WOLLO UNIVERSITY
COLLAGE OF BUSINESS AND ECONOMICS
DEPARTMENT OF ACCOUNTING AND FINANCE

DISTANCE MODULE FOR DEGREE PROGRAM

ADVANCED FINANCIAL ACCOUNTING (ACFN3151)

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Distance Education Program

2020

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OVER VIEW OF ACCOUNTING FOR JOINT VENTURES AND PUBLIC ENTERPRISES

Learning objectives:

Dear students, after successfully completing this chapter you will be able to:

- ☞ Define the joint venture;
- ☞ Differentiate joint venture with partnership;
- ☞ Describe and explain accounting for joint venture;
- ☞ Define the term public enterprises;
- ☞ Explain the characteristics of public enterprises;
- ☞ Describe the benefits of public enterprises;
- ☞ Understand Proclamation 25/1992 with regard to public enterprises in Ethiopia;
- ☞ Understand and explain accounting for public enterprises;

1.1.Characteristics and Historical Background

A joint venture differs from a partnership in that it is limited to carrying out a single project, such as production of a motion picture (movie) or construction of a building. Historically, joint ventures were used to finance the sale or exchange of a cargo of merchandise in a foreign country. In its traditional form a joint venture is a cooperative arrangement between two or more parties (venturers) for the purpose of carrying out a single project and is usually dissolved upon completion of the project.

Historically, joint ventures were used to finance the sale or exchange of a cargo or merchandise in a foreign country. In an era when marine transportation and foreign trade involved many hazards, individuals (venturers) would band together to undertake a venture of this type. The capital required usually was larger than one person could provide, and the risks were too high to be borne alone. Because of the risks involved and the relatively short duration of the project, no net income was recognized until the venture was completed. At the end of the voyage, the net income or net loss was divided among the ventures, and their association was ended.

? Explain the characteristics and historical background of joint venture?

1.2.Present-day Joint Ventures

In today's business community, joint ventures are less common but still are employed for many projects such as (1) the acquisition, development, and sale of real property; (2) exploration of oil and gas; and (3) construction of bridges, buildings, and dams. Joint ventures, in the sense in which the term is generally used in business today, are largely a post-second world war development. Ordinarily, a joint venture denotes a strategic alliance whereby two or more parities combine their resources and skills in an economic activity with the objective of receiving benefits from it. The participants in a joint venture are generally referred to as ventures. The joint venture can be national or an international one, the latter being present if the participants come from different countries. Joint ventures have long been used in international business for expansion into markets, particularly in developing countries. In recent years, joint ventures are being used as the principal vehicle for foreign direct investments.

The characteristic features of joint ventures give rise to some very important accounting issues which need to be addressed by the accounting standard setters. There are two sides of these accounting issues. One is accounting and financial reporting by the joint ventures and the other is accounting and financial reporting of joint venture investments by the ventures. The former becomes most acute when the economic systems and accounting systems of the ventures diverge considerably.

? Explain the present day’s joint ventures?

1.3.Types of Joint Ventures

Considering the nature of joint venture arrangements, joint ventures can be classified as belonging to one of the following types.

1. Jointly controlled entities

2. Jointly controlled operations
3. Jointly controlled assets

1. Jointly controlled entities

A jointly controlled entity is a joint venture which involves the establishment of a corporation, partnership or other entity (create a separate entity) in which each venturer has an interest. The capital contribution on the participating venturers, profit sharing and operating policies of the venture are governed by the joint venture arrangement. The entity has its own organizational structure and its legal form maybe either corporation, partnership, or any other form of business organization. The entity operates in the same way as other entities, except that an arrangement between the venturers establishes joint control over the activity of the entity. An example is when an entity commences a business in a foreign country in conjunction with a goverSageent or other agency in that country, by establishing a separate entity which is jointly controlled by the entity and the goverSageent or agency in the foreign country. A jointly controlled entity maintains its own accounting records and prepares and presents financial statements in the same way as other entities in conformity with the appropriate accounting standards. Generally, jointly controlled entities maybe divided into two forms:

a. Incorporated and
b. Unincorporated

a. Incorporated

The incorporated entities, i.e. corporations are juridical persons. An incorporated entity owns assets, incurs liabilities and expenses, and earns revenues in its own name and for its own account. Being a legal person, an incorporated entity has the right to enter into contract in its own name, it can sue and it can be sued.

b. Unincorporated

Ordinarily, an unincorporated entity is not treated as a legal person. Although the unincorporated entity can in its name acquire assets, incur liabilities and conduct business operations, from a legal point of view, the owners of the entity are directly and proportionately in control of all the assets and liabilities.

2. Jointly Controlled Operation

In this situation no separate entity is formed. Instead, parts of the venturers' existing enterprise work on a common project and coordinate their activities. The organizational structure remains flexible. In some case joint "project teams" are formed, in others responsibilities are delegated as and when the need arises. The distinctive feature of this type of joint venture is that the assets and expertise assigned by each venturer for the joint venture activity remain under the direct control of the venturer who assigns them. The participating venturers perform their respective parts of the joint venture actively using their own resources. The benefits are shared by the venturers on an agreed basis. Examples of joint venture operations include those joint venture arrangements under which the venturers jointly produce, market and distribute a particular product using each venturer's resources such as its property, plant and equipment, technical expertise and employees.

3. Jointly Controlled Assets

Although these are not separate legal entities, the resources contributed by the participating venturers are combined together for the purpose of a joint venture project which is managed either by one venturer typically known as operator, or by a joint managements team. The joint venture agreements define the responsibilities and obligations, of the operator, the interest of the parties etc. The distinctive feature of a joint venture of this type is that each venturer possesses an undivided interest in its assets. The costs of running the project are shared by the participating ventures on an agreed basis; each venturer usually takes a portion of the output of the joint venture. This type of joint venture arrangements is prevalent in the extractive industries (eg. oil, gas, and minerals). An example of a jointly controlled assets venture is where two or more oil exploration companies enter into a joint arrangement to undertake oil exploration or to build an oil pipeline.

? Dear learner! Explain the three types of joint ventures?

2.3 Accounting by Joint Venturers

The accounting and financial reporting by a joint venture depends on its organizational form and characteristics. Many joint venture enterprises develop their own accounting system within the framework of generally accepted accounting principles of the country of operation. Although different countries have different accounting standards, in the case of international joint ventures, it is necessary that the accounting practices of these joint ventures not only conform to the national accounting standards of the host countries but also provide useful information for the foreign venturers. This can best be accomplished by using internationally accepted accounting standards. The accounting procedures in the case of each of the three types of joint ventures are described below.

1. Accounting by Jointly Controlled Entities

The formation of a jointly controlled entity is a transaction in which the ownership interest in the venture is exchanged for whatever consideration is received from the participating venturers. If all the venturers provide cash for ownership interest in the joint venture, the accounting for preparation of the opening balance sheet of this enterprise is fairly simple. If the venturers contribute only non-monetary assets (assets other than cash) or cash plus some non-monetary assets, the fair market value of each non-monetary asset needs to be estimated. An independent appraisal of the non-monetary assets may be required in cases where their values are not apparent from other sources. After preparation of the opening balance sheet of the jointly controlled entity, normal accounting in accordance with the generally accepted accounting principles in the country of operation is applied to the future transactions.

The legal form of a jointly controlled entity may influence the choice of financial reporting methods by the joint venture. If it is a partnership, the financial accounting and reporting procedure of the entity should follow the applicable established procedure for partnership accounting. Sometimes, the financial statements of a partnership form of a joint venture entity would include a “statement of venturers’ capital” showing each venturer’s capital balance at the beginning of the accounting year, plus venturer’s share of the net income for the year, plus (if any) new capital contribution by the venturer during the year, an minus any withdrawal by the venturer during the year. The ending balance of each venturer’s capital account shown in the statement of venturers’ capital, should be reported against each venturer’s name in the “venturer’s capital section” of the balance sheet.

Illustration on unincorporated joint venture

"A" Corporation and "B" Corporation formed an unincorporated joint venture on January 1, 2010. They agreed to share profits or losses equally. A Corp. contributed $ 1 million in cash. B corp. contributed an ongoing business as to which the only tangible assets are fixed assets with an original cost of $800,000 and accumulated depreciation of $ 200,000 equaling a net book value of $ 600,000. The fixed assets contributed by B corp. have a market value of $ 850,000. Since the fair market value of each participant's contribution is considered to be equal to A corp.'s cash contribution of 1 million, the business contributed by B corp. is considered to include joint concern value giving rise to goodwill of $ 150,000. They decided to amortize the goodwill over 40 years, i.e. $ 3,750 per year.

The formation of the joint venture A&B Corp. was recorded with the following journal entry:

Cash	$1,000,000	
Fixed assets	850,000	
Goodwill	150,000	
A Capital		1,000,000
B Capital		1,000,000
To record the investment by the venturers		

The joint venture operated in 2010 and its condensed financial statements for the year 2010 were as follows:

A&B Corporation (A joint venture)
Income statement

For the year ended, December 31, 2010

Revenue		$ 5,000,000
Costs and expenses		4,000,000
Net Income		1,000,000
Division of net income		
A	$ 500,000	
B	500,000	
Total	$ 1,000,000	

A&B Corporation (A joint venture)
Statement of Venturer's capital
For the year ended, December 31, 2010

	A	B	Combined
Investments, Jan. 1, 1998	$1,000,000	$1,000,000	$2,000,000

Add: Net income	500,000	500,000	1,000,000
Venturer's capital at end of year	$1,500,000	$1,500,000	$3,000,000

A&B Corporation (A joint venture)

Balance Sheet

December 31, 1998

Assets		
Current assets		$ 3,200,000
Other assets (including unamortized goodwill)		4,800,000
Total assets		8,000,000
Liabilities and venturer's capital		
Current liabilities		1,600,000
Long-term debt		3,400,000
Venturer's capital:		
A	1,500,000	
B	1,500,000	3,000,000
Total liabilities and venturer's capital		$ 8,000,000

If the jointly controlled entity is an incorporated one, i.e. a corporation, its financial reporting and accounting procedures should follow the conventional or legal requirements on corporate accounting in the country of operation. In the case of financial reporting by international joint ventures whatever their form, international standards are to be taken as "benchmarks" which will be adjusted or modified to suit the local enviroSageent.

2. Accounting by Jointly Controlled Operations

The activities of jointly controlled operations are delegated to the participating venturers, and each venturer carries out its part of the activities using its own resources. In this type of joint venture, no separate accounts of the joint venture operations are prepared. Therefore, the question of accounting by joint ventures does not arise. Each venturer maintains accounting records for its part of a joint venture operation, which will be discussed under the topic accounting for investments in joint ventures.

3. Accounting by Jointly Controlled Assets

These joint ventures normally maintain separate accounting records of the expenses incurred for the outputs delivered to the joint venture participants. These accounting records are maintained by the operator of the undertaking. In most cases, the joint venture agreement may include an accounting agreement. The main provisions of the accounting agreement encompass the approval, funding, reporting, allocation, charging and audit of expenditures applicable to the joint venture.

Generally, the operator is given authority to commit and incur expenditures by virtue of an approved AFE (authority for expenditure) within the agreed work program and budget. An AFE covers a particular activity. In a joint venture for oil exploration, for example, it may cover an exploration well or the construction of part of the production facilities. The AFE is normally broken down and reported against controllable cost categories. As a result, a measure of control is exerted by the venturers (non-operators), whilst allowing the operator the flexibility to perform the task. Any revisions to the work program and budget are to be approved by the venturers periodically.

During the various stages of joint venture activity, the operator will receive cash and non-cash resources from the participating venturers. The operator will make cash calls on the venturers and will deposit the funds into bank accounts under joint names of the venturers. The operator will have the authority to operator these joint bank accounts. The operator will make disbursement from these bank accounts. If the operator is one of the undertaking must be segregated from its financial operations of other areas of involvement.

The accounting agreement for a joint venture involving joint venture assets, normally lays down procedures for reporting back to the venturers, on a monthly basis, expenditures, commitments, estimated total expenditures against budget, cash balances, accruals, etc. This information needs to be in sufficient detail for venturers to review the current management, and also for them to use information as appropriate in their own financial statements.

The accounting agreement generally specifies how the various costs are to be allocated between the participating venturers. In accordance with the agreement, at regular intervals, the operator sends bills to the individual venturers for their respective shares of the total joint venture costs. The simplest form of allocation is where each partner has a fixed equity interest. After inception of the joint venture the percentage interests of the venturers may change. The cost allocation is adjusted to reflect the circumstances.

Another level of allocation is accounting for the income or tariff derived from joint venture activity for the use of its assets by enterprise other than the joint venture participants. For example, an outside oil exploration company may wish to use the oil pipelines system of a joint venture for a tariff based on each barrel of throughput. The arrangement may suit the existing pipeline owing joint venture because the production from their own field may be in decline. With the high investment in oil pipelines, a great deal of thought, effort and negotiations required to effect an arrangement between the pipeline owners and the outsider, these arrangements are now becoming more commonplace. Procedures for allocating these revenues to the participating venturers of jointly controlled assets need to be agreed by all the venturers.

If the operator is one of the venturers and some of its own resources are used for joint venture activity, there may be some problems in charging expenditures to the joint venture. There is no problem with direct expenditures to the joint venture. There is no problem with direct expenditures, so long as the operator's accounting system can clearly identify the costs to a particular joint venture. Problems may arise over the amount to be charged to the joint venture for the services of facilities and staff of a large operator involved in many activities. There is no fixed method for charging expenditures. It is up to the participating venturers to come to an equitable arrangement. However, an underlying principle in a cost sharing arrangement should be that the operator neither losses nor gains by virtue of acting in that capacity.

In most cases, the agreements for the jointly controlled assets contain provisions for audit mechanisms. Thus, the participating venturers are able to review and check in detail the information substantiating the expenditure reports submitted by the operator. Instead of performing individual audits, it is the usual practice for the participants to provide members for a joint audit team to visit the operator's premises.

2.3 Accounting for Investments in Joint Ventures

When accounting and reporting for interests in joint ventures, it is essential that each venturer reflect the substance of the joint venture arrangement whatever its structure of form. The procedures of accounting for the three types of joint ventures are discussed below.

1. Accounting for Jointly Controlled Entities

The basic issue in accounting for investments in jointly controlled entities relates to the choice of method of reporting the investments in the financial statements of participating venturers. The choice of method determines the amounts reported for the investment in the balance sheet and the manner in which operating results from the investment is reported in the income statement. Some argue that the legal form of a jointly controlled entity should not govern the choice of method. This argument is valid from the point of view of the accounting principle of "substance over form". However, in the case of a joint venture, the form and substance of the venture are inseparable, and the form is usually decided by the substance of the joint arrangement, and vice versa.

In order to accomplish the objectives set out in the joint venture arrangement, a jointly controlled entity may be either incorporated or unincorporated. In a corporate joint venture each of the participating venturers hold an interest represented by some proportion of the venture's capital. The joint venture is a separate legal entity (juridical person) and holds the title of the assets and liabilities of the venture. However, an incorporated joint venture generally may have no legal persons to own the assets and the liabilities used in the venture. The participating venturers, therefore, usually own the assets and liabilities of an unincorporated joint venture, directly and proportionately. Since the existence of a legal personality in an incorporated joint venture establishes an indirect relationship between the investing venturer and the assets and liabilities of the venture, it may not be appropriate to account for such investments in the same way as for investments in unincorporated joint ventures where a direct relationship exists between the investor and the assets and the liabilities of the venture.

Possible methods of accounting for investment in joint venture entities

a) Full Consolidation method;
b) Equity method;
c) Proportionate consolidation method;
d) Expanded equity method
e) Cost method

A. Full Consolidation Method

The full consolidation method which ordinarily referred to us consolidation is appropriate under the circumstances where the investor controls the investee. The investee is a legal entity in which the investment has been made. In this case the investor holds the majority controlling interest and it has the ability to control unilaterally the financial and operating policies of the investee.
Under the consolidation method, the specific assets and liabilities of the investee are included in the consolidated balance sheet of the investor, and the specific revenues and expenses of the investee are included in the investor's consolidated income statement. Thus, the consolidated financial statements of the investor are prepared. That portion of the investee's net assets (assets – liabilities) and earnings allocable to other investors is shown in the consolidated financial statements as minority interests (a quasi-liability in the balance sheet and quasi-expenses in the income statements).

The principal advantage attributed to the full consolidation method is that it reflects the full scope of operations and financial position as an integral part of the investor's financial statements with outside interest treated as minority. The principal disadvantage of this method is that it shows assets and operations that are not under the direct control of the investors as if they were.

The full consolidation method meets the requirements of generally accepted accounting principles when one of the investors is in control. The control aspect of joint venture arrangement, however, makes full consolidation inappropriate for reporting investments in jointly controlled entities. As mentioned earlier, the joint venture arrangement for a jointly controlled entity precludes unilateral control by any of the venturers. According to the definition of a joint venture, given earlier, majority ownership interest of any venture does not necessarily establish majority control of that venture. Therefore, the use of full consolidation in accounting for jointly controlled entities seems inappropriate.

B. Equity Method

The equity method is used when the investor has the ability to exercise "significant influence" over the investee. A "significant influence" is normally presumed to exist when the investor has 20% or more ownership interest in the investee. The main principle of the equity method is that the initial investment is recorded at cost and reported as a one-line item in the balance sheet of the investor. This is why this method is sometimes called one-line consolidation. The investment is increased (decreased) by the investor’s proportionate share of profit (loss) declared by the investee. When a dividend is received by the investor, the investment amount is reduced by the amount of dividend received. At the time of preparing the investor’s financial statements, if any difference is observed between the carrying values of the net assets reported in the financial statements of the investee, such a difference should be amortized.

The equity method has some advantages, it is a simple method. It is an acceptable practice for reporting investment in non-controlled entities and it is widely used throughout the world. It generally reflects that the investor (who does not have majority control over the investee) has only a net exposure to the liabilities of the investee by presenting the investment as a net position. Under the equity method, the investor's share of the net income of the investee is recognized as the income of the investor in the accounting period in which the net income is earned by the investee.

Some of the disadvantages attributed to the equity method in the case of accounting for investments in jointly controlled entities are;

i. it tends to obscure the nature and volume of the business of a venture that conducts significant operations through jointly controlled entities;
ii. it excludes from the venturer's financial statements assets and liabilities essential to the conduct of the venturer's business operations through jointly controlled entities;
iii. it excludes from the income statements elements of revenue and expenses arising from the operation of the jointly controlled entity, that may be a significant aspect of the venturer's operations;
iv. it is not informative about the economic effect of the venturer's investment in and commitment to jointly controlled entities with thin equity and heavy debt financing.

Because of the increasing use of jointly controlled entities to conduct business activities that are integral part of the operations of the participating venturers, as well as their potential for off-balance sheet financing, the equity method does not seem to reflect the economic realities of joint venture arrangement. An appropriate method of accounting for investment in jointly controlled entities is necessary that provides more useful information about the operations, the financial resources of the venturer and the risk to which they are subject.

C. Proportionate Consolidation Method

Under the proportionate consolidation method, an investor consolidates in its financial statements its proportionate share of each asset, liability, revenue, and expense item of an investee. Some of the advantages attributed to the propionate consolidation method of reporting investments in jointly controlled entities are;

i. it provides information in a venturer's financial statements on past and prospective changes in economic resources and obligations of a venturer that is useful to present and potential stockholders and creditors;

ii. it reflects significant economic relationships between the venturer and the jointly controlled entity, such as complementary or integrated operations and obligations through direct or indirect guarantee or support agreement;

iii. it recognizes that a part of the assets, liabilities and operations of a joint venture enterprise is under control of a venturer.

The proportionate consolidated method assumes that the individual venturers control their share of future economic benefits through their share of the assets and liabilities of the jointly controlled entity. As mentioned earlier, this may be true for unincorporated jointly controlled entities. The assets and liabilities of an incorporated entity are owned and directly controlled by entity itself. The owners possess an ownership interest in the entity. In the absence of a contractual arrangement which establishes joint control, the owner who has a majority ownership interest in an incorporated entity is in a position to exercise unilateral control over the assets and liabilities through its unilateral controlling power over the entity. If a contractual arrangement (joint venture agreement) establishes "joint' control of the incorporated entity (venture) by the participating venturers, no individual owner (venturer) has the ability to exercise unilateral control over the entity as well as over the assets and liabilities directly controlled by the entity itself. Under such circumstances, the use of proportionate consolidation method for reporting interest in jointly controlled incorporated entities has some disadvantages; for instance;

(a) By combining the venturer's proportionate share of the jointly controlled entity's balance sheet items with its own balance sheet items, the proportionate consolidation method implies that the venturer has the legal right to use or dispose of all the reported assets or to settle all the reported liabilities. in the case of a jointly controlled entity, the legal right to dispose of assets and settle liabilities lies with the entity itself and control of the entity is shared by other venturers;

(b) The use of proportionate consolidation for reporting investments in jointly controlled incorporated entities can cause users of financial statements to be misled as to the availability and distribution of assets and liabilities that would be reported by a venturer,

(c) It is also not clear that proportionate consolidation is more informative to users than equity treatment used to account for significant long-term investment. Thus, given the complexity of the propionate consolidation method its costs might outweigh its benefits.

The Equity and Proportionate methods illustrated

The two methods may be illustrated by assuming that X Co and Y Co each invested $400,000 for a 50% interest in an unincorporated joint venture on January 2, 2010. Condensed financial statements for the joint venture, XY Co, for 2010 were as follows:

XY Co (A joint venture)
Income statement
For the year ended December 31, 2010

Revenue		$2,000,000
Costs and expenses		1,500,000
Net Income		500,000
Division of net income		
X co.	$ 250,000	
Y co.	250,000	
Total	$500,000	

XY Co (A joint venture)
Statement of Venture's capital
For the year ended, December 31, 2010

	X Co	Y Co.	Combined
Investments, Jan. 2, 2001	$400,000	$400,000	$800,000
Add: Net income	250,000	250,000	500,000
Venturer's capital at end of year	$650,000	$650,000	$1,300,000

XY Co (A joint venture)
Balance Sheet
December 31, 2010

Assets	
Current assets	$1,600,000
Other assets	2,400,000
Total assets	4,000,000
Liabilities and venture's capital	

Current liabilities		800,000
Long-term debt		1,900,000
Venturer's capital:		
X co	650,000	
X co	650,000	1,300,000
Total liabilities and venture's capital		$4,000,000

Under the equity method of accounting, both X co. and Y co. would prepare the following journal entries for the investment in XY Company: Journal entries for unincorporated joint venture under equity method of accounting.

January 2, 2010		
Investment in XY Co.	400,000	
Cash		400,000
To record investment in joint venture		

Dec. 31, 2010		
Investment in XY Co.	250,000	
Investment Income		250,000
To record share of XY Co. net income (50% x 500,000)		

Under the proportionate share method of accounting, in addition to the two foregoing journal entries, both X and Y companies would prepare the following journal entry for their respective share of the assets, liability, revenue, and expense of XY Company: Additional venturer's journal entries for unincorporated joint venture under proportionate share method of accounting.

December 31, 2010		
Current assets (1,600,000 x 0.5)	800,000	
Other assets (2,400,000 x 0.5)	1,200,000	
Costs and expenses (1,500,000 x 0.5)	750,000	
Investment income	250,000	
Current liabilities (800,000 x 0.5)		400,000
Long-term debt (1,900,000 x 0.5)		950,000
Revenue (2,000,000 x 0.5)		1,000,000
Investment in XY co.		650,000

To record proportionate share of joint venture's assets, liabilities, revenue, and expenses.

Use of the equity method of accounting for unincorporated joint ventures is consistent with the accounting for corporate joint ventures specified by APB Opinion No. 18. However, information on material assets and liabilities of a joint venture maybe relegated to a note to financial statements, thus resulting in off-balance sheet financing. The propionate share method of accounting for unincorporated joint ventures avoids the problem of off-balance sheet financing but has the questionable practice of including portions of assets such as plant assets in each venturer's balance sheet.

D. Expanded Equity Method

Under the expanded equity method, an investor presents its proportionate share of the assets, liabilities, revenues and expenses of the investee in tits consolidated financial statements, but as separate line items and without combining these amounts directly with its "own" assets, liabilities, revenue and expenses. The balance sheet items like current assets, current liabilities, property, plant and equipment, intangible assets, and long-term liabilities are shown in two separate lines-one line showing the amount representing the item directly controlled by the investor (investor's own and consolidated amount), and other line showing the amount representing investor's proportionate share of the item in the balance sheets of the jointly controlled incorporated entities. Similar for revenues and expenses, two separate line items are presented in the consolidated income statement.

The expanded equity method of accounting for investment in jointly controlled entities has most of the advantages and disadvantages attributed to the proportionate consolidation method but avoids the combination of assets, liabilities and operations directly owned and controlled with the portion of assets, liabilities and operations over which the investor does not have complete control. Two important advantages of the expanded equity method in reporting investment in jointly controlled incorporated entities are:

(a) It distinguishes assets, liabilities, revenues and expenses completely controlled by the venturer, from those represented by the venturer's interest in the jointly controlled venture's assets, liabilities, revenue and expenses;

(b) It provides more meaningful information about the venturer in both the balance sheet and income statement that may enable users to get a better perspective of the venturer's financial position.

E. Cost Method

Under the cost method, an investor records its investment at cost, and reports the investment as a single line on its balance sheet. Profits earned by the investee are not recognized in investor's accounts until such profits are distributed as dividends. The investment account continues to be carried in the balance sheet at the initial cost of investment. When dividend is distributed by the investee, the investor recognizes its share of the dividend as current income. Dividends received in excess of investor's share of earnings subsequent to the date of investment are considered a ***return of investment*** and are recorded as reductions of the cost of the investment. Compared to the equity method, one major shortcoming of the cost method is that it is not consistent with the accrual concept of accounting and it does not report earnings and losses on a timely basis.

The cost method of accounting for an investment in another entity is normally used in circumstances where the investor neither controls nor has the ability to exercise significant influence over the investee. Considering the fact that venturer's joint control is the most fundamental characteristic of a joint venture arrangement, the use of cost method in accounting for investments in jointly controlled entities may not be appropriate under normal circumstances. However, there may be circumstances in which a venturer may not be in a position to exercise its rightful control over an international joint venture because of political instability or server and prolonged foreign exchange restrictions in the host country. Also for various reasons, there may be uncertainty about the safety of the assets invested in a host country. Under such circumstances, the cost method may be used in compliance with the accounting convention of "conservatism"

2. Accounting for Jointly Controlled Operations

In the case of jointly controlled operations, the participating venturers use their assets and other resources for the purpose of joint venture activity. Normally, no distinction is made between the assets and other resources used for the venturer's own activities and for the joint venture activity. There are usually no separate accounting records or financial statements for the jointly controlled operation although the venturers may prepare memorandum accounts for management control purposes.

Since a venturer carries out its part of the jointly controlled operations in the same way as it would have done for its own operations, each venturer retains in its accounting records and, hence, recognizes in its financial statements the assets that it controls. It also includes in its accounting records the liabilities and expenses that it incurs in respect of the jointly controlled operations and the revenue that it earns from the sale of its share of production. These liabilities, expenses and revenue are recognized along with the venturer's own liabilities, expenses and revenues in its financial statements. If the involvement of a venturer in jointly controlled operations constitutes a significant part of its operations, that fact should be disclosed in the notes to the financial statements. The disclosure should include the financial implications of such involvements in terms of the volume of business activities. If any significant liability is incurred for undertaking the venturer's part of jointly controlled operations, that should be disclosed.

3. Accounting for Jointly Controlled Assets

This type of venture is not a separate entity. Each venturer owns directly a specified share of the jointly controlled assets. This type of arrangement is often described as an undivided interest. Each venturer includes in its accounting records its own share of the jointly controlled assets. It also records liabilities that it has incurred in raising finance for the purpose of the joint venture activity and its share of those liabilities that it has incurred or guaranteed jointly with other venturers. Each venturer recognizes these assets and liabilities by combining these items with those of its own in its balance sheet. This treatment reflects both the substance and, the legal form of the joint venture arrangement. The participating venturers own directly the assets and are responsible for the liabilities of the joint venture, rather than holding an interest in a separate entity.

The products of this type of joint ventures are usually divided among the participating venturers in accordance with an agreed proportion. A venturer is at liberty to dispose of its share of the products in any manner it wishes. Each venturer includes in its accounting records and, hence recognizes in its income statement, revenues from the sale of its share of the joint venture's products together with its share of the expenses incurred by the joint venture. If a venturer incurs any expenses in financing its interest in the joint venture and for selling its share of the joint venture's products, these are recognized in the venturer's financial statements.

It is preferable to disclose in notes to the venturer's financial statements the aggregate carrying amounts of each category of assets and liabilities that are dedicated to the activities of jointly controlled assets. Also, the venturer should disclose its share of any contingent liabilities of the joint venture. The responsibility of the venturer, if any, for the other venturer's share of contingent or direct liabilities, should also be disclosed.

? What are corporate joint ventures? What accounting standards for such ventures were established in APB Opinion no. 18?

? Compare the equity method of account with the proportionate share method of accounting or an investment in an unincorporated joint venture.

1.4.Joint Venture Provisions in Ethiopia

Article 271 of the Commercial Code of Ethiopia, defines a joint venture as "an agreement between partners on terms mutually agreed and is subject to the general principles of law relating to partnership." According to Article 272, the following are stated about joint ventures:

- A joint venture is not made known to third parties.
- A joint venture agreement need not be in writing and is not subject to registration and other forms of publication required in respect of other business organizations.
- A joint venture does not have legal personality.
- Where a joint venture is made known to third parties, it shall be deemed, insofar as such are concerned, to be an actual partnership.

Article 278 states grounds for joint venture dissolution:

1) A joint venture may be dissolved on one of the following grounds:
    - the expiry of the term fixed by the memorandum of association, unless there is provision for its extension;
    - the completion of the venture;
    - failure of the purpose or impossibility of performance;
    - a decision of all the partners for dissolution taken at any time;
    - a request for dissolution by one partner, where no fixed term has been specified;
    - dissolution by the court for good cause at the request of one partner;

- the acquisition by one partner of all the shares;
- death, bankruptcy or incapacity of a partner, unless otherwise lawfully agreed;
- a decision of the manager, if such power is conferred upon him in the memorandum of association.

2) The provision of this Article shall apply not withstanding any provision to the contrary in the memorandum of association.

1.5. Public Enterprises

Public Enterprises may be defined as autonomous or semi-autonomous bodies owned by the goverSageent and engaged in providing services and or products.

The growth of public enterprises has been partly by nationalization and partly through creation of new ones. Some industries are also reserved for the public sector as a matter of national policy. Such industries could be airways, defense industries, railways, telecommunication and the like.

The need to have public enterprises may be justified on a number of grounds:

- Limitation of the free price mechanism

  It is realized that in spite of all its advantages, a free price mechanism had serious limitations which had to be overcome in the long term interests of the economy. An economy cannot sustain itself and grow unless it is healthy in terms of production potential which should increase with the pasSage of time that is development of different economic sectors in harmony or proper sectoral balance. However, the nature of market mechanism is such that all economic activities are guided by economic rationalism which in the case of provision of products or services means profitability. Market mechanism would refuse to run those productive services which could not yield adequate profits. But such ventures are necessary for the development of the economy. The public authorities thus maintain these projects at a loss and meet the loss from their tax revenue.

- Basic industries need huge investment

  Private enterprise is either not able to raise the necessary funds or not ready to assume such large risks. In such cases, even if these enterprises could possibly be profitable, the goverSageent has to step in to establish them. Cases of very long term projects also come in this category.

- GoverSageent’s duty to help in economic development

Such a policy entails a number of responsibilities and some of these results in the government going in for various types of public enterprises. In an underdeveloped country, additionally, we find that there is an overall shortage of capital. It becomes, therefore, the task of the authorities to assume the responsibility of filling the gap and thereby removing the specific shortages. The role of basic and key industries which provide an impetus and necessary basis for the general economic development may also be mentioned in this connection.

It is not very likely that the private sector which moves solely on the basis of profit motive, will find it always convenient to move ahead and establish these industries in time and adequate measure. The private sector would find it easier and more profitable to expand at a rapid rate once basic inputs like skilled human resource are created through education and training.

- Creation of economic surpluses and their utilization

  A number of public undertakings directly add to the capital assets of the economy in the form of roads, bridges, factories and the like. They are, in so far as they are not in the public sector by virtue of nationalization only, net additions to the capital stock of the country and, therefore, they contribute to its total productive power. Such an addition might also result from utilization and exploitation of resources which were hitherto going waste; or from change in the allocation of resources. Public enterprises can also help the economy a lot by diverting its productive resources into those lines which will accelerate the growth process later through a provision of an infrastructure, basic and key industries and so on.

- Final choice of projects are made in the interest of the economy as a whole

  If social benefits exceed social costs in the case of any service, then its production should be taken up. But it is possible that on grounds of social benefits some projects are sound but not on grounds of commercial profitability. Under such circumstances, these projects can be taken up by authorities in the public sector.

- Limitation on demand of merit goods on account of price if left in private hands

  Merit goods are those expected to enhance the general welfare of the community and should be provided through public enterprises either along with public enterprises or in place of it. It is generally believed that the supply of such services should be adequate and should be available at low or zero prices so as to encourage their consumption. In case of education, the goverSageent may not only provide it for free but also insist that all children up to a certain age must attend schools.

- The overall economic policy of a country may dictate the use of public enterprises in some sectors

  There are some industries like electricity generation where there are economies of scale. If such services are provided by a large number of firms competing with each other, it wouldn't be possible to reap these economies. Authorities may, therefore, think it more desirable to have a public monopoly than private monopoly for such services.

- Effective economic control of the economy

  Effective economic control of the whole economy is sought to be brought in the hands of the state. In other words, the argument of not letting the emergence of a monopoly in private hands is extended to the whole economy. The authorities might plan to have a strategic control over the working of the whole economy through controlling certain key sectors.

- Better protection of natural resources

  In the case of some natural resources like forests, mines and the like, the commercial interests of a private enterprise often come into conflict with those of the nation. A private jungle contractor authorized to cut trees is likely to make a quick profit by cutting down as many trees as possible. This may result in a large scale and quick denuding of the land causing soil erosion and upsetting the ecological balance.

1.5.1. Benefits of Public Enterprises

Public enterprises are highly beneficial to the economy. In general, we can sub group the benefits of public enterprises in to two as an economic and social benefit.

1. Economic Benefits of Public Enterprises

Public enterprises are so important in strengthening the economy of a particular nation by providing the following benefits:

- Public enterprises generate revenue in the form of divided, interest on loans, taxes, etc. which are paid to the government.

- Public enterprises maximize the social welfare and developmental opportunities of the economy, since they exploit the natural and technological recourses of the state.
- Public enterprises help in reducing regional disparities through fair dispersal of industries in taking in to account rural areas of the country in proper perspective.
- Public enterprises provide infrastructural facilities that can help for the development of the economy.
- By exporting the foreign currency generating goods and services of the country and by substituting imported products and services, public enterprises can save foreign exchange.

2. Social Benefits of Public Enterprises

Public enterprises provide social benefits by promoting welfare of the society. The social benefits of the society are summarized as follows:

- Public enterprises provide job opportunity for the society and play its role in the reduction of unemployment.
- Public enterprises provide various welfare benefits such medical, transportation, housing and other social benefits to employees.
- Public enterprises provide goods and services at cheaper price to low income groups.
- Public enterprises play a social role by safeguarding the interest of consumers by offering items of good quality with a reasonable price.

1.5.2. Forms of Public Enterprises

The enterprises which are not run on departmental basis have, in general, two forms. One is as a firm or company owned and controlled by the government and functions under the same laws of the country as private firms or companies of similar type.

Another form of public enterprise is what may be called the public corporation.

- Public corporations are
    - Set up by legislation which defines:
        - Sphere of activities
        - Rights, immunities
    - Artificial legal persons

- Can take independent decisions
- Can sue and be sued
- Have their own personnel policy, management pattern and the like
- Can retain and reuse their funds according to adopted policy

1.5.3. Public Enterprise in Ethiopia

Proclamation No. 25/1992 is a legal provision governing establishment and operation of public enterprises in Ethiopia. The public enterprises in Ethiopia include those nationalized and established afresh by the goverSageent over the years. As per the proclamation a public enterprise is defined as a wholly state owned enterprise established pursuant to the proclamation to carry on for gain manufacturing, distribution, service rendering or other economic and related activities.

According to the proclamation:

- Every enterprise shall be established by regulation and the establishment regulation shall contain:
  - The name of the enterprise
  - A statement the enterprise shall be governed by the proclamation
  - The purpose for which the enterprise is established
  - The authorized capital
  - The amount of initial capital paid up both in cash and in kind
  - A statement that the enterprise shall not be liable beyond its total assets
  - The head office of the enterprise
  - A statement that may authorize the enterprise to open branches
  - The name of the supervising authority
  - The duration for which the enterprise is established
- Each enterprise shall have:
  - A supervising authority
  - A management board
  - Management
  - Necessary staff
- A supervising authority is an authority that is designated by the Council of Ministers with a view to protecting the ownership rights of the state.

- Each enterprise shall keep accounts as per GAAP
- Financial year of the enterprises shall be determined by the supervisory authority
- Each enterprise shall have a Legal Reserve Fund
    - 5% of net profit transferred annually to LRF until the fund equals 20% of the capital
    - The fund may be utilized for covering:
        - Losses
        - Unforeseen expenses and liabilities
    - The board of the enterprises, upon approval of the authority, may establish other funds
- Taxes and Duties
    - Shall be paid as per relevant provisions of applicable laws
- State dividend
    - The amount to be paid to the goverSageent in the form of state dividend shall be determined by the supervisory authority based upon proposal of the board

Proclamation NO.25/1992: Definition of Terms

Art.2 (1) **Public Enterprise**: a wholly state owned public enterprise established pursuant to Proc.No.25/1992 to carry on business for gain in manufacturing, distribution, service rendering or other economic related activities.

Art.2 (3) **Total Assets:** all immovable and movable property, receivables, cash and bank balances of the enterprise including intangible assets, deferred charges and other debit balances.

Art.2 (4) **Net Total Assets:** total assets less current liabilities, long term debts, deferred income and other liabilities.

Art 2 (5) **Capital:** the original value of the net total assets assigned to the enterprise by the state at the time of its establishment or any time thereafter.

Art.20 (1) the **paid up capital** shall not be less than 25% of the authorized capital at the time of its establishment.

Art. 20 (2) the authorized **capital** of the enterprise shall be fully paid up with in 5 years from the date of its establishment.

Art.2 (7) **Net Profit:** any excess of all revenue and other receipts over costs and operating expenses properly attributable to the operations of the financial year including depreciation, interest and taxes.

Art. 2(9): **State Dividend:** remaining balance after deduction of the transfers to the **legal reserve fund** and **other reserve fund** from net profits.

Art. 29 (2) **Legal reserve**: 5% of net income of the financial year.

The following Articles in Proclamation No. 25/1992 states about accounting for Public Enterprises:

Art. 27-28.

- Public enterprises follow generally accepted accounting principles
- The financial year used by public enterprises are determined by the supervisory authority.
- Accounts should be closed at least once a year-with in three months following the end of the financial year.

Art. 29.

- Legal reserve 5% of net profits until such reserve equals 20% of the capital of the enterprise. The legal reserve is used to cover losses and enforceable expenses and liabilities.
- Other reserve funds may established with the approval of the supervisory authority.

1.7.1. Accounting for Public Enterprises

Accounting for the public enterprise must be based on clear understanding of the underlying assumptions to be made on the characteristics of the public enterprise, and the type or structural relationship established.

Entity accounting is accounting for a separate organization that has legal personality of its own separate from its owners. The accounting equation assets equal liabilities plus capital could be applicable in its entirety to the public enterprise. The double entry system of accounting together with the accrual basis of accounting is essential for more adequate follow up of the enterprise business transactions. Most of the asset accounting of public enterprises is the same as in private corporate entity accounting except for variations in classification and valuation methods. Liabilities, which represent accruals to and claims creditors, will be accounted for in similar manner as in private corporate accounting entity except for classification.

Proclamation No. 25/1992 contains provisions for accounting for public enterprises in Ethiopia, such as the formation, operation, privatization, amalgamation and division, as well as dissolution and winding up of public enterprises.

1. **Formation**

Example: On January1, 2006, the GoverSageent of Ethiopia formed XYZ Enterprise with Authorized Capital of Birr 50,000,000 in accordance with the requirements of Proc.No. 25/1992 with an investment of the following assets:

Cash	Br. 15,000,000
Equipment (fair value)	700,000

Required: Pass the journal entry to record the above investment.

