of uncollectible receivables is generally inevitable. Firms attempt to develop a credit policy neither too conservative (leading to excessive lost sales) nor too liberal (leading to excessive uncollectible accounts). Past records of payment and the financial condition and income of customers are key inputs to the credit-granting decision.

Two general approaches to recognizing the cost of uncollectible receivables are found in practice.

**Allowance method:** If uncollectible accounts receivable are both probable and estimable, an estimate of uncollectible receivables is recognized and net accounts receivable is reduced. Most large firms use this method.

**Direct-write-off method:** If uncollectible accounts are not probable or estimable, no adjustment to income or receivables is made until specific accounts are considered uncollectible.

### **Use of Accounts Receivable as a Source of Cash**

Business enterprises generally raise the cash needed for current operation through the collection of accounts receivable. It is possible to accelerate this process by selling receivables (Factoring):

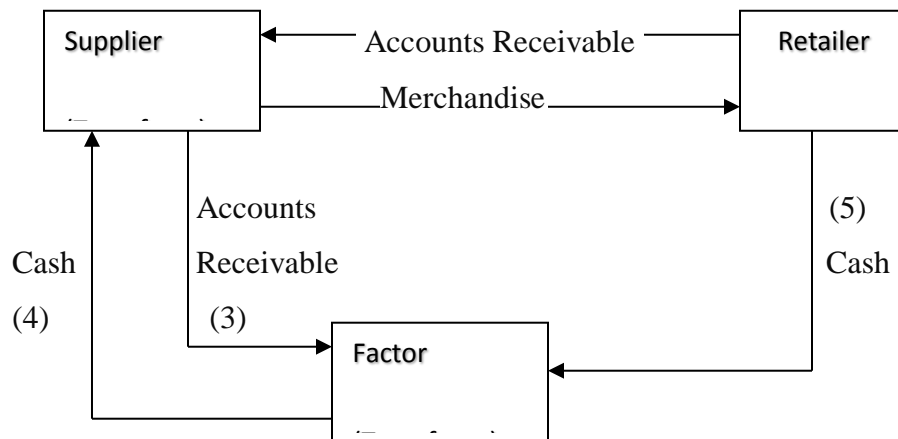


- Assigning receivables
- Pledging receivables as collateral for loans.

### Factoring Accounts Receivable

Factoring refers to selling accounts receivable to another party. The enterprise selling the accounts receivable is called the transferor and the company buying the receivables is called transferee (factor).

Factoring transfers ownership of the receivables to the factor. Factoring is common in the textile industry and in retailing. Suppliers to apparel retailers, department stores, and discount retailers prefer not to risk shipping merchandise without assurance that a factor will purchase the resulting receivables. The diagram below depicts the relationship among the parties.



The factor plays a key role in the continuance of the business relationship between supplier and retailer. The factor charges a fee in return for accepting the risk of default by retailers. If that risk increases, the factor will increase the fee, reduce the amount of receivables purchased, or suspend credit to the supplier.

### 4.6.Summary

Receivables are claims held against customers and others for money, goods, or services. For financial statement purposes, companies classify receivables as either current (short-term) or noncurrent (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 noncurrent. Receivables are further classified in the balance sheet as either trade or nontrade receivables. Customers often owe a company amounts for goods bought or services rendered. A

company may sub classify these trade receivables, usually the most significant item it possesses, into accounts receivable and notes receivable.

The basic issues in accounting for accounts and notes receivable are the same: recognition, valuation, and disposition. Accounts receivable are recognized only when the criteria for recognition are fulfilled. They are valued at the original exchange price between the firm and the outside party, less adjustments for cash discounts, sales returns and allowances, trade discounts and uncollectible accounts yielding an approximation to net realizable value, the amount of cash expected to be collected.

#### **4.7. Exercise**

##### **Multiple Choices**

1. When customers make purchases with a national credit card, the retailer
  - A. Is responsible for maintaining customer accounts.
  - B. Is not involved in the collection process.
  - C. Absorbs any losses from uncollectible accounts.
  - D. Receives cash equal to the full price of the merchandise sold from the credit card company.
2. The two methods of accounting for uncollectible accounts are the direct write-off method and the
  - A. Accrual Method
  - B. Net Realizable Method
  - C. Bad Debt Method
  - D. Allowance Method
3. A 90-day note dated April 20 would mature on
  - A. July 19
  - B. July 21
  - C. July 20
  - D. July 18
4. Under the direct write-off method of accounting for uncollectible accounts, Bad Debt Expense is debited

- A. When a credit sale is past due.
  - B. At the end of each accounting period.
  - C. Whenever a pre-determined amount of credit sales have been made.
  - D. When an account is determined to be uncollectible.
5. An aging of a company's accounts receivable indicates that \$6,000 are estimated to be uncollectible.