Journal Entry:	Cash	15,000,000	
	Equipment (fair Value)	700,000	
	State Capital		15,700,000

1.8. Chapter Summary

A joint venture differs from a partnership in that it is limited to carrying out a single project, such as production of a motion picture (movie) or construction of a building. Historically, joint ventures were used to finance the sale or exchange of a cargo of merchandise in a foreign country. In its traditional form a joint venture is a cooperative arrangement between two or more parties (venturers) for the purpose of carrying out a single project and is usually dissolved upon completion of the project.

A joint venture is one of a number of business arrangements which investors can use.It is suitable as an intermediate structure to test a business relationship or where the parties do not want to enter into more permanent and restrictive business arrangements.

Either the equity method of accounting or proportionate method of accounting may be used for an investment in an un incorporated joint venture. In proportionate share method of accounting, the investor recognizes in its accounting records its share of each asset , liability, revenue, and expense of the joint venture.

Public Enterprises are autonomous or semi-autonomous bodies owned by the government and engaged in providing services and or products.

The public enterprises in Ethiopia include those nationalized and established afresh by the government over the years. As per the proclamation a public enterprise is defined as a wholly state owned enterprise established pursuant to the proclamation to carry on for gain manufacturing, distribution, service rendering or other economic and related activities.

Accounting for the public enterprise must be based on clear understanding of the underlying assumptions to be made on the characteristics of the public enterprise, and the type or structural relationship established.

1.9.Self-Test Questions

Now, this unit is completed you must have to test your progress by doing the following self-test and compare your answer with the answer key given at the end.

Part I:

1. Ventures are represented by ownership share in the joint venture. This is true for which type of joint venture?
   A. Jointly Controlled entity
   B. Jointly Controlled assets
   C. Jointly Controlled operation
   D. None of the above

2. The proportionate method of accounting is appropriate for;
   A. Corporate joint ventures only
   B. Unincorporated joint ventures only
   C. Both corporate joint ventures and unincorporated joint ventures
   D. Neither corporate joint ventures nor unincorporated joint ventures
3. Which type of joint venture is a separate entity?

   A. Jointly Controlled entity

B. Jointly Controlled assets
C. Jointly Controlled operation
D. None of the above

4. Public enterprises are so important for;

A. Public enterprises generate revenue in the form of divided, interest on loans, taxes.
B. Public enterprises help in reducing regional disparities through fair dispersal of industries in taking in to account rural areas of the country in proper perspective.
C. Public enterprises provide infrastructural facilities that can help for the development of the economy.
D. All of the above

CHAPTER TWO

ACCOUNTING FOR SALES AGENCIES AND PRINCIPAL; BRANCHES AND HEAD OFFICE

Learning objectives:

Dear students, after successfully completing this chapter you will be able to:

- Describe the characteristics of agency, principal, head office and branch;
- Distinguish agency and branch;
- Describe accounting for sales agency;
- Describe accounting for branches;
- Identify the reciprocal ledger accounts and their use;
- Explain the alternative methods of billing merchandise to branches;
- Prepare combined financial statements for home office and branch;
- Describe transactions between branches;

2.1 Characteristics of Principal and Agency and Branch

An agency relationship refers a contract under which one or more persons (the principals) engage another person (the agent) to carry out some service on their behalf that involves delegating some decision making authority to the agent.

The tem **branch** is used to describe a business unit located at some distance from the home office. This unit carries merchandises, makes sales, approves customers' credit, and makes collections from its customers. A branch may obtain merchandises solely from the home office, or a portion may be purchased from outside suppliers. The cash receipts often are deposited in a bank account belonging to the home office; the branch expenses then are paid from an imprest cash fund or a bank account provided by the home office. As the imprest cash fund is depleted, the branch submits a list of cash payments supported by vouchers and receives a check or a transfer from the home office to replenish the fund. The use of an imprest cash fund gives the home office considerable control over the cash transactions of the branch. However, it is common practice for a large branch to maintain its own bank accounts.

? Explain the characteristics of agency and principal?

2.2 Distinguishing Sales Agency, Branch and Division

Sales Agency: Sales agency is a term applied to a business unit that performs only a small portion of the functions associated branch. The **sales agency** is not an autonomous operation but acts on behalf of the home office. The agency may display and demonstrate sample merchandise, take orders, and arrange for delivery. The orders typically are filled by the home office because a sales agency usually does not stock inventory. Merchandise selection, advertising, granting of credit, collection of accounts, and other aspects of operating the business usually are conducted by the home office.

Branch: The term Branch is used to describe a business unit located at some distance from the Home Office. Branches are economic and accounting entities. However, branches are not legal entity. Branches may carry merchandise obtained from Home Office, make sales, approve customers' credit, and make collections from its customers. A **branch** usually has more autonomy and a greater range of services than a sales agent does. However, the extent of autonomy and responsibility of a branch varies, even among different branches of the same business enterprise. A branch typically stocks merchandises and fills customers' orders.

Division: Division is a business segment or a business enterprise which generally has more autonomy than a branch. Division may be as separate company or may not be a separate company. If the division is not a separate company, the accounting procedures are the same as Branch. If the division is a separate company (subsidiary company), the financial accounting requires consolidation, which will be discussed in later topics.

Differences among Sales Agency, Branch and Division			
Characteristics	**Sales Agency**	**Branch**	**Division**
Degree of Autonomy	Low	Moderate	High
Accounting Entity	No	Yes	Yes
Legal Entity	No	No	Possible

Economic Entity	No	Yes	Possible

? Differentiate Sales agency, Branch and Division?

2.3. Accounting for Sales Agency

The term sales agency sometimes is applied to a business unit that performs only a small portion of the functions traditionally associated with a branch. For example, a sales agency usually caries samples of products but does not have an inventory of merchandise. Orders are taken from customers and transmitted to the home office, which approves the customers' credits and ship the merchandise directly to customers. The agency's accounts receivable are maintained at the home office, which also performs the collection function. An imprest cash fund generally is maintained at the sales agency for the payment of operating expenses. Sales agencies do not require complete accounting systems to account for their limited activities. Ordinarily, cash receipts and disbursements records are sufficient for accounting at agency location. Records for sales agency operations must be maintained in the central accounting system of the enterprise.

? Explain the nature of accounting for sales agency?

Illustration 2.1: Journal Entries for a Sales Agency

Journal entries required at the home office in connection with a sales agency (Dessie Agency), assuming the perpetual inventory system is used

Home Office

Journal Entries for Dessie Agency Transactions

1.	Inventory Samples: Dessie Agency	1,500	
	Inventories		1,500
	[To record merchandise shipped to sales agency for use as samples]		
2.	Imprest Cash Fund: Dessie Agency	1,000	
	Cash		1,000
	[To establish imprest cash fund for sales agency]		

3.	Trade Accounts Receivable	50,000	
	Sales: Dessie Agency		50,000

[To record sales made by sales agency]

4.	Cost of Goods Sold: Dessie Agency	35,000	
	Inventories		35,000

[To record cost of merchandise sold by sales agency]

5.	Operating Expenses: Dessie Agency	10,000	
	Cash		10,000

[To replenish imprest cash fund (several checks during the period)]

6.	Sales: Dessie Agency	50,000	
	Cost of Goods Sold: Dessie Agency		35,000
	Operating Expenses: Dessie Agency		1,000
	Income Summary: Dessie Agency		9,000

[To close revenue and expense accounts to a separate income summary ledger account for a sales agency]

7.	Income Summary: Dessie Agency	9,000	
	Income Summary		9,000

[To close net income of sales agency to Income Summary ledger account]

The entries illustrated are examples of how an accounting system can be expanded to provide separate information for agency operations. Accumulation of such information is both practical and inexpensive even when an enterprise has a large number of sales agency operations.

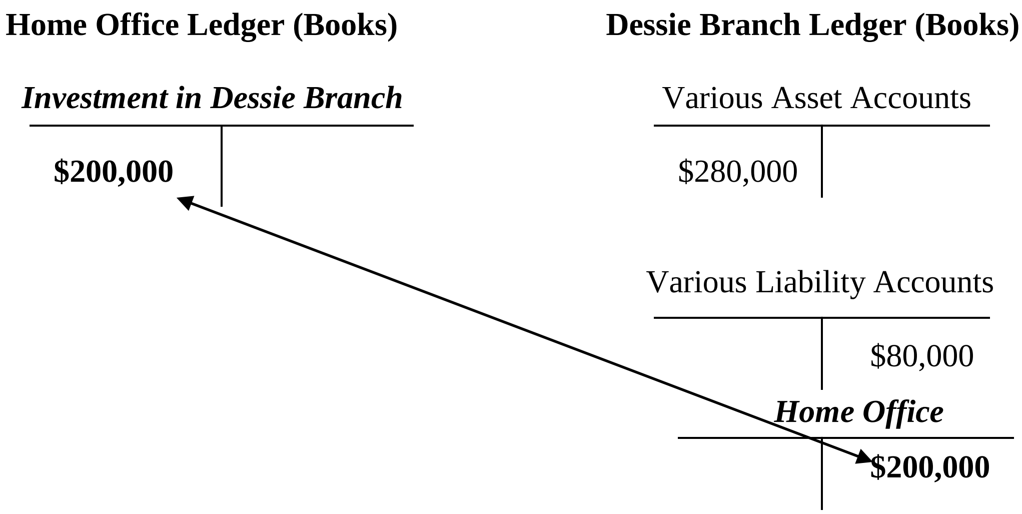
2.3 Accounting for Branch

The accounting system of a business enterprise may provide for a complete set of accounting rerecords at each branch (almost completely decentralized); policies of another enterprise may keep all accounting records in the home office (highly centralized). There are companies where their branches submit daily reports and business documents to the home office, which enters all transactions by branches in computerized accounting records kept in a central location. The home office may not even conduct operations of its own but simply serve as accounting and control center for the branches. Therefore, no journal or ledger is maintained in the branch. In order to determine the operating results of each branch, separate branch account for sales, cost of good sold, and expenses are maintained in the home office ledger. A branch may maintain a complete set of accounting records consisting of journal, ledgers, and a chart of accounts similar to those of an independent business enterprise, except that the branch maintain capital accounts. A special account entitled "Home Office" is used in place. Financial statements are prepared at regular intervals by the branch and forwarded to the home office. The number and types of ledger accounts, the internal control system, the form and content of the statements, and the accounting policies generally are prescribed by the home office. In this chapter the discussion is about a branch operation that maintains a complete set of account records. Transactions recorded by a branch, therefore, should include all controllable expenses and revenue for which the branch manager is responsible. If the branch manager has responsibility over all branch assets, liabilities, receipts, and expenditures, the branch accounting records should reflect this responsibility. Expenses such as depreciation are not subject to control by a branch manager; therefore, both the branch plant assets and the related depreciation ledger account generally are maintained by the home office.

? What do we mean by centralized and decentralized accounting system of branches?

2.3.1. Underlying Principles of Decentralized branch accounting

In accounting for a decentralized branch where there is branch ledger having full set of accounts except capital accounts, there must be some tie-in between the branch ledger and the general ledger at the home office. All properties in the branch belong to the entire enterprise and are part of the assets of the entire enterprise and liabilities incurred at the branch are liabilities of the entire enterprise. However, although the accounting system at the branch is much like that of an independent company, the branch is not considered a separate entity but only a segment of the business. The concept of subsidiary ledger-controlling account relationship could be used in order to describe the relationship between home office and branch. The following chart will help to understand the basic features of the system:



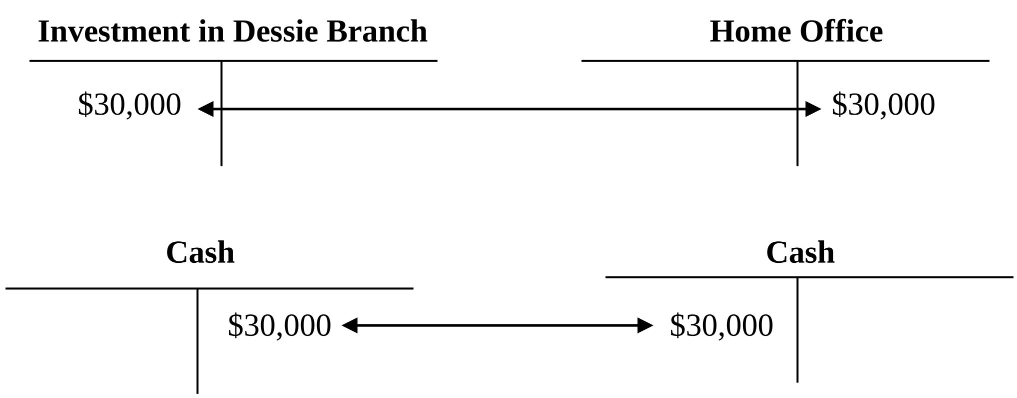
In the Home Office Ledger account the *Investment in Dessie Branch* has a debit balance of $200,000. This balance represents the difference between total assets and total liabilities recorded in the branch ledger ($280,000 - $80,000). To simplify things, for this illustration purposes all assets and liabilities are represented by one account each. The total of all assets is $280,000(Debit) and the total of all the liabilities is $80,000 (Credit). If this record was for an independent company, the capital account would have shown $200,000 credit balance. However, this is a branch and there is no capital account. Therefore, to make the branch ledger self-balancing, the account *Home Office* ledger account is used. The balance shown in *Home Office* in the Dessie branch ledger is equal to the balance shown in the Investment in Dessie branch account maintained at home office ledger. The two accounts having equal but opposite balances are known as ***reciprocal accounts***.

2.4 Reciprocal Accounts

Transactions of the home office with external entities are recorded in the home office accounting records in the usual fashion. Similarly, transactions between a branch and unrelated entities are recorded on the branch books in accordance with established accounting procedures. Although these transactions affect the amount of the home office investment at the branch, recognition of the change due to these transactions is delayed until the accounts are closed at the end of the accounting period. At that time, the income summary account in the branch ledger is closed to the Home Office account. The Home Office account in branch ledger is credited for all merchandise, cash, or other resource provided by the home office, and is debited for all cash, merchandise or other assets sent by the branch to the home office or to other branches. The Home Office account is a quasi-ownership equity account that shows the net investment by the home office in the branch or it represents the equity of the home office in the branch net assets. At the end of the accounting period when the branch closes its accounting records, the income summary account is closed to the Home Office account. A net income increases the credit balance of the Home Office account; a net loss decreases this balance.

In the home office accounting records (i.e. Home office ledger), a reciprocal ledger account with a title such as Investment in Branch is maintained. The investment in Branch account is an asset account representing the investment of the home office in branch net assets. This noncurrent asset account is debited for cash, merchandise, and services provided to the branch by the home office, and for net income reported by the branch. It is credited for the cash or other assets received from the branch and for any net loss reported by branch. A separate investment account generally is maintained by the home office for each branch. If there is only one branch, the account title is likely to be investment in branch; if there are numerous braches, each account title includes a name or number to identify each branch. This reciprocal relationship between home office and branch accounts is a continuous relationship. Whenever the home office increases (debits) its branch accounts, the branch should increase (credit) its home office account. Similarly, any decrease (debit) in the home office account on the branch book should be accompanied by a decrease (credit) in the branch account on the home office books. The only reason that differences between home office and branch accounts occur are time lags in recording information on the two sets of books and errors.

To illustrate the relationship between the reciprocal ledger accounts, assume that the home office opens a new branch in Dessie and begins branch operations by sending $30,000 cash to the branch. The entries in the two ledgers are illustrated as follows:



? Explain the use of reciprocal ledger accounts in home office and branch accounting systems.

2.5 Expenses Incurred by Home Office and Allocated to Branches

Some business enterprises follow a policy of notifying each branch of expenses incurred by the home office on the branch's behalf. As previously stated, plant assets located at a branch generally are carried in the home office accounting records. If a plant asset is acquired by the home office for the branch, the journal entry for the acquisition is a debit to an asset account and credit to Cash or an appropriate liability account. If the branch acquires a plant asset, it debits the Home Office ledger account and credits Cash or an appropriate liability account. The home office debit an asset account, such as Equipment: Branch, and credit the reciprocal account Investment in Branch.

The home office also usually acquires insurance, pays property and other taxes, and arranges for advertising that benefits all branches. Expenses such as depreciation, property taxes, insurance, and advertising must be considered in determining the profitability of a branch. A policy decision must be made as to whether these expense data are to be retained at the home office or are to be reported to the branches so that the income statement prepared by each branch will give a complete picture of its operations. An expense incurred by the home office and allocated to a branch is recorded by the home office by a debit to Investment in Branch and credit to an appropriate expense ledger account; the branch debits an expense account and credits Home Office.

If the home office does not make sales itself but functions only as an accounting and control center, most or all of its expenses may be allocated to the branches. To facilitate comparison of the operating results of the various branches, the home office may charge each branch interest on the capital invested in that branch. Such interest expense recorded by the branches would be offset by interest revenue recorded by the home office and would not appear in the combined income statement of the business enterprise as a whole.

? Does the allocation of home office expenses to branch operations affect the income of an enterprise? If not, what is the advantage of such allocation? Discuss.

2.6 Alternative Method of Billing Merchandise Shipments to Branches

In relation to the shipment made from home office to branches, three alternative methods are available to the home office (i.e. for billing merchandise shipped to its branches). The shipment may be billed:

(1) at cost,

(2) at a percentage above cost, or

(3) at the retail selling price.

The shipment of merchandise to home office does not constitute a sale. This is because ownership of the merchandise does not change as a result of shipment from home office to branch.

1) Billing at Cost

Billing ***at cost*** is the simplest procedure and is widely used method of billing merchandises to branches. This method avoids the complication of unrealized gross profit in inventories and permits the financial statements of branches to give a meaningful picture of operations. However, billing merchandise to branches at cost attributers all gross profits of the enterprise to the branches, even though some of the merchandise may be manufactured by the home office. Under these circumstances, cost may not be the most realistic basis for billing shipments to branches.

2) Billing at a percentage above cost

Billing shipments to a branch ***at a percentage above cost*** (such as 150% of cost) may be intended to allocate a reasonable gross profit to the home office. When merchandise is billed to a branch at a price above cost, the net income reported by the branch is understated and the ending inventories are overstated, for the enterprise as a whole. Adjustments must be made by the home office to eliminate the excess of billed prices over cost (intra company profits) in the preparation of combined financial statements for the home office and the branch.

3) Billing at Retail Selling Prices

Billing shipment to a branch at retail selling prices may be based on a desire to strengthen internal control over inventories. The inventories ledger account of the branch shows the merchandise received and sold at retail selling prices. Consequently, the account will show the ending inventories that should be on hand at retail prices. The home office record of shipments to a branch, when considered along with sales reported by the branch, provides a perpetual inventory stated at selling prices. If the physical inventories taken periodically at the branch don't agree with the amounts thus computed, an error or theft may be indicated and should be investigated promptly.

? What are the alternative methods of billing merchandise shipment to branches?

2.7 Financial Statements for Branch and Home Office

2.7.1. Separate financial statements for Branch and for Home Office

A separate income statement and balance sheet should be prepared for the branch so that management of the enterprise may review the operating results and financial position of the bralnch. The income statement has no unusual features if merchandise is billed to the branch at cost. However, if merchandise is billed to the branch at retail selling prices, the branch's income statement will show a net loss approximating the amount of operating expenses. The only unusual aspect of the balance sheet for a branch is the use of the Home Office ledger account in lieu of the ownership equity accounts for separate business enterprise. The separate financial statements prepared for a branch may be revised at the home office to include expenses incurred by the home office allocable to the branch and to show the results of branch operations after elimination of any intracompany profits on merchandise shipments.

Separate financial statements also may be prepared for the home office so that management will be able to appraise the result of its operations and its financial position.

2.7.2. Combined Financial Statements for Home Office and Branch

After separate financial statements are prepared for branches and home office, it is important to emphasize that separate financial statements of the home office and of the branches are prepared for internal use only; they do not meet the needs of investors or other external users of financial statements. Therefore, it is necessary to combine the data on the income statements of the home office and that of branches to form one overall income statement for the company. Similarly, the data on the balance sheets of the home office and of the branches need to be combined so as to have a balance sheet for the company as a whole. This could be facilitated by the use of working papers. The working paper will have an amount column for each branch, a column for the home office, and column headed "Elimination" and a final amount column to which the combined figures are extended. Then, the combined balance sheet, for instance, shows the financial position of the business enterprise as a single entity. A convenient starting point in the preparation of a combined balance sheet consists of the adjusted trail balances of the home office and of the branches. The assets and liabilities of the branch are substituted for the Investment in Branch ledger account included in the home office trail balance. Similar accounts are combined to produce a single total amount for cash, trade accounts receivable, and other assets and liabilities of the enterprise as a whole.

In the preparation of a combine balance sheet, reciprocal ledger accounts are eliminated because they have no significance when the branch and home office are report as a single entity. The balance of the Home Office account is offset against the balance of the Investment in branch account; also, any receivables and payables between the home office and the branch (or between two branches) are eliminated.

The operating results of the enterprise (the home office and all braches) are shown by an income statement in which the revenue and expenses of the branches are combined with corresponding revenue and expenses for the home office. Any intracompany profits or losses are eliminated.

What is the need for preparing combined financial statements?

? What is the need for preparing combined financial statements?

Illustration 2.2: Home Office (HO) and Branch Accounting

To illustrate accounting for the operations of a branch, assume that Abay Company established its branch in Dessie. Abay Company bills merchandise to Dessie Branch at home office cost and that Dessie branch maintains complete accounting records and prepares financial statements. Both home office and branch use the perpetual inventory system. Equipment used at branch is carried in the home office accounting. Certain expenses such as advertising and insurance, incurred by the home office on behalf of the branch, are billed to the branch. Transactions and events during the first year (2018) of operations of Dessie Branch were as follows:

1. Cash of $50,000 was forwarded to Dessie Branch.
2. Dessie Branch purchased Equipment with a 10-years life for $20,000 cash. (recorded in Home Office books)
3. Received merchandise shipment from homeoffice at the $25,000 home office cost.
4. The credit sales by Dessie Branch amount to $35,000 on account. The cost of the merchandise sold was $20,000.
5. Returned $2,500 of the merchandise acquired from the home office.
6. Payments for operating expense by Dessie Branch totaled $5,000
7. Collections of trade accounts receivable by Dessie Branch totaled $18,000.
8. Dessie Branch remitted $10,000 to the home office.
9. Operating expenses incurred by the home office and charged to Dessie Branch totaled $3,000.

Journal entries to record these transactions in both home office and branch books are as follows.

Tran.	**Home Office Ledger (Books)**			**Dessie Branch Ledger (Books)**		
1	Investment in Dessie Branch	50,000		Cash	50,000	
	Cash		50,000	Home Office		50,000
2	Equipment: Dessie Branch	20,000		Home Office	20,000	
	Investment in Dessie Branch		20,000	Cash		20,000
3	Investment in Dessie Branch	25,000		Inventories	25,000	
	Inventories		25,000	Home Office		25,000
4	None			Trade A/R	35,000	
				CGS	20,000	
				Sales		35,000
				Inventories		20,000
5	Inventories	2,500		Home Office	2,500	
	Investment in Dessie Branch		2,500	Inventories		2,500

6	None	Operating Expenses 5,000 Cash 5,000
7	None	Cash 18,000 Trade A/R 18,000
8	Cash 10,000 Investment in Dessie Branch 10,000	Home Office 10,000 Cash 10,000
9	Investment in Dessie Branch 3,000 Operating Expenses 3,000	Operating Expenses 3,000 Home Office 3,000

When the branch obtains merchandise from outsiders as well as from the home office, the merchandise acquired from the home office should be recorded in a separate Inventory from Home Office ledger account.

After the transactions for Abay Company are posted, in the home office accounting records, the Investment in Dessie Branch account will have a debit balance of $45,500 [before the accounting records are closed and the branch net income of $7,000 ($35,000 - $20,000 - $5,000 - $3,000) is transferred to the Investment in Dessie Branch ledger account].

In the accounting records of Dessie Branch, the Home Office ledger account has a credit balance of $45,500 (before the accounting records are closed and the net income of $7,000 is transferred to the Home Office account). This is shown below:

Reciprocal ledger account in accounting records of home office

Investment in Dessie Branch

Date	Explanation	Debit	Credit	Balance
2018	Cash sent to branch	50,000		50,000 Dr
Month, Day	Equipment purchased by branch, carried at HO accounting records		20,000	30,000 Dr
	Merchandise billed to branch at cost	25,000		55,000 Dr
	Merchandise returned from branch		2,500	52,500 Dr
	Cash received from branch		10,000	42,500 Dr
	Operating Expenses billed to branch	3,000		**45,500 Dr**

Reciprocal ledger account in accounting records of Dessie branch

Home Office

Date	Explanation	Debit	Credit	Balance
2018	Cash received from home office		50,000	50,000 Cr
Month, Day	Equipment purchased by branch, carried at HO accounting records	20,000		30,000 Cr
	Merchandise received from HO		25,000	55,000 Cr

	Merchandise returned to Home Office	2,500		52,500 Cr
	Cash sent to Home Office	10,000		42,500 Cr
	Operating Expenses billed by HO		3,000	**45,500 Cr**

The adjusting and closing entries that relate to the branch are shown below:

Home Office Ledger (Books)	Dessie Branch Ledger (Books)
None	Sales 35,000 CGS 20,000 Operating Expenses 8,000 Income Summary 7,000
Investment in Dessie Branch 7,000 Income: Dessie Branch 7,000	Income Summary 7,000 Home Office 7,000
Income: Dessie Branch 7,000 Income Summary 7,000	None

Working paper for Combined Financial Statements

A working paper for combined financial statements has three purposes:

(1) to combine ledger account balances for like assets and liabilities,

(2) to eliminate any intracompany profits or losses, and

(3) to eliminate the reciprocal accounts.

The working paper illustrated next is based on adjusted trial balances for Abay Company (home office) and branch (Dessie branch) and these are shown in the first two columns of the working paper. In addition the same data is going to be used with regard to Dessie Branch and Abay Company. All the routine year-end adjusting entries are assumed to have been made, and the working paper is begun with the adjusted trail balances of the home office and Dessie Branch. Income taxes are disregarded for this illustration purpose.

Working paper for Combined Financial Statements of Home Office and Dessie Branch

For the Year Ended December 31, 2018

(Perpetual Inventory System: Billing at Cost)

	Adjusted trial balances		Elimination	Combined
	Home Office	Dessie Branch		
	Dr (Cr)	Dr (Cr)	Dr (Cr)	Dr (Cr)
Income Statement				
Sales	(320,000)	(35,000)		(355,000)
Cost of Goods Sold	210,000	20,000		230,000
Operating Expenses	50,000	8,000		58,000
Net income (to statement of retained earnings below)	60,000	7,000		67,000
Totals	0	0		0
Statement of retained earnings				
Retained earnings, Jan. 1, 2018	(100,000)			(100,000)
Net income (from above)	(60,000)	(7,000)		(67,000)
Dividends	20,000			20,000
Retained Earnings, Dec. 31, 2018 (to balance sheet below)				147,000
Totals				0
Balance Sheet				
Cash	57,000	33,000		90,000
Trade accounts receivable (net)	33,000	17,000		50,000
Inventories	54,500	2,500		57,000
Investment in Dessie Branch	45,500		(45,500)	
Equipment	120,000			120,000
Accumulated depreciation	(20,000)			(20,000)
Trade Accounts payable	(30,000)			(30,000)
Home Office		(45,500)	45,500	
Common Stock, $12 par	(120,000)			(120,000)
Retained Earnings (from above)	.	.	.	(147,000)
Totals	0	0	0	0

Note that the $45,500 debit balance of the Investment in Dessie Branch account and the $45,500 credit balance of the Home Office account are the balances before the respective accounting records are closed, that is before the $7,000 net income of Dessie Branch is entered in these two reciprocal accounts. In the Elimination column, the balance of the Investment in Dessie Branch account is offset against the balance of the Home Office account. This elimination appears in the working paper only; it is not recorded in the accounting records of either the home office or branch, because its only purpose is to facilitate the preparation of combined financial statements.

Based on the working paper prepared for Abay Company, the following financial statements are prepared.

Abay Company
Income Statement
For the Year Ended December 31, 2018

Sales	$355,000
Cost of Goods Sold	230,000
Gross profit on sales	125,000
Operating expenses	58,000
Net Income	$67,000
Earnings per share of common stock	$6.70

Abay Company
Statement of Retained Earnings
For the Year Ended December 31, 2018

Retained Earnings, January 1, 2018	$100,000
Add: Net Income	67,000
Sub total	167,000
Less: Dividends	20,000
Retained Earnings, December 31, 2018	$147,000

Abay Company
Balance Sheet
December 31, 2018

Assets

Cash		$90,000
Trade accounts receivable (net)		50,000
Inventories		57,000
Equipment	120,000	
Less: Accumulated depreciation	(20,000)	100,000
Total Assets		$297,000

Liabilities and Stockholders' Equity

Trade Accounts payable		$ 30,000
Common Stock, $12 par	$120,000	
Retained Earnings	147,000	267,000
Total Liab.& Stockholders' Equity		$297,000

Billing of Merchandise to Branches at Prices above Cost

The above illustration for Abay Co. is based on merchandise shipments between the home office and Dessie branch at home office cost. Many companies, however, bill merchandise shipped to branches at cost plus markup percentage (or alternatively at retail selling prices). Because both these methods involve similar modifications of accounting procedures, a single example illustrates the key points involved. Reasons commonly cited for internal transfers of merchandise above cost include equitable allocation of income between the various units of the enterprise, efficiency in pricing inventories, and concealment of the true profit margins from branch personnel.

When the home office ships merchandise to its branches billed at some percentage above cost, the accounting records of the home office are adjusted to permit measurement of actual cost of merchandise transferred. This is usually done through an unrealized gross profit account.

Example: Change one assumption of the former example, the home office bills merchandise shipped to branches at 20% above cost. The merchandise shipment in the previous example is thus billed at 30,000 (25,000+20% mark up of 25,000). The journal entry in both the home office and branch records to record these shipments ($25,000 + 20% markup = $30,000) under perpetual inventory system will be as follows:

Home Office Ledger (Books)			Dessie Branch Ledger (Books)		
Investment in Dessie Branch	30,000		Inventories	30,000	
Inventories		25,000	Home Office		30,000
Allowance for overvaluation of inventories: Dessie Br.		5,000			

Similarly, the return of merchandise by branch to home office will be recorded as follows:

Home Office Ledger (Books)			Dessie Branch Ledger (Books)		
Inventories	2,500		Home Office	3,000	
Allowance for overvaluation of inventories: Dessie Br.	500		Inventories		3,000
Investment in Dessie Branch		3,000			

In the accounting records of the home office, the Investment in Dessie branch ledger account now has a debit balance of $50,000 before the accounting records are closed and the branch net income or loss is entered in the Investment in Dessie branch account. This amount is $4,500 larger than the $45,500 balance in the prior illustration, i.e. assuming shipment at home office cost. This increase represents the 20% markup over cost of the merchandise shipped to Dessie branch, and not returned [$4,500 = 20% on (25,000 - 2,500)]. The investment in Dessie branch account is shown below:

Reciprocal ledger account in accounting records of home office

Investment in Dessie Branch

Date	Explanation	Debit	Credit	Balance
2018,Month, Day	Cash sent to branch	50,000		50,000 Dr
	Equipment purchased by branch, carried at HO accounting records		20,000	30,000 Dr
	Merchandise billed to branch at 20% above cost	30,000		60,000 Dr
	Merchandise returned from branch		3,000	57,000 Dr
	Cash received from branch		10,000	47,000 Dr
	Operating Expenses billed to branch	3,000		**50,000 Dr**

In the accounting records of Dessie branch, the Home Office ledger account now has a credit balance of $50,000, before the accounting records are closed and the branch net income or loss is entered in the Home Office account.

Reciprocal ledger account in accounting records of Dessie branch

Home Office

Date	Explanation	Debit	Credit	Balance
2018,Month, Day	Cash received from home office		50,000	50,000 Cr
	Equipment purchased by branch, carried at HO accounting records	20,000		30,000 Cr
	Merchandise received from HO		30,000	60,000 Cr
	Merchandise returned to Home Office	3,000		57,000 Cr
	Cash sent to Home Office	10,000		47,000 Cr
	Operating Expenses billed by HO		3,000	**50,000 Cr**

Dessie branch recorded the merchandise received from the home office at billed price of $30,000; the home office recorded the shipment by credits of $25,000 to Inventories and $5,000 to Allowance for Overvaluation of inventories: Dessie branch. Use of the allowance account enables the home office to maintain a record of the cost of merchandise shipped to Dessie branch, as well as the amount of the unrealized gross profit on the shipments.

At the end of the accounting period, Dessie branch will report its inventories (at billed prices) at \$3,000. The cost of these inventories is \$2,500 (\$3,000 ÷ 1.20 = \$2,500). In the home office account records, the required balances in the Allowance for Overvaluation of Inventories: Dessie branch ledger account is \$500 (=\$3,000 - \$2,500); thus, this account balance must be reduced from its present amount of \$4,500 (=\$5,000 - 500) to \$500. The reason for this reduction is that the 20% markup of billed prices over cost has become realized gross profit with respect to the merchandise sold by the branch. Consequently, at the end of the year the home office should reduce its allowance for overvaluation of the branch inventories to the \$500 excess valuation contained in the ending inventories. The adjustment of \$4,000 in the allowance account is transferred as a credit to the Income: Dessie branch account, because it represents additional gross profit on branch operations over that reported by the branch. Thus, the actual net income for Dessie branch is \$7,000, the same as in the prior illustration in which merchandise was billed to the branch at cost. Under the present assumption, however, the branch reports a net income of \$3,000 only. This amount is recorded by the home office and adjusted to a net income of \$7,000 (4,000 + 3,000), as shown by the following journal entries at the end of year 2018:

Home office accounting records

Investment in Dessie branch	3,000	
Income: Dessie branch		3,000
[To record the net income reported by branch]		
Allowance for Overvaluation of Inventories: Dessie branch	4,000	
Income: Dessie branch		4,000
[To reduce allowance to amount by which ending inventories of branch exceed cost]		
Income: Dessie branch	7,000	
Income summary		7,000
To close branch net income (as adjusted) to Income summary account		

After these journal entries have been posted, the ledger accounts in the home office general ledger used to record branch operations appear as shown below:

Investment in Dessie Branch

Date	Explanation	Debit	Credit	Balance
2018,Month,	Cash sent to branch	50,000		50,000 Dr
Day	Equipment purchased by branch,			
	carried at HO accounting records			30,000 Dr
	Merchandise billed to branch at 25%		20,000	
	above cost	30,000		60,000 Dr
	Merchandise returned from branch			57,000 Dr
	Cash received from branch		3,000	47,000 Dr
	Operating Expenses billed to branch	3,000	10,000	50,000 Dr
	Net income for 2018 reported by	4,000		54,000 Dr
	branch			

Allowance for Overvaluation of Inventories: Dessie branch

Date	Explanation	Debit	Credit	Balance
2018,Month,	Markup of merchandise shipped to			
Day	Dessie branch during year 2006			
	(20% above cost)		5,000	5,000 Cr
	Markup of merchandise returned from			
	Dessie branch (20% above cost)	500		4,500 Cr
	Realization of 20% markup on			
	merchandise sold by branch during			
	2018	4,000		500 Cr

Income: Dessie Branch

Date	Explanation	Debit	Credit	Balance
2018,Month,	Net income reported by Dessie branch			
Day	for 2006		3,000	3,000 Cr
	Realization of 20% markup on			
	merchandise sold by branch		4,000	7,000 Cr
	Net income of branch (as adjusted)			
	closed to Income summary account	7,000		0

In a separate balance sheet for the home office, the $500 credit balance of the Allowance for Overvaluation of Inventories: Dessie branch account is deducted from the $54,000 debit balance of the Investment in Dessie branch account, thus reducing the carrying amount of the investment account to a cost basis. The closing entries for the branch at the end of year 2018 appear below

Branch accounting records

Sales	35,000	
CGS		24,000
Operating Expenses		8,000
Income Summary		3,000

[To close revenue and expense ledger account]

Income summary 3,000
Home Office 3,000
[To close the net income in the Income summary account to the Home Office account]

After these closing entries have been posted by the branch, the Home Office ledger account in the accounting records of Dessie branch below has a credit balance of $54,000 the same as the debit balance of the Investment in Dessie branch account in the accounting records of the home office.

Home Office

Date	Explanation	Debit	Credit	Balance
2018,Month, Day	Cash received from home office		50,000	50,000 Cr
	Equipment purchased by branch, carried at HO accounting records	20,000		30,000 Cr
	Merchandise received from home office		30,000	60,000 Cr
	Merchandise returned to home office	3,000		57,000 Cr
	Cash sent to home office	10,000		47,000 Cr
	Operating Expenses billed by HO		3,000	50,000 Cr
	Net income for 2018		4,000	54,000 Cr

Working paper when Billings to branches are at Prices above Cost

The working paper for combined financial statements when billings to the branch are made at prices above cost is shown below. It differs from the previously illustrated working paper by the inclusion of an elimination to restate the ending inventories of the branch to cost. Also, the net loss reported by Dessie branch is adjusted by the $4,000 of merchandise markup that was realized as a result of sales by the branch. As stated earlier, the amounts in the Eliminations column appear only in the working paper. The amounts represent a mechanical step to aid in the preparation of combined financial statements and are not entered it the accounting records of either the home office or the branch.

Abay Company
Working paper for Combined Financial Statements of Home Office and Dessie Branch
For the Year Ended December 31, 2018
(Perpetual Inventory System: Billing above Cost)

	Adjusted trial balances		Elimination	Combined
	Home Office	Dessie Branch		
	Dr (Cr)	Dr (Cr)	Dr (Cr)	Dr (Cr)
Income Statement				
Sales	(320,000)	(35,000)		(355,000)
Cost of Goods Sold	210,000	24,000	(a) (4,000)	230,000
Operating Expenses	50,000	8,000		58,000
Net income (to statement of				
retained	60,000	3,000	(b) 4,000	67,000
earnings below)	0	0		0
Totals				
Statement of retained earnings	(100,000)			(100,000)
Retained earnings, Jan. 1, 2006	(60,000)	(3,000)	(b) (4,000)	(67,000)
Net income (from above)	20,000			20,000
Dividends				
Retained Earnings, Dec. 31, 2006				147,000
(to balance sheet below)				0
Totals				
Balance Sheet	57,000	33,000		90,000
Cash	33,000	17,000		50,000
Trade accounts receivable (net)	54,500	3,000	(a) (500)	57,000
Inventories	50,000		(c)(50,000)	
Investment in Dessie Branch				
Allowance for overvaluation of	(4,500)		(a) 4,500	
inventories: Dessie branch	120,000			120,000
Equipment	(20,000)			(20,000)
Accumulated depreciation	(30,000)			(30,000)
Trade Accounts payable		(50,000)	(c) 50,000	
Home Office	(120,000)			(120,000)
Common Stock, $12 par	.	.	.	(147,000)
Retained Earnings (from above)	0	0	0	0
Totals				

(a) To reduce ending inventories and cost of goods sold of branch to cost, and to eliminate balance in Allowance for Overvaluation of inventories: Dessie branch ledger account.
(b) To increase net income of branch by portion of merchandise markup that was realized.
(c) To eliminate reciprocal ledger accounts.

Note that the amounts in the combined columns of this working paper are exactly the same as in the working paper prepared when the merchandise shipment to the branch were billed at cost. Therefore, there will not be a difference in the financial statements prepared in either of the alternative methods of billing merchandise shipments to braches.

Treatment of Beginning Inventories Priced above cost

The working paper illustrated earlier for billing shipments at a percentage above cost shows how the ending inventories and the related allowances for overvaluation of the inventories were handled. However, because this was the first year of operation for Dessie branch, no beginning inventories were involved.

Perpetual Inventory system

Under this inventory system is a used, no special problem arise when the beginning inventories of the branch include an element of unrealized gross profit. The working paper eliminations would be similar to those illustrated previously when perpetual inventory system is used and billed above cost.

Periodic Inventory system

To demonstrate the handling of beginning inventories carried by Dessie branch at an amount above cost, lets continue with the illustration of Abay Company for a second year of operation, i.e. 2019. In the previous illustrations, the assumption was that Abay Company uses periodic inventory system, at home office and branch. However, now assume that both the home office and Dessie branch adopted the periodic inventory system in year 2019. When the periodic inventory system is used, the home office credits Shipments to Branch (a contra account to Purchases) for the cost of merchandise shipped and Allowance for Overvaluation of Inventories for the markup over cost. The branch debits Shipments from Home Office (analogous to Purchases account) for the billed price of merchandise received.