If Allowance for Doubtful Accounts has a \$2,000 debit balance, the adjustment to record bad debts for the period will require

- A. Debit to Bad Debt Expense for \$8,000.
- B. Debit to Allowance for Doubtful Accounts for \$8,000.
- C. Debit to Bad Debt Expense for \$4,000.
- D. Credit to Allowance for Doubtful Accounts for \$4,000.

# CHAPTER FIVE

## INVESTMENT

### 5.1 Nature and classification of investments

The meaning of investment is putting your money into an asset that can grow in value or produce income or both. For example, you can buy equity stock of a listed company in the hopes of receiving regular dividends and capital appreciation in the form of the share price.

#### Objectives of Investment

The need for investment will grow as you move ahead in life. Growing responsibilities will demand an increase in investment. The primary objectives of investment are listed below:

#### Safeguard your Money

Investing keeps your money safe from immediate and unnecessary expenditures. It also helps you keep your money safe from inflation effects. Inflation erodes the value of your money unless it is invested in an interest-earning asset. Thus, investing will help you automatically keep up with inflation.

#### Grow your Savings

Investment is the only way to start growing your invested money. It allows your money to earn interest and if you keep the interest invested it will also start to earn interest.

#### Build Funds for Emergencies

Life is usually a series of ups and downs. Few times you are earning decent and saving money while other times you need a large sum for an emergency. Building investment pools help you on such rainy days.

#### Secures your Retired Life

Retired life is where you don't have a source of income to sustain your life. Once you have built a retirement corpus, you can experience the freedom that comes with it.

#### Save Tax

Investment in tax-saving instruments like life insurance plans, ULIPs, PPF, NPS, etc allows you to claim deductions on your taxable income. Thus, investing in specific assets can help you reduce your tax liability. Many of these investments also help you reduce your future tax with tax-free maturity values.

#### Fund Bigger Life Goals

Monthly income will not be enough to purchase your next car or build a house for your family. However, if you invest a small sum in a few years both could be possible.

#### Different Categories of Investments

Depending on the type of asset you invest in you can expect a certain degree of risk and return ratio. You can divide all investments into the following categories:

### **Owner's Equity**

These are some of the high-risk investments as you are directly holding the ownership stake. Owners only earn after paying all the expenses and liabilities. Ownership stake makes you a party to the profits and losses of the company.

### **Lending**

Lending is considered safer than equity ownership as you secure an obligation from the borrower to pay interest. Thus, you hold the first right to the money over the owners. However, the rate of return will also be lower.

### **Money Market Participation**

Money market investments are short-term debt obligations, which can last up to 365 days or less. Examples include T-bills, Commercial Papers, etc. Even though these investments will earn less, they are safe.

## **5.2. Accounting for Debt investment**

A **debt security** is an investment in bonds issued by the government or a corporation. At the time of purchasing a bond, the acquisition costs are recorded in an asset account, such as “Debt Investments.” Acquisition costs include the market price paid for the bond and any investment fees or broker's commissions. For example, if Computers Galore purchases five of the 10%, ten-year \$1,000 bonds issued by VEI on July 1 for \$5,500 and pays broker's fees of \$50, the entry to record the purchases would include both the purchase price and broker's fees in the cost of the investment.

**General Journal**

Date	Account Title and Description	Ref.	Debit	Credit
20X0				
July 1	Debt Investments		5,550	
	Cash			5,550
	Purchase of five VEI bonds			

The bonds pay interest every December 31 and June 30. When the semiannual interest is received on December 31, the entry to record it increases (debits) cash and increases (credits) interest revenue for \$250 ( $\$5,000 \times 10\% \times \frac{6}{12}$ ).

**General Journal**

Date	Account Title and Description	Ref.	Debit	Credit
20X0				
Dec. 31	Cash		250	
	Interest Revenue			250
	Interest on VEI bonds			

The bonds may be held to maturity or sold. If they are held to maturity, the bonds are classified as a long- term investment and the difference between the maturity value and the cost of the bonds is amortized to the income statement over the life of the bonds. If the bonds are held for sale (not held for maturity), their value changes as the market changes. At the time of the sale, a gain or loss is recorded for the difference between the book value and the proceeds received from the sale. For example, if one of the bonds was sold for \$1,050 on June 1, the entry would include

a loss of \$60, the difference between the cost of \$1,110 (\$5,550 total acquisition cost divided by 5 bonds acquired) and the proceeds of \$1,050.

### General Journal

Date	Account Title and Description	Ref.	Debit	Credit
20X1				
June 1	Cash		1,050	
	Loss on Sale of Debt Investments		60	
	Debt Investments			1,110
	Sale of one VEI bond			

### 5.3.Accounting for equity investments

An **equity security** is an investment in stock issued by another company. The accounting for an investment in an equity security is determined by the amount of control of and influence over operating decisions the company purchasing the stock has over the company issuing the stock. If less than 20% of the stock is acquired and no significant influence or control exists, the investment is accounted for using the **cost method**. If 20–50% of the stock is owned, the investor is usually able to significantly influence the company it has invested in. Assuming the investor does not control the number of positions on the Board of Directors or hold key officer positions, this investment would be accounted for using the **equity method**. If the investor has 50% or more of a company's stock, significant influence and control are deemed to exist and the investor reports its results using **consolidated financial statements**. Although percent of voting stock owned serves as a guideline, the amount of influence and control is used to determine the accounting for equity securities.

#### Cost method

The cost method of accounting for stock investments records the acquisition costs in an asset account, Equity Investments. As with debt investments, acquisition costs include commissions and fees paid to acquire the stock. If 72 shares of PWC Corporation are acquired when the market price is \$28 and a \$25 broker's fee is paid, the entry to record the purchase is:

**General Journal**

<b>Date</b>	<b>Account Title and Description</b>	<b>Ref.</b>	<b>Debit</b>	<b>Credit</b>
20X0				
Jan. 18	Equity Investments [(72 shares × \$28) + \$25]		2,041	
	Cash			2,041
	Acquire 1% of PWC Corporation stock			

As dividends are received, dividend income is recorded. If PWC Corporation pays a \$1 per share cash dividend, the entry to record the receipt of the dividend increases (debits) cash and increases (credits) dividend revenue.

**General Journal**

<b>Date</b>	<b>Account Title and Description</b>	<b>Ref.</b>	<b>Debit</b>	<b>Credit</b>
20X0				
Mar. 12	Cash		72	
	Dividend Revenue			72
	Dividends received			



Equity investments accounted for by using the cost method are classified as either trading securities or available-for-sale securities, and the value of the investment is adjusted to market value. When an equity investment accounted for under the cost method is sold, a gain or loss is recognized for the difference between its acquisition cost and the proceeds received from the sale. Assume 36 of the PWC Corporation shares purchased were sold for \$30 per share and a fee of \$25 was paid. The entry to record the sale would increase (debit) cash for the proceeds received of \$1,055 ( $36 \times \$30 = \$1,080 - \$25 \text{ fee}$ ), decrease (credit) equity investments by \$1,020.60 ( $\$2,041 \div 72 = \$28.35 \times 36 \text{ shares}$ ) and record a gain on the sale for the \$34.40 difference.

#### General Journal

Date	Account Title and Description	Ref.	Debit	Credit
20X0				
May 27	Cash		1,055	
	Equity Investments			1,020.60
	Gain on Sale of Equity Investments			34.40
	Sale of 36 share of PWC Corporation			

The equity method of accounting for stock investments is used when the investor is able to significantly influence the operating and financial policies or decisions of the company it has invested in. Given this influence, the investor adjusts the value of its equity investment for dividends received from, and the earnings (or losses) of, the corporation whose stock has been purchased. The dividends received are accounted for as a reduction of the investment value because dividends are a partial return of the investor's investment. Assume The Sisters, Inc. acquired 30% of the stock of 2005 GROUP for \$72,000 on Jan. 1. During the year, 2005 GROUP paid dividends totaling \$30,000 and had net income of \$150,000. Under the equity

method, the \$9,000 in dividends ( $\$30,000 \times 30\%$ ) received by The Sisters, Inc. would decrease the Investment in 2005 GROUP account rather than be reported as dividend revenue. The same account would increase \$45,000 for The Sisters, Inc. 30% share of net income ( $\$150,000 \times 30\%$ ) as they treat their share of net income as revenue. At the end of the year, the balance in the Investment in 2005 GROUP account would be \$108,000.