The beginning inventories for 2019 were carried by Dessie branch at $3,000, or 120% of the cost of $2,500 (= $2,500 x 1.2). Assume that during 2019 the home office shipped merchandise to Dessie branch that cost $100,000 and was billed at $120,000, and that Dessie branch sold merchandise for $126,000 that was billed at 84,000. The journal entries to record the shipment and sales under the periodic inventory system are indicated below:

<table>
<tr><th>Home Office Ledger (Books)</th><th>Dessie Branch Ledger (Books)</th></tr>
<tr><td>Investment in Dessie Branch 120,000
Shipment to Dessie Branch 100,000
Allowance for overvaluation of inventories: Dessie Br. 20,000</td><td>Shipments from Home Office 120,000
Home Office 120,000</td></tr>
<tr><td>None</td><td>Cash (Trade A/R) 126,000
Sales 126,000</td></tr>
</table>

The branch inventories at the end of year 2019 amounted to $18,000 at billed prices, representing cost of $15,000 plus a 20% markup. The flow of merchandise for Dessie branch during year 2019 is summarized as follows:

Abay Company
Flow of Merchandise for Dessie Branch
During 2019

	Cost	Mark up (20% of cost)	Billed Price
Beginning Inventories	$2,500	$500	$3,000
Add: Shipment from HO	100,000	20,000	120,000
Available for sale	102,500	20,500	123,000
Less: Ending Inventories	(15,000)	(3,000)	(18,000)
Merchandise sold	87,500	17,500	105,000

The activities of the branch for year 2019 are reflected in the three home office ledger accounts next:

Investment in Dessie Branch

Date	Explanation	Debit	Credit	Balance
2019,Month, Day	Balance, December 31, 2018			54,000 Dr
	Equipment purchased by branch, carried at HO accounting records		5,000	59,000 Dr
	Merchandise billed to branch at 20% above cost	120,000		179,000 Dr
	Cash received from branch		50,000	129,000 Dr
	Operating Expenses billed to branch	10,000		139,000 Dr
	Net income for 2019 reported by branch	5,000		144,000 Dr

Allowance for Overvaluation of Inventories: Dessie branch

Date	Explanation	Debit	Credit	Balance
2018,Month, Day	Balance, December 31, 2018			500 Cr
	Markup of merchandise shipped to Dessie branch during year 2019 (20% above cost)		20,000	20,500 Cr
	Realization of 20% markup on merchandise sold by branch during 2019	17,500		3,000 Cr

Income: Dessie Branch

Date	Explanation	Debit	Credit	Balance
2018 Month, Day	Net income reported by Dessie branch for 2019			
	Realization of 20% markup on merchandise sold by branch		5,000	5,000 Cr
	Net income of branch (as adjusted) closed to Income summary account		17,500	22,500 Cr
		22,500		0

In the accounting records of the home office at the end of year 2019, the balance required in the Allowance for Overvaluation of Inventories: Dessie branch ledger account is $3,000, that is, the billed price of $18,000 less cost of $15,000 for merchandise in the branch's ending inventories. Therefore, the allowance account balance is reduced from $20,500 to $3,000. This reduction of $17,500 represents the 20% markup of merchandise above cost that was realized by Dessie branch during year 2019 and is credited to the Income: Dessie branch account.

The Home office account in the branch general ledger shows the following activity for year 2019:

Home Office

Date	Explanation	Debit	Credit	Balance
2018,Month, Day	Balance December 31, 2018			54,000 Cr
	Equipment purchased by branch, carried at HO accounting records	5,000		59,000 Cr
	Merchandise received from home office		120,000	179,000 Cr
	Cash sent to home office	50,000		129,000 Cr
	Operating Expenses billed by HO		10,000	139,000 Cr
	Net income for 2019		5,000	144,000 Cr

The working paper for combined financial statements under the periodic inventory system appears as follows:

Abay Company
Working paper for Combined Financial Statements of Home Office and Dessie Branch
For the Year Ended December 31, 2018
(Periodic Inventory System: Billing above Cost)

	Adjusted trial balances		Elimination	Combined
	H. Office	Dessie Br		
	Dr (Cr)	Dr (Cr)	Dr (Cr)	Dr (Cr)
Income Statement				
Sales	(400,000)	(126,000)		(526,000)
Inventories, Dec. 31, 2018	54,500	3,000	(b) (500)	57,000
Purchases	250,000			250,000
Shipments to Dessie branch	(100,000)		(a)100,000	
Shipments from home office		120,000	(a)(120,000)	
Inventories, Dec. 31, 2019	(60,000)	(18,000)	(c) 3,000	(75,000)
Operating Expenses	150,000	16,000		166,000
Net income (to statement of retained earnings below)	105,500	5,000	(d) 17,500	128,000
Totals	0	0		0
Statement of retained earnings				
Retained earnings, Jan. 1, 2018	(147,000)			(147,000)

Net income (from above)	(105,500)	(5,000)	(d) (17,500)	(128,000)
Dividends	45,000			45,000
Retained Earnings, Dec. 31, 2018				
(to balance sheet below)				230,000
Totals				0
Balance Sheet				
Cash	16,000	79,000		95,000
Trade accounts receivable (net)	93,000	47,000		140,000
Inventories, Dec. 31,2019	50,000	18,000	(c) (3,000)	65,000
Allowance for overvaluation of inventories: Dessie branch	(20,500)		(a) (20,000) (b) (500)	
Investment in Dessie Branch	139,000		(e)(139,000)	
Equipment	125,000			125,000
Accumulated depreciation	(35,000)			(35,000)
Trade Accounts payable	(40,000)			(40,000)
Home Office		(139,000)	(e) 139,000	
Common Stock, $12 par	(120,000)			(120,000)
Retained Earnings (from above)	.	.	.	(230,000)
Totals	0	0	0	0

(a) To eliminate reciprocal ledger accounts for merchandise shipments.
(b) To reduce beginning inventories of branch to cost.
(c) To reduce ending inventories of branch to cost.
(d) To increase net income of branch by portion of merchandise markup that was realized.
(e) To eliminate reciprocal ledger accounts.

Closing entries

The closing entries for the branch and the adjusting and closing entries for the home office at the end of year 2019 are illustrated below:

Inventories, Dec. 31, 2019	18,000	
Sales	126,000	
Inventories, Dec. 31, 2018		3,000
Shipments from Home office		120,000
Operating Expenses		16,000
Income Summary		5,000

[To record ending inventories and to close beginning inventories, revenue, and expense ledger accounts]

Income summary	5,000	
Home Office		5,000

[To close the net income in the Income summary account to the Home Office account]

Home Office Accounting records

Investment in Dessie branch	5,000	
Income: Dessie branch		5,000
[To record net income reported by branch]		

Allowance for Overvaluation of Inventories: Dessie branch	17,500	
Income: Dessie branch		17,500

[To recognize as realized income the markup of merchandise applicable to goods sold by branch during year 2019]

Income: Dessie branch	22,500	
Income summary		22,500

[To close branch income to income summary ledge account]

Inventories, Dec. 31, 2019	60,000	
Sales	400,000	
Shipments to Dessie branch	100,000	
Inventories, Dec. 31, 2018		54,500
Purchases		250,000
Operating Expenses		150,000
Income summary		105,500

[To record ending inventories and to close beginning inventories, revenue, and expense ledger accounts]

Income summary	128,000	
Retained Earnings		128,000
[To close income summary ledger account]		

Retained earnings	45,000	
Dividends		45,000

[To close dividends ledger account]

Explain the nature of the "shipments to branch" account on the home office books and the "shipments form home office" account on the branch books.

2.8. Reconciliation of Reciprocal ledger Accounts

At the end of an accounting period, the balance of the Investment in branch ledger account in the accounting records of the home office may not agree with the balance of the Home Office account in the accounting records of a branch, because certain transactions may have been recorded by one office but not by the other. Moreover, reciprocity between home office and branch accounts will not exist at year-end if errors have been made in recording reciprocal transactions either on the home office or the branch books. The approach for reconciling home office and branch accounts at year-end is similar to the approach used for bank reconciliations. The lack of agreement between the reciprocal ledger account balances causes no difficulty during an accounting period, but at the end of each period the reciprocal account balances must be brought into agreement before combined income statements are prepared.

Illustration 2.3: Reconciliation of Reciprocal ledger Accounts

Assume that the home office and branch accounting records of HH Co. contain the following data on December 31, 2017:

Investment in Branch A (in accounting records of Home Office)

Date	Explanation	Debit	Credit	Balance
2017				
Nov. 10	Balance			62,500 Dr
Dec. 10	Cash received from branch		20,000	42,500 Dr
27	Collection of branch trade A/R		1,000	41,500 Dr
29	Merchandise billed to branch	8,000		49,500 Dr

Home Office (in account records of Branch A)

Date	Explanation	Debit	Credit	Balance
2017				
Nov. 30	Balance			62,500 Cr
Dec. 7	Cash sent to home office	20,000		42,500 Cr
28	Equipment purchased by branch, carried at HO accounting records	3,000		39,500 Cr
30	Collection of home office trade A/R		2,000	41,500 Cr

Comparison of the two reciprocal ledger accounts discloses the four reconciling items describe below:

1. A debit of $8,000 in the Investment in Branch A ledger account without a related credit in the Home Office account.

On December 29, the home office shipped merchandise costing $8,000 to the branch. The home office debits its reciprocal ledger account with the branch on the date merchandise is shipped, but the branch credits its reciprocal account with the home office when the merchandise is received, perhaps a few days later. The required journal entry on December

31, 2017, in the branch accounting records, assuming use of the perpetual inventory system, appears below:

Inventories in Transit	8,000	
Home Office		8,000

[To record the shipment of merchandise in transit from home office]

2. A credit of $1,000 in the Investment in Branch A ledger account without a related debit in the Home Office account.

On December 27, trade accounts receivable of the branch was collected by the home office. The collection was recorded by the home office by a debit to Cash and a credit to Investment in Branch A. No journal entry was made by Branch A; therefore, the following journal entry is required in the accounting records of Branch A on December 31, 2017.

Home Office	1,000	
Trade accounts receivable		1,000

[To record collection of accounts receivable by home office]

3. A debit of $3,000 in the Home Office ledger account without a related credit in the Investment in Branch A account.

On December 28, the branch acquired equipment for $3,000. Because the equipment used by the branch is carried in the accounting records of the home office, the journal entry made by the branch was a debit to Home Office and a credit to Cash. No journal entry was made by the home office; therefore, the following journal entry is required on December 31, 2017, in the accounting records of the home office:

Equipment: Branch A	3,000	
Investment in Branch A		3,000

[To record equipment acquired by branch]

4. A credit of $2,000 in the Home Office ledger account without a related debit in the Investment in Branch A account.

On December 30, trade accounts receivable of the home office was collected by Branch A. The collection was recorded by Branch A by a debit to Cash and a credit to Home Office. No journal entry was made by the home office; therefore, the following journal entry is required in the accounting records of the home office on December 31, 2017.

Investment in Branch A	2,000	

Trade accounts receivable 2,000

[To record collection of accounts receivable by Branch A]

The effect of the foregoing end-of-period journal entries is to update the reciprocal ledger accounts as shown by the reconciliation below:

HH Co - Home Office and Branch A
Reconciliation of Reciprocal Ledger Accounts
December 31, 2017

	Investment in Branch A account (in home office accounting records)	Home Office account (in branch accounting records)
Balance before adjustments	$49,500 Dr	$41,500 Cr
Add: (1) Merchandise shipped to branch by home office		8,000
(4) Home office trade A/R collected by branch	2,000	
Less: (2) Branch trade A/R collected by home office		(1,000)
(3) Equipment acquired by branch	(3,000)	
Adjusted balances	**$48,500 Dr**	**$48,500 Cr**

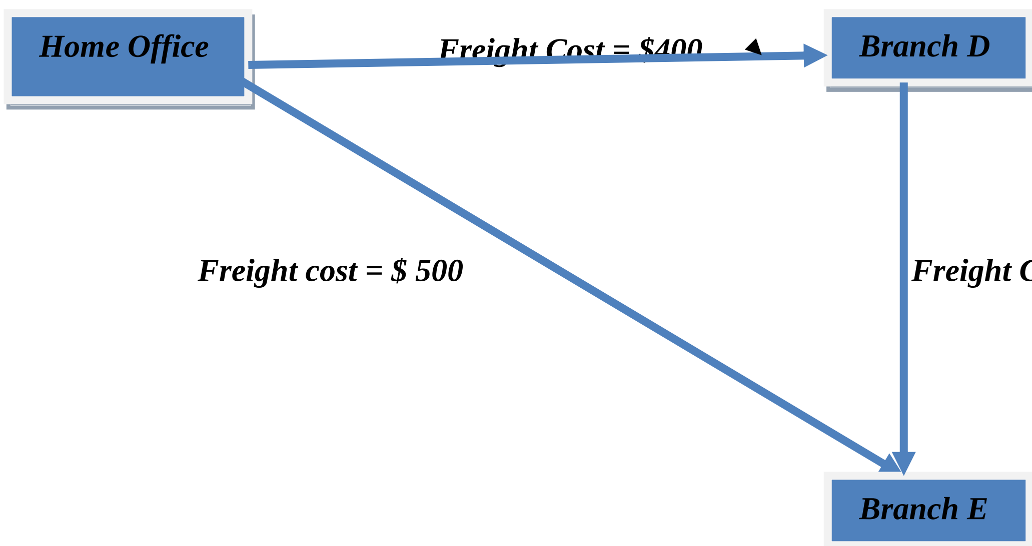
2.9. Transactions between branches

Efficient operations may on occasion require that assets be transferred from one branch to another. Generally, a branch does not carry a reciprocal ledger account with another branch but records the transfer in the Home Office account. For example, if Branch A ships merchandise to Branch B, Branch A debits Home Office and credits Inventories (assuming that the perpetual inventory system is used). On receipt of the merchandise, Branch B debits Inventories and credits Home Office. The home office records the transfer between branches by a debit to Investment in branch B and a credit to Investment in Branch A.

The transfer of merchandise from one branch to another does not justify increasing the carrying amount of inventories by the freight costs incurred because of the indirect routing. Only freight costs of the direct shipment from the home office are included in inventory costs. Excess freight costs incurred as a result of such transfers should be recorded as expenses of the home office because the home office makes the decision to transfer the merchandise.

Illustration 2.4: Transaction between branches

To illustrate assume the home office shipped merchandise costing $6,000 to Branch D and paid freight costs of $400. Subsequently, the home office instructed Branch D to transfer this merchandise to Branch E. Freight costs of $300 were paid by Brach D to carry out this order. If the merchandise had been shipped directly from the home office to Branch E, the freight costs would have been $500. The journal entries required in the three sets of accounting records (assuming that the perpetual inventory system is used) are as follows:



In accounting records of home office:

Investment in Branch D	6,400	
Inventories		6,000
Cash		400

[To record shipment of merchandise and payment of freight costs]

Investment in Branch E	6,500	
Excess freight expense-Interbranch transfer	200	
Investment in Branch D		6,700

[To record transfer of merchandise from Branch D to Branch E under instruction of home office]

Interbranch freight of $300 paid by Branch D caused total freight costs on this merchandise to exceed direct shipment costs by $200 ($400 +$300 - $500 = $200)

In accounting records of Branch D:

Freight In	400	
Inventories	6,000	
Home Office		6,400

[To record receipt of merchandise from home office with freight cost paid in advance by home office]

Home Office	6,700	
Inventories		6,000
Freight In		400
Cash		300

[To record transfer of merchandise to Branch E under instruction of home office and payment of freight costs of $300]

In accounting records of Branch E

Inventories	6,000	
Freight In	500	
Home Office		6,500

[To record receipt of merchandise from Branch D transferred under instruction of home office and normal freight costs billed by home office]

The excess freight costs from such shipments generally result from inefficient planning of original shipments and should not be included in inventories.

In recognizing excess freight costs of interbranch transfers as expenses attributable to the home office, the assumption is that the home office makes the decision directing all shipments. If branch managers are given authority to order transfers of merchandise between branches, the excess freight cost should be recorded as expenses attributable to the branches.

? How transaction between branches handled?

2.10. Chapter Summary

A branch is a business unit located at some distance from the Home Office. Branches are economic and accounting entities. However, branches are not legal entity. Branches may carry merchandise obtained from Home Office, make sales, approve customers' credit, and make collections from its customers.

A branch usually has more autonomy and a greater range of services than a sales agent does. However, the extent of autonomy and responsibility of a branch varies, even among different branches of the same business enterprise. A branch typically stocks merchandises and fills customers' orders.

An agency relationship refers a contract under which one or more persons (the principals) engage another person (the agent) to carry out some service on their behalf that involves delegating some decision making authority to the agent.

Division is a business segment or a business enterprise which generally has more autonomy than a branch. Division may be as separate company or may not be a separate company. If the division is not a separate company, the accounting procedures are the same as Branch. If the division is a separate company (subsidiary company), the financial accounting requires consolidation, which will be discussed in later topics.

The accounting system of a business enterprise may provide for a complete set of accounting rerecords at each branch (almost completely decentralized); policies of another enterprise may keep all accounting records in the home office (highly centralized).

A separate income statement and balance sheet should be prepared for the branch so that management of the enterprise may review the operating results and financial position of the branch.

To meet the needs of investors or other external users of financial statements it is necessary to combine the data on the income statements of the home office and that of branches to form one overall income statement for the company. Similarly, the data on the balance sheets of the home office and of the branches need to be combined so as to have a balance sheet for the company as a whole.

2.11. Self-Test Questions

Now, this chapter is completed you must have to test your progress by doing the following self-test and compare your answer with the answer key given at the end.

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Multiple Choice Questions

Select the best answer for each of the following multiple-choice questions:

1. If the home office of ABC Co. maintains the accounting records of the plant assets of its branch and that branch acquired equipment for $5,000 cash, the appropriate journal entry for the branch is:
   A. Debit the Home Office ledger account and credit a plant asset account for $5,000
   B. Debit the Home Office account and credit Cash for $5,000
   C. Debit a plant asset account and credit the Home Office account for $5,000
   D. Debit Cash and credit the Home Office account for $5,000
2. In a working paper for a combined income statement for the home office and its branch, what element is eliminated as an offset to shipments to branch?
   A. Home Office
   B. Investment in Branch
   C. Shipments from home office
   D. None of the above
3. In accounting for branch transactions, it is improper for the home office to:
   A. Credit cash received from a branch to the Investment in Branch ledger account.
   B. Maintain Common Stock and Retained Earnings ledger accounts for only the home office.
   C. Debit shipments of merchandise to the branch from the home office to the Investment in Branch ledger account.
   D. Credit shipments of merchandise to the branch to the Sales ledger account.
4. Which of the following ledger accounts is displayed in the combined financial statements for a home office and branch?
   A. Shipments to Branch
   B. Home Office
   C. Dividends Declared
   D. Allowance for Overvaluation of Inventories: Branch

5. A possible shortcoming of billing at cost the merchandise shipped from a home office to a branch is;
    A. All gross profit on the sale of merchandise is attributed to the home office
    B. the branches difficulty in applying the retail method of inventory
    C. Gross profit information is concealed from branch personnel.
    D. Gross profit of the home office is understated.
    E. none

CHAPTER THREE

INSTALLMENT AND CONSIGNMENT CONTRACTS

Learning objectives:

Dear students, after successfully completing this chapter you will be able to:

- ☞ Define installment sales;
- ☞ Define consignment sales;
- ☞ Explain the characteristics of installment sales;
- ☞ Discuss the features of consignment sales;
- ☞ Differentiate regular sales from installment and consignment sales;
- ☞ Describe the accounting for consignor and consignee;
- ☞ Discuss the profit measurement under installment method;
- ☞ Discuss the accounting for consignment by consignor and consignee records.

3.1.Installment Sales

For many business enterprises, installment sales have been a key factor in achieving large-scale operations. For instance, in Ethiopia, this is common in the electronics merchandising business. The installment sales have itsown advantages and disadvantages. Credit losses often increase when sales are made on the installment plan, but this disadvantage generally is more than offset by the expanded sales volume and gross profit on sales.

Installment sales pose some difficult problems for accountants. The most basic of these problems is the matching of expenses and revenue.

The unique issues related to installment sales are:

- When should the gross profit from installment sales be recognized?
- What should be done with costs that occur in periods subsequent to the sale?
- How should defaults, trade-ins, and repossessions be recorded?

3.1.1. Special Characteristics of Installment Sales

An installment sale is a sale of real or personal property or services which provides for a service of payments over a period of months or years. A down payment usually, but not always, is required. Since, the seller must wait a considerable period of time to collect the full sales price, it is customary to provide interest on the unpaid balances and to add carrying charges to the listed selling price.

The risk of non-collection to the seller is greatly increased when sales are made on the installment plan. Customers generally are in weaker financial condition then those who buy or open account; furthermore, the credit rating of the customers and their ability to pay may change significantly during the period covered by installment contract. The risk of non-collection is guaranteed by security agreement which enables them to repossess the property if the buyer falls to make payments.

The seller's right to protect their security interest (uncollected balance of a sale contract) and to repossess the property varies by type of industry, the form of the contractual arrangement, and the statutes relating to repossessions. For the service-type business, repossession obviously is not available as a safeguard against the failure to collect. In reality, for many types of personal property as well, the sellers' right to repossess may be more a threat than a real assurance against loss. The product sold may have been damaged or may have depreciated to a point that it is worth less than the balance due on the installment contract. A basic rule designed to minimize losses from non payments of installment contracts is to require a sufficient down payment, payment to cover the loss of value when property moves out of the "new Merchandise" category. A corollary rule is that the payment schedule should not be outstripped by the projected decline in value of the property. For example, if a customer buying an automobile on the installment plan finds after a year or so that the car is currently worth less than the balance still owed on the contract, the customer's motivation to continue the payments may be reduced.

Competitive pressures within an industry often will not permit a business to adhere to these standards. Furthermore, repossession may be a difficult and expensive process, especially if the customer is non-cooperative or necessary to make the merchandise salable, and the resale of such merchandise may be difficult. For these reasons, doubtful accounts expense is likely to be significantly higher on installment sales than regular credit sales.

A related problem is the increased collection expenses when payments are spread over an extended period. Accounting expenses also are multiplied by the use of installment sales, and large amounts of working capital are tied up in installment receivables. In recognition of these problems, many business executives have concluded that the handling of installment receivables is a separate business, and they therefore sell their installment receivable to finance companies which specialize in credit and collection activities.

From the above discussion, it is understood that installment sales pose some challenging problems. The most basic problems are:

- Difficulty of matching costs with related revenue
- Greater risk of non-collection or higher doubtful accounts expense
- Repossession of highly damaged or depreciated property
- Higher collection expenses
- Reconditioning and repairing costs for repossessed property
- Substantial amount of working capital is tied up in receivables

? What are some characters tics that distinguish an installment sale from an ordinary sale?

What are some characteristics that distinguish an installment sale from an ordinary sale on 30-day credit terms?

3.1.2. Methods for Recognition of Profits on Installment Sales

The determination of net income on installment sales is complicated by the fact that the amounts of revenue and related costs and expenses are seldom known in the period when the sale is made. Substantial expenses such as collection, accounting, repairs, and repossession are likely to be incurred in subsequent periods. In some business, the risk of non-collection may be go great as to raise doubts as to the recognition of any revenue or profit at the point of sale. The first objective in development of accounting policies for installment sales should be reasonable matching of expenses and revenue. However, in recognition of the diverse business conditions under which installment sales are made, three approaches are used:

(1) the accrual basis of accounting(recognition of gross profit at the time of sale)

(2) the cost recovery method of accounting, and

(3) The installment method of accounting.

1. Accrual Method of Gross Profit Recognition (At the Time of Sale)

To recognize the entire gross profit at the time of an installment sale is to say in effect that installment sales should be treated like regular sales on credit. The merchandise has been delivered to the customer and an enforceable receivable of definite amount has been acquired. The excess of the receivable contract over the cost of merchandise delivered is realized gross profit in the traditional meaning of the term. The journal entry consists of a debit of installment contracts receivable and a credit to installment sales. If a perpetual inventory system is maintained, another journal entry is needed to transfer the cost of merchandise from the inventories account to the cost of installment sales account. No recognition is given to the seller's retention of title to the merchandise because the normal expectation is completion of the contract through collection of receivable. Implicit in this recognition of gross profit at the time of sale is the assumption that all expenses relating to the sale will be recognized in the same period so that the determination of net income consists of matching realized revenue with expired costs.

These expenses include collection expenses and doubtful expenses. The journal entries to record such expenses would consist of debits to expense accounts and credits to asset valuation accounts such as Allowance for Doubtful Accounts and Allowance for Collection Costs. The Allowance accounts would be debited in later periods as uncollectible installment contracts become known and as collection costs are incurred.

2. Cost Recovery Method of Gross Profit Recognition

In some cases accounts receivable may be collectible over a long period of time. In addition the terms of sale may not be definite, and the financial position of customers may be extremely unpredictable, thus making it virtually impossible to find a reasonable basis for estimating the degree of collectability of the receivable. In such cases, either the installment method or the cost recovery method of accounting may be used for installment sales. Under the cost recovery method, no profit is recognized unit all costs of the item sold have been fully recovered. After all costs have been recovered, additional collections on the installment receivables would be recognized as revenue (profit), and only current collection expenses would be charged to such revenue. The cost recovery method of accounting is rarely used.

3. **Installment Method of Gross Profit Recognition**

The third approach to the measurement of income from installment sales is to recognize gross profit in installments over the term of the contract on the basis of cash collections.

Collection of receivables rather than sales is used as the basis for realization of gross profit. In other words, a modified cash basis of accounting is substituted for the accrual basis. This modified cash basis of accounting is known as the installment method of accounting.

? Explain the approaches for recognition of gross profit on installment sales.

Example 3.1: At the beginning of Year 3, SANDRO Company sold merchandise on installment basis for Br 200,000 that have cost of Br 130,000. The first payment is to be collected at the end of Year 3. The cash collection performances are as follows:

Year 1... Br 90,000
Year2.. Br 60,000
Year3.. Br 50,000

Instruction: Determine the realized gross profit to be reported each year under Accrual Method; Cost Recovery Method; and Installment Method.

1. Accrual Method

Year 1	Installment Sales..	Br 200,000	100%
	Cost of Installment Sales.....................................	130,000	65%
	Realized Gross Profit	Br 70,000	35%
Year 2	Realized Gross Profit	-0	
Year 3	Realized Gross Profit	-0	

The Br 70,000 gross profit is realized in Year 1. Therefore, there is no gross profit to be realized in Year 2 and Year 3 from this installment sale.

2. Cost Recovery Method

The gross profit to be realized is the difference between the cash collection and unrecovered cost:

	Cash Collection	Unrecovered Cost	Realized Gross Profit	Rema rk
Year 1	90,000	130,000	90,00 – 130,000 = **(40,000)**	40,000 cost is not recovered
Year 2	60,000	40,000	60,000 – 40,000 = Br **20,000**	Cost is fully Recovered
Year 3	50,000	0	50,000 – 0 = **Br 50,000**	Cost is fully Recovered
Total	200,000		70,000	

3. Installment Method

Under installment method of gross profit and revenue recognition, each cash collection consists of certain percentage of gross profit and certain percentage of cost recovery.

	Cash Collection	Percentage of Gross Profit	Realized Gross Profit
Year 1	90,000	35%	90,000 @ 35% = 31,500
Year 2	60,000	35%	60,000 @ 35% = 21,000
Year 3	50,000	35%	50,000 @ 35% = 17,500
Total	200,000		70,000

3.1.3. The Installment Method of Accounting

Under the installment method of accounting, each cash collection on the contract is regarded as including both a return of cost and a realization of gross profit in the ratio that these two elements were included in the selling price.

For example, assume that ABC trading sold equipment for $1,000 which was acquired at a total cost of $800. The $200 excess of the sales price over cost is regarded as deferred gross profit. Because cost and gross profit constituted 80% and 20%, respectively, of the sales price, this 80:20 ratio is used to divide each collection under the contract between the recovery of cost and the realization of gross profit. If $250 is received as a down payment, $50 of the deferred gross profit is considered realized in the current accounting period. At the end of each period, the Deferred Gross Profit ledger account balance will equal 20% of the Installment Receivables remaining uncollected. The realized Gross Profit on Installment Sales account will show for each period an amount equal to 20% of the collections during that period.

The circumstances in which the use of the installment method of accounting was permitted were:

(1) Collection of installment receivables is not reasonably assured,

(2) Installment receivables are collectible over an extended period of time, and

(3) There is no reasonable basis for estimating the degree of collectability of the installment receivables.

***Illustration 3.1*: Single Sale of Real Estate on the installment plan**

On November 1, Year 1, HT Real Estate, which maintained accounting records on a calendar year basis, sold a building for Br 215,000 whose construction cost was Br 140,000. Commission and other expenses pertaining to the sale was Br 15,000. The Br 15,000 was an expense treated as deductions in determining the gross profit on the sale rather than as charges to specific expense accounts. The net amount of receivable from the sale was therefore Br 200,000, of which 70% represented the cost i.e. the return on the investment and 30% represented deferred gross gain. All collections from the buyer including the down payment were regarded as consisting of 70% cost recovery of 30% realization of Gross Profit or gain. The contract of sale called for a down payment of Br 65,000 and a promissory note, with payment every six months in the amount of Br 30,000 plus interest (finance charges) of the annual interest rate of 10% on the unpaid balance. Instruction: Record the transaction under the installment method.

Transaction of Year 1:

HT Real Estate

Journal Entries to Record Sale of Building on Installment Plan

Year 1. Nov. 1	Cash...	50,000	
	Notes Receivable...	150,000	
	Building...		140,000
	Deferred Gain on Sale of Building..................		60,000
	Recording building on installment plan. Net cash is the difference between the Br 65,000 down payment and the Br 15,000 commission expense (65,000 –15,000)		
Dec.31	Deferred Gain on sale of Building	15,000	
	Realized Gain on sale of building.........................		15,000
	Realized Gain Computed at 30% of cash collected on the contract during Year1		
Dec.31	Interest Receivables……………………..	2,500	
	Interest Revenue…………………………………		……2,500

To accrue interest for two months at 10% on notes receivables of Br 150,000. Br 150,000 @ 10% @ 2/12 = 2,500

Transaction of Year 2:

Year 2 May.1	Cash..	37,500	
	Interest Receivable...		2,500
	Interest Revenue		5,000
	Notes Receivable		30,000
	Collected Semiannual installment on notes receivable plus interest for six months at 10% on Br 150,000		
Nov.1	Cash..	36,000	
	Interest Revenue..		6,000
	Notes Receivable..		30,000
	Collected Semiannual installment on notes receivable plus interest for six months at 10% on unpaid balance of Br 120,000 (Br 150,000 – 30,000)		
Dec.31	Deferred Gain on sale of Building	18,000	
	Realized Gain on sale of building..............................		18,000
	Realized Gain Computed at 30% of cash collected on the contract during Year2 (Br 60,000 @ 30% = Br18,000)		
Dec.31	Interest Receivables...	1,500	
	Interest Revenue...		1,500
	To accrue interest for two months at 10% on notes receivables of Br 90,000. Br 90,000 @ 10% @ 2/12 = 1,500		

Transaction of Year 3:

Year 3 **May.1**	Cash..	34,500	
	Interest Receivable...		1,500
	Interest Revenue..		3,000
	Notes Receivable..		30,000
	Collected semiannual installment on notes receivable plus interest for six months at 10% on Br 90,000		

Nov.1	Cash……………………………………..33,000		
	Interest Revenue………………………3,000		
	Notes Receivable……………………...30,000		
	Collected Semiannual installment on notes receivable plus interest for six months at 10% on unpaid balance of Br 60,000 (Br 90,000 – 30,000)		
Dec.31	Deferred Gain on sale of Building	18,000	
	Realized Gain on sale of building.........................		18,000
	Realized Gain Computed at 30% of cash collected on the contract during Year2 (Br 60,000 @ 30% = Br18,000)		
Dec.31	Interest Receivables...	500	
	Interest Revenue...		500
	To accrue interest for two months at 10% on notes receivables of Br 30,000. Br 30,000 @ 10% @ 2/12 = 500		

Transaction of Year-4:

<u>Year 4</u>	Cash	31,500	
May 1	Interest Receivable...		500
	Interest Revenue		1,000
	Notes Receivable		30,000
	Collection of the final semiannual installment plus interest for six months at 10% on Br30, 000		

<u>Note</u>: If a sale on the installment plan results in a loss, the entire loss must be recognized in the year of the sale.

Sales of merchandise on the installment plan by a dealer (Merchandising Businesses)

Assume a large volume of installment sales of merchandise by company which used the installment method of accounting because the collectibles of the receivable cannot be estimated. The first requirement is to keep separate all sales made on the installment plan as distinguished from ordinary sales. The accounting records for installment receivables usually are maintained by contract rather than by customer; if several articles are sold on the installment plan to one customer; it is convenient to account for each contract separately. However, it is not necessary to compute the rate of gross profit on each individual installment sales or to apply a different rate to collections on each individual contract. The average rate of gross profit on all installment sales during a given year generally is computed and applied to all collections received *(net of interest and carrying charges)* on installment receivables originating in that year.

Illustration 3.2:

View Company sells merchandise on the installment plan as well as on regular terms i.e. on cash or 30-day open accounts and uses a perpetual inventory system. For the installment sale the customer's account is debited for the full amount of the selling price, including interest and carrying charges, and is credited for the amount of the down payment. At the beginning of Year 5, View Company's ledger included the following accounts.

Installment contracts receivable – Year 3 ……………………… Br 20,000debit
Installment contracts receivable –Year 4……………………………85, 000debit
Deferred interest and carrying charges on installment sales………...17,500credit
Deferred gross profit – year 3 installment sales……………………...4,500credit
Deferred gross profit – year 4installmentsales……………………...19,460credit

The gross profit rate on installment sales (excluding interest and carrying charges) uses 25% in Year 3 and 28% in Year 4. During Year 5, the following transactions relating to installment sales were completed by View Company:

1. Installment sales, cost of installment sales and deferred gross profit for Year 5 are listed below: Installment sales not including Br 30,000 deferred interest and

Carrying charges (Installment Contract Receivable)...……...Br 200,000debit
Cost of installment sales………………...……………………..138,000debit
Deferred gross profit – Year 5installmentsales……………….....62,000 credit
Rate of gross profit on installment sales (62,000/200,000)…………31%

2. Cash collection on installment contract during Year 5 are summarized below:

	Sales Price	Interest and Carrying Charges	Total Cash Collected
Installment Receivable Year5	80,000	10,000	90,000
Installment Receivable Year4	44,500	12,500	57,000
Installment Receivable Year3	17,000	1,850	18,850
Total	141,500	**24,350**	165,850

3. Customers who purchased merchandise in Year 3 were unable to pay the balance of their contracts, Br 1,150. The contracts consisted of Br 1,000 sales price and B150 in interest and carry charges, and included Br 250 of deferred gross profit (Br 1000 @ 25% = Br 250). The current fair value of the merchandise repossessed was Br 650.

4. Deferred Gross Profit was Realized in Year 5 on cash collected during the year

Relating to Year 5 sales, Br 80000@31%..Br24,800
Relating to Year 4 sales, Br 44,500@ 28%...12,460
Relating to Year 3 sales, Br 17000 @ 25%... 4,250
Total……………………………………………………………Br41,510

Recording Transactions: the journal entries to record the transactions for View Company relating to installment sales for Year 5 are given below:

View Company
General Journal

Installment Sales ReceivableYear5……………………….230,000
Installment Sales……………………………….………..….200, 000
Deferred interest & carrying charges on installment sales……...30,000
[To record installment sales during year 5]

Cost of Installment Sale ……………………………….138, 000
Inventories …………………………………………………… 138,000
[To record cost of installment sales]

Cash…………………………………………………….165,850
Installment Receivable Year 5……………………………… …90,000
Installment Receivable Year 4……………………………… 57,000
Installment Receivable Year 3………………………………. …18,850
[To record cash collections on installment accounts during Year 5]

Inventories (reposed merchandise)…………………………...650
Deferred gross profit Year 3 installment sales ……………….250
Deferred interest and carrying charges on installment sales….150
Doubtful account expense …………………………………100
Installment Sales Receivables…………………………..……. 1,150
[*To record default on installment contracts originating in Year 3 and repossession of merchandise]*

Adjusting Entries: the adjusting journal entries for View Company at December 31, Year 5, are as follows:

View Company
General Journal

Installment sales…………………………………………200,000
Cost of installment sales……………………………………138,000
Deferred Gross Profit……………………………………….62,000
[To record deferred gross profit on Year 5 installment sales]

Deferred Gross Profit – Year 5installmentsales……….….24,800
Deferred Gross Profit – Year 4installmentsales……….....…12,460
Deferred Gross Profit – Year 3installmentsales……4,250
Realized Gross Profit on installment sales……………………41,510
[To record realized gross profit]

Deferred interest and carrying charges on installment sales……24,350
Revenue from interest and carrying charges……..…………24,350
[*To record interest and carrying charges earned during Year5]*

1.9.1.1.1.1. Account Balances at end of Year 5

Installment Contract Receivables –Year4…………………………….…Br 28,000 debit
Installment Contract Receivable –Year5………………………………..140,000 debit
Deferred interest and carrying charges on installment……………………...23,000 credit
Deferred Gross Profit – Year 4 installment sales……………………….………7,000 credit
Deferred Gross Profit – Year 5 installment sales…………………….……..37,200 credit

These amounts may be rearranged in slightly different form to test the accuracy of the deferred gross profit on installment contracts at the end of Year5:

View Company
Proof of Deferred Gross Profit
December 31, Year 5

	Contract Receivables	Deferred Interest & CC	Net Contract Receivables	Gross Profit %	Deferred GP
Year 4 accounts	Br28,000	Br3,000	Br25,000	28	Br7,000
Year 5 accounts	140,000	20,000	120,000	31	37,200
Totals	168,000	23,000	145,000		44,200

Note: Instead of separating the collections applicable to the sales price and to the interest and carrying charges, it would be possible to determine the gross profit rate by inclusion of the interest and carrying charges in the selling price in the computation of the gross profit rate.

Financial statement presentation of installment sales accounts

The presentation of accounts relating to installment sales in the financial statements raises some interesting theoretical issues, regardless of whether the accrual basis or the installment method of accounting is used.

a) Income Statement

A partial income statement for Year 5 for View Company, which uses the installment method of accounting, is presented below. This statement is based on the installment sales information illustrated, plus additional assumed data for regular sales.

View Company

Partial Income Statement

For Year Ended December 31, Year 5

	Installment Sales	Regular Sales	Combined
Sales	Br200,000	Br300,000	Br500,000
Cost of goods sold	138,000	222,000	360,000
Gross profit on sales	Br62,000	Br78,000	140,000
Less: Deferred GP on Year 5sales	37,200		37,200
Realized GP on Year 5sales	Br24,800	Br78,000	Br102,800
Add: Realized GP on prior years' installmentsales			16,710
Total Realized Gross Profit			Br119,510

If the accrual basis of accounting were used for all sales, a gross profit of Br 140,000 would be reported in Year 5. Revenue from interest and carrying charges on installment contracts may be added to sales to arrive at total revenue; in a classified income statement, such revenue generally is reported as Other Revenue.

b) Balance Sheet

Installment contracts receivable, net of deferred interest and carrying charges, are classified as current assets, although the collection period often extends more than a year beyond the balance sheet date. This rule is applicable whether the accrual basis or the installment method of accounting is used. The definition of current assets specifically includes installment accounts and notes receivable if they conform generally to normal trade practices and terms within the industry. This classification is supported by the concept that current assets include all resources expected to be realized in cash or sold or consumed during the normal operating cycle of the business.

The classification of deferred gross profit on installment sales in the balance sheet when installment method of accounting is used for financial accounting purposes is controversial. A common practice for many years was to classify it as a deferred credit at the end of the liability section. Critics of this treatment pointed out that no obligation to an outsider existed and that the liability classification was improper.

The existence of a deferred gross profit account is based on the argument that the profit element of an installment sale has not yet been realized. Acceptance of this view suggest that the related installment receivable will be overstated unless the deferred gross profit account is shown as a deduction from installment contracts receivable.

3.1.4. Defaults and Repossessions

If a customer defaults on an installment contract for services and no further collection can be made, it is a default without the possibility of repossession. A similar situation exists for certain types of merchandise which have no significant resale value. The journal entry required in such cases it to write off the uncollectible installment contract receivable, cancel the deferred gross profit related to the receivable, and debit Doubtful Accounts Expense for the difference. In other words, the Doubtful Accounts Expense is equal to the Unrecovered Cost contained in the installment contract receivable.