#### Investment in 2005 Group

Investment	72,000	9,000 Dividends Received
Share of net income	45,000	
108,000		

The entries by The Sisters, Inc. to record the acquisition of 2005 GROUP stock, receipt of dividends, and share of net income are:

### General Journal

Date	Account Title and Description	Ref.	Debit	Credit
20X0				
Jan. 1	Investment in 2005 GROUP		72,000	
	Cash			72,000
	Acquire 30% of 2005 GROUP stock			
Dec. 31	Cash		9,000	
	Investment in 2005 GROUP			9,000
	Dividends received—2005 GROUP			
Dec. 31	Investment in 2005 GROUP		45,000	
	Revenue from Investment in 2005 GROUP			45,000
	Share of net income—2005 GROUP			

### Consolidated financial statements

A company that owns greater than 50% of another entity is called the **parent company**. The company whose stock is owned is called the **subsidiary company**. A parent company uses the equity method to account for its investment in its subsidiary. When financial statements are prepared, the assets and liabilities (balance sheet), revenues and expenses (income statement), and cash flows (cash flow statement) of both the parent company and subsidiary company are combined and shown in the same statements. These statements are called consolidated balance sheets, consolidated income statements, and consolidated cash flow statements—together they

are called consolidated financial statements and represent the financial position, results of operations, and cash flows of the parent company and any other companies it controls.

#### **5.4. Impairment of investment value**

An investor is required to assess its equity method investment for impairment when events or circumstances suggest that the carrying amount of the investment may be impaired.

##### **5.4.1. Loss in investment value that is other than temporary**

An investor records an impairment charge in earnings when the decline in value below the carrying amount of its equity method investment is determined to be other than temporary. “Other than temporary” does not mean that the decline is of a permanent nature. The unit of account for assessing whether there is an other-than-temporary impairment (OTTI) is the carrying value of the equity method investment as a whole.

#### **Impairment of Amortized Cost Investments**

Impairment is the condition that exists when the carrying value of an asset is higher than its fair value. Investments carried at amortized cost must be tested for impairment on each reporting date. If an entity issues interim financial statements, the interim dates are also considered to be reporting dates. Impairment tests must be conducted on an instrument-buy-instrument basis, meaning that each debt security investment classified as held-to-maturity must be tested for impairment on its own. The impairment of held-to-maturity investments that is considered to be other-than-temporary is calculated and recorded using the current expected credit loss model that we will discuss in the next section. Impairment losses are other than temporary if the entity does not plan to sell the investment or believes that it will be required to sell the investment before its amortized cost can be recovered.

#### **5.5. Transfer between categories**

The transfer between categories of investments should be accounted for at fair value. ASC 320-10-35-10 indicates how the security's unrealized holding gain or loss should be treated at the date of the transfer. The treatment of the unrealized gain or loss at the transfer date is outlined in the chart below.

Accounting for Unrealized Holding Gain or Loss Upon Transfers between Categories			
	From Trading	From Available for Sale	From Held to Maturity
To Trading	-	Reverse equity component and recognize in earnings immediately	Recognize in earnings immediately
To Available for Sale	Already recognized in income - no reversal	-	Recognize in equity section
To Held to Maturity	Already recognized in income - no reversal	Continue reporting in equity and amortize to income as yield adjustment	-

The use of fair value for debt securities transferred into the held-to-maturity category may create a premium or discount that should be amortized thereafter as an adjustment of yield. For debt securities transferred into the held-to-maturity category from the available-for-sale category, the difference between the amortized cost and its fair value at the date of the transfer is amortized as a yield adjustment in accordance with the effective interest method described in ASC 310. However, amortization of the unrealized holding gain or loss reported in equity will offset or mitigate the effect on interest income of the amortization of the premium or discount for that held-to-maturity security.

When a security is transferred from held-to-maturity to available-for-sale, the security's amortized cost basis carries over to the available-for-sale category for the following purposes: subsequent amortization or accretion of the historical premium or discount, comparison of fair value and amortized cost for the purpose of determining unrealized holding gains and losses, and required disclosure of amortized cost.

### 5.3.Summary

This chapter states an **equity security** is an investment in stock issued by another company. The accounting for an investment in an equity security is determined by the amount of control of and influence over operating decisions the company purchasing the stock has over the company issuing the stock. If less than 20% of the stock is acquired and no significant influence or control exists, the investment is accounted for using the **cost method**. If 20–50% of the stock is owned, the investor is usually able to significantly influence the company it has invested in. Assuming the investor does not control the number of positions on the Board of Directors or hold key officer positions, this investment would be accounted for using the **equity method**. If the investor has 50% or more of a company's stock, significant influence and control are deemed to exist and the investor reports its results using **consolidated financial statements**. Although percent of voting stock owned serves as a guideline, the amount of influence and control is used to determine the accounting for equity securities.

A debt security is an investment in bonds issued by the government or a corporation. At the time of purchasing a bond, the acquisition costs are recorded in an asset account, such as “Debt Investments.” Acquisition costs include the market price paid for the bond and any investment fees or broker's commissions.

#### **5.4.Exercise**

1. A business organized as a separate legal entity is a
  - A. Corporation.
  - B. Proprietor.
  - C. Government unit.
  - D. Partnership.
2. Which of the following is not one of the three forms of business organization?
  - A. Corporations
  - B. Partnerships
  - C. Proprietorships
  - D. Investors
3. Which of the following would not be considered an internal user of accounting data for the Xanadu Company?

- A. President of the company
- B. Production manager
- C. Merchandise inventory clerk
- D. President of the employees' labor union

4. The liability created by a business when it purchases coffee beans and coffee cups on credit from suppliers is termed a(n)

- A. Account payable
- B. Account receivable
- C. Revenue
- D. Expense

5. The right to receive money in the future is called a(n)

- A. Account payable.
- B. Account receivable.
- C. Liability.
- D. Revenue

## CHAPTER SIX

### INVENTORIES

#### 6.1 Nature and classification of inventory

Accounting for inventory in a retail operation presents several challenges. Retailers with certain types of inventory may use the specific identification method to value their inventories. However, it would be extremely difficult to use such an approach at retailing enterprises that have **high-volume**, many different types of merchandise and to determine the cost of each sale, to enter cost codes on the tickets, to change the codes to reflect declines in value of the merchandise, to allocate costs such as transportation, and so on.

An alternative is to compile the inventories at retail prices. In most retail concerns, an observable pattern between cost and price exists. Retail prices can therefore be converted to cost through use of a formula. This method, called the **retail inventory method**, requires that the retailer keep a record of:

- 1) The total cost and retail value of goods purchased,
- 2) The total cost and retail value of the goods available for sale, and
- 3) The sales for the period.

#### Retail-Method Concepts

- **Original selling price** – the price at which goods originally are offered for sale.
- **Markup** – the original or initial margin between the selling price and cost. It also is referred to as gross margin or mark-on.
- **Additional markup** – an increase in the sales price above the original sales price. The original sales price is the base from which additional markup is measured.
- **Markup cancellation** – cancellation of all or some, of an additional markup. The reduction does not reduce the selling price below the original selling price. Additional markup less markup cancellations is usually called **net markups** or **additional net markups**.
- **Markdown** – a reduction in selling price below the original sales price.
- **Markdown cancellation** – an increase in the sales price (that does not exceed the original sales price) after a reduction in the original markdown less markdown cancellations are referred to as net markdowns.



Example: Assume that Designer Clothing Store recently purchased 100 dress shirts from More Inc. The cost for these shirts was Br1,500, or Br15 a shirt. Designer Clothing established the selling price on these shirts at Br30 a shirt. The manager noted that the shirts were selling quickly, so he added a markup of Br5 per shirt. This markup made the price too high for customers, and sales lagged. The manager then reduced the price to Br32. At this point we would say that Designer Clothing has had a markup of Br5 and a markup cancellation of Br3. As soon as the major marketing season passed, the manager marked the remaining shirts down to a sales price of Br23. At this point, an additional markup cancellation of Br2 has taken place, and a Br7 markdown has occurred. If the shirts are later written up to Br24, a markdown cancellation of Br1 would occur.

Retailers use markup and markdown concepts in developing the proper inventory valuation at the end of the accounting period. To obtain the appropriate inventory figures, proper treatment must be given to markups, markup cancellations, markdowns, and markdown cancellations. The cost/retail ratio makes up one of the main components used to calculate the retail inventory method. Two methods exist for calculating the cost/retail ratio.

- 1) The **conventional retail (LCM)** method includes markups but excludes markdowns. This method results in a lower ending inventory value.
- 2) **The retail method (Average cost)**: uses both markups and markdowns to calculate the ratio. This method results in a higher-ending inventory value.