- ☞ Doubtful Accounts Expense = Unrecovered Cost = Installment Receivables – Deferred GP – Deferred interest and Carrying Charges. However, in most cases a default by a customer leads to repossession of merchandise. The doubtful accounts expense is reduced by the current fair value of the property repossessed, and it is possible, though not likely, for repossession to result in a gain. The principal difficulty in accounting for defaults followed by repossession is estimation of the current fair value of the merchandise at the time of repossession. The current fair value should allow for any necessary reconditioning costs and provide for a normal gross profit on resale.
- ☞ Doubtful Accounts Expense = Unrecovered Cost = Installment Receivables – Deferred GP – Deferred interest and Carrying Charges – Current fair value repossessed inventory
- ☞ Current fair value = expected resale value – reconditioning cost – normal gross profit. In the previous example of repossession by View Company, the following are accomplished:
    1) It eliminated the defaulted installment contracts receivable of Br1,150
    2) It cancelled deferred gross profit of Br 250 and deferred interest and carrying charges of Br150
    3) It recognized an asset equal to Br 650 current fair value of the repossessed merchandise and
    4) It recognized doubtful accounts expense of Br 100, the difference between the unrecovered cost in the defaulted receivable Br 750 and the current fair value of

the repossessed merchandise Br 650

3.1.5. Other accounting issues relating to installment sales

Special accounting issues arise in connection with:

1. Acceptance of used property as a trade -in
2. Computation of interest on installment contracts receivable
3. The use of the installment method of accounting solely for income tax purposes, and

1. Trade-in

Trade-in is acceptance of a used property as partial payment for a new one. An accounting problem is raised only if there is an over allowance. An over allowance is the excess of the trade-in allowance over the current fair value of the used property. An over allowance on trade-ins is significant as it actually represents a reduction in the stated selling price of the new merchandise.

Example 3.2:

Assume that an article with a cost of Br 2,400 is sold on an installment contract for Br 3,300. Used merchandise is accepted as a trade-in at a "value" of Br 1,100, but the dealer expects to spend Br 50 in reconditioning the used merchandise before reselling it for only Br 1,000. Assume further that the customary gross profit rate on used merchandise of this type is 15%, which will cover the selling costs, various overhead costs, and also provide a reasonable gross profit on the resale of the used merchandise. The current fair value of the trade-in and the amount of the Over Allowance may be computed as follows:

Trade-in Allowance given to custome…………..……………………….…….		Br1,100
Deduct current fair value of trade-in		
Estimated reseal value of article traded-in…………………..Br1,000		
Less: Reconditioning Costs…………………...……………..Br50		
Gross Profit Margin (Br 1,000 @15%...	150	200
Current fair value of article traded in...		800
Over Allowance on trade -in………………………………………..		Br 300

Assuming that a perpetual inventory system is used, the journal entry to record the installment sale and the merchandise traded in follows:

Inventories (Trade-in)…………………………...…………...800		
Installment Contracts Receivable (Br 3,300– 1,100)…………2,200		
Cost of Installment Sales……………………………………..2,400		
Installment sales (3,300 –300)…………………………………		3, 000
Inventories (new) ………………………………………………..		2,400

To record sale of merchandise for Br 3,000, consisting of gross sales price of Br 3,300 minus an over allowance of Br 300 given on the trade-in

2. Interest on Installment Contracts Receivable

Installment contracts usually provide for interest and other so-called "carrying charges" to be paid concurrently with each installment payment. Such deferred payment charges, regardless of the label placed on them, represent a cost of borrowing to the buyer and logically may be referred to as "Interest". However, only the portion of the payment which is applied to reduce the principal of the contract is considered in the measurement of realized gross profit under the installment method of accounting. The interest revenue for financial accounting purpose should be computed periodically by the application of the effective interest rate to the unpaid balance of the installment contracts receivable.

3. Installment Method for Income Tax Purposes Only

The popularity of the installment method for income tax purposes is explained by its capacity for Postponing the recognition n of taxable income and the payment of income taxes.

3.2. Consignment Sales

3.2.1. Definition of Consignment Sales

The term consignment means a ***transfer of possession*** of merchandise from the owner to another person who acts as the sales agent of the owner. ***Title*** to the merchandise remains with the owner, who is called a ***consignor***; the sales agent who has possession of the merchandise is called a ***consignee***. The relationship between the consignor & the consignee is that of principal and agent. Consignees are responsible to consignors for the merchandise placed in their custody until it is sold or returned. As the title to merchandise is retained by the consignor, the consignees do ***neither*** include the ***inventories*** in their records, nor include a ***trade accounts payable*** or other liability. The only obligation of consignees is to ***give reasonable care*** to the consigned merchandise & to account for it to consignor. When the consigned merchandise is sold, the consignor records the sale, & the receivable is the property of the consignor. As a result the consignor bears any ***credit losses***, provided that the consignee has exercised due care in granting credit & making collections. However, the consignee may guarantee the collection of consignment trade account receivable; under this type of consignment contract, the consignee is said to be a ***del credere agent***.

The shipment of merchandise on consignment may be referred to by the consignor as a ***consignment out***, and by the consignee as a ***consignment in***.

3.2.2. Distinction between a Consignment and a Sale

A clear distinction between the two is necessary for proper measurement of income. Regular sales and consignment, both, involve the shipment of merchandise. Title does not pass when merchandise is shipped under consignment agreement. Thus, no revenue and profit should be recognized at the time of the consignment shipment, because there is no change in ownership of merchandise. If the consignee's business should fail, the consignor would not be in a position of a creditor, instead the consignor is the owner of unsold merchandise that was initially consigned. Some reasons why a manufacturer or wholesaler prefers to consign merchandise rather than to make outright sales are:

- The consignor may be able to persuade dealers to stock the items on a consignment basis where they will not be willing to purchase the merchandise out right (regular sales)
- The consignor avoids the risk inherent in selling on account to credit customers of questionable financial strength
- From the stand point of a consignee the acquisition on consignment rather than by outright purchase requires less amount of capital investment and avoids the risk of loss if the merchandise cannot be sold and become obsolete.

3.2.3. Right and Duties of the Consignee

When merchandise is shipped on consignment, a contract is needed on such points as:

- Credit terms to be granted to customers by the consignee
- Expenditures of the consignee to be reimbursed by the consignor
- Commission allowed to the consignee – that may be 5% or 10%,etc
- Frequency of reporting and payment by the consignee

- Handling and care of the consigned merchandise

The general rights and duties of the consignee may be summarized as follows:

Rights of Consignee	Duties of Consignee
1.To receive compensation or commission for merchandise sold for the account of the consignor	1.To give reasonable care and protection in relation to the nature of the consigned merchandise
2.To receive reimbursement for expenditures such as freight & insurance made in connection with consignment	2.To keep the consigned merchandise separate from owned inventories or be able to identify the consigned merchandise. Similarly, the consignee must identify and segregate the consignment accounts receivable from other receivables.
3.To sell consigned merchandise on credit if the consignor has not forbidden credit sales	3.to use care in extending credit on sales of consigned merchandise and to be diligent in setting prices on consigned on consigned merchandise and in collecting consignment Accounts Receivables
4.to make the usual warranties as to the quality of the consigned merchandise and to bind the consignor honor such warranties	4.to render complete report of sales of consigned merchandise and to make appropriate and timely payments to the consignor

In granting credit as in caring for the consigned merchandise, the consignee is obliged to act prudently and to protect the property rights of the consignor of consigned merchandise are the property of the consignor.

- Because the receivables from the sale of consigned merchandise are the property of the consignor, the consignor bears any credit losses provided that the consignee has exercised due care in granting credit and making collections.
- However, the consignee may guarantee fee collection of consignment account receivable; under this type of consignment contract, the consignee is said to be a del credereagent

The consignee also must follow any special instructions by the consignor as to care of the consigned merchandise. If the consignee acts prudently in providing appropriate care and protection for the consigned merchandise, the consignee is not liable for any damage to the merchandise that may occur.

3.2.4. The Account Sale (Report of Sales)

The report rendered by the consignee to the consignor is called an Account Sale which includes information such as:

- The quantity of merchandise received and sold
- Expenditures made by the consignee that must be reimbursed by the consignor
- Cash advances made by the consignor to the consignee
- Amounts owed or remitted to the consignor

The consignee makes payments to the consignor as portions of the merchandise are sold or payments may not be required until all the consigned merchandise either has been sold or has been returned to the consignor.

3.2.5. Accounting for the Consignee

The receipt of the consignment shipment could be recorded by the consignee in several ways. The objective is to create a memorandum record of the consigned merchandise; no purchase has been made and no liability exists. Therefore the receipt of the consignment could be recorded by a memorandum notation in the general journal, or by an entry in a separate ledger of consignment shipments, or by a memorandum entry in a general ledger account entitled Consignment In.

Example 3.3: ABC Electronics Trading (located in Dessie) ships 10 units of Television Sets to XYZ Trading at Bahir Dar on consignment basis on August 1, 2018. Each unit is to be sold at Br 400. The consignee is to be reimbursed for freight costs Br 135 and is to receive a commission of 20% of the authorized selling price. After selling all the consigned merchandise, XYZ Trading has to send to the consignor an account sale.The journal entries to record different transactions by Consignee are as follows:

a) To record the payment of freight costs on the shipment from the consignor

Consignment-in –ABC Electronics………………..135
Cash……………………………………………..135

b) Sold 10 TV Sets at a stipulated selling price

Cash……………………………………………4,000
Consignment-in – ABC Electronics…………….4, 000

c) Commission of 20% earned on TV setssold

Consignment-in –ABC Electronics ……………..…800
Commission Revenue – Consignment Sales ………800

d) Payment in full toConsignor

Consignment-in –ABCElectronics……………..…3,065
Cash………………………………………..3,065

After posting all the four journal entries above; the consignment-in account in the accounting records of the consignee appears as follows:

Consignment In – ABC Electronics

Date	Explanation	Debit	Credit	Balance
	Received 10 units of TV Sets to be sold for Br 400 each at a commission of 20% of selling price			
	Fright Costs paid by consignee........................	135		135 dr
	Sales of the merchandise (Br 400 @ 10 units)...		4,000	3,865cr
	Commission revenue (Br 4,000 @20%)...........	800		3,065cr
	Payment to Consignor.....................................	3,065		-0-

After selling all the consigned merchandise XYZ Trading sends ABC Electronics an Account Sales which is presented in the following manner:

XYZ Co.
Bahir Dar, Ethiopia
Account sales
Aug. 31, 2018

Sales for account and risk of:
ABC Electronics.
Dessie, Ethiopia

Sales; 10 TV sets @ $400		$4,000
Charges:		
Freight costs	$135	
Commission (4,000 x 0.20)	800	935
Balance (remittance to consignor)		$3,065
Consigned TV sets on hand		none

There might be several variations from the pattern of journal entries illustrated above:

- If a freight cost on consigned goods is charged to Freight in account, it should later be reclassified by a debit to Consignment In and a credit to Freight In

- If an advance is made by the consignee to the consignor, it is recorded as a debit to the Consignment In account, and the final payment is reduced by the amount of advance
- If merchandise is received on consignment from several consignors, a controlling account entitled Consignments In may established in the general ledger, and a supporting account for each consignment set up in a subsidiary consignments ledger.
- Consignment In may have debit balance or credit balance. A debit balance will exist in a Consignment In account if the total of expenditures, commissions, and advances to the consignor is larger than the proceeds of sales of that particular lot of consigned merchandise. A credit balance will exist if the proceeds of sales are in excess of the expenditures, commissions, and advances to the consignor. The total of the Consignment In accounts with debit balance should be included among the current assets in the balance sheet; the total of the Consignment In accounts with credit balance should be classified as a current liability.

3.2.6. Accounting for Consignors

When a consignor ships merchandise to the consignees, it is essential to have a record of the location of this portion of inventories. Therefore, the consignor may establish in the general ledger a Consignment Out account for every consignee. If consignment shipments are numerous, the consignor may prefer to use a controlling account for subsidiary Consignment-Out ledger account. The Consignment-Out ledger account represents a special category of inventories.

Should gross profit on consignment be determined separately?

There are different alternatives as an accounting method for consignors: A separate determination of net income on consignment sales and a separate determination of gross profits on consignment sales. Another possibility to consider is a separate determination of consignment revenue apart from other sales revenue. Determination of a separate net income from consignment sales seldom is feasible, because this would require allocations of many operating expenses on a rather arbitrary basis. Thus, determination of net income from the consignment sales cannot be justified.

The determination of gross profits from consignment sales as distinguished from gross profits on other sales is much simpler, because it is based on the identification of direct costs associated with the consignments.

The choice of accounting methods by the consignor depends on whether

1. Consignment gross profit are measured separately from the gross profit on regular sales; or
2. Sales on Consignment are merged with regular sales without any effort to measure gross profit separately for the two categories of sales.

The journal entries required under these alternative methods of accounting for consignment shipments now will be illustrated, first under the assumption that gross profits on consignment sales are to be determined separately and second under the assumption that consignment sales are to be merged with regular sales

Example 3.4*:*

ABC Electronics Trading (located in Dessie) ships 10 units of Television Sets which has cost Br 250 each to XYZ Trading at Bahir Dar on consignment basis on August 1, 2018. Each unit is to be sold at Br 400. The cost of packing the merchandise for shipment was Br 30; all costs incurred in the packing department are charged to the Packing Expense account. The consignee paid freight charges of Br 135 to an independent truck line to deliver the shipment. All 10 TV sets were sold by the consignee for Br 400 each. After deducting the commission of 20% and the freight charges of Br 135, the Consignee sent the Consignor a check for Br 3,065. The Consignor uses perpetual inventory system.

Instruction: Pass the necessary journal entries and determine the balance of consignment out account assuming that:

1. Gross profit on consignment sales are determined separately ;and
2. Gross profits on consignment sales are not determined separately

1. Gross profit on consignment sales are determined separately

Shipment of merchandise costing Br 2,500 on consignment	Consignment out- XYZ ....2,500 Inventories......................... 2,500
Packing expenses of Br 30 allocated to consigned merchandise. It is recorded as packing expense	Consignment out- XYZ ....30 PackingExpenses.............. 30
Consignment sales of Br 4,000 reported by consignee and payment of Br 3,065 received after the consignee deducts Br135 freight charges and commission of Br 800	Cash ....3,065 Consignment out- XYZ ....135 Commission Expense .... 800 ConsignmentSales.............. 4,000
Cost of consignment sales recorded, Br 2,665(Br 2,500 + Br 135 + Br 30 = Br 2,665)	Costs ofConsignmentsales............ 2,665 Consignmentout- XYZ......... 2,665

e. Summary of Consignment Out Account

Consignment-Out: XYZ Trading

Cost of goods shipped	2,500		
Packing Expenses	30		
Freight Costs	135		
		2,665	Consignment costs
	<u>2,665</u>	<u>2,665</u>	

f. Presentation in incomestatement:

ConsignmentSales...Br4,000
Less: Cost ofconsignmentsales………………………Br 2,665
Commission.. <u>800</u> <u>3,645</u>
Gross Profit on consignmentsales... <u>B</u>r535

2. Gross profits on consignment sales are not determined separately

a) Shipment of merchandise costing Br 2,500 on consignment	Consignment-Out: XYZ............... 2,500 Inventories......................... 2,500
b) Packing expenses of Br 30 allocated to consigned merchandise. It is recorded as packing expense	No journal entry required, total packing expense is reported among

c) Consignment sales of Br 4,000 reported by consignee and payment of Br 3,065 received after the consignee deducts Br135 freight charges and commission of Br 800	Cash .... 3,065 Freight Expense.............................. 135 Commission Expense ....800 Sales.................................... 4,000

Cost of goods shipped	2,500	2500	Consignment costs
	2,500	2500	

d) Cost of consignment sales recorded, Br 2,500	Costs of goods sold .... 2,500 Consignment out-XYZ.......... 2,500

e) Summary of Consignment-Out Account

Consignment-Out: XYZ Trading

f) Presentation in income statement:

Included in total sales Br4,000
Included in cost of all merchandise sold............................Br2,500
Included in total packing expense................................... 30
Included in total freight expense..................................... 135
Included in total commission expense............................ 800

3.2.7. Accounting for partial sale of consigned goods

Determining the gross profit assuming that the entire consignment had been sold by the consignee is relatively simple. When there is a partial sale of consigned goods, the consignor must determine the amount of gross profit realized on the partial sale rather than the entire sale. Example: take the previous illustration except that only four of the 10 TV sets consigned by ABC Electronics had been sold by the end of the accounting period. The account sales received at the end of the current period includes the following information:

XYZ Trading
Account sales to ABC Electronics

Sales: 4 TV sets @ $400		$1,600
Charges: Freight costs	135	
Commission (1,600 x 0.2)	320	455
Total payable to consignor		$1,145

Less: Check enclosed	500
Balance payable to consignor	$645
Consigned merchandise on hand	6 TV sets

1. Gross profit on consignment sales are determined separately

a) Shipment of merchandise costing Br 2,500 on consignment	Consignment-Out:- XYZ .... 2,500 Inventories............................. 2,500
b) Packing expenses of Br 30 allocatedto consigned merchandise. It is recorded as packingexpense	Consignment-Out:- XYZ .... 30 PackingExpenses.................. 30
c) Consignment sales of Br 1,600 reported by consignee and payment of Br 500 received. Charges by consignee: Br 135 freight charges; and commission of Br 800	Cash... 500 Accounts Receivable............................ 645 Consignment-Out:- XYZ .... 135 Commission Expense-CS......................320 Consignment Sales................... 1,600
d) Cost of consignment sales recorded, Br 1,066 (4 @ (Br 250 + Br 3 + Br 13.5))	Costs of Consignment sales............... 1,066 Consignment-Out:- XYZ 1,066
e) Direct cost relating to unsold merchandise in hands of consignee deferred when profits are not determined separately: Packing costs, 6 @Br 3........................Br18 Freight costs, 6 @Br13,50 ....81 Total...Br99	No journal entry is required

f) Summary of Consignment Out Account

Consignment-Out: XYZ Trading

Cost of goods shipped	2,500	1,066	
Packing Expenses	30	1,599	Balance
Freight Costs	135		
	2,665	2,665	
Balance	1,599		

f) Presentation in balance sheet

Current Assets:

Inventories on Consignment Br1, 599

2. Gross profit on consignment sales are not determined separately

a) Shipment of merchandise costing Br 2,500 on consignment	Consignment-Out: - XYZ .... 2,500 Inventories............................. 2,500
b) Packing expenses of Br 30 allocated to consigned merchandise. It is recorded as packing expense	No journal entry is required; total packing expense is reported among operating expenses
c) Consignment sales of Br 1600 reported by consignee and payment of Br 500 received. Charges by consignee: Br 135 freight charges; and commission of Br 800	Cash.. 500 AccountsReceivable..............................645 Freight Expense....................................135 Commission Expense-CS......................320 Sales....................................... 1,600
d) Cost of consignment sales recorded, Br 1,000 (4 @ Br 250 = Br 1,000)	Costs of Goods sold .... 1,000 Consignment out–XYZ 1,000
e) Direct cost relating to unsold merchandise in hands of consignee deferred when profits are not determined separately: Packing costs, 6 @Br3.........................Br18 Freight costs, 6 @Br13,50 ....81 Total..Br99	Consignment-Out: XYZ....................... 99 Packing Expense................. 18 Freight Expense................. 81

f) Summary of Consignment Out Account

Consignment-Out: XYZ Trading

	2,500	1,000	
	99	1,599	Balance
	2,599		
Balance	1,599	2,599	

f) Presentation in balance sheet

Current Assets:

Inventories on Consignment Br1, 599

3.2.8. Other issues in Consignment Contracts

- **Return of unsold merchandise by consignee**

The costs of packing and shipping merchandise to a consignee, whether paid directly by the consignor or by the consignee, properly are included in inventories. However, if the consignee for any reason returns merchandise to the consignor, the packing and freight costs incurred on the original outbound shipment should be written off as expense of the current period. The place utility originally created by these costs is lost when the merchandise is returned. Any charges borne by the consignor on the return of shipment also should be treated as expense, along with any repair expenditures necessary to place the merchandise in salable condition.

A clear distinction should be made between freight costs on consignment shipments and outbound freight on regular sales. The latter is a current expense, because the revenue from sale of the merchandise is recognized in the current period. The freight costs on consignment shipment create an increment in value of the merchandise which is still the property of the consignor. This increment, along with the cost of acquiring or producing the merchandise, is to be offset against revenue in a future period when the consigned merchandise is sold.

- **Advances from consignees**

Although cash advances from a consignee sometimes are credited to the Consignment Out account, a better practice is to credit a liability account, Advances from consignees. The Consignment Out account will then continue to show the carrying amount of the merchandise on consignment rather than being shown net of a liability to the consignee.

- **Nature of the consignment out account**

There is a need to understand where Consignment Out belongs in the basic five types of accounts: assets, liabilities, owners' equity, revenue, and expenses. The Consignment Out account belongs in the asset category. The account is debited for the cost of merchandise shipped to a consignee; when the consignee reports sale of all or a portion of the merchandise, the cost is transferred from Consignment Out to Cost of Consignment Sales. To be even, more specific, Consignment Out is a current asset, one of the inventories group to be listed on the balance sheet as Inventories on Consignment, or perhaps combined with other inventories if the amount is not material. The costs of packing and transporting consigned merchandise constitute costs of inventories, and these costs should be debited to the Consignment Out account.

3.3. Summary

Installment sale is a sale of real or personal property or services which provides for a service of payments over a period of months or years. A down payment usually, but not always, is required. Since, the seller must wait a considerable period of time to collect the full sales price, it is customary to provide interest on the unpaid balances and to add carrying charges to the listed selling price.

In some business, the risk of non-collection may be go great as to raise doubts as to the recognition of any revenue or profit at the point of sale. The first objective in development of accounting policies for installment sales should be reasonable matching of expenses and revenue. The methods for recognition of profits on installment sales are;

- the accrual basis of accounting(recognition of gross profit at the time of sale)
- the cost recovery method of accounting, and
- The installment method of accounting.

The term consignment indicates transfer *of possession* of merchandise from the owner to another person who acts as the sales agent of the owner. *Title* to the merchandise remains with the owner, who is called a *consignor*; the sales agent who has possession of the merchandise is called a *consignee*.

When a consignor ships merchandise to the consignees, it is essential to have a record of the location of this portion of inventories. Therefore, the consignor may establish in the general ledger a Consignment Out account for every consignee. If consignment shipments are numerous, the consignor may prefer to use a controlling account for subsidiary Consignment-Out ledger account. The Consignment-Out ledger account represents a special category of inventories.

3.4. Self-Test Questions

Now, this chapter is completed you must have to test your progress by doing the following self-test and compare your answer with the answer key given at the end.

Multiple Choices

1. The method of accounting for installment sales which reports the full gross profit in the year of sale is;

A. Installment method
B. Cost recovery method
C. Accrual method
D. None of the above

2. David sold a piece of land to Dawson for $50,000. The land originally cost $350,000. Dawson made a down payment of $50,000 and signed an installment contract calling for annual payments of $25,000 and 10% interest on the outstanding balance. The gross profit percentage is ;
   A. 30%
   B. 40%
   C. 60%
   D. 20%
3. What does the balance in a consignment- out account represent?
   A. The amount that a consignee owes to a consignor at any time
   B. The consignor`s cost of all consignment inventories being held by consignees.
   C. The amount of consignment sales made by the consignee during the current period.
   D. The net of all consignment cost incurred by the consignor less all receipts from the consignee.
4. On January 1, 2018, ABC sold a machine that costs $50,000 for a down payment of $35,000 and three annual payments of $18,000. Payments begin on December, 31,2018. If ABC uses the cost recovery method, how much profit will be reported in 2018?
   A. $3000
   B. $0
   C. $35,000
   D. $18,000
5. Consignment marketing is a popular means by which companies can get wide distribution of their products. Which of the following statement is true?
   A. The consignor has no risks.
   B. The consignor is guaranteed all the goods will be sold.
   C. The consignor might be willing to attempt to sell goods that it would otherwise not carry.
   D. The consignor has no costs to record as a result of this type of marketing.

CHAPTER FOUR

BUSINESS COMBINATIONS

Learning objectives:

Dear students, after successfully completing this chapter you will be able to:

- ☞ Describe the nature and types of business combination.
- ☞ Identify the defensive tactics used to block business combinations through hostile takeover.
- ☞ Describe the reasons for business combinations.
- ☞ Identify the techniques for arranging business combinations.
- ☞ Distinguish the accounting methods for business combinations.
- ☞ Learn about the alternative forms of business combinations, from both the legal and accounting perspectives
- ☞ Understand alternative approaches to the financing of mergers and acquisitions
- ☞ Introduce concepts of accounting for business combinations emphasizing the purchase method
- ☞ Understand how firms make cost allocations in a purchase method combination

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4.1.Nature of Business Combinations

Business combinations have been a common business transaction since the start of commercial activity. It is the group of acquisition of all of a company's assets at a single price. According to the Financial Accounting Standards Board, a ***business combination*** is an event or a procedure, in which, an enterprise acquires net assets that constitute a business or acquires equity interests of one or more other enterprises and obtains control over that enterprise or enterprises. Commonly, business combinations are often classified as ***mergers and acquisitions/consolidation.*** The term merger applies to when an existing company acquires another company and combines that company's operation with its own. The term acquisition/consolidation applies when two or more previously separate firms merge in to one new, continuing company.

4.2. Definition, Classes, Reasons and Types of Business of Combination

4.2.1. Definition of Business Combination

Business combinations are events or transactions in which two or more business enterprises, or their net assets, are brought under common control in a single accounting entity. According to the Financial Accounting Standards Board, a business combination is an event or a procedure, in which, an entity acquires net assets that constitute a business or acquires equity interests of one or more other entities and obtains control over that entity or entities *(SFAS No. 141)*.

Amalgamation *– two or more firms may amalgamate, either by taking over or by the formation of a new firm. A decision to amalgamate shall be taken by each of the firms concerned. Special meetings of shareholders of different classes or meetings of debenture holders shall approve the taking over or being taken over* ***(Art.549 & 550, Commercial Code of Ethiopia)***

The Financial Accounting Standards Board has suggested the following definitions for terms used in business combinations:

- ✓ **Combined Enterprise**: The accounting entity that results from a business combination.
- ✓ **Constituent Companies:** The business enterprises that enter into a combination.
- ✓ **Combinor:** A constituent company entering into a combination whose owners as a group ends up with control of the ownership interests in the combined enterprise.
- ✓ **Combinee:** A constituent company other than the combinor in a business combination. The term acquired, acquiree and combinee can be used interchangeably.

The following are the assertions relating to business combinations as per SFAS No.141

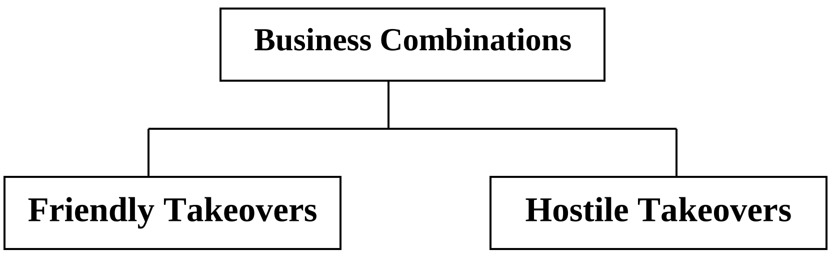
1. Business combination is a transaction or other event in which an acquirer obtains control of one or more businesses.
2. An acquirer can be identified in every business combination.
3. The business combination acquisition date is the date the acquirer obtains control of the acquiree.
4. A business combination is accounted for by applying the acquisition method.

5. By obtaining control of an acquiree, an acquirer becomes responsible and accountable for all of the acquiree's assets, liabilities, and activities, regardless of the percentage of its ownership in the acquiree.

? Dear learner! Explain business Combination?

4.2.2. Classes of Business Combinations

Business combinations are classified into two classes based on nature: friendly takeovers and unfriendly (hostile) takeovers.



- In a friendly takeover, the boards of directors of the potential combining companies negotiate mutually agreeable terms of a proposed combination. The proposal is submitted to share holders of all constituent companies for approval.
- Unfriendly (hostile) takeover - results when the board of directors of a company targeted for acquisition resists the combination. The target combinee uses one or more of the several defensive tactics.

4.2.2.1.Defensive Tactics for Hostile Takeovers

A target company has various options on how to fight a hostile takeover, which is also called a hostile merger. The target company generally obtains assistance of an investment banker and lawyer to ensure that fighting the hostile takeover will be successful. The common tactics used by target companies to defend hostile takeovers are:

1. **Inform shareholders:** Target companies may **inform shareholders** why the merger will be disadvantageous for the company.
2. **Repurchase of stock:** is sometimes undertaken by companies to decrease the attractiveness of the target company for hostile takeover. Mergers can be attractive due to a company's liquidity

position. If the company has a lot of cash, it can be used to cover all or part of the debt undertaken to finance the acquisition. By using available cash to repurchase stock, the firm decreases its attractiveness as a takeover target. Moreover, repurchase of shares increases the price per share which makes takeover more expensive.

3. ***Pac-man Defense:*** Pac-Man defense is a hostile defense strategy named after the popular arcade video game of the 1980's. According to this strategy, the target company "turns the tables" and attempts to acquire an acquiring company which attempted the hostile takeover. Although these hostile takeover defense strategies may not be successful, there are costs such as transaction costs which are involved in undertaking them. Transaction costs may include hiring of investment bankers and lawyers. In making decisions whether or not to undertake any defense actions against hostile takeovers, management needs to continue to act in the best interests of shareholders by keeping the maximization of the shareholders' wealth as the main objective.
4. ***White Knight:*** is another hostile takeover defense strategy. It involves finding a more appropriate acquiring company that will take over the target company on more favorable terms and at a better price than the original bidder. White knights are seen as a protector of the target company against the **black knight** which is the acquiring company which attempted a hostile takeover.
5. **Golden parachute:** is another way to discourage hostile takeover. This strategy means including provisions in the employment contracts of top executives which will require a large payments to key executives if the organization is taken over. Nevertheless, the

6. amounts to be paid are small relative to the size of the transaction. Therefore, this strategy may not be sufficiently effective on its own but will make the acquisition target less attractive.
7. ***Scorched Earth:*** The disposal, by sale or by spin-off to stockholders, of one or more profitable business segments.
8. **Leveraged recapitalization:** is yet another way to deter hostile takeovers. It refers to the distribution of a sizable dividend financed by debt. This increases the financial leverage of the target company and decreases its attractiveness.
9. ***Poison Pill:*** The term **poison pill** was created by mergers and acquisitions lawyer Martin Lipton in the 1980's and refers to a further hostile takeover defense strategy. It involves an arrangement that will make the target company's stock unattractive for the acquiring company. The poison pill strategy includes two main variations. Such variations are flip-in and flip-over. **Flip-in** tactic occurs

when management offers to buy shares at a discount to all investors except for the acquiring company. Such an option is exercised when the acquiring company purchases a certain amount of the shares of the target company. **Flip-over** occurs where the Target Company will be able to purchase shares of the acquiring company at a discount after the merger is completed. This will decrease the value of the acquiring company's shares and dilute the company's control. The poison pill can be effective in discouraging a hostile takeover and allows the target company more time to find a white knight. Yahoo is a famous example of a company that uses poison pill as a defense strategy. It will be exercised if any company or investor buys more than 15% of its shares without the approval of the board of directors.

10. ***Green Mail:*** is another defensive strategy. It leads to the target company buying a large bulk of shares from one or more shareholders which attempt a hostile takeover. An acquisition of common stock presently owned by the prospective combinor at a price substantially in excess of the prospective combinor's cost, with the stock thus acquired placed in the treasury or retired.
11. **Crown jewel:** the target company may also use the **crown jewel defense** strategy. **Crown jewels** refer to the most valuable assets and parts of the company. According to this strategy, the target company has the right to sell its best and most profitable assets and valuable parts of the business to another party if a hostile takeover occurs. This discourages hostile takeovers as it makes the target company less attractive.

? What are the classes of business combination?

? Explain the defensive tactics used to block business combinations through hostile takeover.

4.2.3. Reasons for Business Combination

Why do business enterprises enter into a business combination? There are a number of reasons for business combinations which are discussed as follows:

1. **Growth**

In recent years Growth has been main reason for business enterprises to enter into a business combination. Firms can achieve growth through external and internal methods. The external (e.g. business combination) method of achieving growth is more rapid than growth through internal methods, as per advocates of external method. There is no question that expansion and diversification of product lines, or enlarging the market share for current products, is achieved readily through a business combination with another enterprise. Combinations enable satisfactory and balanced growth of an enterprise. The company can cross many stages of growth at one time through combination. Growth through combination is also cheaper and less risky. By acquiring other enterprises, a desired level of growth can be maintained by an enterprise. When an enterprise tries to enter new line of activities, it may face a number of problems in production, marketing, purchasing. Business combination enables to acquire or merge with an enterprise already operating indifferent lines that have crossed many obstacles and difficulties. Combination will bring together experiences of different persons in varied activities. So combination will be the best way of Growth.

2. **Better Management**

Combinations results in better management. Combinations result running the large scale enterprises. A large enterprise can offer to use the service of expertise. Various managerial functions can be efficiently managed by those persons who are qualified for such jobs. This is not possible for small individual enterprises.

3. **Economies of Scale**

A combined enterprise will have more resources at its command than the individual enterprises. This will help in increasing the scale of operations so that economies of large scale will be availed. The economies of scale will occur as a result of more intensive utilization of production facilities, distribution network, research and development facilities, etc. The economies of scale will lead to financial synergies

4. **Operating Economies**

A number of operating economies will be available with the combination of two or more enterprises. Duplicating facilities in accounting, purchasing, marketing, etc will be eliminated. Operating inefficiencies of small concerns will be controlled by superior management emerging from the combinations. The acquiring company will be in a better position to operate than the acquired companies individually. Whether the horizontal or vertical business combinations, it may provide operating synergies when the duplicated facilities are eliminated.

5. **Tax advantages.**

When an enterprise with accumulated losses merges with a profit making enterprise, it is able to utilize tax shields (benefits). An enterprise having losses will not be able to set-off losses against future profits, because it is not a profit earning unit. On the other hand, if it merges with an enterprise earning profits then the accumulated losses of one unit will be set-off against future profit of the other unit. In this way, combinations will enable an enterprise to avail tax benefits. The tax law that permits setting off losses is either Loss Carry Forward or Loss Carry Back.

6. **Diversification of business risk**.

When one company involves business combination, it can diversify risks of operations. A Company involving business combination can minimize risks as the enterprise is diversifying operation or line of their activity. Since different companies are already dealing in their respective lines, there will be risk diversification.

7. **Acquisition of Intangible Assets**

Business combinations bring together both intangible and tangible resources. Thus, the acquisition of patents, mineral rights, research, customer databases, or management expertise may be a primary motivating factor in a particular business combination.

8. **Fewer Operating Delays**

Plant facilities acquired through a business combination are operative and already meet enviroSageental and other goverSageental regulations. The time to market is critical, especially in the technology industry. Firms constructing new facilities can expect numerous delays in construction, as well as in getting the necessary goverSageental approval to commence operations. EnviroSageental impact studies alone can take months or even years to complete.

9. **Cost advantage**

It is frequently less expensive for a firm to obtain needed facilities through combination than through development, especially during periods of inflation.

10. **Avoidance of Takeovers**

Many companies combine to avoid being acquired themselves. Smaller companies tend to be more vulnerable to corporate takeovers, so many of them adopt aggressive buyer strategies as the best defense against takeover attempts by other companies.

11. Better Financial Planning

A combined enterprise will be able to plan their resources in a better way. The collective finance of merged enterprises will be more and their utilization may be better than in separate enterprises. It may happen that one of the merging enterprises has short Gestation period (A period of time from making investment to collecting the returns) while the other has longer Gestation period. The profits with short gestation period will be utilized to finance the other enterprise with long gestation period. When the enterprise with longer gestation period starts earning profits then it will improve financial position as a whole.

12. Elimination of Fierce Competition

Combination of two or more enterprises will eliminate competition among them. The enterprises will be able to save their advertising expenses. This enables the combined enterprise to reduce prices. The consumer will also benefit in the form cheaper goods being made available to them.

? Why do business enterprises enter into a business combination?

4.2.4. Types of Business Combinations

There are three types of business combinations: Horizontal Combination, Vertical Combination, and Conglomerate Combination:

1. **Horizontal Combination:** is a combination involving enterprises in the same industry. E.g. assume combination of Coca Cola and Pepsi Company**.**
2. **Vertical Combination:** A Combination involving an enterprise and its customers or suppliers. It is a combination involving companies engaged in different stages of production or distribution. It is classified into two: Backward Vertical Combination – combination with supplier and Forward Vertical Combination – combination with customers. **E.**g.1: A Tannery Company acquiring a Shoes Company -Forward

E.g.2: Weaving Company acquiring both Ginning and Spinning Company - Backward

3. **Conglomerate (Mixed) Combination:** is a combination involving companies that are neither horizontally nor vertically integrated. It is a combination between enterprises in unrelated industries or markets.

? Dear Learner! Explain the types of business combination?

Antitrust Considerations

Antitrust litigations are one obstacle faced by large corporations that undertake business combinations. A business combination that leads to lessen the competition or tend to create a monopoly is not allowed by the goverSageent. GoverSageent on occasion has opposed concentration of economic power in large business enterprises as the formation of monopoly discourages competition. Antitrust is a law that encourages perfect competition and discourages monopoly. Business combinations may lead to formation of monopoly so that they are challenged department of goverSageent. The type of combination determines the degree of concentration of economic power. Ho*rizontal* combinations create the largest concentration of economic power and play a negative role in discouraging competition than the other two types of business combinations.

4.3. Methods for Arranging Business Combinations

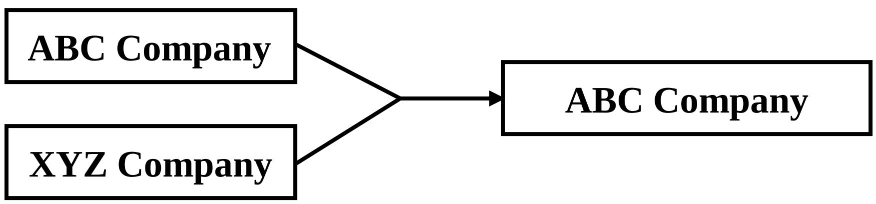
The four common methods for carrying out a business combination are:

- Statutory Merger
- Statutory Consolidation,
- Acquisition of Common Stock, and
- Acquisition of Assets

1. Statutory Merger

Statutory Merger is a merger in which one of the merging companies continues to exist as a legal entity while the other or other are dissolved. A business combination in which one company (the survivor) acquires all the outstanding common stock of one or more other companies that are then dissolved and liquidated, with their net assets owned by the survivor. The ***survivor*** can effect the transaction by exchanging voting common stock or preferred stock, cash, or long-term debt (or a combination of these) for all of the outstanding voting common stock of the acquired company or companies. It is executed under provisions of applicable state laws. The boards of directors of the constituent companies normally negotiate the terms of a plan of merger, which must then be approved by the stockholders of each company involved. In a statutory merger, one or more of the combinee companies are liquidated and thus cease to exist as separate legal entities, and their activities often are continued as ***divisions*** of the survivor, which now owns the ***net assets*** (assets minus liabilities), rather than the outstanding common stock, of the liquidated corporations.

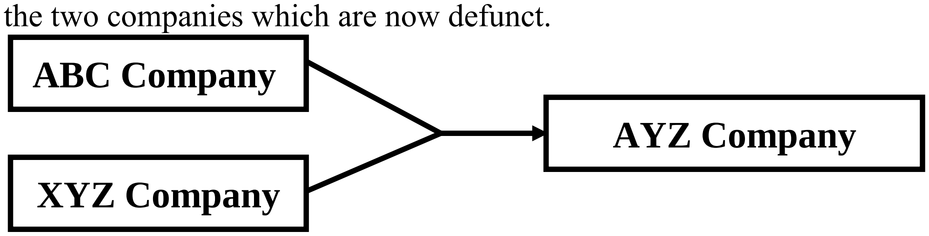
E.g. ABC Company acquires all the outstanding common stock (net assets) of XYZ Company where XYZ Company is legally liquidated



2. Statutory Consolidation

Statutory Consolidation is a business combination in which a new corporation issues common stock for all outstanding common stock of two or more other corporations that are then dissolved and liquidated, with their net assets owned by the new corporation. It is a merger in which a new corporate entity is created from the two or more merging companies, which cease to exist. It differs from statutory merger, in which one survives as a legal entity from two or more constituent companies.