Steps to determine ending inventory by the conventional retail method:

1. Find goods available for sale at cost and at retail price.

$$\text{Cost of goods available for sale} = \text{Purchases (net)} + \text{Freight in}$$

2. Calculate ratio of cost to retail price.

$$\text{Cost to retail ratio} = \frac{\text{Cost of goods available at cost}}{\text{Cost of goods available at retail}}$$

3. Find ending inventory at retail price.

$$\text{Ending inventory at retail price} = \text{Cost of goods available for sale} - \text{sales (net)}$$

4. Find ending inventory at cost

$$\text{Ending inventory at cost} = \text{ending inventory at retail} \times \text{cost to retail ratio}$$

To illustrate the retail method of estimating inventories using conventional and average cost methods use the following data for Yomiyu plc:

	<b>Cost</b>	<b>Retail</b>
Beginning inventory	Br500	Br1,000
Purchases(net)	20,000	35,000
Markups		3,000
Mark up cancellations		1,000
Mark downs		2,500
Markdown cancellation		2,000
Net sales		25,000

**Computation of ending inventory:**

	<b>Cost</b>		<b>Retail</b>
Beginning inventory	Br500		Br1,000
Purchases	20,000		35,000
<b>Merchandise available for sale</b>	<b>20,500</b>		<b>36,000</b>
Add:			
Markups		3,000	
Less: Mark up cancellations		(1,000)	
Net mark ups			2,000
	<u><b>20,500</b></u>		<b>38,000</b>
<b>Cost-to-retail ratio = 20,500/38,000= 53.9%.....(conventional method)</b>			
Deduct:			9,800
Mark downs		2,500	
Less: Mark down cancellations		(2,000)	
Net markdowns			500
	<b>20,500</b>		<b>37,500</b>
<b>Cost-to-retail ratio = 20,500/37,500= 54.7%.....(average cost method)</b>			
Deduct: Net sales			<b>25,000</b>

Ending inventory at retail	<b>12,500</b>
<b>Value of Ending Inventory = ending inventory at retail x cost ration</b>	
Conventional method= 12,500 x 53.9% = <b>6,737.50</b>	
Average cost method = 12,500 x 54.7% = <b>6,837.50</b>	

Advantages:

1. To verify the reasonableness of the cost of inventory at the end of the accounting period.
2. When only the selling price is available it permits valuation of inventory
3. To estimate the cost of inventory for interim accounting period

The retail inventory method of computing inventory is used widely:

- 1) To permit the computation of net income without a physical count of inventory,
- 2) As a control measure in determining inventory shortages,
- 3) In regulating quantities of merchandise on hand, and
- 4) For insurance information.

#### Self test:

Presented below is information related to KK Company.

	<u><b>Cost</b></u>	<u><b>Retail</b></u>
Beginning inventory	Br 200,000	Br 280,000
Purchases	1,425,000	2,140,000
Markups		95,000
Markup cancellations		15,000
Markdowns		35,000
Markdown cancellations		5,000
Sales		2,250,000

#### Instructions

- 1) Compute the inventory by the conventional retail inventory method.
- 2) Compute the inventory by the retail inventory method

#### 6.2 Physical goods and costs included in inventory

The retail inventory method becomes more complicated when we consider such items as freight-in, purchase returns and allowances, and purchase discounts. In the retail method, we treat such items as follows.

- **Freight costs** are part of the purchase cost.
- **Purchase returns** are ordinarily considered as a reduction of the price at both cost and retail.
- **Purchase discounts and allowances** usually are considered as a reduction of the cost of purchases.

In short, the treatment for the items affecting the cost column of the retail inventory approach follows the computation for cost of goods available for sale. Note also that sales returns and allowances are considered as proper adjustments to gross sales. However, when sales are recorded gross, companies do not recognize sales discounts. To adjust for the sales discount account in such a situation would provide an ending inventory figure at retail that would be overvalued.

In addition, a number of special items require careful analysis:

**Transfers-in** from another department are reported in the same way as purchases from an outside enterprise.

**Normal shortages** (breakage, damage, theft, shrinkage) should reduce the retail column because these goods are no longer available for sale. Such costs are reflected in the selling price because a certain amount of shortage is considered normal in a retail enterprise. The cost of normal shrinkage is included in the cost of goods sold.

**Abnormal shortages** (theft, unusual spoilage etc), on the other hand, are deducted from both the cost and retail columns and reported as a special inventory amount or as a loss. The cost of abnormal shrinkage that is material in amount is reported separately in the income statement.

**Employee discounts** (given to employees to encourage loyalty, better performance, and so on) are deducted from the retail column in the same way as sales. These discounts should not be considered in the cost-to-retail percentage because they do not reflect an overall change in the selling price.

### **6.3. Valuation of inventories: A cost-basis approach**

Different issues affect inventory valuations. Two of these are current replacement cost and selling prices.

Special inventory categories often include items for resale that are damaged, shopworn, obsolete, defective, trade-ins, or repossessions. These inventory items are assigned a cost related to their condition, namely, their current replacement cost, if it can be determined reliably in an

established market for the items in their current condition. Current replacement cost is defined as the price for which the items can be purchased in their present condition.

#### Valuation of Inventories at net selling prices

Valuation of inventories at net selling prices (Sales prices less direct costs of completion and disposal) has some appeal, especially when one considers that economic value is added as the goods are brought to market.

For example, in a retail stores goods are more valuable than they were at the wholesaler's warehouse; value is added by the process of bringing the goods nearer the ultimate market.

The valuation of inventories at net selling prices is appropriate for some types of business enterprises producing commodities that have readily determinable market prices. When the production of such commodities is complete, revenue may be considered realized. In some enterprises having selling prices established by contract, the sale is reasonably assured, and completed inventories may be valued at net selling prices.

#### **Exercise:**

Q1. Afire destroys all of the merchandise of AA Company on February 10, 2015. Presented below is information compiled up to the date of the fire.

Inventory, January 1, 2015	Br 400,000
Sales to February 10, 2015	1,950,000
Purchases to February 10, 2015	1,140,000
Freight-in to February 10, 2015	60,000
Rate of gross profit on selling price	40%

Q2. Astaire Company uses the gross profit method to estimate inventory for monthly reporting purposes. Presented below is information for the month of May.

Inventory, May 1	Br 160,000
Purchases (gross)	640,000
Freight-in	30,000
Sales	1,000,000
Sales returns	70,000
Purchase discounts	12,000

Instructions

- (a) Compute the estimated inventory at May 31, assuming that the gross profit is 25% of sales.  
 (b) Compute the estimated inventory at May 31, assuming that the gross profit is 25% of cost.

### 6.3.1. Gross profit Method of Estimating Inventory

Most companies would like to prepare interim financial statements such as monthly, quarterly or semiannually. Physical count inventory is made at the end of year. For this reason the companies use some methods to calculate its ending inventory, one of these methods called "The Gross Profit Method"(sometimes called "the Gross Margin Method"). The **gross profit method** estimates the cost of ending inventory by applying the gross profit ratio to net sales (at retail). This type of estimate often is needed when inventory is **destroyed, lost, or stolen**.

**To compute** the ending inventory by the Gross Profit Method, there are five steps:

1. To determine the gross profit rate whether as a percentage of sales or a percentage of cost (cost of goods sold ) , if the percentage was of cost , you must convert this percentage to a percentage of sales because the cost of goods sold is variable , convert the percentage from cost to sales as follows :

$$\text{Gross profit on sales} = \frac{\text{Percentage markup on cost}}{(100\% + \text{percentage markup on cost})}$$

For example if the percentage of gross profit is 25% of cost, it can be converted in to percentage of sales as follows:

$$\text{Gross Profit on sales} = \frac{0.25}{(1+0.25) \times 100} = 20\%$$

**Note:** The computed gross profit of sales must equal the computed gross profit of cost.

To illustrate this problem assume the following information that related to XY Company:-

Beginning Inventory Br20,000

Purchases Br160,000

Sales Br190,000

Gross Profit percentage 25% of cost.

**Solution:**

$$\text{Gross profit on sales} = \frac{\text{Percentage markup on cost}}{(100\% + \text{percentage markup on cost})}$$

$$\text{Gross profit on sales} = \frac{25\%}{(100\% + 25\%)} = 20\%$$

Gross Profit = Br190,000 \* 20% = **Br38,000**

Cost of goods sold = Br190,000 - 38,000 = Br152,000

Gross Profit on Cost = Br152,000 \* 25% = **Br38,000**

2. Compute the total cost of goods available for sale.

**Cost of goods available for sales = Beginning Inventory + Net Purchases + Freight in**  
**(Net Purchases = Purchases – (Discount + Returns & Allowances Purchases))**

3. Compute the estimated Gross profit;

**Estimated Gross profit = Sales × Gross Profit percentage**

4. Compute the cost of goods sold:

**Cost of goods sold = Sales - Gross Profit**

5. Compute ending inventory:

**Cost of goods available for sale - cost of goods sold**

To illustrate, assume that ABC Corp. has a beginning inventory of Br60,000 and purchases of Br200,000, both at cost. Sales at selling price amount to Br280,000. The gross profit on selling price is 30 percent. ABC applies the gross margin method as follows.