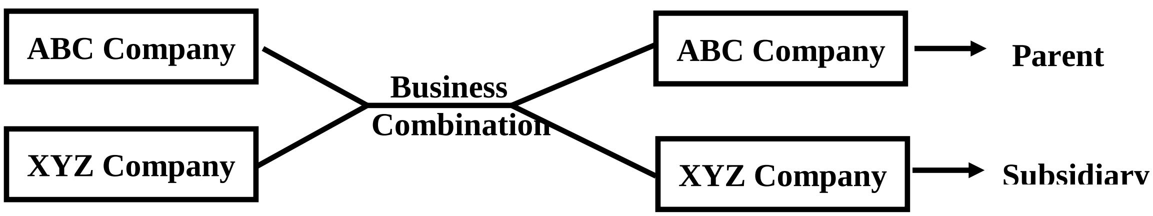
E.g. ABC Company acquires XYZ Company; but a new Company AYZ is created to issue common stocks for the two companies which are now defunct.



3. Acquisition of Common Stock

One corporation (the ***investor***) may issue preferred or common stock, cash, debt, or a combination thereof to acquire a controlling interest in the voting common stock of another corporation (the investee). This stock acquisition program may be accomplished through direct acquisition in the stock market, through negotiations with the principal stockholders of a closely held corporation or through a tender offer to stockholders of a publicly owned corporation. A ***tender offer*** is a publicly announced intention to acquire, for a stated amount of consideration, a maximum number of shares of the combinee's common stock "tendered" by holders thereof to an agent, such as an investment banker or a commercial bank. The price per share stated in the tender offer usually is well above the prevailing market price of the combinee's common stock. If a controlling interest in the combinee's voting common stock is acquired, that corporation becomes ***affiliated*** with the combinor (***parent company)*** as a ***subsidiary*** but is not dissolved and liquidated and remains a separate legal entity. The business combination through this method requires authorization by the combinor's board of directors and may require ratification by the combinee's stockholders. Most hostile takeovers are accomplished by this means.

E.g. ABC Company acquires over 50% of the voting stock of XYZ Company, a parent–subsidiary relationship results and XYZ Company is now a subsidiary of ABC Company (Parent)



4. Acquisition of Assets

A business enterprise may acquire all or most of the gross assets or net assets of another enterprise for cash, debt, preferred or common stock, or a combination thereof. The transaction generally must be approved by the boards of directors and stockholders of the constituent companies. The selling enterprise may continue its existence as a separate entity or it may be dissolved and liquidated; it does not become an ***affiliate*** of the combinor.

Summary of Methods for Arranging Business Combinations

Type of Combination	***Action of Acquiring Company***	***Action of Acquired Company***
Statutory Merger	Acquires all stock or net assets and then transfers assets & liabilities to its own books.	Dissolves & goes out of business. It may also remain as separate division of the acquiring company
Statutory Consolidation	Newly created to receive assets or capital stock of original companies	Both original companies may dissolve while remaining as separate divisions of newly created company.
Acquisition of	Acquires more than 50% stock	Remains in existence as legal

Common Stock	that is recorded as an investment. Controls decision making of acquired company.	corporation, although now a subsidiary of the acquiring company.
Acquisition of Assets	Acquires all or most of the gross assets	The acquiree company may remain in existence or may be liquidated but not a subsidiary of the acquiring company

The last two methods for carrying out a business combination, the combinor issues its common stock, cash, debt, or a combination thereof, to acquire the common stock or the net assets of the combinee. These two methods do not involve the liquidation of the combinee.

? Dear Learner! Differentiate between a statutory merger and a statutory consolidation.

4.4. Establishing Price for a Business Combination

Establishing the price for a business combination is a very important early step in planning a business combination. The price for a business combination consummated for cash or debt generally is expressed in terms of the total dollar amount of the consideration issued. When common stock is issued by the combinor in a business combination, the price is expressed as a ratio of the number of shares of the combinor's common stock to be exchanged for each share of the combinee's common stock

Illustration of Exchange Ratio The negotiating officers of Palmer Corporation have agreed with the shareholders of Simpson Company to acquire all 20,000 outstanding shares of Simpson common stock for a total price of Br 1,800,000. Palmer's common stock presently is trading in the market at Br 65 a share. Stockholders of Simpson agree to accept 30,000 shares of Palmer's common stock at a value of Br 60 a share in exchange for their stock holdings in Simpson. The exchange ratio is expressed as 1.5 shares of Palmer's common stock for each share of Simpson's common stock, in accordance with the following computation:

Number of shares of Palm corporation common stock tobeissued………………30,000
Number of shares of Simpson company stock tobeexchanged…………………..20,000

Exchange ratio: 30,000/ 20,000………………………………………………....1.5:1

The amount of cash or debt securities, or the number of shares of common or preferred stock, to be issued in a business combination generally is determined by variations of two methods:

1) Capitalization of expected average annual earnings of the combinee at a desired rate of return. Expected average income is calculated by taking the incomes earned during the recent years. The abnormal items, if any, included in the income of any year should be eliminated.
2) Determination of current fair value of the combinee's net assets (includinggoodwill).

Capitalization of Expected Average annual earnings

Example 4.1: Assume that the business earned the following profit for the last five years:

Year	**Net Income**
2001....................................	Br 90,000
2002....................................	110,000
2003....................................	120,000
2004....................................	140,000
2005....................................	130,000

Note: the Br 140,000 profit in the Year 2004 included extraordinary gain of Br 40,000 which is required to be excluded in the computation of expected average profit, and thus the profit for that same year is Br 100,000. The average operating income of the five years is expected to continue in the future and in this industry the average return on asset is 10% of the fair market value of the identifiable assets. **Instruction:** Determine the fair value of the assets under capitalization method.

- Calculation of Average expected future Income(earnings)

Average Expected Income = $\frac{90,000 + 110,000 + 120,000 + 100,000 + 130,000}{5}$ = **Br 110,000**

- Capitalized Fair Value of Assets = Br 110,000 / 10% = Br1,100,000

4.5. Accounting Methods for Business Combinations

There were two methods of accounting for business combinations: Pooling-of-Interest and Purchase Method. Some business combinations were accounted for under Pooling-of-Interest while some business combinations were accounted for under purchase accounting method, in the past.

1. Pooling-of-Interest Accounting

The original premise of the pooling-of-interests method was that certain business combinations involving the **issuance of common stock** between an issuer and the **stockholders of a combinee were** more in the nature of a **combining of existing stockholder** interests than an **acquisition of assets or raising of capital.** Combining of existing stockholder interests was evidenced by combinations involving common stock exchanges between corporations of approximately equal size. The shareholders and managements of these corporations continued their relative interests and activities in the combined enterprise as they previously did in the constituent companies. Because neither of the like-size constituent companies could be considered the **combinor** under the criteria set forth to determine combinor, the pooling-of-interests method of accounting provided for carrying forward to the accounting records of the combined enterprise the combined assets, liabilities, and retained earnings of the constituent companies at their **carrying amounts** in the accounting records of the constituent companies. The current fair value of the common stock issued to effect the business combination and the current fair value of the combinee's net assets are disregarded in a pooling of interests Under Pooling-of-Interest (Uniting Interest) accounting method, the balance sheet items of the two companies are simply added together. Pooling of interests was the preferable method to use because it doesn't result in the creation of goodwill. This in turn leads to higher reported earnings.

2. Purchase Accounting

Because the majority of business combinations involve an identified combinor and one or more combinees, many accountants consider it logical to account for business combinations, regardless of how consummated, as the acquisition of assets. Thus, assets (including goodwill) acquired in a business combination for cash would be recorded at the amount of cash paid, and assets acquired in a business combination involving the issuance of debt, preferred stock, or common stock would be recorded at the current fair value of the assets or of the debt or stock, **whichever was more clearly evident**.

Under purchased method change in the basis of accounting occurs, thus acquired entity's assets are to be recorded at their current fair values not at book value and goodwill is also created. This approach is known as purchase accounting for business combination, and was widely used prior to the increase in popularity of pooling-of-interests accounting. According to SFAS No. 141, the following principles should be used for applying Acquisition (Purchase) Method of Accounting for business combinations:

- ***Recognition Principle*** - in a business combination accounted for under purchase accounting, the acquirer recognizes all of the assets acquired and all of the liabilities assumed.
- ***Fair Value Measurement Principle*** - in a business combination, the acquirer measures each recognized asset acquired and each liability assumed and any non-controlling interests at its acquisition date fair value.
- ***Disclosure Principle*** – the acquirer should include the information in its financial statement so as to help users of financial statements evaluate the nature and financial effect of business combinations recognized by the acquirer. The disclosure should include primary reasons for the business combination; the allocation of purchase price paid to the assets acquired and liabilities assumed by major balance sheet caption; and when significant, disclosure of other information such as amount of goodwill by reportable segment and the amount of purchase price assigned to each major intangible asset class.

? Identify and explain accounting methods for business combinations.

Procedures under Purchase Method of Accounting for Business Combinations

1. **Determination of the Combinor or the Acquiring Company** – this steps deals with identification of the combinor
2. **Determination of the Acquisition Cost –** assets to be acquired and liabilities to be assumed are identified and then, like other exchange transactions, measured on the basis of the fair values exchanged. The Cost of combinee includes also some other costs as discussed below.
3. **Allocation of the Acquisition Cost –** when assets are acquired in groups, it requires not only ascertaining the cost of the asset (or net asset) group but also allocating that cost to the individual assets (or individual assets and liabilities) that make up the group.
4. **Determination of Goodwill –**The goodwill should be determined and recorded under purchased method
5. **Recording the Acquisition–** the transaction is recorded as of the date of business combination
6. **Consolidation of Financial Statement and Accounting after business combinations -** the nature of an asset and the manner of its acquisitions determines an acquiring entity's subsequent accounting for the asset (This will be discussed in chapter five)**.**

1. *Determination of the Combinor:*

To use the purchase method, one company must be designated as the "acquiring company or combinor". Because the carrying amounts of the net assets of the combinor are not affected by a business combination, the combinor must be accurately identified. Thus, FASB provided the following guidelines in SFAS No. 141 for identifying the combinor (acquiring company):

- The FASB stated that in a business combination effected solely by the distribution of cash or other assets or by incurring liabilities, **the** constituent company that **distributes cash or other assets or incurs liabilities** is generally the acquiring entity [SFAS 141, Par. 17].
- For combinations effected by the issuance of equity securities, the common theme is that the combinor is the constituent company whose stockholders as a group retains or receives the largest portion of the voting rights of the combined enterprise and thereby can elect a majority of the governing board of directors or other group of the combined enterprise. The company that issues the equity interest is generally the acquiring company. [SFAS141, Par. 18]

? How is the combinor in a purchase-type business combination determined?

2. *Determination of the Acquisition Cost (Cost of Combinee):*

The acquisition cost in a business combination accounted for by the purchase method is the total of:

- ✔ The amount of purchase consideration paid by the combinor.
- ✔ The combinor's direct out-of-pocket costs of the combination.
- ✔ Any contingent consideration that is determinable on the date of the business combination

A. ***Amount of Consideration*** - this is the total amount of cash paid, the current fair value of other assets distributed, the present value of debt securities issued, and the current fair (or market) value of equity securities issued by the combinor.

B. ***Out-of-Pocket Costs*** - included in this category are legal fees and finder's fees. A ***finder's fee*** is paid to the investment banking firm or other organizations or individuals that investigated the combine, assisted in determining the price of the business combination, and otherwise rendered services to bring about the combination. Costs of registering and issuing debt ***securities in*** a business combination are debited to Bond Issue Costs; they are not part of the cost of the combinee. Costs of registering and issuing ***equity securities*** are not direct costs of the business combination, but are offset against the proceeds from the issuance of the securities. Indirect out-of-pocket costs of the combination, such as salaries of officers involved in the combination, are expensed as incurred by the constituent companies.

Out-of-Pocket Costs of Business Combinations	
Direct out-of-Pocket Costs	**Indirect out-of-Pocket Costs**
Finders fees	Salary and overhead costs incurred in negotiation
Travel costs	Allocation of general expenses
Accounting fees	Fees associated with registering securities with SEC
Legal fees	Cost of issuing equity securities
Investment banker advisory fees	Cost of debt securities

Direct out-of-Pocket Costs are added to the Cost of Acquisition of Combinee where as indirect out-of-pocket costs are immediately expensed by the constituent companies.

C. ***Contingent Consideration***

Contingent consideration is additional cash, other assets, or securities that may be issuable in the future, contingent on future events such as a specified level of earnings or a designated market price for a security issued to complete the business combination.

- Contingent consideration that is **determinable on the consummation date** of a combination is recorded as part of the cost of the combination.
- Contingent consideration **not determinable on the date of the combination** is recorded when the contingency is resolved and the additional consideration is paid or issued (or becomes payable or issuable).

Illustration of Contingent Consideration - the contract for **Norton Company's** acquisition of the net assets of **Robinson Company** provided that Norton would pay Br 800,000 cash for Robinson's net assets (including goodwill), which would be included in the Robinson Division of Norton Company. The following contingent consideration also was included in the contract:

1) Norton was to pay Robinson Br 100 a unit for all sales by Robinson Division of a slow-moving product that had been written down to scrap value by Robinson prior to the business combination. No portion of the Br 800,000 price for Robinson's net assets involved the slow-moving product.
2) Norton was to pay Robinson 25% of any pre-tax accounting income in excess of Br 500,000 (excluding income from sale of the slow-moving product) of Robb Division for each of the four years subsequent to the business combination.

On January 2, Year 1, the date of completion of the business combination, Robinson Company had firm, non-cancelable sales orders for 500 units of the slow-moving product. The sales orders and all units of the slow-moving product were transferred to Norton by Robinson. Norton's cost of the net assets acquired from Robinson should include Br 50,000 (500 @ Br 100 = Br 50,000) for the determinable contingent consideration attributable to the backlog of sales orders for the slow- moving product. However, because any pre-tax accounting income of Robb Division for the next four years cannot be determined on January 2, Year 1, no provision for the 25% contingent consideration is included in Norton's cost on January 2, Year 1.

Subsequent Issuance of Contingent Consideration

Contingent consideration that is determinable on the date of a purchase-type business combination is included in the measurement of cost of acquisition. Any other contingent consideration is recorded when the contingency is resolved and the additional consideration becomes issuable or is issued. Returning to the Norton Company illustration, assume that by December 31, Year 1, the end of the first year following Norton's acquisition of the net assets of Robinson Company, another 300 units of the slow-moving product had been sold, and Norton's Robb Division had pre-tax accounting income of Br 580,000 (exclusive of income from the slow-moving product). On December 31, Year 1, Norton would prepare the following journal entry to record the resolution of contingent consideration:

Goodwill	50,000	
Payable to Robinson Company...............................		50,000

To record payable contingent consideration applicable to January2, 1999, business combination as follows:

Sale of slow-moving product (300@Br100)..	30,000
Pre-tax income of Robinson division [(580,000 –500,000@.25]………....	20,000
Total payable……………………………………………………………...	50,000

The additional goodwill in the foregoing journal entry is amortized over the remaining economic life of the goodwill recorded in the business combination. Some purchase-type business combinations involve contingent consideration based on subsequent market prices of debt or equity securities issued to effect the combination. Unless the subsequent market price equals at least a minimum amount on a subsequent date or dates, additional securities, cash, or other assets must be issued by the combinor to compensate for the deficiency.

3. Allocating Acquisition Cost (Allocation of Cost ofCombinee)

According to SFAS No. 141, the following principles for allocating cost of a combine in a purchase-type business combination are applicable:

- The cost of a combinee in a business combination must be allocated to assets (other than goodwill) acquired and liabilities assumed based on their estimated fair values on the date of the combination.
- Any excess of total costs of the acquired company over the amounts allocated to identifiable assets acquired less liabilities assumed is assigned to goodwill

Identifiable Assets and liabilities

As per SFAS No.141, methods for determining fair values of identifiable assets and liabilities of a purchased combinee included:

- Present values for receivables and liabilities;
- Net realizable values for marketable securities, finished goods and goods-in-process inventories, and for plant assets held for sale or for temporary use;
- Appraised values for intangible assets, land, natural resources, and non-marketable securities; and
- Replacement cost for inventories of material and plant assets held for long-term use.

In addition, the Financial Accounting Standards Board has provided the following guidelines:

1. The following combinee intangible assets were to be recognized individually and valued at fair value:
    - Assets arising from contractual or legal rights, such as patents, copyrights, andfranchises.
    - Other assets that are separable from the combinee entity and can be sold, licensed, exchanged, and the like, such as customer lists and non-patented technology.
2. A part of the cost of a combinee is allocable to identifiable tangible and intangible assets that resulted from research and development activities of the combined enterprise. Subsequently, such assts are to be expensed, as required by FASB Statement No. 2, unless they may be used for other than research and development activities in the future.
3. In a business combination, leases of the combinee-lessee are classified by the combined enterprise as they were by the combinee unless the provisions ofthe lease are modified to the extent it must be considered a new lease. Thus, uSageodified capital leases of the combinee are treated as

capital leases by the combined enterprise, and the leased property and related liability are recognized in accordance with the guidelines of FASB statement No.141.

4. A combinee in a business combination may have pre-acquisition contingencies, which are contingent assets (other than potential income tax benefits of a loss carry forward), contingent liabilities, or contingent impairments of assets, that existed prior to completion of the business combination. If so, an allocation period, generally not longer **than one year from the date the combination is completed**, may be used to determine the current fair value of a pre-acquisition contingency. A portion of the cost of a purchased combinee is allocated to a pre-acquisition contingency whose fair value is determined during the allocation period. Otherwise, an estimated amount is assigned to a pre-acquisition contingency if it appears probable that an asset existed, a liability had been incurred, or an asset had been impaired at the completion of the combination. Any adjustment of the carrying amount of a pre-acquisition contingency subsequent to the end of the allocation period is included in the measurement of net income for the accounting period of theadjustment.

4. *Determination of Goodwill*

Goodwill: When the **price paid** for a business exceeds the sum of the values assigned to identifiable assets, including intangible assets, the excess price is recorded as Goodwill. Goodwill cannot be recorded unless the price paid for a company exceeds the total fair values assigned to all identifiable assets, net of liabilities assumed. Goodwill reflects intangible assets that could not be measured separately and future benefits from other factors such as excess earning ability and achieving economies of scale. The amount of goodwill recognized on the date the business combination is consummated and may be adjusted subsequently when contingent consideration becomes issuable.

Negative Goodwill: In some purchase-type business combinations (known as bargain purchases), the current fair value assigned to the identifiable net assets acquired exceed the total cost of the combinee. Negative goodwill means an excess of current fair value of the combinee’s identifiable net assets over their cost to the combinor. A bargain purchase is most likely to occur for a combinee with a *history of losses* or when *common stock prices are extremely low*.

The excess of the current fair values over total cost is applied pro rata to reduce (but not below zero) the amounts initially assigned to *plant assets and intangible assets*. If any excess of current fair values over cost of the combinee’s net assets remains after the foregoing reduction, it is recognized as an *extraordinary gain by the combinor*.

? When does goodwill result from a business combination?

Illustration: Purchase Accounting for Statutory Merger, with Goodwill

On December 31, 2012, Mason Company (the combinee) was merged into Saxon Corporation (the combinor or the survivor). Both companies used the same accounting principles for assets, liabilities, revenue and expenses and both had a December 31 fiscal year. Saxon issued 150,000 shares of its Br.10 par common stock (current fair value is Br. 25 a share) to Mason's stockholders for all 100,000 issued and outstanding shares of no-par, Br. 10 stated value common stock. In addition, Saxon paid the following out of pocket costs associated with the business combination:

Accounting fees:	
For investigation of Mason as prospective combinee	Br. 5,000
For SEC registration statement for Saxon common stock	60,000
Legal fees:	
For the business combination	Br. 10,000
For SEC registration statement for Saxon common stock	50,000
Finder's fee	51,250
Printer's charges for printing securities and SEC reg statement	23,000
SEC registration statement fee	750
Total out of pocket expenses	Br. 200,000

There was no contingent consideration in the merger contract.

Immediately prior to the merger, Mason Company's condensed balance sheet was as follows:

Mason Company (combinee)

Balance Sheet (prior to business combination)

December 31, 2012

Assets:	
Current assets	Br. 1,000,000
Plant assets (net)	3,000,000
Other assets	600,000
Total assets	Br. 4,600,000

Liabilities and Stockholder's Equity

Current liabilities	Br. 500,000
Long term debt	1,000,000
Common stock, no par, $10 stated value	1,000,000
Additional paid in capital	700,000
Retained earnings	1,400,000
Total liabilities and capital	Br. 4,600,000

Using the guidelines in APB Opinion No. 16, the board of directors of Saxon Corporation determined the current fair values of Mason Company's assets and liabilities (identifiable net assets) as follows:

Current assets	Br. 1,150,000
Plant assets	3,400,000
Other assets	600,000
Current liabilities	(500,000)
Long term debt (present value)	(950,000)
Identifiable net assets of combinee	Br. 3,700,000

Required:

1. Record necessary journal entries related to the business combination.
2. Determine the amount of goodwill.
3. Allocate cost of combinee.

The following are journal entries required by Saxon Corporation to record the merger. Saxon uses the investment ledger to accumulate the total cost prior to assigning the cost to identifiable net assets and goodwill.

Investment in Mason Co. common stock (150,000*25)	3,750,000	
Common stock (150,000*10)		1,500,000
Paid in capital in excess of par		2,250,000
To record merger with Mason Company as purchase		
Investment in Mason Co. common stock (5,000+10,000+51,250)	66,250	
Additional Paid-in Capital (60,000+50,000+23,000+750)	133,750	
Cash		200,000
To record out of pocket costs incurred with Mason Company.		

Accounting, legal, and finder's fees are as investment cost; other out of pocket costs are recorded as a reduction in the proceeds received from issuance of common stock.

The journal entry required to allocate cost of the liquidated Mason Company to identifiable assets and liabilities is recorded as:

Current assets	1,150,000	
Plant assets	3,400,000	
Other assets	600,000	
Discount on long term loan	50,000	
Goodwill	116,250	
Current liabilities		500,000
Long term debt		1,000,000
Investment in Mason co common stock (3,750,000+66,250)		3,816,250

To allocate total cost of liquidated Mason Company to identifiable assets and liabilities, with the remainder to goodwill. (Income tax effects disregarded).

Amount of goodwill to be recognized is computed as follows:

Total cost of Mason company		3,816,250
Mason's identifiable net assets (4,600,000-1,500,000)	3,100,000	
Excess (deficiency) of current fair value over carrying amounts		
Current assets	150,000	
Plant assets	400,000	
Long term debt	50,000	
		3,700,000
Amount of goodwill		116,250

No adjustments are made to reflect the current fair values of Saxon's identifiable net assets or goodwill as Saxon is the combinor.

Mason Company (the combinee) records the following condensed journal entry to record the dissolution and liquidation of the company on Dec 31, 1999.

Current liabilities	500,000
Long term debt	1,000,000

Common stock, $10 stated value	1,000,000	
Paid in capital in excess of stated value	700,000	
Retained Earnings	1,400,000	
Current assets		1,000,000
Plant assets (net)		3,000,000
Other assets		600,000

To record liquidation of company in conjunction with merger with Saxon Corporation

Illustration: Purchase accounting for acquisition of net assets, with bargain purchase excess

On December 31, 2012, Davis Corporation acquired the net assets of Fairmont Corporation directly from Fairmont for Br. 400,000 cash, in a purchase type business combination. Davis paid legal fees of Br. 40,000 in connection with the combination.

The condensed balance sheet of Fairmont prior to the business combination, with related current fair value data, is presented below:

FAIRMONT CORPORATION (combinee)
Balance Sheet (prior to business combination)
December 31, 2012

	Carrying Amounts	Current Fair Value
Assets		
Current assets	Br. 190,000	Br. 200,000
Investment in marketable debt	50,000	60,000
Plant assets (net)	870,000	900,000
Intangible assents (net)	90,000	100,000
Total assents	Br. 1, 200,000	Br. 1,260,000
Liabilities and Stockholders' Equity		
Current liabilities	Br. 240,000	Br. 240,000
Long term debt	500,000	520,000
Total liabilities	740,000	Br. 760,000
Common stock, $1 par	600,000	
Deficit	(140,000)	
Total stockholders' equity	460,000	
Total liabilities & stockholders' equity	Br. 1,200,000	

Required:

1. Determine the amount of goodwill and prorate to plant and intangible assets.
2. Record necessary journal entries related to the business combination.
3. Allocate cost of combinee.

Thus, Davis acquired identifiable net assets with current fair value of 500,000 (1,260,000-760,000) for a total cost of 440,000 (400,000+40,000). The 60,000 excess of the current fair value of the assets over their cost is prorated to plant and intangible assets in ratio of their respective current fair value.

To plant assets: 60000*900,000/900,000+100,000=	54,000
To intangible assets: 60,000*100,000/900,000+100,000=	6,000
Total	60,000

The journal entries below record Davis Corporation's acquisition of the net assets of Fairmont Corporation and payment of 40,000 legal fees.

Investment in Net Assets of Fairmont Corp	400,000	
Cash		400,000

To record acquisition of net assets of Fairmont Corporation

Investment in net assets of Fairmont Corp	40,000	
Cash		40,000

To record legal fee paid in acquisition of net assets of Fairmont Corporation.

Current assets	200,000	
Investment in Marketable Debt Securities	60,000	
Plant assets (900,000-54000)	846,000	
Intangible assets (100,000-6,000)	94,000	
Current liabilities		240,000
Long term debt		500,000
Premium on long term debt (520,000-500,000)		20,000
Investment in net assets of Fairmont		440,000

To record allocation of total cost of net assets acquired to identifiable net assets.

Total cost of net assets acquired to identifiable net assets, with excess of current fair value of the net assets over cost is allocated to noncurrent assets other than marketable securities.

4.6. Comparison of Purchase and Pooling Accounting

The following table summarizes principal aspects of purchase accounting and pooling of interest accounting for business combinations:

Aspect	Acquisition Method	Pooling-of-Interest Method
Underlying premise	Acquisition of assets	Combining of stockholder interests
Valuation of combinee's net assets	At current fair value on date of business combination	At historical book value on date of business combination
Goodwill recognition	Recognized if combinor's cost exceeds combinee's identifiable net assets	No
Combination costs	Included as part of purchase price unless incurred in connection with issuance of stock, a cost that reduces paid-in capital.	Expensed immediately.
Shares issued to create business combination	Recorded at fair value if any shares are issued.	Based on book value of combinee's contributed capital and retained earnings at beginning of year.

? Differentiate purchase and pooling of interest accounting for business combination.

4.7. Criticisms of Methods of Accounting for Business Combinations

Criticism of Purchase Method

The principal criticism of acquisition method is the residual basis for valuing goodwill. These critics contend that part of the amounts thus assigned to goodwill probably apply to other identifiable tangible assets. Accordingly, goodwill in a business combination should be valued directly and any remaining cost not directly allocated to all identifiable assets including goodwill would be proportionately apportioned to those assets or recognized as a loss.

Amortization of goodwill attributable to business combination is considered inappropriate and the amount should be treated as a reduction of stockholders' equity of the combined enterprise.

Critics also argue that there is no theoretical support for the arbitrary reduction of previously determined current fair values of assets by an apportioned amount of purchase price excess. Rather an amortization of the entire bargain purchase excess is suggested.

The fact that current fair values of the net assets of the combinee only are reflected is also viewed as inconsistent.

Criticism of Pooling-of-Interests Method

The principal objections to pooling-of-interest method are:

- The assumption that some business combinations involving exchange of voting common stock result in a combining of existing stockholder interests other than an acquisition of assets is difficult to support in any accounting theory.
- The assets of the combinee are not accounted for at their cost to the issuer. As a result, net income for each accounting period subsequent to a pooling type business combination is misstated.

? Discuss criticisms to accounting for business combination.

4.8. Chapter Summary

Business combinations are events or transactions in which two or more business enterprises, or their net assets, are brought under common control in a single accounting entity.

Business combinations are classified into two classes based on nature: friendly takeovers and unfriendly (hostile) takeovers. In friendly takeover the Board of Directors of all constituent companies amicably (friendly) determine the terms of the business combination. In hostile m type of takeovers, the target combinee typically resists the proposed business combination.

There are a number of reasons for business combinations. Such as growth, economies of scale, operating economies, diversification of business risk, monopolistic ambitions, better management, tax advantages, elimination of fierce competition, better financial planning getting financial gains etc…

The four common methods for carrying out a business combination are: Statutory Merger, Statutory Consolidation, Acquisition of Common Stock, and, Acquisition of Assets.

The two methods of accounting for business combinations are Pooling-of-Interest and Purchase Method. The acquisition cost in a business combination accounted for by the purchase method is the total of amount of purchase consideration paid by the combinor, combinor's direct out-of-pocket costs of the combination and any contingent consideration that is determinable on the date of the business combination.

Good will is the excess of cost of a combine over identifiable net assets of the combinee. The amount of goodwill recorded on the date the business combination may be adjusted subsequently when contingent consideration becomes issuable. Negative goodwill resulted when the current fair values assigned to the identifiable net assets acquired exceed the total cost of the combinee (acquisition cost).

4.9.Self-Test Questions

Now, this chapter is completed you must have to test your progress by doing the following self-test and compare your answer with the answer key given at the end.

Multiple Choices

1. The target company attempts to acquire an acquiring company which attempted the unfriendly merger .This statement indicates?
   A. Repurchase of stock defensive tactic
   B. Pac-man Defense defensive tactic
   C. Golden parachute defensive tactic
   D. Leveraged recapitalization defensive tactic
2. Direct Out of pocket costs and indirect out of pocket costs are often incurred in the process of business combination. How should those costs be accounted for in a Purchase transaction?
   A. Direct out of pocket costs increases investment and indirect costs decreases investment.
   B. Direct out of pocket costs increases investment and indirect costs decreases expenses.
   C. Direct out of pocket costs increases investment and indirect costs decreases Paid- in capital.
   D. Direct out of pocket costs increases investment and indirect costs increases investment.
3. Which of the following is /are reason/s for business combination?
   A. Achieving growth.
   B. Cost savings through elimination of duplicate facilities.
   C. Quick entry for new and existing products into domestic and foreign markets.
   D. Diversification of business risk.
   E. All of the above.
4. ___________a method of arranging business combination with survivor company :
   A. Statutory merger

B. Statutory consolidation
C. Acquisition of assets
D. Acquisition of common stock

5. On January 31, 2018, AA Corporation pays Br. 700,000 cash and issues 100,000 shares of Br. 20 par common stock with a market value of Br. 30 per share for the acquisition of net assets of BB Company. If AA Corporation pays Br 100,000 for determinable contingent consideration on the date of combination and indirect costs of Br. 200,000, the amount of AA corporation's investment in net assets BB Company is:

A. Br.5,000,000
B. Br.3,800,000
C. Br.4,600,000
D. Br.600,000

CHAPTER FIVE

CONSOLIDATED FINANCIAL STATEMENTS

Learning objectives:

Dear students, after successfully completing this chapter you will be able to:

- ☞ Understand the nature of consolidated financial Statements
- ☞ Apply the fair value/cost and equity methods of accounting for stock investments
- ☞ Recognize the benefits and limitations of consolidated financial statements
- ☞ Understand the requirements for inclusion of a subsidiary in consolidated financial statements
- ☞ Prepare a consolidated balance sheet at the date of acquisition, including preparation of eliminating entries
- ☞ Learn the concept of minority interest when the parent company acquires less than 100% of the subsidiary's outstanding common stock
- ☞ Prepare consolidated balance sheets subsequent to the date of acquisition, including preparation of eliminating entries
- ☞ Apply the concepts underlying preparation of a consolidated income statement
- ☞ Understand the impact of intercompany profit for inventories on preparation of consolidation working papers
- ☞ Prepare consolidated working papers for the year of acquisition when the parent company uses the full equity method to account for its investment in a subsidiary.
- ☞ Prepare consolidated working papers for the year subsequent to acquisition
- ☞ Allocate excess of purchase price over book value to include identifiable net assets

5.1. Consolidated Financial Statements on the Date of Business Combination under Purchase Accounting (Acquisition Method)

The Parent Co. prepares Parent Financial Statements while the Subsidiary prepares Subsidiary Financial Statements. However, Consolidated Financial Statements is prepared by the ParentCo. by combining separate financial statements of the parent and the subsidiary as the Parent Company is the Reporting Entity.

The Parent and Subsidiary Relationships

- If the Parent Company owns more than 50% voting stock of another company, that company is anAffiliate
- The combinor's acquisition of common stock of a combinee corporation resorts to investor-investee (parent-subsidiary) relationship.
- If the investor acquires a controlling interest, a parent-subsidiary relationship is established. The investee becomes a subsidiary of the acquiring parent company (investor) but remains a separate legal entity.
- Strict adherence to the legal aspect would require issuance of separate financial statements for the parent company and the subsidiary on the date of combination and for all subsequent periods.
- But strict adherence to the legal form disregards the substance of most parent-subsidiary relationship.
- **A parent company and its subsidiary are a single economic entity.**
- Hence, consolidated financial statement are issued to report the financial position and operating results of a parent company and its subsidiaries as thought they comprised a single accounting entity.

Nature of consolidated financial statements

They are similar to the combined financial statements for a Home Office and its branches. Assets, liabilities, revenue, and expenses of the parent company and its subsidiaries are totaled; inter- company transactions and balances are eliminated; and the final consolidated amounts are reported in the balance sheet, income statements, statement of stockholders' equity, and statement of cash flows. However, the separate legal entity status of the parent and subsidiary corporations necessitates eliminations that are generally more complex.

Should all subsidiaries be consolidated?

There is no reason for excluding from consolidation any subsidiary that is controlled. This is because the purpose of consolidation is to present for a single entity the combined resources, obligations and operating results of a family of related corporations. In FASB statement No.94 Consolidation of all majority-owned subsidiaries issued in 1987, FASB required the consolidation of nearly all subsidiaries. Only subsidiaries not actual controlled were excluded from consolidation.

The Meaning of Controlling Interest

Traditionally, an investor's direct or indirect ownership of more than 50% of an investee's outstanding common stock has been required to evidence the controlling interest underlying a parent-subsidiary relationship. However, even though such a common stock ownership exists, other circumstances may negate the parent company's ***actual*** control of the subsidiary.

For Example:

1. Subsidiary in liquidation or reorganization in court and supervised by bankruptcy proceedings is not controlled by its parent.

2. A **foreign subsidiary** in a country having severe production, monetary or income tax restrictions may be subject to the authority of the foreign country rather than the parent company.

3. If **minority shareholders** of a subsidiary have the right to participate effectively in the financial and operating activities of the subsidiary in the ordinary course of business, the subsidiary's financial statements should not be consolidated with those of the parent company.

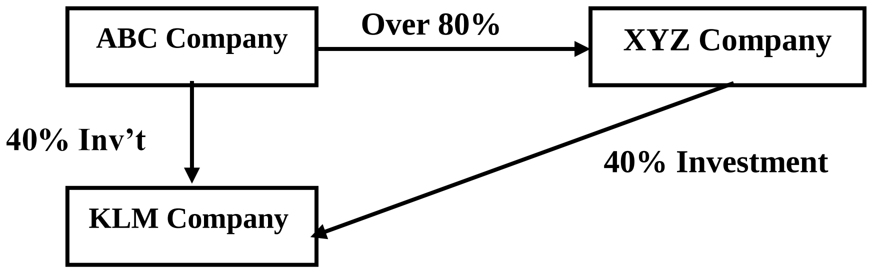
Example of Controlling Interest

- Direct Controlling Interest = Father – Son Relationship

$$\boxed{\textbf{ABC Company}} \xrightarrow{\text{80\% Inv't}} \boxed{\textbf{KLM Company}}$$

- Indirect Controlling Interest = Father – Son – Grandson Relationship

Father and Son together control Grandson



Father controls Son; Son controls Grandson

Parent Company's control of a subsidiary might be achieved indirectly as follows:

Example: If ABC Company owns 80% of outstanding common stock of XYZ Company and 40% of KLM Company's common stock and also XYZ Company owns 40% of KLM Company's common stock, ABC Company controls both XYZ and KLM Company. ABC Company owns 72% of KLM Company (40% directly and 32% indirectly).

Criticism of Transitional concept of control

- Many accountants criticize the traditional definition of control described above which emphasizes legal form.
- They argue that an investor **owning less than 50% of an investee's voting** common stock in substance may control the affiliate, especially if the remaining stock is scattered among a large number of shareholders who do not attend shareholder's meetings or give proxies
- Effective control of an investee is also possible **if individuals comprising management** of the investor corporation own a substantial number of shares of the investee or successfully solicit proxies from the investee's other shareholders.
- The SEC in financial reporting Release No 25 required companies to emphasize economic substance over legal form in adopting a consolidationpolicy.
- The FASB also issued a discussion memorandum which dealt at length with the question of ownership (legal form) versus control (economic substance) as a basis forconsolidation.

FASB'S proposed redefinition of Control

- Based on the discussion memorandum FASB issued a proposed statement that would have defined control of an entity as power over its assets. That is power to use or direct the use of the individual assets of another entity in essentially the same way as the controlling entity can use its ownassets.
- In 1999, the FASB issued a revised proposed statement that would define ***control*** as a parent company's **non-shared decision-making ability that enables** it to guide the ongoing activities of its subsidiary and to use that power to increase the benefits that it derives and limit the losses that it suffers from the activities of that subsidiary.
- The proposed statement further stated that in the absence of evidence that demonstrated otherwise, the existence of control of a corporation shall be presumed if an entity (including its subsidiaries):
    1) Has a majority voting interest in the election of a corporation's governing body or a right to appoint a majority of the members of its governing body.
    2) Has a large minority voting interest in the election of a corporation's governing body and no other party or organized group of parties has a significant voting interest.
    3) Has a unilateral ability to (1) Obtain a majority voting interest in the election of a corporation's governing body or (2) Obtain a right to appoint a majority of the corporation's governing body through the present ownership of convertible securities or other rights that are currently exercisable at the option of the holder and the expected benefit from converting those securities or exercising that right exceeds its expected cost.
- By the latter proposal, the FASB planned to repeal the long standing requirement of majority ownership of an investee's outstanding common stock as a prerequisite for consolidation.
- Objectively determined legal form was to be replaced by subjectivity determined economic substance as the basis for consolidated financial statements.

Steps for Consolidation

1. Update the balances of accounts affected by business combination transaction

2. Record the financial information for both Parent and Subsidiary on the worksheet
3. Remove the Investment in Subsidiary balance
4. Remove the Subsidiary's equity account balances
5. Remove Intercompany transactions (e.g. payables andreceivables)
6. Adjust the Subsidiary's net assets to CFV
7. Allocate any excess of cost over CFV to identifiable intangible assets or goodwill
8. Combine all account balances

5.1.1. Consolidation of Wholly Owned Subsidiary on Date of Business Combination under Purchase Accounting (AcquisitioSageethod)

Example 5.1. There is no question of control of a wholly owned subsidiary. Thus, as an illustration assume that on December 31, 2002, Palm Corporation issued 10,000 shares of its 10par common stock (current fair value Br 45 a share) to shareholder of **Starr Company** for all the outstanding Br 5 par common stock of **Starr**. There was no contingent consideration. Out of pocket costs of the business combination paid by **Palm Corp** on December 31, 2002 consisted of the following;

Finder's fees and legal fees ofthecombination	Br 50,000
Costs of issuing common stock	35,000
Total costs...	Br85,000

Assume also that the combination qualified for purchase accounting. Starr Company was to continue its corporate existence as a wholly owned subsidiary of Palm Corporation. Both companies had a December 31 fiscal year and use the same accounting policies. Income tax rate for both companies was 40%. Financial statements of the two companies as of December 31, 2002 prior to combination are presented below follow:

	Palm Corporation	Starr Company
Income statement		
Net sales...	Br 990,000	Br 600,000
Interest revenue..	10,000	- 0-
Total Revenues..	**1,000,000**	**600,000**
Cost & expenses:		
Cost of goodssold	635, 000	410, 000
Operating expense..	158,333	73,333
Interest expense..	50, 000	30, 000
Income taxExpense..	62,667	34, 667
Total Costs and expenses..	**(906,000)**	**(548, 000)**
Net income...	94, 000	52, 000
Statement of RES		
Retained Earnings beginning ofyear........................	65,000	100,000
Add: Net income...	94,000	52,000
Less: dividends..	(25,000)	(20,000)
Retained Earnings ending ofyear............................	134,000	132,000
Balance sheet		
Assets:		
Cash..	Br100, 000	Br 40,000
Inventories...	150,000	110, 000
Other current assets..	110,000	70,000
Receivable from StarrCo..	25, 000	
Plant asset (net)...	450,000	300,000
Patent (net)...	- 0 -	20,000
Total...	835, 000	540,000
Liability and SHE:		
Payable to PalmCorp		25,000
Income taxespayable...	26,000	10, 000
Other liabilities..	325,000	115,000
Common stock Br 10 par...	300,000	
Common stock for Br 5par......................................		200,000
Additional Paid in capital..	50,000	58, 000
RetainedEarnings..	134,000	132, 000
Total liabilities andSHE	835,000	540, 000

On Dec, 31, 2002 current fair values of Starr Company's identifiable assets and liabilities were the same as their carrying amount, except for the following 3assets:

Current Fair Values	
Inventories....................................	Br135,000
Plantassets(net).............................	Br365,000
Patent (net)...	Br25,000

Because Starr was to continue as a separate corporation and generally accepted principles do not sanction write-ups of assets of a going concern, Starr didn't prepare journal entries for the combination. Palm Corporation recorded the combination as a purchase on December 31, 2002 with the following journal entries.