Beginning inventory (at cost).....	Br 60,000
Purchases (at cost).....	<u>200,000</u>
Goods available (at cost).....	260,000
Sales (at selling price).....	Br280,000
Less: Gross profit (30% of Br280,000).....	<u>84,000</u>
Sales (at cost).....	<u>196,000</u>
<b>Approximate inventory (at cost).....</b>	<b><u>Br 64,000</u></b>

The gross profit method is used:

- To control and verify the validity of inventory.
- To estimate inventory valuation between physical count.
- To estimate the inventory when the necessary information is not available.
- when both the inventory and inventory records are lost

<b>Comparison of Gross profit method and retail Method</b>		
	<b>Gross-Profit Method</b>	<b>Retail Method</b>
<b>Data required</b>	<ul style="list-style-type: none"> <li>• Cost of beg. inventory, purchases, sales and gross profit ratio</li> </ul>	<ul style="list-style-type: none"> <li>• Cost and retail price of beg. inventory, purchases, sales price and price adjustments</li> </ul>
<b>User</b>	<ul style="list-style-type: none"> <li>• Any company can use this method to estimate ending inventory</li> </ul>	<ul style="list-style-type: none"> <li>• Only retail store can apply this method to estimate inventory</li> </ul>
<b>Ratio computation</b>	<ul style="list-style-type: none"> <li>• Gross profit ratio is estimated from past years' experience (not updated with the price adjustments of the current year).</li> </ul>	<ul style="list-style-type: none"> <li>• Cost ratio can be calculated at different stage and is updated with current year's price adjustment data.</li> </ul>
<b>Acceptance</b>	<ul style="list-style-type: none"> <li>• Not acceptable for the annual financial reporting but acceptable for the interim report.</li> </ul>	<ul style="list-style-type: none"> <li>• Not acceptable for the annual financial reporting but acceptable for the interim report</li> </ul>
<b>Physical inventory</b>	<ul style="list-style-type: none"> <li>• No physical count of inventory is needed</li> </ul>	<ul style="list-style-type: none"> <li>• No physical count of inventory is needed</li> </ul>

### 6.3.Summary

In this chapter most companies would like to prepare interim financial statements such as monthly, quarterly or semi-annually. Physical count inventory is made at the end of year. For this reason the companies use some methods to calculate its ending inventory, one of these methods called "The Gross Profit Method"(sometimes called "the Gross Margin Method"). The gross profit method estimates the cost of ending inventory by applying the gross profit ratio to net sales (at retail). This type of estimate often is needed when inventory is destroyed, lost, or stolen.

### 6.4.Exercise

- 1.in a perpetual inventory system,
  - (b) LIFO cost of goods sold will be the same as in a periodic inventory system.
  - (c) Average costs are based entirely on unit cost simple averages.
  - (d) a new average is computed under the average cost method after each sale.
  - (e) FIFO cost of goods sold will be the same as in a periodic inventory system.
2. Company Y has the following inventory data:
  - August 1 Beginning inventory 20 units at \$10
  - 8 Purchases 130 units at \$15



17 Sale 80 units

25 Purchases 30 units at \$20

30 Sale 60 units

3. Assuming that a perpetual inventory system is used, what is ending inventory (rounded) under the average cost method for August? (DO NOT ROUND INTERMEDIATE CALCULATIONS).

- A. \$641.33
- B. \$611.11
- C. \$800.00
- D. \$500.00

4. Simpson Inc. purchased inventory as follows:

Jan. 5 500 units at \$10.00

Jan. 15 1,000 units at \$15.00

Jan. 25 200 units at \$20.00

What is the average unit cost of inventory?

- A. \$14.12
- B. \$15.00
- C. \$13.00
- D. \$15.83

5. Delightful Discs has the following inventory data:

Nov. 1 Inventory 30 units @ \$6.00 each

8 Purchase 120 units @ \$6.45 each

17 Purchase 60 units @ \$6.30 each

25 Purchase 90 units @ \$6.60 each

A physical count of merchandise inventory on November 30 reveals that there are 100 units on hand. Ending inventory under LIFO periodic inventory system is

- A. \$657
- B. \$632
- C. \$1,269
- D. \$1,295

6. Hardaway Inc. purchased inventory as follows:

Jan. 10 200 units at \$5.00

Jan. 20 500 units at \$10.00

Jan. 30 800 units at \$15.00

7. Hardaway Inc. had no beginning inventory and has 500 units on hand as of January 31. Assuming the specific identification method is used and ending inventory consists of 100 units from the Jan. 10 purchase, 300 units from the Jan. 20 purchase, and 100 units from the Jan. 30 purchase, ending inventory would be

- A. \$13,000
- B. \$4,000
- C. \$7,500
- D. \$5,000