1. **Issuance of 10,000 common stocks to stockholders of StarrCompany**

Investment in Starr Co.CommonStock	450,000	
CommonStock		100,000
Paid in capital in excessofpar		350,000

2. **Out of pocketcosts**

Investment inStarrCo	50,000	
Paid incapital	35,000	
Cash		85,000

The above entries are the same as the entries for a statutory merger accounted for using Purchase Method but they do not include any debit or credit, to record individual assets and liabilities of Starr Company in the records of Palm Corporation. This is because the investee was not liquidated as in a merger; it remains a separate legal entity.

Preparation of Consolidated Balance Sheet

Purchase accounting for the business combination of **Palm Corporation** and Starr Company requires a **fresh start** for the consolidated entity. This reflects the theory that a business combination that meets the requirement of purchase accounting is an acquisition of the combines' net assets (assets less liabilities) by thecombinor.

1. The operating results of the two companies prior to combination are those of two separate economic- as well as legal – entities. Accordingly, a consolidated balance sheet is the only consolidated financial statement issued by the investor (Palm Corporation) on the date of the business combination. This can be done with the use of a workingpaper.
2. The parent company's investment account and the subsidiary's stockholder's equity accounts do not appear in the consolidated Balance sheet because they are reciprocal or intercompany accounts.
3. Under purchase accounting theory, the parent company (combinor) assets and liabilities are reflected at **carrying amount** and that of the subsidiary (the combinee's) at **current fair values** except inter company accounts, in the consolidated balancesheet.

4. **Goodwill** is recognized to the extent the cost of the parent company's investment in 100% of the subsidiary's outstanding common stock exceeds the current fair value of the subsidiary's identifiable net assets.

Palm Corporation and Subsidiary

Consolidated Balance Sheet

December 31, 2002

Assets:	
Cash (15,000 + 40,000)...	55,000
Inventories (150,000 + 135,000)	285,000
Others (110,000 + 70,000)	180,000
Plant assets (net) (450,000 + 365,000)..	815,000
Patent (net) (0+25,000)	25,000
Good will..	15,000
Total assets	1,375,000
Liabilities and Shareholders' Equity:	
Liabilities:	
Income taxes payable (26,000 + 10,000)	36,000
Others (325,000 + 115,000)	440,000
Stock holder's equity:	
Common stock, Br 10 par	400,000
Additional Paid in capital..	365,000
Retained Earnings	134,000
Total liabilities & shareholder'sequity..	1, 375,000

Goodwill = Investment in Starr Company - Values of Starr Company's net assets at CFV

Goodwill = 500,000 – (Br 635,000 – 150,000) = Br 500,000 – 485,000 = **15,000**

Working Paper for Consolidated Balance Sheet

- Preparation of consolidated balance sheet on the date of purchase type business combination usually requires the use of a working paper for consolidated balance sheet, even for a parent company and a wholly owned subsidiary.
- A consolidated balance sheet is prepared using a working paper for Palm Corporation a shown below.
- The working paper for consolidated balance sheet on the date of purchase-type business combination has the following features:

1) The elimination is not entered in either the parent company's or the subsidiary's accounting records; it is only a part of the working paper for preparation of the consolidated balance sheet.
2) The elimination is used to reflect differences between current fair values and carrying amounts of the subsidiary's identifiable net assets because the subsidiary did not write up its assets to current fair values on the date of the business combination.
3) The Elimination column in the working paper for consolidated balance sheet reflects increases and decreases, rather than debits and credits. Debits and credits are not appropriate in a working paper dealing with financial statements.
4) Intercompany receivables and payables are placed on the same line of the working paper for consolidated balance sheet and are combined to produce a consolidated amount of zero.
5) The respective corporations are identified in the working paper elimination. The reason for precise identification is to deal with the eliminations of intercompany profits (orgains).
6) The consolidated paid-in capital amounts are those of the parent company only. Subsidiary's Paid-in capital amounts always are eliminated in the process ofconsolidation.
7) Consolidated retained earnings on the date of purchase-type business combination include only the retained earnings of the parent company. This treatment is consistent with the theory that purchase accounting reflects a fresh start in an acquisition of net assets (assets less liabilities), not a combining of existing stockholderinterest.
8) The amounts in the consolidated column of the working paper for consolidated balance sheet reflects the financial position of a single economic entity comprising two legal entities, with all intercompany balances of the two entitieseliminated

Palm Corporation and Subsidiary Working Paper for Consolidated Balance Sheet December 31, 2002				
	Palm Corp	**Starr co.**	**Elimination**	**Consolidated**
Assets:				
Cash	15,000	40,000		55,000
Inventories	150,000	110,000	25,000	285,000
Other current assets	110,000	70,000		180,000
Intercompany receivables (payables)	25,000	(25,000)		
Investment in Starr Co.	**500,000**		**(500,000)**	
Plan asset (net)	450,000	300,000	65,000	815,000
Patent (net)	-0-	20,000	5,000	25,000
Goodwill (net)	-0-	-0-	15,000	15,000
Total asset	1,250,000	515,000	(390,000)	1,375,000
Liabilities & SHE:				
Income taxes Payables	26,000	10,000	–	36,000
Other Liabilities	325,000	115,000	–	440,000
Common stock Br 10 par	400,000	–	–	400,000
Common stock Br 5 par	–	200,000	(200,000)	–
Additional Paid in capital	365,000	58,000	(58,000)	365,000
Retained Earnings	134,000	132,000	(132,000)	134,000
Total Liab. & SHE	1,250,000	515,000	(390,000)	1,375,000

Working Paper Elimination Journal Entries shown below:

	Debit	**Credit**
Common stocks Br5par-Star	200,000	
Additional paidincapital-Star	58,000	
RetainedEarnings-Starr	132,000	
Inventories(135,000-110,000)	25,000	
Plant assets(net)(365,000-300,000)	65,000	
Patent(net)(25,000-20,000)	5,000	
Goodwill(net)(500,000-485,000)	15,000	
Investment in Star Company		500,000

5.1.2. Consolidation of Partially Owned Subsidiary on Data of Business Combination under Purchase Method of Accounting

Consolidation of a parent company and its partially owned subsidiary differs from the consolidation of a wholly owned subsidiary in one major respect - the recognition of minority interest (non-controllinginterest).

Minority interest or no controlling interest is a term applied to the claims of stockholders other than the parent company (controlling interest) to the net income or losses and net assets of the subsidiary. The minority interest in the subsidiary's net income or losses is displayed in the consolidated income statement, and the minority interest in the subsidiary's net assets is displayed in the consolidated balance sheet.

Example 5.2: To illustrate the consolidation techniques for a purchase type business combination involving a partially owned subsidiary, assume the following facts:

On December 31,2003 **Post Corporation** issued 57,000 shares of its Br 1 par common stock (Current fair value Br 20 a share) to stockholders of **Sage C**ompany in exchange for 38,000 of the 40,000 outstanding shares of **Sage's** Br 10 par common stock Thus **Post** acquired 95% of the interest in **Sage** (38/40). There was no contingent consideration. Out-of-pocket costs of the combination paid in cash by **Post** on December 31, 2003 were as follows:

- Finder's and legal feesofCombination.....................................Br 52,250
- Cost ofissuingshares 72,750
- Total...125,000

Financial Satements of the two companies before combination are given as follows;

Income statement	Post Corporation	Sage Company
Net sales	**Br 5,500,000**	**Br 1,000,000**
Costs & Expenses:		
Cost of goods sold	3,850,000	650,000
Operating expense	925,000	170,000
Interest expense	75,000	40,000
Income tax Expense...............................	260,000	56,000
Total Costs and expenses	(5,110,000)	(916,000)
Net income	390,000	84,000
Statement of RES		
Retained Earnings, beginning of year	810,000	290,000
Add: Net income	390,000	84,000
Sub-totals...	1,200,000	374,000
Less: Dividends	(150,000)	(40,000)
Retained Earnings End of the year	1,050,000	334,000

BALANCE SHEET		
	Post Corporation	**Sage Company**
Assets:		
Cash	Br 200,000	Br 100,000
Inventories	800,000	500,000
Other current assets	550,000	215,000
Plant asset, (net)	3,500,000	1,100,000
Goodwill (net)...	100,000	-0-
Total...	**5,150, 000**	**1,915,000**
Liability and SHE:		
Income taxes payable................................	100,000	16,000
Other liabilities	2,450,000	930,000
Common stock Br 1 par............................	1,000,000	
Common stock for Br 10 par		400,000
Additional Paid in capital	550,000	235,000
Retained Earnings....................................	1,050,000	334,000
Total liabilities and SHE...........................	**5,150, 000**	**1,915,000**

On Dec, 31, 2003 current fair values of **Sage** company's identifiable assets and liabilities were the same as their carrying amount, except for the following assets:

Market Values	
Inventories......................................	Br 526,000
Plant assets (net).............................	Br1,290,000
Leasehold	Br30,000

Post Corporation records the combination with **Sage Company** as a purchase and thus, the following journal entries are made:

1. **Issuance of 57,000 shares to Sage company**

Investment in Sage Company (57,000 shares @ Br 20)	1,140,000	
Common Stock...		57, 000
Paid in capital..		1,083,000

2. **To record out-of-pocket cost**

Investment in Sage Company..	52,250	
Paid in capital..	72,750	
Cash		125,000

Investment in Subsidiary Account

Investment in Sage Company	
1,140,000	
52,250	
1,192,250	

Working Paper for Consolidated Balance Sheet

As minority interest in net assets of a partially owned subsidiary& measurement of goodwill acquired in the combination complicates the process, it is advisable to use a working paper.

Developing the Elimination

• Common stock –Sage Company	400,000
• Additional paid in capital- Sage Company	235,000
• RES, Sage Company	334,000
• Intercompany accounts (net assets = A – L)	**969,000**

The footing of **Br 969,000** of the debit items of the partial elimination above represents the **carrying amounts** of the net assets of **Sage Company a**nd is Br 223,250 less than the investment in Sage Company of Br 1,192,250. Part of this **Br 223,250** difference is the excess of the total cost of **Post Corporation's** investment in **Sage Company** plus the **minority interest** in Sage Company's net assets over the carrying amounts of Sage's identifiable net assets. Difference between current fair vales and carrying amount of combinee's identifiable assets are presented below:

• Inventories (526,000 – 500,000)	26,000
• Plant assets (net) (1,290,000 – 1,100,000)	190,000
• Leasehold..	30,000
• Total..	**246,000**

Working Paper Elimination Journal Entry:

Common Stock – Sage Company..	400,000
Additional paid in capital – Sage Company...........................	235,000
RES – Sage Company	334,000
Inventories (526,000 – 500,000)	26,000
Plant assets, net (1,290,000 – 1,100,000)...............................	190,000

Leasehold	30,000	
Goodwill	38,000	
Investment in Sage Company		1,192,250
Minority Interest in Net Assets of Subsidiary		60,750

Computation of Goodwill and Minority Interest:

The revised footing of Br 1,215,000 (969,000 + 246,000) of the debit items of the above partial elimination represents the current fair values of Sage Company's identifiable net assets on December 31, 2003. Two items must be recorded to complete the elimination for Post Corporation and Subsidiary. Thus, Minority Interest and Goodwill should be computed. First, computations of Minority interest in combinee's identifiable net assets

Minority interest:

CFV of net assets 1,215,000
Minority interest (100% – 95%) 5%
Minority interest (5% @ 1,215,000) .... **60,750** – This is recorded by crediting Minority Interest Account like liability

Alternative way of **Calculating Net Assets at CFV:**

Cash	100,000
Inventories	526,000
Other Current Assets	15,000
Plant (net)	1,290,000
Leasehold	30,000
Total Assets at CFV	2,161,000
Less: Liabilities at CFV (16,000 + 930,000)	946,000)
Net Assets at CFV	1,215,000

Goodwill:

Second, the Goodwill acquired by **Post Corporation** in the business combination with **Sage Company** is computed as follows and recorded:

Investment for 95% interest in Sage Company.. 1,192,250
Less: CFV of 95% of Investment in net assets (1,215,000 @ 0.95).......... 1,154,250
Goodwill acquired by Post Corporation **38,000**

The working paper for consolidated balance sheet is presented below:

Post Corporation and Subsidiary
Working Paper for Consolidated Balance Sheet
December 31, 2003

	Post Corporation	Sage Company	Elimination	Consolidated
Assets:			↑ (↓)	
Cash	75,000	100,000		175,000
Inventories	800,000	500,000	26,000	1,326,000
Other current assets	550,000	215,000		765,000
Investment in Sage Co	**1,192,250**		**(1,192,250)**	
Plan asset (net)	3,500,000	1,100,000	190,000	4,790,000
Leasehold Assets (net)	-0-	-0-	30,000	30,000
Goodwill (net)	100,000		38,000	138,000
Total asset	6,217,250	1,915,000	(908,250	7,224,000
Liabilities & SHE:				
Income taxes Payables	100,000	16,000	–	116,000
Other Liabilities	2,450,000	930,000	–	3,380,000
Minority Interest in NAs Sub			60,750	60,750
Common stock Br 1 par	1,057,000	–		1,057,000
Common stock Br 10 par	–	400,000	(400,000)	–
Additional Paid in capital	1,560,250	235,000	(235,000)	1,560,250
Retained Earnings	1,050,000	334,000	(334,000)	1,050,000
Total Liability & SHE	6,217,250	1,915,000	(908,250)	7,224,000

Consolidated Balance sheet of the parent company and partially owned subsidiary

Post Corporation and Subsidiary
Consolidated Balance Sheet
December 31, 2003

Assets:

Cash	Br 175, 000
Inventories	1,326,000
Other Current assets	765,000
Total current assets	2, 266,000
Plant assets, net	4,790,000
Leasehold	30,000
Goodwill	138,000
Total assets	7,224,000

Liabilities and SHE:

Liabilities:

Income tax payable	116,000
Other	3,380,000
Minority Interest in net assets of subs	60,750

Total liabilities..	3,556,750
Stockholders' Equity:	
Common stock Br 1par..	1,057,000
Additional PIC..	1,560,250
Retained Earnings..	1, 050,000
Total Shareholders' Equity..	3,667,250
Total Liability and SHE...	7,224,000

Nature of Minority Interest

The appropriate classification and presentation of minority interest in consolidated financial statements is a perplexing problem, especially it is:

- Recognized only in the consolidation process
- Doesn't result from business transactions of either the parent or subsidiary

Two concepts have been developed for consolidated reports to account for minority interest:

1. Parent Company Concept
2. Economic Unit Concept

1. Parent Company Concept

The parent company concept emphasizes the interests of the parent's shareholders. This concept treats the minority interest in net assets of a subsidiary as a liability. This liability is increased each accounting period subsequent to the date of a business combination by an expense representing the minority's share of the subsidiary's net income.

Consolidated statements reflect those stockholders' interest in the parent itself, plus their undivided interests in net asset of the parent's subsidiaries. It shows stockholders' interest in the parent and undivided interest in the parent's subsidiaries. The consolidated balance sheet is essentially a modification of the parent's balance sheet with assets and liabilities of all subsidiaries substituted for the parent's investment in subsidiaries.

To summarize, the Parent Company concept**:**

- Treats the minority interest in subsidiary's net assets as aliability
- The liability increases by minority's share of net incomeor
- The liability decreases by minority's share of netlosses
- Dividends declared by the subsidiary to minority stockholders decreases theliability

2. Economic Unit Concept

In the economic unit concept, the minority interest in the subsidiary's net assets is displayed in the stockholders' equity section of the consolidated balance sheet. The consolidated income statements display the minority interest in the subsidiary's net income as a subdivision of total consolidated net income.

Economic Unit Concept Characteristics:

- Emphasizes control of the whole by a single management
- Sometimes called the entity theory
- Consolidated financial statements are intended to provide information about group of legal entities – a parent and its subsidiaries – operating as a singleunit.
- Both controlling and consolidated net income is net of the minority's share of the subsidiary's net income.

In substance minority shareholders are special classes of creditors to the consolidated company because they exercise no control of ownership over operations of either parent (subsidiary).
If consolidated financial statements are to present fairly the operating results and financial position of a single economic entity the niceties of minority shareholder's ownership of part of the subsidiary should be disregarded.

The display of minority interest in the liability section is consistent with the parent company concept of consolidated statements.There is no ledger account for minority interest in net assets of subsidiary, in either the parent company's or subsidiary's records.

Alternative Method of Valuing Minority Interest & Good Will

The previous computation of minority interest and goodwill was based on two premises: Identifiable net assets of a partially owned subsidiary should be valued on a single basis at CFV; and Only Subsidiary Goodwill acquired by the Parent Company should be recognized, in accordance with the cost method of valuing assets.

Subsidiary's Net Assets	969,000

Excess of CFV over Book Value	246,000
CFV of Net Assets..	1,215,000
Parent Company's Share in Subsidiary	95%
Minority Interest in Subsidiary	5%
Acquisition Cost...	1,192,250

Solution:

Minority Interest = 5% @ NetAssets
Minority Interest = 5% @ 1,215,000
Minority Interest = Br60,750
Goodwill= Acquisition Cost – Share of Net Assets
Goodwill= 1,192,250 – (95% @ 1,215,000)
Goodwill= 1,192,250 – 1,154,250
Goodwill=Br 38,000

Two other alternatives to the procedure of computing minority interest and goodwill have been suggested:

1. The first alternative would assign Current Fair Values to a partially owned purchased subsidiary's identifiable assets only to the extent of the Parent Company's Ownership Interest therein. For example; 95% in the example above; 95% @ 246, 000 = 233,700 which is the total difference between CFV and Carrying Amounts of Sage Company's identifiable net assets. The minority interest in net assets of the subsidiary would be based on the carrying amounts of the subsidiary's identifiable net assets rather thanCFV.

Minority Interest = 5% @ 969,000 carrying value of net assets =48,450

Goodwill =1,192,250 – (969,000 – 5% @ 969,000) – (1,215,000-969,000)@95% =38,000

AcquisitionCost……………………………………………………………………		1,192,250
Book ValueofSubsidiary…………………………………………………	969,000	
MinorityInterest(5%@969,000)...	(48,450)	920,550
Cost in-excess of the Book Value		271,700
Allocation based on CFV in-excess of Book Value (1,215,000-969,000)@95% .		233,700

Goodwill 38,000

The Goodwill would be the same as computed previously. The 233,700 would be reflected in the aggregate debits to inventories, plant assets, and leasehold in the working paper elimination. Supporters argue that CFV of combinee's identifiable net assets of the subsidiary should be reflected in consolidated financial statements only to the extent that they have been acquired by the combinor.

2. CFV is assigned to total net assets of Subsidiary including goodwill through independent implied or inferred value.

This is to value minority interest in net assets of subsidiary and goodwill is to obtain a CFV for 100% of a partially owned purchased subsidiary's total net assets, either through independent measurement of minority interest or by inference from the cost of the parent company's investment in subsidiary. Independent measurement of the minority might be accomplished by reference to quoted market price of publicly traded common stock owned by minority stockholders of subsidiary. By inference from the cost of post corporation's investment is as follows:

Total cost of investment of Post co.in Sage……………………..…..………………1,192,250

Post percentage of ownershipof Sage………………………………………… 95%

Implied CFV of 100% of Sage's total net assets(1,192,250/0.95)………… ………1,255,000

Minority Interest:(5%@1,255,000)... ………….62,750

Goodwill (1,255,000 – 1,215,000 which is the CFV Sage'identifiableNA) ………….40,000

Bargain -Purchase excess in consolidated balance sheet

There may be excess of CFV of subsidiary's net assets over the cost of parent Company's investment in the subsidiary's Common Stock (negative goodwill). The same principle as the previous chapter (pro rata reduction) is applied.

Disclosure of Consolidation Policy

In notes to financial statements, a description of consolidation policy shall be reflected in consolidated financial statements.

Advantages and shortcomings of consolidated financial statement

- They are useful principally to stockholders and prospective investors of the parent company. These users are given comprehensive financial information for the economic unit represented by the parent company and its subsidiaries, without regard for legal separateness of the individual companies.
- Creditors of each consolidated company and minority shareholders of subsidiaries have only limited use from consolidated financial statements because they do not show individual financial position and operating results. In addition creditors of constituent companies can't ascertain the asset coverage of their claims
- The major criticism of consolidated statements comes from financial analysts. They argue that consolidated statements of diversified companies (conglomerates) are impossible to classify in a single industry. Hence, they stat that such statements can't be used for comparative purposes or for financial analysis.

5.2. Consolidated Financial Statements Subsequent to Date of Business Combination under purchase method of accounting

Subsequent to date of a business combination the parent company accounts for operating results of subsidiary. That is it accounts for:

- Net income or net loss, and
- Dividends declared paid bysubsidiary

In addition, a number of intercompany transactions and event that frequently occur in a Parent-Subsidiary relationship shall be recorded.

All the three basic financial statements must be consolidated for accounting periods subsequent to the date of purchase type business combination. The items that must be included in the elimination are:

1. The Subsidiary's beginning-of-year stockholder's Equity and its dividends, and the parent's investment;
2. The parent's investment incomeaccounts;
3. Unamortized Current Fair Value excesses of the subsidiary;and
4. Certain operating expenses of thesubsidiary

5.2.1. Accounting for operating Results of Wholly owned purchased subsidiaries

A parent company may choose the **Equity Method** or **the Cost Method** to account for the operating results of consolidated purchased subsidiaries.

1. EquityMethod

- The Parent company records its share of subsidiary's net income or net loss, adjusted for depreciation and amortization of differences between current fair values and carrying amounts of a purchased subsidiary's net asset on the date of business combination, as well as its share of dividends declared bysubsidiary.
- Proponents of the equity method of accounting maintain that the method is consistent with accrual accounting, because it recognizes increases or decreases in the carrying amounts of parent company's investment in the subsidiary when they are **realized** by the subsidiary as net income or net loss, not when they are **paid** by the subsidiary asdividends.
- Proponents claim that it stresses the **economic substance** of the parent-subsidiary relationship because the two companies constitute a single economic entity for financialaccounting.

- They also claim that dividends declared by subsidiary are not revenues to the parent (as claimed by cost methods): instead, they are liquidations (reduction) of investment insubsidiary.

2. **Cost Method**

    - Parent Co. accounts for the operations of a subsidiary only to the extent that dividends are decrared bysubsidisry.
    - Dividends declared by the subsidiry subsequent to the business combination are revenue to parent company
    - Dividends declared by the subsidiary in excess of postcombination net income are reduction in carrying amount of the investrment in subsidiary. (Liquidating Dividend).
    - Net income or net loss of subsidiary is not recorded by parent company when the cost method of accounting is used.
    - Supporters argue that the cost method appropriately recoginizes **legal form**ofthe parent company – subsidiary relationship.
    - Parent company and subsidiry are sparate legal entities; accounting for a subsidiary's operations should recognize the separatness, according to proponents of cost method.

Choosing Between the Two Metheds

- Consolidated financial statement amounts are the same regadless of the mehods used. But the working paper eliminations are different
- The equity method is appropriate for pooled subsidaries as well purchasedsubsidiaries.

Illustration of eqiuity method for wholly owned purchased subsidiary for first year after business Combination.

Example 5.3:

1. Assume that Starr Company had net income of Br 60,000 for the year ended December 31, 2003, and dividends of Br 24,000 are declared on December 20,2003.

December 20, 2003:

DividendsDeclared………………………	24,000	
Intercompany DividendsPayable...........		24,000

Intercompany dividends payable willbe eliminated when preparing consolidated statement. Palm corporation will record the follwingentry:

December 20, 2003:

IntercompanyDividendReceivable	24,000	
Inv't in Starr Co. CommonStock.........		24,000

December 31, 2003:

Investment in Starr Co.CommonStock	60,000	
IntercompanyInvestmentIncome.........		60,000

2. **Adjustment of purchased subsidiary's net income:**

Palm must prepare a third equity method journal entry on December 31,2003 to adjust Starr's net income for depreciation and amortization attributable to the difference between CFV and carrying values of Starr's Co. net assets on Dec. 31,2002, the date ofcombination.

- Because such differences were not considered by the subsidiary, the subsidiary's 2003 net income is overstated from the point of view of the consolidatedentity.
- Assume that on Dec. 31,2002 (date of combination), differences between CFV& carrying values of Starr company's net assets were asfollow:

		Dec 31, 2002	**Dec 31, 2003**
Inventories(FIFO)……………………………………		Br25,000	
Plant assets (net):			
Land	15,000		15,000
Building(15Years)	30,000		28,000
Machinery(10Years)..............................	20,000	65,000	18,000
Patent (5 Years)		5,000	4,000
Goodwill (life 30 Years)		15,000	14,500
Total..		110,000	79,500

Palm Corporation prepares the following additional equity method journal entry to reflect the effects of depreciation and amortization of the differences between the CFV and carrying amounts of Starr Company's net assets on Starr's net income for the year endedDec.31.2003.

The amount of amortization, which the difference between CFVs and carrying amounts of Starr Company's net assets on December 31, 2003 is determined as follows:

Inventories –toCGS…………………………………………..Br25,000

Building - depreciation (30,000/15)..2,000
Machinery – depreciation (20,000/ 15)..2,000
Patent- amortization (5,000/ 5)..1,000
Goodwill-amortization (15,000/ 30) .... 500.
Total **30,500**

December 31, 2003:

IntercompanyInvestmentIncome............................	30,500	
Investment in Starr Co. CommonStocks.....		30,500

Note: Intercompany Investment Income = 60,000 - 30,500 = 29,500

The working paper elimination subsequent to combination must include accounts that appear in the constituent companies' income statement, Retained Earnings statement and balance sheet because all the three statement are to be consolidated. A consolidated statement of cash flows is prepared from the three basic consolidated financial statements and their information.

Developing the Elimination:

- The working paper elimination are asfollows:

A. Removing Subsidiary' equity account and increase inassets

Common stock-Starr... 200,000
Add paidin capital-Starr.. ..58,000
RetainedEarnings- Starr.. 132,000
Inter-companyInvestmentIncome.................................29,500
Plant asset (net) –Starr...61,000
Patent(net)–Starr...4,000
Goodwill(net)–Starr...14,500
COGS-Starr...25,000
Operating expenses –StarrCompany..............................5,500

Investment in Starr Co. Commonstock....	505,500
Dividends declared –Starr......................	24,000

The above working paper elimination journal entry is to eliminate intercompany investment and equity accounts of subsidiary at beginning of year, and subsidiary dividend.

B. For year 2003 depreciation and amortization on differences between CFVs and carrying amounts of Starr's net assets based on the following assumptions:

	COGS	**Expenses**
Inventories sold	Br 25,000	-
Building depreciation..		2,000
Machinerydepreciation..		2,000
Patent amortization..		1,000
Goodwill amortization...		500
Total	25,000	5,500

C. Allocate unamortized differences between combination date CFVs and carrying amounts of Starr’s net asset.(income tax effects are disregarded)

Working Paper Eliminations for Equity Method

- ✓ Three components of the subsidiary’s stock holders’ equity are reciprocal to the parent company’s Investment Ledger Account.
- ✓ The subsidiary’s beginning-of-year retained earnings amount is eliminated.
- ✓ Subsidiary’s dividends are an offset to the subsidiary’s retained earnings.
- ✓ The balance of the parent company’s Investment Ledger Account is net of the dividends received from the subsidiary.
- ✓ The elimination of the subsidiary’s beginning-of-year retained earnings makes beginning-of- year consolidated retained earnings identical to the end-of-previous-year consolidated retained earnings.
- ✓ The debits to the subsidiary’s plant assets, patent, and goodwill bring into the consolidated balance sheet the un-amortized differences between current fair values and carrying amounts of the subsidiary’s assets on the date of the business combination.
- ✓ The amount of the parent company’s inter-company investment income is an element of the balance of the parent’s Investment Ledger Account.

Palm Corporation and Subsidiary Working Paper For Consolidated Financial Statements For Year Ended Dec.31,2003				
Types of financial statements:	**Palm Corporation**	**Star Company**	**Elimination**	**Conso-lidated**
Income statement				
Revenue:				
Net Sales	1,100,000	680,000		1,780,000
Intercompany Investment Income	29,000		a (29,000)	
Total Revenue	1,129,000	680,000	(29,000)	1,780,000
Cost of goods sold	700,000	450,000	a 25,000	1,175,000
Operating expenses	217,667	130,000	a 6,000	353,667
Interest expense	49,000			49,000
Income tax expenses	53,333	40,000		93,333
Total Costs and Expenses	1,020,000	620,000	*31,000	1,671,000
Net income	109,000	60,000	(60,000)	109,000
Statement of Retained Earnings				
Retained Earnings Jan.1, 2003	134,000	132,000	a (132,000)	134,000
Net income for the year	109,000	60,000	(60,000)	109,000
Subtotal	243,000	192,000	(192,000)	243,000
Dividend Declared	30,000	24,000	**a (24,000)	30,000
Retained Earnings end of year	213,000	168,000	(168,000)	213,000
Balance Sheet				
Cash	5,900	72,100		78,000
Intercompany Receivables (Payables)	24,000	(24,000)		–
Inventories	136,000	115,000		251,000
Other current assets	88,000	131,000		219,000
Investment in Betty Company	515,000	–	a (515,000)	–
Plant asset, net	440,000	340,000	a 60,000	840,000
Patent, net	–	16,000	a 4,000	20,000
Goodwill, net	–	–	a 25,000	25,000
Total Asset	**1,208,900**	**650,100**	**(426,000)**	**1,433,000**
Liability and SHE				
Income tax payable	40,000	20,000		60,000
Other liabilities	190,900	204,100		395,000
Common stock Br 10 par	400,000	–		400,000
Common stock Br 5 par	–	200,000	a (200,000)	–
Additional paid-in capital	365,000	58,000	a (58,000)	365,000
Retained Earnings	213,000	168,000	a (168,000)	213,000
Total Liability & SHE	**1,208,900**	**650,100**	**(426,000)**	**1,433,000**

Br 30,500 is an increase in total costs and expenses and a decrease in net income Br 24,000 is a decrease in dividends and an increase in retained earnings.

<u>Note:</u> Use the working paper and prepare consolidated financial statements (Consolidated income statement, statement of retained Earning and balance sheet)

PALM CORPORATION AND SUBSIDIARY
Consolidated Income Statement
For Year Ended December 31, 203

Net sales		Br1,780,000
Cost and expenses:		
Cost of goods sold	1,175,000	
Operating expenses	353,667	
Interest Expense	49,000	
Income Taxes Expense	93,333	
Total costs and expenses		(1,671,000)
Net Income		Br109,000
Basic earnings per share (40,000 shares outstanding)		Br2.74

PALM CORPORATION AND SUBSIDIARY
Consolidated Statement of Retained Earnings
For year ended December 31, 2003

Retained earnings, beginning of year	Br134,000
Add: Net Income	109,000
Subtotal	Br243,000
Less: Dividends (Br 0.75 a share)	30,000
Retained earnings, end of year	Br213,000

PALM CORPORATION AND SUBSIDIARY
Consolidated Balance Sheet
December 31, 2003

Assets:

Cash	78,000
Inventories	251,000
Other Assets	219,000
Plant Assets, net	841,000
Patent, net	20,000
Goodwill	25,000
Total Assets	**1,433,000**

Liabilities and Stockholders' Equity:

Liabilities:

Income taxes payable	60,000
Other liabilities	395,000
Stockholders' Equity:	
Common stock, Br10 par	400,000
Additional paid-in capital	365,000
Retained earnings	213,500
Total liabilities and stockholders' equity	**1,433,000**

The following point are noticeable in the consolidated financial statements and the working paper:

- In effect, the elimination of the inter-company investment income comprises a reclassification of the inter-company investment income to the adjusted components of the subsidiary's net income in the consolidated incomestatement.
- The increases in the subsidiary's cost of goods sold and operating expenses, in effect, reclassify the comparable decrease in the parent company's Investment ledger account under the equity method ofaccounting.
- The inter-company receivable and payable, placed in adjacent columns on the same line, are offset without a formalelimination.
- The elimination cancels all inter-company transactions and balances not dealt with by the offset described above.
- The elimination cancels the subsidiary's retained earnings balance at the ***beginning-of-year***, so that each of the three basic financial statements may be consolidated inturn.
- The first-in, first-out method is used by subsidiary to account for inventories; thus the difference attributable to subsidiary's beginning inventories is allocated to cost of goods sold for the year ended.
- Income tax effects of the elimination's increase in subsidiary's expenses are not included in the elimination.
- One of the effects of the elimination is to reduce the differences between the current fair values and the carrying amounts of the subsidiary's net assets, except land and goodwill, on the business combination date.
- The parent company's use of the equity method of accounting results in the equalities described below:

- **Parent Company Net Income = Consolidated NetIncome**
- **Parent Company Retained Earnings = Consolidated RetainedEarnings**

> Despite the equalities, consolidated financial statements are superior to parent company financial statements for the presentation of financial position and operating results of parent and subsidiarycompanies.

Closing Entries:

After consolidated financial statements have been completed, both the parent company and its subsidiaries prepare closing entries and post to ledger accounts, to complete the accounting cycle for the year. The subsidiary's closing entries are prepared in the usual fashion. However, the parent company's use of equity method of accounting necessitates specialized closing entries. The equity method of accounting disregards legal form in favor of economic substance. However, state corporation laws generally require separate accounting for retained earnings available for dividends to stockholders.

For the Parent Company (Palm Corporation), the December 31, 2003 closing entries under the Equity method of accounting for purchased subsidiary are as follows:

To close revenue accounts:

Net Sales..	1,100,000	
Investment Income from subsidiary.....................................	29,000	
Income Summary...		1,129,000

To close expense accounts:

Income Summary	1,020,000	
Cost of Goods Sold...		700,000
Operating Expenses..		217,667
Interest Expense		49,000
Income Tax Expense		53,333

To close income summary accounts; to transfer net income legally available for dividends to retained earnings; and to segregate 100% share of adjusted net income of subsidiary not distributed as dividends by the subsidiary:

Income Summary	109,000	
Retained Earnings of Subsidiary (29,000 – 24,000)		5,000
Retained Earnings (109,000- 5,000)...		104,000

To close dividends declared accounts:

Retained Earnings	30,000	
Dividend		30,000

5.3. Accounting for Operating Results of partially Owned purchased Subsidiaries Subsequent to Date of Business Combination

This requires computation of the minority interest in net income or net loss of the subsidiary. Under the parent concept of the consolidated financial statements, the consolidated income statement of a parent company and its partially owned subsidiary includes an expense: **minority interest** in net income (loss) of subsidiary. In the consolidated balance sheet, the minority interest in net assets of subsidiary is displayed among **liabilities**.

Illustration of Equity method for partially owned purchases subsidiary for first year after Business Combination (Continuing with post-Sage company relationship)

Example 5.4 : Assume that on December 5, 2004 Sage Co. declared dividend of Br 1 per Share Payable on December 19, 2004 and net income of Sage for the year was Br 90,000.

December 5, 2004: To record declaration of dividend payable

Dividends Declared (40,000 @ 1)..	40,000	
Dividends Payable (Br 40,000 @ 0.05)..................................		2,000
Intercompany Dividends Payable (40,000 @ 0, 95)		38,000

December 19, 2004: ***To record payment of dividend declared***

Dividends Payable...	2,000	
Intercompany Dividends Payable	38,000	
Cash		40,000

Post record the following journal entries for 2004, under the equity method in relation with subsidiary

December 5, 2004: to record dividend declared by Sage Company for proportionate Share of Dividend

Intercompany Dividend Receivable...	38,000	
Investment in Sage Company..		38,000

December 19, 2004: ***To record receipt of dividend from Sage Company***

Cash..	38,000	
Intercompany Dividend Receivable.		38,000

(Proportionate Share of Dividend)

December 31, 2004:

Investment in Sage Company.. 85,500
Intercompany Investment Income (95% @ 90,000 =85,500).... 85,500

To record 95% of net income of Sage Company for the year ended dec.31, 2004 Adjustment of purchased Subsidiary's net income. Assume the following CFV and carrying values:

	Excess Cost	Expense	Dec.31,Balance
Inventories (FIFO)	26,000	(26,000)	—
Plant Assets, net:			
Land..	60,000	—	60,000
Building (20 Years).............................	80,000	(4,000)	76,000
Machinery (5 Years)	50,000	(10,000)	40,000
Leasehold (6Years)	30,000	(5,000)	25,000
Total	246,000	(45,000)	201,000

In addition, Post acquired goodwill in the amount of Br 38,000 to be amortized over 40 years.

Post Corporation prepares the following additional entry to consider the above items.

Intercompany Investment Income (95% @ 45,000)............................ 42,750
Investment in Sage Company Common Stock........................ 42,750

The amortization of goodwill will be recorded as*:*

Amortization Expense (38,000/40).. 42,750
Investment in Sage Co.CommonStock..................... 42,750

The Investment in Sage Company

Investment in Sage Co

1,192,250	38,000
85,500	42,750
	950
1,196,050	

Note: Goodwill in a business combination involving a partially owned subsidiary is attributable totheparentcompanyinapartiallyownedsubsidiaryratherthanthesubsidiary.Consequently,amortization of goodwill is debited to the amortization Expense ledger account of the parent company.

Developing the Elimination Entries

- **PostCorporation**usestheequitymethodofaccountingforitsinvestmentin **SageCompany** results in balance the Investment ledger account that is a mixture of three components.
    - **i.** The carrying amount of Sage's identifiable netassets
    - **ii.** the"currentfairvalueexcessorExcessCostoverCFV:whichisattributabletoSage's

identifiable assets: and

iii. the goodwill acquired by post in the business combination withSage

A. The Eliminations column of the working paper is presentedbelow:

Common Stock –Sage Company	400,000	
Add paid in capital – Sage Company	235,000	
Retained Earnings – Sage Company	334,000	
IntercompanyInvestmentIncome-Post	42,750	
Plant Assets (net) – Sage Company	176,000	
Leasehold – Sage Company	25,000	
Goodwill – Sage Company	38,000	
CGS – Sage Company..	26,000	
Operating Expenses- Sage Company	19,000	
Investment in Sage Company		1,196,050
Dividends – Sage Company		40,000
Minority Interest in Net Assets of the sub		58,750

For year 2004 depreciation and amortization on differences between CFVs and carrying amounts of Sage's net assets are as follows:

	COGS	Operating Expenses
Inventories Sold	26,000	
Building Depreciation		4,000
Machinery Depreciation		10,000
Leasehold Amortization		5,000
Total	26,000	19,000

B. Minority Interest in Net Income and NetAssets

Minority Interest in Net Income of Subsidiary	2,250	
Minority Interest in Net Assets of Subsidiary		2,250

Minority interest in subsidiary's adjusted net income for year 2000 is computed as follows:

Net Income of Subsidiary	Br 90,000
Net reduction of elimination (A) (43,000 + 2000)..................................	(45,000)
Adjusted Net Income of subsidiary...	45,000
Minority Interest in Adjusted Income (45,000 x 0.05)	(**2,250**)

Post Corporation and Subsidiary

Working paper for consolidated
Financial statements For year Ended
Dec.31,2004

	Post Corp.	Sage Co.	Elimination	Consolidated
Income statement				
Revenue:				
Net Sales	5,611,000	1,089,000		6,700,000
Intercompany Investment income	42,750		(a)(42,750)	
Total Revenue	**5,653,750**	**1,089,000**	**(42,750)**	**6,700,000**
Cost of goods sold	3,925,000	700,000	(a) 26,000	4,651,000
Operating expenses.................................	*556,950	129,000	(a)19,000	704,950
Interest and income tax expense	710,000	170,000		880,000
Minority interest in net income of Sub...............			**(b) 2,250**	**2,250**
Total costs and Expenses	5,191,950	999,000	**** 47,250**	**6,238,200**
Net income...	**461,800**	**90,000**	**(90,000)**	**461,800**
Statement of Retained Earrings				
Retained Earnings Jan.1.2004..................	1,050,000	334,000	(a)(334,000)	1,050,000
Net income for the year...........................	461,800	90,000	(90,000)	461,800
Subtotal..	1,511,800	424,000	(424,000)	1,511,800
Dividend Declared....................................	1,58,550	40,000	*** (a)(40,000)	158,550
Retained Earnings end of year	**1,353,250**	**384,000**	**(384,000)**	**1,353,250**
Balance sheet				
Inventories	861,000	439,000		1,300,000
Other Current Assets	639,000	371,000		1,010,000
Investment in Sage Co. CS	1,196,050		(a)(1,196,050)	
Plant asset(net)	3,600,000	1,150,000	(a) 176,000	4,926,000
Leasehold(net)..			(a) 25,000	25,000
Goodwill (net)...	95,000		(a)37,050	132,050
Total asset	**6,391,050**	**1,960,000**	**(958,000)**	**7,393,050**
Liabilities and SHE				
Liabilities	2,420,550	941,000		3,361,550
Minority interest in net asset Subsidiary...			(a)58,750 (b)2,250	61,000
Common stock Br 1 par............................	1,057,000			1,057,000
Common stock Br 10 par..........................		400,000	(400,000)	
Additional paid-in capital	1,560,250	235,000	(235,000)	1,560,250
Retained Earnings	1,353,250	384,000	(384,000)	1,353,250
Total Liab & SHE...................................	**6,391,050**	**1,960,000**	**(958,000**	**7,393,050**

**includes Br 950 amortization ofgoodwill*
*** An increase in total costs and expenses, and a decrease in netincome*
**** A decrease in dividends and an increase in retained earnings.*

Consolidated Financial statements

The consolidated income statement, statement of retained earnings and balance sheet of Sweet Corporation and subsidiary for the year ended Dec.31, 2004 are shown below:

- **Income Statement**

Post Corporation and Subsidiary Sage Company **Consolidated Income statement** **For the year ended December 31, 2004**		
Net Sales		Br 6,700,000
Costs and Expenses:		
Cost of Goods Sold	4,651,000	
Operating Expense	704,950	
Interest and Income Tax Expense	880,000	
Minority Interest in Net Income of The Subsidiary	2,250	
Total Costs and Expenses		(6,238,200)
Net Income		461,800
Earning per share of common stock (462,750 / 1,057,000 shares)		Br 0.44

- **Retained Earnings Statement**

Post Corporation and Subsidiary Sage Company **Consolidated Retained Earning Statement** **For year ended Dec.31 2004**	
Retained earnings, beginning of the year	Br 1,050,000
Add: Net income	461,800
Subtotal	1,511,800
Less: Dividends (Br 0.15 a share)	(158,550)
Retained Earnings, Ending of the Year	1,353,250

- **Balance Sheet**

Post Corporation and Subsidiary Sage Company **Consolidated Balance Sheet** **For year ended Dec.31, 2004**	
Assets:	
Inventories	1,300,000
Other Assets	1,010,000
Plant Assets, net	4,926,000
Leasehold, net	25,000
Goodwill, net	132,050
Total assets	7,393,050
Liabilities and Stockholders' Equity:	
Liabilities:	
Liabilities Other Than Minority Interest	3,361,550
Minority interest in net assets of subsidiary	61,000
Stockholders' Equity:	

Common stock, Br 1par	1,057,000
Additional Paid In Capital..	1,560,250
Retained Earnings	1,353,250
Total liabilities and stockholders' equity...	7,393,050

Closing Entries:

Parent's Dec.31 2004 closing entries under the Equity method of accounting for purchased subsidiary are as follows:

To close revenue accounts

Net Sales..	5,611,000	
Intercompany investment income	42,750	
Income summary...		5,653,750
To close expense accounts:		
Income Summary	5,191,950	
Cost of Goods Sold		3,925,000
Operating Expenses		556,950
Interest and Income tax expense		710,000

To close income summary accounts; to transfer net income legally available for dividends to retained earnings; and to segregate 95% share of adjusted net income of subsidiary not distributed as dividends:

Income Summary	461,800	
Retained Earnings of Subsidiary (42,750 – 38,000)		4,750
Retained Earnings (462,750 – 4,750)............................		457,050
To close dividends declared accounts:		
Retained Earnings	158,550	
Dividend Declared		158,550

5.4.Chapter Summary

5.5.Self-Test Questions

Now, this chapter is completed you must have to test your progress by doing the following self-test and compare your answer with the answer key given at the end.

Multiple Choice Questions

1. Which of the following is correct about the consolidated balance sheet for the parent and subsidiaries on the date of purchase type business combination?

A. The assets and liabilities of the parent and subsidiary are eliminated from the consolidated balance sheet.
B. The parent company investment account appears from the consolidated balance sheet.
C. Intercompany payables and receivables do not appear from the consolidated balance sheet.
D. None of the above

2. A single economic entity aspect requires ;
   A. The preparation of consolidated financial statements
   B. The preparation of separate financial statements by the parent and subsidiaries
   C. Both A and B   D. Neither A nor B
3. The consolidation of a parent company with its partially owned subsidiary differs from a consolidation of wholly owned subsidiary with respect to;
   A. The recognition of minority interest
   B. The recognition of good will
   C. The elimination of parents investment account
   D. None of the above
4. Which one of the following accounts would not appear on the consolidated financial statements at the end of the first fiscal period of the combination?
   A. Investment in Subsidiary
   B. Common Stock- Parent
   C. Additional Paid-In Capital – Parent
   D. Retained earnings - Parent

CHAPTER SIX

FOREIGN CURRENCY ACCOUNTING

Learning objectives:

Dear students, after successfully completing this chapter you will be able to:

- Define foreign currency
- List and differentiate types of currency-related exposures
- Familiarize Accounting for Foreign Currency Transaction
- differentiate Accounting principles and methods for foreign currency transactions
- familiarized with Methods and Procedures of Foreign Currency Translation
- Produce financial statements using translation or re-measurement, or both

6.1 Accounting for Foreign Currency Transactions

Businesses that involve in international trades or Multi-National Company (MNC) need foreign currencies to enter into different transactions. A "Multi-National Company" is one that conducts its business in more than one country via branches, joint ventures, subsidiaries etc. In most countries, the foreign currency is treated as a commodity or a money-market instrument. Thus, different Multi-National Companies (MNCs) involve buying and selling of foreign currency. The following different Exchange Rates are applicable for buying and/or selling foreign currency:

Spot Rates: are rates used by banks for immediate delivery or receipts of a foreign currency. The two spot rates are (i) **Spot Selling Rate**: The rate charged by the bank for current sales in foreign currency; and (ii) **Spot Buying Rate**: The rate applied by the bank to acquire a foreign currency. The spot buying rate is usually lower than the spot selling rate.

Forward Rates: are rates applied to foreign currency transactions to be consummated at a future date. The two forward rates are **(i) Forward Selling Rate**: The rate charged by the bank for future sales in foreign currency, and (ii) **Forward Buying Rate**: The rate applied by the bank to acquire a foreign currency in the future. The forward buying rate is usually lower than forward selling rate. **Spread:** is the difference between the selling and the buying spot rates and represent gross profit to a foreign currency trader

The transactions engaged into by the multinational company must be recorded in the reporting currency in the accounting records of the enterprise. The appropriate spot rate is used for this purpose. If the spot exchange rate for the foreign currency changes on the date of financial statement preparation prior to settlement of the transaction, or on the settlement date itself, a **foreign currency transaction gain or loss** is recognized for display in the income statement of the enterprise for the accounting period in which the rate changes. For MNC, if all its transactions are accounted for in one currency, no problem arises, however often local currencies are used and thus, MNCs are exposed to different risks as discussed in the next topic as a result of foreign exchange rate fluctuations.

6.1.1. Economic, Transaction, and Translation Exposure

1. Economic Exposure

It is sometimes called operating exposure. This is an exposure that measures the extent to which a firm's market value is sensitive to unexpected changes in foreign currency. Currency fluctuations affect the value of the firms' cash flows, income statement and balance sheet by altering its competitive position. Economic Exposure is the sensitivity of the future home currency value of the firm's assets and liabilities and the firm's operating cash flow to random changes in exchange rates. Economic exposures measures the change in the present value of the firm resulting from any change in expected future operating cash flows caused by an unexpected change in exchange rates.

2. Transaction Exposure

Transaction Exposure measures gains or losses that arise from the settlement of existing financial obligations whose terms are stated in foreign currency. Transaction exposure measures the extent to which income from individual transactions is affected by fluctuations in foreign exchange values. It is the risk of loss due to adverse foreign exchange rate movements that affect the home currency value of import and export contracts denominated in a foreign currency. It is also the risk, faced by companies involved in international trade that currency exchange rates will change after the companies have already entered into financial obligations. Such exposure to fluctuating exchange rates can lead to major losses for firms. It usually takes place from changes in exchange rates between dates of inception of a contract denominated in foreign currency and settlement of the contract. For example, the transaction exposure may arise from the following transactions:

- Purchasing or selling on credit when prices are stated in a foreign currency
- Borrowing or lending funds when repayment is to be made in a foreign currency
- Being a party to an unperformed foreign exchange forward contract
- Acquiring assets or incurring liabilities denominated in a foreign currency

Foreign Currency Transaction Gains and Losses

During the period liabilities are open, if the selling spot rate decreases (foreign currency weakens against the domestic currency), it results in a foreign currency transaction gain; if the selling spot rate increases (foreign currency strengthens against the domestic currency), it will result in a foreign currency transaction loss. Gains and losses are reported in a firm's income statement in the period in which they occur.

Example 6.1:

Ethio Trading Company purchased goods on account from **US Company** on December 21, 2008 at $100,000 terms n/30. The spot selling rate for a dollar is Br 16.60

Inventories...	1,660,000	
Accounts Payable		1,660,000

To record purchase on 30-day open account from US supplier for $100,000, translated at the spot selling rate $1 = Br 16.60

Determine the foreign currency transaction gain or loss for the Ethio Trading Company assuming that on December 31, 2008, the spot selling rate for a US dollar was Br 16.58

Liability on December 21, 2008...	Br 1,660,000
Less: Liability on December 31, 2005 ($100,000 @ 16.58)............	1,658,000
Foreign currency transaction gain	Br 2,000

Journal Entry:

Accounts Payable	2,000	
Foreign Currency Transaction Gain		2,000

Determine the foreign currency transaction gain or loss for the Ethio Trading Company assuming that on maturity date, February 19, 2011, the spot selling rate for a US dollar was Br 16.61

Liability on December 31, 2008..	Br 1,658,000
Less: Liability on December 31, 2005 ($100,000 @ 16.61)............	1,661,000
Foreign currency transaction loss...	(Br3, 000)

Journal Entry:

Accounts Payable	1,658,000	
Foreign Currency Transaction Loss	3,000	
Cash……		1,661,000

Exercise 6.1: Ethio Trading Company purchased goods on account from US Company on December 21, 2008 at $100,000 terms n/30. The spot selling rate for a dollar is Br16.60 on the date of transaction. On December 31, 2008, the spot selling rate for a US dollar was Br 16.63. On Maturity date, February 19, 2011, the spot selling rate for a US dollar was Br 16.59. Instruction: Record the foreign currency transaction on each date.

3. Translation Exposure or Accounting Exposure

Translation exposure is a risk attributed to change in a firm's financial position when the firm's consolidated financial statements are affected by changes in foreign exchange rates. Translation involves converting financial statements of foreign subsidiaries from the local currency to the home currency. It is also known as Accounting Exposure. Translation exposure or accounting exposure measures the potential losses or gains that would appear on the consolidated financial statements following a change in exchange rates. It is a risk that a company's equities, assets, liabilities or income will change in value as a result of changes in exchange rate. This occurs when a firm denominates a portion of its equities, assets, liabilities or income in a foreign currency. The translation adjustments are an inherent result of the process of translating a foreign entity's financial statements from the functional currency to reporting currency. Translation adjustments are not included in determining net income for the period but are disclosed and accumulated in a separate component of consolidated equity until sale or until complete or substantially complete liquidation of the net investment in the foreign entity takes place.

6.2. Accounting for Translation of Foreign Currency Financial Statements

6.2.1. Translation Terminology

- **Functional Currency –** SFAS No. 52 is the primary source of GAAP for translation of foreign currency financial statements. Statement of Financial Accounting Standards No. 52 (SFAS 52) introduced the concept of the Functional Currency. SFAS No. 52 defined the **Functional Currency** of a foreign entity as the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash. Functional currency is the monetary unit of account of the **Principal Economic Environment** in which an economic entity operates. The functional currency is used to differentiate between two types of foreign operations:
    - Those that are self-contained and integrated into a local environment
    - Those that are an extension of the parent and integrated with the parent
- **Reporting Currency** – is the currency in which the parent company prepares its financial statements; that is the currency used in published reports and financial documents of the parent company. It is a currency in which the parent firm prepares its own financial statements; that is, US dollars for a US companies or Birr for Ethiopian companies.
- **Foreign Currency** – any currency other than the reporting currency of the parent company
- **Local Currency** is the currency unit used in a country referenced. Local currency is the currency in the country where the foreign subsidiary is operating. For example, Birr is the local currency in Ethiopia.
- **Exchange Difference (Spread)**– difference resulting from translating a given number of units of one currency into another currency at different exchange rates
- **Foreign Operation** – a subsidiary, associate, joint venture, or branch whose activities are based in a country other than that of the reporting enterprise.

6.2.2. Identifying Functional Currency

The functional currency for a given foreign operation is a matter of fact. Management judgment is required in the functional currency determination process. FASB provided that the salient (most important) economic factors set forth below and possibly others, should be considered both individually and collectively when determining the functional currency.

- Cash Flow Indicator – denomination of cash flows.
- Sales Price Indicator – responsiveness of selling prices to exchange rates on a short-term basis.
- Sales Market Indicator - existence of an active local sales market for the product
- Expense Indicator – existence of a local source for operating costs
- Financing Indicator – denomination of the firm's primary financing
- Intercompany Indicator – the volume of intercompany transactions.

To determine the functional currency, the most heavily weighted factors are indicators related to **Cash Flows and Expense and Revenue Items**. Based on the above six indicators, Multinational company may use the reporting currency or local currency, or foreign currency other than local currency for the operation of foreign subsidiary. The functional currency may be the currency of the country in which the foreign entity is located **(local currency)**, the **reporting currency**, or the currency of other foreign country (**foreign currency)**.

- If the foreign entity's operations are self-contained and integrated in a particular country and are not dependent on the economic environment of the parent company, the functional currency is the foreign currency (either local currency or foreign currency other than local currency).
- The functional currency of a foreign company would be the reporting currency if the foreign operation is an integral component or extension of the parent company's operations. That is, the daily operations and cash flows of the foreign operation of the foreign entity are dependent on the economic environment of the parent company.
- An exception is required for subsidiaries located in environments in which the cumulative rate of inflation during the preceding three years exceeds 100 percent. In such hyper inflationary

environments, the reporting currency becomes the functional currency. A Local Currency can be a Functional Currency only in a Stable Economy if:

- Cash flows are local currency
- Sales prices are determined by local conditions / in local currency
- Expenses are paid in local currency / driven by local conditions
- Financing done in local currencies
- Inventory value liked to local conditions.

When a multinational enterprise prepares consolidated or combined financial statements that include the operating results, financial position and cash flows of foreign subsidiaries or branches, the enterprise must **translate** the amounts in the financial statements of the foreign entities from the entities' **functional currency to the reporting currency**. Similar treatment must be given to investments in other (foreign) investee's for which the parent company uses the equity method of accounting. In addition, if foreign entity's accounting records are maintained in a **local currency** of the foreign country that is not the **entity's functional currency**; the foreign entity's account balances must be **re-measured to the functional currency from local currency**

6.2.3 Translation Exchange Rates

In translation of foreign subsidiary financial statements, there needs to raise two questions:

1. How should translation gains and losses be reported in the financial statements or should be accounted for? Should they be included in income?
2. What exchange rate should be use d to translate each line of the foreign financial statements into the domestic currency? That is which exchange rate should be used to translate foreign currency account balances to reporting currency?

Translation methods may employ a single rate or multiple rates. There are three alternative exchange rates for translation of foreign subsidiary financial statements: current rate, historical rate, and average rate.

- **Current Rate** – exchange rate prevailing as of the financial statement date
- **Historical Rate** – exchange rate prevailing when a foreign currency asset was first acquired or a foreign currency liability was first incurred

- **Average Rate –** is simple or weighted average exchange rate of either current or historical exchange rates

Based on ways of presenting the information exchange rates are classifed as:

1. **Direct Qoates:-** the number of Ethiopian birr needed to purchase one unit of foreign currency(The first collumn).
2. **Indirect Qoutes**:- the number of foreign currency unit that could be purchased using one Ethiopian birr.(The second column).

6.2.4 Alternative Methods of Translation of Foreign Subsidiary's Financial Statement

If the exchange rate for the functional currency of a foreign subsidiary or branch remained constant instead of fluctuating, translation of financial statements would be simple. All financial statement amounts would be translated at the constant exchange rate. However, exchange rates fluctuate frequently. Hence, a problem is faced which exchange rate to use. The several methods (translation models) for foreign currency translation may be grouped into four basic classes as shown below:

1. Current / Non-current Method
2. Monetary/ Non monetary Method
3. Temporal Method
4. Current Rate Method

In general, all the four translation models agree on the translation of sales revenues & other revenues and most operating expenses on the income statement except depreciation expense. Typically, these are translated using the **historical rate** in effect when the revenue was earned or the expense recognized. That may be an **average rate** for the period.

1. Current / Noncurrent Method

This method focuses on traditional accounting classification for assets and liabilities:

Balance Sheet Translation**:**

- Current items on the balance sheet (current assets and current liabilities) are translated at the current rate.

- Long-term items on the balance sheet (all other assets & liabilities) and the elements of owners 'equity are translated at historical rates

Income statement Translation**:**

- Depreciation expense & amortization expenses are translated at historical rates applicable to the related assets.
- All other revenues and expenses are recognized at an **average exchange rate** for the accounting period.

This method was sanctioned by AICPA for many years. Today it has few supporters. The principal objection of this method is with respect to inventories; it represents a departure from historical cost. **Inventories are translated at current rate**, rather than at historical rates in effect when the inventories were acquired, if the current/ noncurrent method of translating foreign currency accounts is applied. Cost of Goods Sold is translated at the current rate because inventory is translated at current rate as it is current asset. Translation gains and losses under this method are generally included in Net Income, but treatment is flexible.

2. Monetary/ Non-monetary Method

This method focuses on the *financial character* of assets & liabilities of the foreign subsidiary financial statement rather than on their balance sheet classifications to determine appropriate rate. Foreign currency assets and liabilities expressed as a fixed number of currency units are defined as monetary (receivables and payables). Other items are non-monetary.

Balance sheet translation**:**

- Monetary items are translated at the current rate – i.e. monetary assets & liabilities representing claims & obligations expressed in a fixed monetary amount are translated at the current rate.
- Nonmonetary items are translated at the historical rate – i.e. all other assets and liabilities, and owners' equity amounts are translated at historical rates. Non-monetary items include fixed assets, long-term investments, and inventories.

Income statement translation**:**

- In the income statement, average exchange rates are applied to all revenues and expense except depreciation expenses, amortization expense, and cost of goods sold, which are translated at **appropriate historical rates**.
- Supporters of this method emphasized its retention of the historical cost principle in the foreign entity's financial statements. It was sanctioned by FASB until the issuance of FASB statement No 52.

Main difference between Current-Noncurrent and Monetary-Nonmonetary:

- Translation rates used for noncurrent receivables and payables is current rate
- Translation rates used for inventory, and prepaid items is historical rate

3. Temporal Method

The temporal model considers currency translation as a measurement conversion process. This method cannot be used to change the attribute of an item being measured; it can only change the unit of measure. The temporal method is very similar to Monetary / Nonmonetary unless there is significant difference in GAAP. Both may present identical results. Differences occur for items that have been **revalued**. If no revaluation is allowed, the two methods yield identical results. Temporal method considers time dimensions and foreign balance sheet items are measured accordingly based on three different values: Past exchange prices – Historical Cost, Current exchange prices - Current Value, Future Values

- Cash, receivables, and payables are translated at the current rate
- Other assets and liabilities may be translated at current or historical rates, depending on their characteristics
- Assets and liabilities carried at past exchange prices are translated at historical rates
- Assets and liabilities carried at current purchase or sales exchange prices or future exchange prices would be translated at current rates
- This flexible method ensures that parent currency is the single unit of measure
- Cost of Goods Sold and Depreciation Expense are translated at their historical rate. Exchange gains and losses from translation are included in current net income.

Criticisms of Temporal Method

- The results of translation frequently do not reflect the underlying economic reality of foreign operations. This is underscored by the volatility of reported earnings using this method.
- Financial results and relationships are distorted. The use of the temporal method can cause distortions such that a net income in the foreign currency translates to a net loss in the home currency.
- Sources of these problems are the requirement for current recognition of the unrealized exchange adjustment and translation of inventories and fixed assets at historical rates, while the debt used to acquire these assets is translated at current rates.

4. Current Rate Method

- All balance sheet amounts other than owners' equity items are translated at the current rate.
- Owners' equity items are translated at the historical rates.
- Revenues and gains and expenses and losses are translated at the rates in existence during the period when the transactions occurred (if practical); otherwise an average exchange rate is used for all revenuers and expenses.

This method provides that all financial relationship remain the same in both local currency and reporting currency. The translation adjustment which result from the application of these rules are reported as a separate component in owners' equity of the parent company's consolidated balance sheet (or parent – only balance sheet if consolidation was not deemed appropriate).

Generally:

	Temporal Method Exchange Rate	Current Rate Method Exchange Rate
Balance Sheet		
Assets		
Cash and receivables	Current	Current
Marketable securities	Current*	Current
Inventory at market	Current	Current
Inventory at cost	Historical	Current
Prepaid expenses	Historical	Current
Property, plant, and equipment	Historical	Current
Intangible assets	Historical	Current
Liabilities		
Current liabilities	Current	Current
Deferred income	Historical	Current
Long-term debt	Current	Current

6.2.5. Translation and Re-measurement: Producing Financial Statements Using Translation or Re-measurement, or Both.

Translation of Foreign Currency Financial Statements (SFAS No. 52)

Translation involves expressing functional currency measurements into the reporting currency. FASB statement No 52 adopted the **current rate method** for translating a foreign entity's financial statements, from the entity's functional currency to the reporting currency of the parent company.

2. **Re-measurement of a Foreign Entity's Records**

When the foreign entity's books are not maintained in its functional currency, the foreign currency financial statements must be re-measured into the functional currency. This is accomplished using the Temporal Method or Monetary and Non-monetary method. FASB provided guidelines for **re-measurement.** The re-measurement process should produce the same result as if the entity's books or records had been initially maintained in the functional currency. To accomplish this result; historical exchange rate is used for some items and current rate is used for others. The monetary assets and liabilities are re-measured using the current exchange rates while the non-monetary items are re-measured at historical rates. The gain /loss from re-measurement is recognized in income measurement

1. **Items re-measured using historical rate are:**
   - Marketable securities carried at cost like equity securities and debt securities not intended to be held until maturity
   - Inventories carried at cost
   - Short term prepayment such as insurance, advertising, and rent
   - Plant assets and accumulated depreciation
   - Intangible assets and related accumulated amortization
   - Deferred charges & credits
   - Deferred revenue
   - Common stock
   - Preferred stock carried at issuance price

- Examples of revenue & expenses related to non-monetary items are Cost of good sold; Depreciation of Plant assets; Amortization of intangibles; and Amortization of deferred charges/ credits

2. **All other items are re measured using the current rate –** for example sales and operating expenses

The appropriate historical or current exchange rate generally is the rate applicable to conversion of the foreign currency for dividends remittances. For instance, a U.S. multinational enterprise having foreign branches, investees, or subsidiaries typically uses the buying spot rate on the balance sheet date or applicable historical date to re-measure the foreign currency financial statements.

As per law of the land (law of the country), financial statements are prepared in a currency of that land regardless of the control existed. Accounting records and books are also maintained in local currency. This determines whether to apply re-measurement or translation to produce foreign financial statements.

1. If functional currency is the parent company's currency (reporting currency), no translation is required but re-measurement of foreign subsidiary financial statements at monetary / non-monetary method eliminates the need for translation.
2. If functional currency is local currency, translation of foreign currency financial statements should be done.
3. If functional currency is a foreign currency other than local currency, first re-measurement is undertaken at **monetary / non monetary method (temporal method)** from local currency to functional currency and then translation is accomplished at current method from functional currency to reporting currency. That is, if a foreign entity's accounting records are maintained in a currency other than its functional currency, account balances shall be re-measured to the functional currency before the statements are translated. If re-measurement is required, it must precede translation.

	Functional Currency	**Currency of Records**	**Required Procedures**
Case 1	Local Currency	Local Currency	Translation
Case 2	Reporting Currency	Local Currency	Re-measurement

Case 3	Other Foreign Currency	Local Currency	Re-measurement & Translation

Example: A US Company having subsidiary in UK

	Functional Currency	**Currency of Records**	**Required Procedures**
Case 1	British Pounds	British Pounds	Translation
Case 2	US Dollar	British Pounds	Re-measurement
Case 3	Euro	British Pounds	Re-measurement & Translation

Example 6.2: **Illustration of Re measurement of a foreign entity's Account Balances**

Assume the SPS Company whose HO is in US made investment by opening a branch in Ethiopia. SPS Company bills merchandise to branch at cost and both use perpetual inventory system. The functional currency is USD, although the Ethiopian Branch maintains its accounting records in ETB.

2.8. Transactions of the Year 2008:

1. Cash of $1,000 was sent by Head Office to the Ethiopian Branch ($1= Br 8.55)
2. Merchandise of $100,000 was shipped at cost to Ethiopian Branch ($1 = Br 8.55)
3. Equipment of Br 8,400 was acquired by branch to be carried in HO records ($1 = Br 8.40)
4. Sales by the branch total Br 639,000 ($1 = Br 8.52) COGS = Br 383,400
5. Collection by branch Br 516,000 ($1 = Br 8.6)
6. Payments operating expenses by branch Br 172,000 ($1 = 8.6 Br)
7. Cash of Br 34,200 was remitted to the Ho ($1 = 8.55 Br)
8. Operating expenses incurred by HO & charged to branch $2,000 ($1= Br 8.55)

Additional Information:

- The exchange rate at the beginning was Br 8.55.......... (1)
- The exchange rate at the year was Br 8.47................... (2)
- Average rate = (8.47+8.55) / 2 = Br 8.51..................... (3)

Instruction: Record the above transaction by the **Home Office** and by **Branch**.

Home Office(US Dollar)			**Ethio Branch (Br)**		
1. Investment in Ethio branch	1,000		Cash	8,550	
Cash		1,000	Home Office		8,550
2. Investment in Ethio branch	100,000		Inventories	855,000	
Inventories		100,000	Home Office		855,000
3. Equipment: Ethio Branch	1,000		Home Office	8,400	
Investment in Ethio Branch......		1,000	Cash		8,400
4. None			Trade A/R	639,000	
			COGS	383,400	
			Sales................		639,000
			Inventories		383,400
5. None			Cash	516,000	
			Trade A/R		516,000
6. None			Operating Expense ..	172,000	
			Cash		172,000
7. Cash	4,000		Home Office	34,200	
Investment in Ethio Branch.......		4,000	Cash		34,200
8. Investment in Ethio Branch...........	2,000		Operating Expense ...	17,100	
Operating expense		2,000	Home Office		17,100

The balance of Investment in Branch and Home Office Accounts are as follows:

Investment in Ethio Branch		**Home Office**	
1,000	1,000	8,400	8,550
100,000	4,000	34,200	855,000
2,000			17,100
98,000			838,050

Branch Trial Balance

SPS Company
Ethio Branch Trial Balance

December 31, 1999

	Debit	**Credit**
Cash	Br 309,950	
Accounts Receivable	123,000	
Inventories	471,600	
Home Office		838,050
Sales...		639,000
Cost of Goods Sold...........................	383,400	
Operation expenses...........................	189,100	
Totals	1,477,050	1,477,050

Branch Trial Balance after Re-measurement

SPS Company Re-measurement of Ethio branch Trial Balance December 31, 1999			
	Balance (Br) Dr (Cr)	**Exchange Rates**	**Balance ($) Dr (Cr)**
Cash	Br 309,950	8.47 (1)	$36,594
A/R	123,000	8.47 (1)	14,522
Inventories	471,600	8.55 (2)	55,158
Home Office	(838,050)		(98,000)
Sales..	(639,000)	8.51 (3)	(75,088)
COGS	383,400	8.55 (2)	44,842
Operating expenses........................	189,100	8.51 (3)	22,221
Subtotal..	- 0 -		249
Remeasurement Gain	- 0 -		(249)
Totals	- 0 -		- 0 -

The transaction Gain is not a ledger account but used to reconcile the total debits and credits of the branch's re-measured trial balance. It is used in measuring branch net income for the year. In a review of the re-measurement of the Ethio branch trial balance, the following four features should be noted:

1. Monetary assets are re-measured at the current rate; the single non-monetary asset- inventory- is re-measured at the appropriate historical rate.
2. To achieve the same result as re-measurement of the Home Office ledger account at appropriate historical rates, the balance of the Home Office's Investment in Ethio Branch account (in dollars) is substituted for the Branch's Home Office account (in Birr). All equity ledger accounts- regardless of legal form of the investee- are re-measured at historical rates
3. A simple average of beginning-of -year and end of year exchange rates is used to re-measure revenue and expense accounts other than cost of goods sold, which is re-measured at the appropriate historical rates. In practice, a quarterly, monthly or even daily weighted average might be computed.
4. A balancing amount labeled foreign currency transaction loss, which is not a ledger account, is used to reconcile the total debits and total credits of the branch's re-measured trial balance.

After the trial balance of Ethio branch has been re-measured from Birr to dollar, combined financial statements for Home Office and branch may be prepared.

***Example 6.3*: Illustration on Translation of a Foreign Entity's Financial Statements**

If a foreign entity's financial statements are expressed in a functional currency other than the parent company's reporting currency, those amounts must be translated to the reporting currency by the current rate method.

Translation of Financial Statements of Foreign Influenced Investee

To illustrate the translation of the financial statements of a foreign investee whose functional currency is its local currency, assume that on May 31, 2008, **Colossus Company**, a U.S. multinational company, acquired 30% of the outstanding common stock of a corporation in Venezuela, which is termed **Venezuela Investee**. Although the investment of Colossus enabled it to exercise influence (but not control) over the operations and financial policies of Venezuela Investee, that entity's functional currency was the Bolivar (B). Colossus acquired its investment in Venezuela Investee for B 600,000, which Colossus acquired at the selling spot rate of B1 = $0.25, for a total cost of $150,000. Out-of-pocket costs of the investment may be disregarded. Stockholders' equity of Venezuela investee on May 31, 2008, was as follows:

Common Stock	B 500,000
Additional paid-in capital	600,000
Retained earnings	900,000
Total stockholders' equity	B 2,000,000

There was no difference between the cost of **Colossus Company's** investment and its equity in the net assets of **Venezuela Investee** (B 2,000,000 @ 0.30 = B600,000, the cost of the investment). The exchange rates for the Bolivar were as follows:

May 31, 1999	$0.25 (1)
May 31, 2000	0.27 (2)
Average for year ended May 31, 2000	0.26 (3)

Translation of Venezuela Investee's financial statements from the functional currency to the U.S dollar reporting currency for the year ended May 31, 2009, is illustrated below:

Venezuela Investee
Translation of Income Statement & Retained Earning Statement to U.S dollar
For year ended May 31, 2000

Income statement	**Venezuela Bolivars**	**Exchange Rates**	**USD**
Net sales	B6,000,000	$0.26(3)	1,560,000
Costs and expenses	(4,000,000)	0.26(3)	(1,040,000)
Net income	2,000,000		$ 520,000
Statement of Retained Earnings			
Retained earning, Beginning	B 900,000	0.25(1)	$ 225,000
Add: net income	2,000,000		520,000
Subtotal	2,900,000		745,000
Less: dividends*	600,000	0.27(2)	162,000
Retained Earnings, end of year	B 2,300,000		$583,000

Venezuela Investee
Translation of Balance Sheet to U.S dollar
For year ended May 31, 2009

	Venezuela B	**Exchange Rates**	**USD**
Assets			
Current assets	B 200,000	0.27(2)	$ 54,000
Plant assets (net)	4,500,000	0.27(2)	1,215,000
Other assets	300,000	0.27(2)	81,000
Total assets	B 5,000,000		1,350,000
Liabilities and SHE			
Current liabilities	B 100,000	0.27(2)	$27,000
Long-term debt	1,500,000	0.27(2)	405,000
Common stock	500,000	0.25(1)	125,000
Paid in capital	600,000	0.25(1)	150,000
Retained earnings	2,300,000		583,000
Foreign currency translation adjustments			60,000
Total liabilities and stockholders' Equity.	B 5,000,000		$1,350,000

- *Dividends were declared May 31, 2009*
- *Income tax effects are disregarded*
- *Average rate was given for the year ended May 31, 2009*
- *Historical rate was given for the year ended May 31, 1999, date of Colossus Company's investment*
- *Current rate was given for the year ended May 31, 2009*

In a review of the translation of the foreign investee's financial statements above, the following features may be emphasized:

1. All assets and liabilities are translated at the current rate.
2. The paid-in capital amounts and the beginning retained earnings are translated at the historical rate on the date of **Colossus Company's** acquisition of its investment in Venezuela Investee.
3. The average rate for the year ended may 31, 2000, is used to translate all revenue and expenses in the income statement.
4. A balancing amount labeled ***foreign currency translation adjustments***, which is not a ledger account, is used to reconcile total liabilities and stockholders' equity with total assets in the translated balance sheet of Venezuela Investee. Foreign currency translation adjustments are displayed in the accumulated other comprehensive income section of the translated balance sheet.

Following the translation of Venezuela Investee's financial statements from Bolivar's (the functional currency of Venezuela Investee) to U.S dollars (the reporting currency of Colossus Company), on May 31, 2000, Colossus prepares the following journal entries in U.S dollars under the equity method of accounting for an investment in common stock:

To record 30% of net income of Venezuela Invested (Income tax effects are disregarded)**:**

Investment in Venezuela Investee Common Stock ($520,000 @ 0.30)	156,000	
Investment income		156,000

To record 30% of other comprehensive income component of Venezuela Investee's stockholders' equity (Income tax effects are disregarded)(To record foreign currency translation adjustment):

Investment in Venezuela Investee Common Stock ($60,000 @ 0.3)	18,000	
Foreign Currency Translation Adjustments		18,000

To record dividends receivable from Venezuela Investee*:*

Dividends Receivable ($162,000 @ 0.30)	48,600	
Investment in Venezuela Investee Common Stock...............................		48,600

The $275,400 balance of the investment account is equal to **Colossus Company's** share of the total stockholders' equity, *including foreign currency translation adjustments*, in the translated balance sheet of Venezuela Investee: [*($125,000 + $150,000 + $583,000 + $60,000) @ 0.30 = $275,400*].

Foreign currency translation adjustments, which are not operating revenues, gains, expenses, or losses, do not enter into the measurement of the translated **net income** or **dividends** of Venezuela Investee; however, the investor's share of the translation adjustments is reflected in the investor's Investment ledger account as other comprehensive income. Foreign currency translation adjustments are displayed in accumulated other comprehensive income in the stockholders' equity section of Venezuela investee's translated balance sheet until sale or liquidation of all or part of Colossus Company's investment in Venezuela Investee. At that time, the appropriate amount of the foreign currency translation adjustment is included in the measurement of the gain or loss on sale or liquidation of the investment in Venezuela Investee.

6.2.6. Other Aspects of Foreign Currency Translation

In addition to topics discussed thus far, FASB statement No 52 included the following:

1. Transaction Gains and Losses Excluded from Net Income

The FASB required that gains and losses from the following foreign currency transactions be accounted for in the same manner as foreign currency translation adjustment:

- Foreign currency translation that are designated as, and are effective as, economic hedges of a net investment in a foreign entity, commencing as of the designation date.
- Intercompany foreign currency transactions that are of a long term investment nature (i.e. Settlement is not planned of anticipated in the foreseeable future), when the entities to the transaction are consolidated, combined or accounted for the equity method.

2. Functional currency in Highly Inflationary Economies

The FASB required that the functional currency of a foreign entity in a highly inflationary economy be identified as the reporting currency.

- Highly inflationary economy is one having cumulative inflation of 100% or more over a 3 year period. Thus financial statement of a foreign entity experiencing severe inflation is re-measured in the reporting currency regardless of the criteria for determination of the functional currency.

3. Income Taxes Related to Foreign Currency Translation

Conventional inter-period and intra-period income tax allocation procedures were prescribed by FASB for the income tax effects of foreign currency translation as follows:

- Interperiod tax allocation for temporary differences associated with foreign currency transaction gains / losses that are reported in different periods for financial accounting and income taxes.
- Interperiod tax allocation for temporary differences associated with foreign currency translation adjustments that do not meet the criteria for non recognition of deferred tax liabilities for undistributed earnings of foreign subsidiaries
- Interperiod tax allocation for foreign currency translation adjustment included in the owners' equality section of the balance sheet.

4. Disclosure of Foreign Currency translation

The FASB required disclosures in the income statement or in a note to the financial statements, of the aggregate foreign currency transaction gains / losses of an accounting period. Further, the FASB required disclosure of changes in foreign currency translation adjustments (as well as other components of accumulated other comprehensive income) during the accounting period. The FASB also has specified additional disclosures for required contracts or other financial instruments designated as hedges of the foreign currency exposure of a net investment in a foreign operation.

6.International Accounting Standard 21

The provisions of IAS 21 "the effects of changes in foreign exchange rates "dealing with translation of foreign currency financial statements are compatible with those of FASB statement No 52 "Foreign currency translations". A difference is that IAS 21 states preference for applying price level adjustment (covered in IAS 29, "financial Reporting in hyperinflationary economies") prior to the translation of financial statements of foreign entities operating in highly inflationary economies.

6.2.7. Appraisal of Accounting Standards for Foreign Currency Translation

Among the criticisms of FASB statement No 52 are the following:

1. It established identifiable distinction b/n transaction gains/losses arising from re-measurement and translation adjustments arising from translation. Both involve comparable activities restatement of amounts in foreign currency to another currency should be treated alike.
2. It abandoned the historical - cost principle by sanctioning use of the current rare method for translation of foreign currency financial statements.
   - It appears that FASB statement No 52 has been accepted by the business community.
   - FASB statement No 8 which was suppressed by FASB statement No52 was in effect for little more than 6 years, during which time it was subject to continuous controversy
   - FASB statement No 8 was criticized for its requirements that translation adjustment be included in net income and that the monetary/ non monetary method be used to translate foreign entity's financial statement.

6.3. Chapter Summary

6.4. Self-Test Questions

CHAPTER SEVEN

ACCOUNTING FOR SEGMENT AND INTERIM REPORTING

Learning objectives:

Dear students, after successfully completing this chapter you will be able to:

- Understand Segment and Interim Financial Reporting
- Understand how non-traceable expenses are allocated to segments
- Apply reportable operating segment tests
- Understand the similarities and differences of interim reporting and annual reporting
- Compute segment profit or loss
- Compute interim-period income tax expense

7.1. Accounting for Segment Reporting; Computation of segment profit and loss

What is Operating Segment?

An operating or industry segment is a component of an enterprise engaged in providing a product or service or a group of related products and services primarily to outsiders or unaffiliated customers for a profit.

Segment Reporting

Disaggregating financial information of an enterprise is known as **segment reporting**. It is sufficient to disaggregate revenues, operating profit or loss and assets identified with particular segment.

Uses of Segment Reporting

There are purposes for which segment reporting is prepared. These are:

1. It permits the users of financial statement to make better assessment of a Company's past performance and future prospects.
2. Disaggregated information provides insight into the differences in segment like profitability, degrees of risk, sources of risk, opportunity for growth, and demands for capital and there by enables a better assessment of the uncertainness associated with the amounts and timings of future cash flows.

7.1.1. Identification of Reportable Industry Segment

The reportable industry segments are identified by the application of quantitative tests specified by the standards of FASB. A reportable Operating segment is any industry segment meeting one of the following three numerical tests:

- Revenue Test
- Operating Profit/Loss Test
- Identifiable Assets Test

Only one test has to be satisfied for a segment to be reportable.

- **10% Revenue Test**

A segment's total revenue must equal or exceed 10% of the combined revenue of all the industry segments of the company. The total Revenues of the segment include both sales to unaffiliated and inter segmental revenues.

- **10% Operating Profit or Loss Test**

The absolute amount of operating profit or loss for each segment must equal or exceed 10% of the absolute value of the combined operating profit of all industry segments that did not incur an operating loss OR the absolute value of the combined operating loss of all industry segments that incurred an operating loss, respectively.

- **10% Identifiable Assets Test**

An identifiable asset of the segment must equal **10%** or more of the combined identifiable assets of all the industry segments.

- **Other Guidelines**

The combined sales revenues of the disclosed segments must equal or exceed 75% of the total company sales. Intersegment sales are excluded from the total. Segments must be added until the 75% test is met, even if the additional segments do not meet the reportable segment criteria.

***Example 7.1*:** **Western Corporation** is a conglomerate entity with operation in four industry segments. The revenue, operating profit and losses, and identifiable asset attributable to each segment are as follows:

Particulars	**A**	**B**	**C**	**D**
Revenues:	Br	Br	Br	Br
• Sales to unaffiliated customers....	7,500	2,000	1,000	10,000
• Inter-Segment Sales.....................	2,000	-	500	2,500
Operating Profit (Loss)	2,500	(500)	(1,500)	3,500
Identifiable Assets	80,000	30,000	20,000	120,000

Instruction: Determine a reportable segment from all the industry segments of Western Corporation.

1. 10% Revenue Test

Total revenue of all the segments .... Br 25,500
10% Revenue.. Br 2,550

- Segment A: 9,500 > 2,550 – It is a reportable segment.
- Segment B: 2,000 < 2,550 – Not a reportable segment.
- Segment C: 1,500 < 2,550 – Not a reportable segment.
- Segment D: 12,500 > 2,550 – It is a reportable segment

2. 10% Operating Profit (loss) Test

Total profits (2,500 + 3,500) .... Br 6,000
10% profit (6,000 x 10%) .... Br **600**
Segment B: 500 < 600 – it is not reportable segment
Segment C: 1,500 > 600 – it is reportable segment

3. 10% Identifiable Assets Test

Total identifiable asset .... Br 250,000
10% identifiable 25,000
Segment B: 30,000 > 25,000 – Reportable Segment
Therefore, all the segments; A, B, C, D are reportable segments

7.1.2. Preparation of Segment Profit or Loss Statement

To calculate segment profit or loss, non-traceable expense has to be allocated to all the segments according to some suitable basis.

Allocation of Non-Traceable Expenses:

Non-Traceable Expenses **are those** expenses of an enterprise not identifiable with operation of a specific operating segment for measurement of segment profit or loss.

Allocation or Apportionment:

Non-traceable expenses are to be allocated among the segment on some **reasonable basis**. The management of the enterprise should devise an appropriate method. The following are some of the methods used in allocation:

1. Ratio of Segment Revenue (Sales Ratio),
2. Ratio of Payroll Total (Payroll Ratio)
3. Ratio of Average Plant Assets and inventories
4. Combined Ratio of all the above- they will take the weighted average of the above three **(the Three Factor Ratio**).

Example 7.2: The following data are given to you for **Multi-Product Corporation**.

		Operating segment		
	Company	**Chemical**	**Food Product**	**Total**
Net Sales	–	110,000	90,000	**200,000**
Traceable expense	–	60,000	70,000	130,000
Non-Traceable expense	40,000	–	–	40,000
Total expense	–	–	–	**170,000**
Income Before Tax	–	–	–	30,000
Income taxes (40%)	–	–	–	12,000
Net Income	–	–	–	**18,000**
Payroll totals	12,000	32,000	48,000	92,000
Average plant assets & inventories	16,000	124,000	276,000	416,000

Instruction: Prepare a statement showing segment profit or loss allocating non-traceable expenses by three factor ratios.

Calculation of Three Factor Ratio:

1. Sales Ratio

Total Sales.. 200,000
Sales of Chemical Product Segment 110,000
Percentage of Chemical Product Segment = 110,000 / 200,000 = 55%
Sales of Food Products Segment... 90,000
Percentage of Food Products Segment = 90,000 / 200,000 = 45%

2. Payroll Totals Ratio

Total payroll.. 80,000
Chemical Segment.......................... 32,000 / 80,000 @ 100 = 40%
Food Segment................................ 48,000 / 80,000 @ 100 = 60%

3. Ratio of Plant Asset and Inventories

Total plant asset and inventories... 400,000
Chemical..................................... 124,000 / 400,000 @ 00 = 31%
Food... 276,000 / 400,000 @ 100 = 69%

4. Calculation of the Three-Factor Ratio

Chemical products segment = (55 + 40 + 31) / 3 = 126 / 3 @ 100 = 42%

Food products segment = (45 + 60 + 69) / 3 = 174 / 3 @ 100 = 58%

Statement Showing Profit or Loss	Chemical Product	Food Product Segment	Total
Net Sales (A)	110,000	90,000	200,000
Expenses:			
Traceable expenses	60,000	70,000	130,000
Non traceable expense allocated on the basis of three factor ratio of 42% & 58%	16,800	23,200	40,000
Total Expenses (B)	76,800	93,200	170,000
Before Tax Segment Profit (A-B)	33,200	(3200)	30,000

***Example 7.3*:**

Data for the three operating segments of **Buna Company** for the year ended June 30, 2003 were as follows.

Operating Segment	**Alpha**	**Beta**	**Gamma**	**Total**
Segment Revenues:				
Sales to unaffiliated customers	200,000	250,000	300,000	750,000
Intersegment sales	25,000	20,000	15,000	60,000
Traceable expenses:				
Inter segment purchase	30,000	10,000	20,000	60,000
Other traceable expenses	100,000	150,000	250,000	500,000
Non-traceable expenses	–	–	–	75,000

Instruction: Prepare a working paper to compute segment profit (loss) of each of the operating segment of Bunna company for the year ended June 30, 2003 assuming Bunna allocate non-traceable expenses to operating segment in the ratio of segment sales to sales to unaffiliated customers.

Calculating Ratio of Segment Sales to Sales to Unaffiliated Customers:

Alpha Segment = 200,000 / 750,000 @100=26.67%

Beta Segment = 250,000 / 750,000 @ 100=33.33 %

Gamma Segment=300,000@750,000@ 100= 40%

Total ratio **4: 5: 6**

Statement showing Segment Revenue and Operating Profit and Loss of Peacock Company for the year ended June 30, 2003

	Alpha	**Beta**	**Gamma**	**Total**
Sales to unaffiliated customers	200,000	250,000	300,000	750,000
Intersegment sales	25,000	20,000	15,000	60,000
Segment Revenue (A)	**225,000**	**270,000**	**315,000**	**810,000**
Traceable Expenses:				
Inter segment purchases	30,000	10,000	20,000	60,000

Others traceable expenses	100,000	150,000	250,000	500,000
Total Purchase	130,000	160,000	270,000	560,000
Non-Traceable Expense (4: 5: 6).....................	20,000	25,000	30,000	75,000
Total Expense (B)...	**150,000**	**185,000**	**300,000**	**635,000**
Operating Profit (A-B)	**75,000**	**85,000**	**15,000**	**175,000**

Example 7.4: **Best Company** operates in three different industries, each of which is appropriately regarded as an operating segment. **Segment A** contributed 60% of **Best's** total sales in the year 2003. Sales for Segment A were Br 900,000 and traceable expenses were Br 400,000 in the year 2003. **Best's** total non-traceable expenses for the year 2003 were Br 600,000. BEST allocates non-traceable expenses based on the ratio of segment sales to total sales, an appropriate method of allocation. Prepare a working paper to compute the segment profit or loss for BEST Company segment A for the year 2003.

Computation of Segment Profit or Loss for **Segment A** of BEST Company for the year 2003

Sales of Segment **A**		900,000
Less: total expenses		
Traceable Expenses	400,000	
Non-traceable Expenses (60% @ 600,000)..........................	360,000	
Total Expenses		760,000
Segment A: Operating Profit		**140,000**

Example7.5:

The non-traceable expenses of **PEAC Company** for the year ended June 30, 2002 totaled Br 620,000. The net sales, payroll and average plant assets and inventories for the two operating segments of **PEAC Company** were as follows:

Particulars	Chemical	Sporting Goods
Net sales	2,800,000	1,200,000
Payroll totals...	300,000	200,000
Average Plant Assets and inventories	1,420,000	580,000

Instruction: Prepare a working paper to allocate **PEAC** Company's non-traceable expenses to the **Chemical Segment** and **Sporting Goods Segment** for the year ended June 30, 2002 assuming that such expenses are allocated on the basis of arithmetic average of the percentage of net sales, payroll totals and average plant assets and inventories (the three factor ratio):

Calculation of Ratios:

1. Sales Ratio

- Chemical Segment = 2,800,000 / 4,000,000 @ 100 = 70%
- Sporting Goods Segment = 1,200,000 / 4,000,000 @100 = 30%

2. **Payroll Ratio**
    - Chemical Segment = 300,000 / 500,000 @ 100 = 60%
    - Sporting goods Segment = 200,000 / 500,000 @ 100 = 40%
3. **Average Plant Assets and Inventories Ratio**
    - Chemical Segment = 1,420,000 / 2,000,000 @ 100 = 71%
    - Sporting Goods Segment = 580,000 / 2,000,000 @ 100 = 29%
4. **Arithmetic Average of the Three factor Ratio**
    - Chemical Segment = (70% + 60% + 71%) / 3 = 201 / 3 = 67%
    - Sporting Segment = (30% + 40% + 29%) / 3 = 99 / 3 = 33%
    - The Three Factor Ratio is 67:33
5. **Allocation Non-Traceable Expenses to the two operating segments:**
    - Chemical Segment = (620,000 @ 67/100) = 415,400
    - Sporting goods Segment = (620,000 @ 33/100) = 204,600

Exercise 7.1:

CAD Company allocates non-traceable expenses to its three operating segments in the ratio of net sales to unaffiliated customers. For the year ended April 30, 2004, relevant data were as follows:

Particular	A	B	C
Revenues (In ETB):			
Net sales to unaffiliated customers	500,000	300,000	200,000
Inter segment transfers out (sales)	80,000	40,000	20,000
Costs and Expenses (In ETB):			
Traceable expenses	400,000	100,000	200,000
Inter-segment transfers-in (purchase from) ..	30,000	60,000	50,000

The non-traceable expenses of CAD Company for the year ended then totaled Br 100,000. Prepare a working paper to compute for each operating segment of CAD Company the following amount of the year ended April 30, 2004:

- Revenue
- Expenses
- Segment profit or Loss (use column for each industry segment)

Checking Figures:			
	Segment A	**Segment B**	**Segment C**
Total Expenses	480,000	190,000	270,000
Operating profit or loss........................	100,000	150,000	(50,000)

Exercise 7.2:

Data with respect to the operating segment of **AWASH Company** for the year ended November 31, 2005 are as follows:

Particulars	A	B	C	D	Total
• Net sales to outsiders.....................................	80,000	40,000	50,000	10,000	180,000

• Inter-segments sales (transfer out)	4,000	8,000	2,000	6,000	20,000
• Inter-segment purchases (transfers-in)	8,000	6,000	4,000	2,000	20,000
• Other transferable expenses	18,000	12,000	10,000	20,000	60,000
• Non-traceable expenses	–	–	–	–	40,000

Awash allocates non-traceable expenses to operating segments by the following reasonable methods; 40% to A, 30% to B, 20% to C and 10% to D.

Instruction**:** Prepare a working paper to compute the segment profit or loss for Awash Company's four operating segments for the year ended November 31, 2005:

Checking Figures:				
Segments	**Segment A**	**Segment B**	**Segment C**	**Segment D**
Operating Expenses	42,000	30,000	22,000	26,000
Operating profit or loss	42,000	18,000	30,000	(10,000)

Exercise 7.3:

CANON Company has 3 stores, each of which is an industry segment. The operating results for each store, before allocating the non-traceable expenses, for the year ended 2004, were as shown below:

Stores:	**GG**	**FI**	**DL**	**Total**
Net sales	416,000	353,600	270,400	1,040,000
Cost of goods sold	215,700	183,300	140,200	539,200
Gross profit on sales	200,300	170,300	130,200	500,800
Less: Fixed Operating expenses	60,800	48,750	50,200	159,750
Variable Operating expenses	54,700	64,220	27,448	146,368
Total Operating expenses	115,500	112,970	77,648	306,118
Income before non-traceable expenses	84,800	57,330	52,552	194,682

Non-traceable expenses in the year 2004 were as follows:

Warehouse and Delivery Expenses:		
Warehouse Depreciation	20,000	
Warehouse Operations	30,000	
Delivery Expenses	40,000	
Total Warehouse and Delivery Expenses		90,000
Corporate Office Expenses:		
Advertising Expenses	18,000	
Corporate Office Salaries	37,000	
Other Corporate Office Expenses	28,000	
Total Corporate Office Expenses		83,000
Total Non-Traceable Expenses		Br173,000

Additional Information:

Delivery expense varies with distance and the number of deliveries. The distances from the warehouse to each store and the number of deliveries made in 2004 were as follows:

Store	Miles	No of Deliveries	Total Miles
GG	150	112	16,800
FI	120	64	12,800
DL	100	104	10,400

Instructions:

A. Allocate company's non-traceable expenses under each of the following plans; and compute the income or loss of each store.

Plan 1: allocate all non-traceable expenses on the basis of sales volume

Plan 2: First allocate corporate office salaries and other corporate expenses equally to warehouse operations and each store; second allocate the resulting warehouse operations expenses, warehouse depreciation and advertising expenses to each store on the basis of sales volume; and third allocate delivery expenses on the basis of delivery miles times number of deliveries.

B. Which plan would you advice the management to adopt? Why?

Checking Figures:				
	GG Store	**FI Store**	**DL Store**	**Total**
Non-traceable expenses Plan 1............	69,200	58,820	44,980	173,000
Operating Profit Plan 1........................	15,600	(1,440)	7,572	21,682
Sales Volume Ratio	40%	34%	26%	100%
Delivery miles Ratio............................	42%	32%	26%	100%
Operating Profit Plan 2........................	18,050	(365)	3997	21,682

Answer for Instruction A:

PLAN 1: statement showing the segment income allocating all non-traceable expenses on the basis of sales volume:

Stores	**GG Store**	**FI Store**	**DL Store**	**Total**
Income before non-traceable expenses (A)	84,800	57,300	52,552	194,682
Non-traceable expenses:				
Warehouse & delivery expenses: (40:34:26)	36,000	30,600	23,400	90,000
Corporate Office Expenses: (40:34:26)..............	33,200	28,220	21,580	83,000
Total Non-traceable expenses (B)	69,200	58,820	44,980	173,000
Operating Profit or Loss	15,600	(1,490)	7,572	21,682

PLAN 2: Workings:

First step: Allocation of corporate office salaries and other corporate expenses equally to warehouse operation and stores

Corporate Office Salaries .... Br 37,000

Other corporate office expense.. Br 28,000
Total.. 65,000
Equal allocation to stores & warehouse 65,000/4 = ... 16,250
Total Warehouse Operation Expenses (30,000 + 16,250) = ... 46,250

Statement Showing the Segment Income or Loss

	GG Store	**FI Store**	**DL Store**	Total
Income before allocation of non-traceable expense (A)................	84,800	57,330	52,552	194,682
Less: Non-traceable expenses:				
FIRST: Equal allocation of corporate office expense and corporate office salaries (37,000 + 28,000 = 65,000)	16,250	16,250	16,250	48,750
SECOND:				
(i) Warehouse Operations Expenses on sales basis (40:34:26).....	18,500	15,725	12,025	46,250
(ii) Warehouse Depreciation (40:34:26).......................................	8,000	6,800	5,200	20,000
(iii) Advertising Expenses (40:34:26)	7,200	6,120	4,680	18,000
THIRD: Delivery expenses on Delivery miles basis (42:32:26)..	16,800	12,800	10,400	40,000
Total Non-traceable expenses (B)	66,750	57,695	45,555	173,000
Operating profit (loss) (A – B)	18,050	(365)	3,997	29,682

Answer for Instruction B: the management should adopt plan 2, because it is allocating expenses on appropriate basis of allocation.

7.1.3. Reporting Disposal of a Business Segment

APB opinion No. 30, deals with the reporting of the disposal of a business segment of a business that has been sold, abandoned, spin-off or otherwise disposed of or although still operating, is the subject of a formal plan for disposal. According to APB Opinion No. 30:

1. The APB concludes that the results of continuing operations should be reported separately from discontinued operations.
2. Any gain or loss from the disposal of a segment of a business should be reported in conjunction with the related results of discontinued operations.

Form of Reporting the Disposal of a Business Segment:
Income fro continuing operation before income taxes.. xxx
Less: Income tax.. xxx
Income from continuing operations xxx
Discontinued operations:
Income (loss) from operations of discontinued segment, net of tax xxx

Loss or Gain on the disposal of the discontinued division, net of tax........................ xxx
Net Income (Loss) xxx

Income from Continuing Operations:

To facilitate comparison, the operating results of the discontinued segment of the enterprise must be excluded from income from continuing operations for all accounting periods presented in comparative income statements.

Example 7.6**:** A Company has 5 Segments:

- Comparative income statements for 3 years 2003, 2004 & 2005 are given
- One segment is disposed in 2004
- For all the three years, income from continuing operations exclude the operating results of the discontinued segments so that comparison of the continued operation is possible

Income (loss) from Discontinued Operations:

Income (loss), net of applicable income taxes, of discontinued segment, for the year of disposal up to the measurement data should be included.

Gain (loss) on Disposal of Discontinued Operations:

This includes the following items:

1. Income (loss) from discontinued operations during phase-out period
2. Gain (loss) on the sale of the segment
3. Income taxes allocated to 1 & 2 above

The following are useful information to determine gain (loss) on disposal of discontinued operations:

- Measurement Date – it is the date on which the decision to dispose the segment is taken
- Disposal Date – it is the actual date of execution of disposal of the segment
- Phase out Period – it is the period between the measurement date and the disposal date. The time gap between the measurement and actual disposal dates.

Note: If the actual disposal date is in the next accounting period, if a profit is expected, it will not be recognized until the disposal date. But, if loss is anticipated, then such loss is to be included in the period of measurement.

Example 7.7**: BERUK Company**, a diversified manufacturing enterprise had four operating division engaged in the manufacturing of products in each of the following industries.

- Food products

- Health aids
- Textiles and
- Office equipment

Financial data for the two years ended Dec.31, 2004 and 2003 are shown below:

Particulars	Net Sales		Cost of Goods Sold		Operating Expenses	
Industry Segment	2004	2003	2004	2003	2004	2003
Food products..........	3,500,000	3,000,000	2,400,000	1,800,000	550,000	275,000
Health Aids..............	2,000,000	1,270,000	1,100,000	700,000	300,000	125,000
Textiles....................	1,580,000	1,400,000	500,000	900,000	200,000	150,000
Office Equipments....	920,000	1,330,000	800,000	1,000,000	650,000	750,000
Total........................	8,000,000	7,000,000	4,800,000	4,400,000	1,700,000	1,300,000

On Jan.1st 2004 **BRUKE** Company adopted a plan to sell the assets and product line of office equipment division at an anticipated gain. On September 1st, 2004, the division's assets and products line were sold for Br 2,100,000 cash at a gain of 640,000 (exclusive of operations during the phase out period).

BRUKE's textile's division has manufacturing plants that produced a variety of textile products. In April 2004, BRUKE sold one of these plants and realized a gain of 130,000. After this sale the operations at the plant that was sold were transferred to the remaining 5 textile plants that BRUKE continued to operate.

In August 2004, the main warehouse of the food products division located on the banks of the larger river was flooded when the river over flew. The resulting uninsured damage of Br 420,000 is not included in the financial data above. Historical records indicate that the river normally over flows every four to five years, causing flood damage to adjacent property. For the two years ended 31st December 2003 & 2004, **BRUKE** realized interest revenue on investments of Br 70,000 and Br 40,000, respectively. For the two years ended Dec. December 31st, 2003 & 2004, **BRUKE** net income was Br 960,000 and Br 670,000, respectively. Income tax expenses for each of the two years should be completed at a rate of 40%.

Required: Prepare comparative income statements for **BRUKE Company** for the years ended December 31, 2003 & 2004

Solution:

I. Calculation of profit before tax for 2004:

Particulars	Food Products	Health Aids	Textiles	Office Equipment
Net sales	3,500,000	2,000,000	1,580,000	920,000
Less: Cost of goods sold	2,400,000	1,100,000	500,000	800,000
Gross Profit	1,100,000	900,000	1,050,000	120,000
Less Operating expense	550,000	300,000	200,000	650,000
Operating Profit (loss)	550,000	600,000	880,000	(530,000)

II. Calculation of Income from Continuing Segments for 2004:

Food Products	550000
Health Aids	600,000
Textiles	880,000
Operating income before tax	2,030,000
Add: Gain on sale of Plant of textile segment	130,000
Income before abnormal loss	2,160,000
Less: Abnormal loss due to flood damage in Food Segment	(420,000)
Income before tax from continuing operation	1,740,000
Less: Income tax expense (40% @ 1,740,000)	(696,000)
Income from continuing operation.	1,044,000

III. Calculation of profit before tax for 2003:

Particulars	Food Products	Health Aids	Textiles	Office Equipment
Net sales	3,000,000	1,270,000	1,400,000	1,330,000
Less: Cost of goods sold	1,800,000	700,000	900,000	1,000,000
Gross Profit	1,200,000	570,000	500,000	330,000
Less Operating expense	275,000	125,000	150,000	750,000
Operating Profit (loss)	925,000	445,000	350,000	(420,000)

IV. Calculation of Income from Continuing Segment for 2003:

Food Products	925,000
Health Aids	445,000
Textiles	350,000
Operating income before tax	1,720,000
Less: Income tax expense (40% @ 1,740,000)	(688,000)
Income from continuing operation	1,032,000

V. Calculation of income from discontinued Segment for 2004:

Operating profit (loss)	(530,000)
Gain on sale of equipment segment	640,000
Income from discontinued segment	110,000
Less Income tax expense (0.4 @ 110000)	44,000
Net income from discontinued operations	66,000

VI. Other Income for 2004:

Interest on investment	70,000
Less: Income Tax expense at 40%	(28,000)
Net Income	42,000

VII. Calculation of Income (Loss) from Discontinued Operation for 2003:

Operating losses	(420,000)
Tax savings on loss @ 40%	168,000
Operating loss from Discontinue Segment	252,000

VIII. Calculation of Other Income for 2003:

Interest on Investment	40,000
Less: Income tax expense @ 40%	16,000
Net Income	24,000

BRUKE Co
Comparative Income Statement
For the years ended Dec. 31, 2003 and 2004

	2003	**2004**
Income from continuing segment	1,044,000	1,032,000
Profit/loss from discontinued operation	66,000	(252,000)
Other income	42,000	24,000
Net Income	1,152,000	804,000

Example 7.8: **CRESCENT Company** had a net income of Br 600,000 for the year ended December 31, 1998, after inclusion of the following events or transactions that occurred during the year:

1. The decision was made on January 2nd, to dispose the Block operating segment
2. The Cinder Block operating segment was disposed on July 1st, 1998
3. Operating income from Jan 2nd to June 30th for the Block operating segment amounted to Br 90,000 before income taxes
4. Cinder Block operating segments net assets with a carrying amount of Br 250,000 were disposed of for Br 100,000.

CRESCENT Company was subject to income taxes at the rate of 40%.

***Required**:*

A. Prepare a working paper to compute CRESCENT Company's income from continuing operations for the year ended Dec. 31, 1998.

B. Prepare a working paper to compute current total income taxes for the year ended Dec. 31st, 1998

Solution:

A. Computation of income from continuing operations of **CRESCENT Company** for the year ended Dec.31, 1998.

Net Income of the Company (i.e. after 40% tax).........	600,000
Add: Income taxes (600,000/ 60%) @ 40%.........	400,000
Income before taxes.........	1,000,000
Less: Operating Income of the Cinder Block Segment during the phase out period.........	(90,000)
Sub-totals.........	910,000
Add: loss o the disposal of Cinder Block Segment (250,000 – 100,000).........	150,000
Income from continuing operations before tax.........	1,060,000

B. Computation of total income taxes of **CRESCENT** Company for the year ended December 31, 1998.

Income from cont. operations.........		1,060,000
Less: Income tax @ 40%.........		(424,000)
Income from continuing operation.........		636,000
Income (loss) from discontinued operation.........	90,000	
Loss on disposal of discontinued segment.........	(150,000)	
Loss from the discontinued segment.........	(60,000)	
Income tax saving at 40% (60,000 @ 40%).........	24,000	(36,000)
Net income of the company.........		600,000
Income tax for continuing operations.........		424,000
Less: tax saving in disc co. operation.........		(24,000)
Total Income tax.........		**400,000**

Example 7.9: TATA Company's accounting records for the year ended August 31, 2004 include the following data with respect to Wallace division, an operating segment. Sale of net assets of that division to Excel Enterprise for Br 300,000 was authorized by TATA's BODs on August 31st, 2004. Closing date of disposal was expected to be February 28, 2005.

Wallace Davison

Net sales for the year ended August 2004.........	200,000
Cost & Expense.........	50,000
Estimated Operating losses for 6 months ending February 28, 2005......	40,000
Estimated carrying amount of net assets Feb. 28, 2005.........	330,000

TATA's income tax rate is 40%, for the year ended August 31st, 2004 and TATA had Br 640,000 income from continuing operations before income taxes

Instruction: Prepare a partial income statement for TATA Company for the year ended August 31st, 2004 to present for the foregoing information.

Solution:

Partial income statement of TATA Company for the year ended August 31st, 2004

Income from continuing operation before tax		640,000
Income tax expense @ 40%		(256,000)
Income from continuing operations		384,000
Discontinued operations (Wallace Division)		
Income from operations discontinued segment		
For the year ended August 31st, 2004 (200,000 – 150,000) =	50,000	
Less: Tax	(20,000)	
Income from operations of Discontinued Segment		30,000
Gain (loss) on disposal of discontinued segment		
Operating loss during the phase-out period..........................	40,000	
Loss on disposal of dis. Segment (330,000 – 300,000) =	30,000	
Gain (loss) on disposal of discontinued segment	(70,000)	
Tax saving (70,000 @ 40%)..	28,000	
Loss on disposal of discontinued segment		(42,000)
Net income		**372,000**

Exercise 7.4: For the year ended June 30, 2006 DISCO Company which has an income tax rate of 40% had the following pre-tax amount

1. Income from continuing operation Br 1,000,000
2. Loss from disposal of net assets of discontinued division "X" (an operating segment) of Br 60,000
3. Loss from operation of division X from July 1st through the measurement date march 31st 2007 amounted Br 150,000
4. Losses from operations of division X from April 1st, 2007 through the disposal date, May 31, 2007 is Br 20,000

Instruction: Prepare a partial income statement for DISCO Company for the year ended June 30, 2006 beginning with income from continuing operation

Exercise 7.5 CHIKO Company's accountant prepared the following comparative income statement

CHIKO Company
Income statement
December 31, 2001, 2002, 2003

Particulars	**2003**	**2002**	**2001**
Net sales	10,000,000	9,600,000	8,8000,000
COGS	6,200,000	6,000,000	5,400,000
Gross Profit...	3,800,000	3,600,000	3,400,000
Operating Expenses	2,200,000	2,400,000	2,100,000

Income from Operations........................	1,600,000	1,200,000	1,300,000
Gain on disposal of a segment...............	900,000	–	–
Income before income tax	2,500,000	1,200,000	1,300,000
Income tax expense	1,000,000	480,000	520,000
Net income	1,500,000	720,000	780,000

During the audit, it is discovered that CHIKO Company entered into contract on January 2nd, 2003 to sell for 3,200,000, the assets and product line of one of its operating segments. The sale was completed on December 31, 2003, for a gain of Br 900,000 before income taxes. The discontinued operations contribution to CHIKO's income before income taxes for each year was as follows:

2003	2002	2001
Br 640,000 loss	Br 500,000 loss	Br 200,000

Required: Prepare Correct Partial Comparative Income Statements for the three years ended December 31, 2003 assuming that income from discontinued segment were ignored. Begin the income statement with income from continuing operation before income taxes.

7.2. Interim Financial Reporting

Generally financial statements are issued at the end of the fiscal year. In APB Opinion No. 28, the Accounting Principles Board adopted the **integral theory** for interim reports of a fiscal year. Under this, each interim period is considered an integral part of the annual reporting period rather than a discrete accounting period. Thus, many enterprises issue complete financial statements for interim accounting periods during the course of a fiscal year. For example, a closely held company with outstanding bank loans may be required to provide monthly or quarterly financial statements to the lending bank. The Securities and Exchange Commission listing agreements require the listed companies to publish quarterly interim financial statements. The APB established guidelines for following components of interim financial reports: revenue, costs associated revenue, all other costs and expenses, and income taxes expense

1. **Revenue:** Revenue from products sold or services rendered should be recognized for an interim period on the same basis as followed for the full year.

2. **Cost Associated with Revenue**

Cost and expenses directly associated with or allocated to products sold or services rendered required the same accounting in interim financial reports as in a fiscal-year financial statements. The following are exceptions:

- Enterprise that uses Gross Margin Method to estimate cost should disclose this fact in interim financial report. Material adjustments reconciling inventories with annual physical inventories should be disclosed.
- Enterprise that use LIFO inventory method should include the estimated cost of replacing the depleted LIFO base layer.
- Lower of cost or market write downs of inventories should be provided for interim periods as for complete period unless decline in inventory on interim date is considered temporary.
- Enterprise using Standard Cost should report Standard Cost Variances for interim report.

Calculation of Cost of Goods Sold:

Example 7.10: LUNA Company sells a single product which it purchases from three different vendors. On August 31, 2002, LUNA's inventory of the product consisted of 1,000 units at FIFO Cost of Br 7,500. LUNA's merchandise transactions, for the year ended December August 31, 2003, were as follows:

Quarter Ended	Units Purchased	Cost per unit	Units Sold	End of Quarter Replacement Cost
Nov. 30, 2003	5,000	Br 8.00	4,500	Br 8.50
Feb. 28, 2003	6,000	Br 8.50	7,000	Br 9.00
May 31, 2003	8,000	Br 9.00	6,500	Br 8.50
Aug. 31, 2003	6,000	Br 8.50	5,500	Br 9.50

Compute LUNA Company's COGS for each of the quarters of the year ended December 31, 2003 assuming that declines were not considered to temporary. Show your computations:

Quarter I: Sales 4,500 units

I. Cost of Goods Sold:

- 1,000 units @ Br 7.50 7,500
- 3,500 units @ Br 8.00 28,000
- 4,500 units **35,500**

II. Ending (Closing) Inventory:

- Ending Inventory Units = (1,000 + 5,000 – 4,500) =...... 1,000 units
- Inventory at FIFO Cost = (1,500 @ Br 8.0).................... Br 12,000
- Inventory at Market Price (1,500 @ Br 8.50) 12,750
- Ending Inventory at LCM .... **Br 12,000**

Quarter II: Sales 7,000 units

I. Cost of Goods Sold:

- 1,500 units @ Br 8.00 12,000
- 5,500 units @ Br 8.50 46,750
- 7,000 units **58,750**

II. Ending (Closing) Inventory:

- Ending Inventory Units = (1,500 + 6,000 – 7,000)......... 500 units
- Inventory at FIFO Cost = (500 @ Br 8.50)..................... Br 4,250
- Inventory at Market Price (500 @ Br 9.00) 4,500
- Ending Inventory at LCM .... Br 4,250

Quarter III: Sales 6,500 units

I. Cost of Goods Sold:

- 500 units @ Br 8.50 4,250
- 6,000 units @ Br 9.00 54,000
- 6,500 units 58,250
- Add: the excess of actual cost of Ending Inventory Over the replacement cost (500 + 8000 – 6500) = 2,000 @ Br 0.50 .... 1.000
- Ending Inventory at LCM .... Br 59,250

II. Ending (Closing) Inventory:

- Ending Inventory Units = (500 + 8,000 – 6,500) =... 2,000 units
- Inventory at FIFO Cost = (2,000 @ Br 9.0)............. Br 18,000.00
- Inventory at Market Price (2,000 @ Br 8.50) 17,000.00
- Ending Inventory at LCM .... Br 17,000.00

Quarter IV: Sales 5,500 units

I. Cost of Goods Sold:

- 2,000 units @ Br 9.00 18,000
- 3,500 units @ Br 8.50 29,750
- 5,500 units 47,750
- Less: Write-off in earlier Quarter as the The market price has gone down...................... 1,000
- Cost of Goods Sold .... Br 46,750

II. Ending (Closing) Inventory:

- Ending Inventory Units = (2,000 + 6,000 – 5,500) = 2,500 units
- Inventory at FIFO Cost = (2,500 @ Br 8.50)............ Br 21,250
- Inventory at Market Price (2,500 @ Br 9.50) 23,750.00
- Ending Inventory at LCM .... Br 21,250

Example 7.11: PUBLIC Company, which uses the perpetual inventory and LIFO method of valuing inventory, has temporarily depleted base layer of its inventory with a cost of Br 85,000 during the third Quarter of its fiscal year ending February 28, 2005. Replacement Cost of the depleted inventory was Br 105,000 on November 30, 2004. On December 31, 2004 PUBLIC made its first purchases of merchandise during the Fourth Quarter at a total cost of Br 180,000 on open account (credit basis). Prepare journal entries for PUBLIC COMPANY on November 30 and December 31, 2004

November 30, 2004: depleted LIFO Base layer is Br 105,000 – 85,000 = Br 20,000
Cost of Goods Sold 20,000

Liability Arising from Depletion of Base Layer of LIFO Inventories		20,000

December 31, 2004:

Inventories	160,000	
Liability Arising from Depletion of Base Layer of LIFO Inventories	20,000	
Trade Accounts Payable...		180,000

3. All Other Cost and Expenses

- All other costs and expenses are allocated to interim periods as incurred or on the basis of time expired, benefit received, or activity associated with the periods.

4. Income Taxes Expense

- To estimate income taxes expense for interim periods, a business enterprise must estimate an **effective income tax rate for the full fiscal year** at the end of each interim period and apply the **estimated rate** to **year-to-date pre-tax income**.
- The result is reduced by income taxes expense provided for prior interim periods to obtain income taxes expense for the current interim period.

Example 7.12: MAXIMA Corporation's statutory income tax rate is 40%. MAXIMA forecasts Pre-tax accounting income of Br 300,000 for the year ending April 30, 1997, and no temporary differences exists between pre-tax accounting income and taxable income. MAXIMA forecasts the following permanent differences between pre-tax accounting income and taxable income for the year ending April 30, 1997.

Dividend Received	Br 60,000
Goodwill Amortization	30,000

Instruction: Compute MAXIMA Corporation's estimated effective income tax rate (**EEITR**) for the year ending April 30, 1997

Solution:

Pre-tax accounting income	Br 300,000
Add: Amortization of Goodwill (non-deductible expense)..............	30,000
Less: Dividend Received	(60,000)
Estimated Taxable Income	270.000
Income tax expense (270,000 @ 40%)..	108,000

EEITR = Income tax / Pre-tax accounting income

EEITR = Br 108,000 / 300,000 = **36%**

Example 7.13: **BAKO Company** has a fiscal year ending on April 30. On July 31, 2001, the end of the 1st Quarter of 2002, BAKO had an effective income tax rate of 55% for 2002. On October 31, 2001, the end 2nd Quarter of 2002, BAKO estimated an Effective Tax Rate of 52%. Pre-tax accounting income for BAKO was as follows:

- For the three months ended July 31, 2001 .... Br 600,000
- For the three months ended October 31, 2001 .... Br 750,000

***Instruction*:** Prepare Journal Entries for Income tax expenses of BAKO Company on July 31 and October 31, 2001

Solution:

Income tax expense for Quarter ended July 31, 2001 (600,000 @ 55%) = Br 330,000

Journal Entry:

Income Tax Expense	330,000	
Income Tax Payable...		330,000

Income tax expense for Quarter ended October 31, 2001:

Cumulative Income for Quarters ending October 31, 2001 (600,000 + 750,000) = 1,350,000

Cumulative Income Tax Expense for two Quarters (1,350,000 @ 52%)	702,000
Less: Income tax expense for the 1st Quarter	(330,000)
Income tax expense for the 2nd Quarter	372,000

Journal Entry:

Income Tax Expense	372,000	
Income Tax Payable...		372,000

***Example 7.14*:**

For its first two quarters of Calendar year 2006, this is its fiscal year; ENTOTO Company had the following data:

Quarter Ended	**Pre-tax Financial Income**	EEITR **for the Year**
March 31, 2006	500,000	38.6%
June 30, 2006	600,000	41.2%

Prepare Journal Entries for ENTOTO Company to accrue income tax expenses for the 1st two quarters of 2006

Solution:

Quarter 1:

Income tax expense for Quarter ended March 31, 2006 (500,000 @ 38.6%) = Br 193,000

Journal Entry:

Income Tax Expense	193,000	
Income Tax Payable...		193,000

Quarter 2:

Cumulative Income for two Quarters (500,000 + 600,000)................................	1,100,000
Cumulative Income Tax Expense for two Quarters (1,100,000 @ 41.2%)	453,200
Less: Income tax expense for the 1st Quarter	(193,000)
Income tax expense for the 2nd Quarter	260,200

Journal Entry:

Income Tax Expense	260,200	
Income Tax Payable...		260,200

Example 7.15: On January 31, 2002, the end of the 1st Quarter of its fiscal year ending October 31, 2002, KASCO Company had the following ledger account balances:

- Income tax expense .... Br 160,000
- Liability arising from depletion of Base layer of LIFO inventory............... 30,000

On February 1, 2002 KASCO purchased merchandise costing Br 110,000 on account and on April 30, 2002, KASCO estimated total income tax expense of Br 340,000 for the six month ended on that date. KASCO uses the perpetual inventory system. Prepare journal entries for KASCO Company on February 1, and April 30, 2002, for the foregoing facts

February 1, 2002:

Inventories	80,000	
Liability Arising from Depletion of Base Layer of LIFO Inventories	30,000	
Trade Accounts Payable		110,000

April 30, 2002:

Cumulative Income Tax for two Quarters	340,000
Less: Income tax expense for the 1st Quarter	(160,000)
Income tax expense for the 2nd Quarter	180,000

Journal Entry:

Income Tax Expense	180,000	
Income Tax Payable		180,000

Disclosure of Interim Financial Data

As minimum disclosure, APB Opinion No. 28 provided that the following data should be included in publicly owned enterprise's interim financial reports to stockholders. The data are to be reported for the most recent quarter and the year to date, or 12 months to date of the quarter's end:

- Sales or gross revenue, income tax expenses, extraordinary items, cumulative effect of a change in accounting principle or practice, and net income
- Basic and diluted earnings per share data for each period presented
- Seasonal revenue, costs, or expenses
- Significant changes in estimates or provisions for income taxes
- Disposal of a business segment and extraordinary, unusual, or infrequently occurring items
- Contingents items
- Changes in accounting principle or estimate
- Significant changes in financial position

The FASB has required the following additional disclosures for reportable operating segments in interim reports: revenues from external customers; Intersegment revenues; segment profit or loss; segment assets if material changes have occurred since the most recent year-end financial statements; description of differences from last annual report in the basis for segmentation or for the measurement of segment profit or loss; and reconciliation of total reportable segments' profit or loss to the enterprise's pre-tax income from continuing operations. The minimum requirements are:

- Sales or gross revenue,
- Income taxes expense,
- Net income, and
- Basic and diluted earnings per share data

REPORTING FOR SEC

SEC has Enforcement Actions Dealing with Wrongful Application. SEC enforced numerous actions for overstatements of quarterly earnings reported in Form 10-Q. Techniques used in such overstatements are

- Premature recognition ("front-ending") of revenues
- Creation of fictitious inventories
- Use of improper Gross Margin percentages
- Improper deferral of cost that should have be recognized as expense
- Overstatement of percentage of completion on construction-type contracts.

Problem 7.1:

AKT Company allocates non-traceable expenses to operating segments on the basis of sales ratio. It is a diversified manufacturing enterprise had four operating division engaged in the manufacturing of products in each of the following industries.

- Electronics Division
- Medical Equipments Division
- Office equipment

Financial data for the year ended December 31, 2004 are shown below:

Industry Segment	Net Sales	Cost of Goods Sold	Operating Expenses
Electronics Division	2,400,000	1,650,000	215,000
Medical Equipments............	1,600,000	800,000	325,000
Office Equipment	1,200,000	1,100,000	150,000
Total	5,200,000	3,550,000	690,000

On December 31, 2004; AKT Company adopted a plan to sell the office equipment division at an anticipated loss. The discontinued segment will be disposed at a loss of Br 70,000 and loss form operating the discontinued segment during phase out period estimated to be Br 60,000. AKT Company disposed one of the manufacturing plant assets of Medical Equipments division during year 2004 and realized a gain of Br 80,000.

Required: Prepare partial income statements for the year ended December 31, 2004, assuming AKT Company's income tax rate is 40%, Br 120,000 non-traceable expense, and only the three industry segments. Back up the income statement with the necessary computations.

7.3. Chapter Summary

7.4. Self-Test Questions

Reference

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