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CONTENTS

INTRODUCTION

IFRS stands for International Financial Reporting Standards and it is a set of principles and rules for reporting various transactions and items in the financial statements.

Just like United States have their US GAAP, Canada has its Canadian GAAP, United Kingdom has its UK GAAP etc, the WORLD will have its world GAAP that is under construction right now. But it's not called “world GAAP”—it is called IFRS.

Before some time, IFRS was called IAS (International Accounting Standards). Indeed, the first standards carried the name starting with “IAS”, e.g. IAS 1—Presentation of Financial Statements. Exactly 41 standards started with IAS. But then, IASs were renamed to IFRS. After renaming and rebranding the titles of new standards start with IFRS.

Today, everything in the world comes closer than ever before. Things are harmonizing and people learn to think and act global.

And indeed, you can see that in every step you make—you can shop the same items anywhere in the world, you can get the same food in McDonalds anywhere in the world, you can even fly anywhere in the world in less than 24 hours.

Accounting and financial reporting are no exception. This is where IFRS has its own spot—it will serve as unified set of principles for financial reporting anywhere in the world.

In today's ever globalizing world, the key concept is COMPARABILITY.

Just imagine yourself as the owner of multinational holding who wants to review financial results of your companies in different countries. But—every country uses different accounting rules! For example, revenues are reported on accrual basis in 1 country, and on cash basis in another country. How can you say which of your companies has better sales if those figures are incomparable?

Or even if you are small investor playing on the stock exchange and you (hopefully) look to financial statements of your prospect investment before buying. How can you read those statements if everybody reports differently?

So you get the picture. IFRS gives us united global set of accounting and reporting rules, so that you understand financial statements from whatever country. And not only this—if your company wants access to international capital or to stock exchange, it must present its financial statements in compliance with IFRS.

IFRSs are designed with the general purpose financial statements of profit-orientated entities in mind. IFRSs may, however, also be useful for non-profit orientated entities. General purpose financial statements give information about financial performance, position and cash flow that is useful for making economic decisions by a range of users, including shareholders, creditors, employees and the general public.

The world has been constantly moving to the single set of global accounting rules. There is a strong ambition to adopt IFRS as a unified set of financial reporting standards all over the planet by 2015.

1. DEVELOPMENT AND IMPLEMENTATION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS

1. Read the article and discuss

1) What is Accounting? Its Definition and Actual Meaning

Accounting is famously known as the "language of business". Through the financial statements - the end-product reports in accounting - it delivers information to different users.

We can then say that accounting is a means through which information about a business entity is communicated. Let's take a moment to illustrate that.

Mr. Strauss started a printing business. He invested $100,000 personal money to start the company's operations. After a month, he wants to know how much the business made. He also wants to know if the money he invested is still there.

Without a way of recording the activities of the business, we will not be able to answer his questions. Surely we can tell him, "Mr. Strauss, we made a lot this month!", but we need proof! And he needs the figures!

We can easily answer Mr. Strauss' questions if we kept track of the company's transactions. If we used $30,000 of the $100,000 we had at the beginning to buy printers and pay the bills, then we'd have $70,000 cash left. If we collected $50,000 from our customers, then we would have $120,000. *Easy, right?*

Okay, that's just a *tiny bit* of what accounting can do. What if we have thousands of transactions? Also, there's a lot more to accounting than just recording. How much income did we make? How much do we owe our creditors? Is this a good investment? Ask away. Accounting would confidently say, "I'll have the reports prepared." *Now, how cool is that?*

2) Accounting Definition

Technical definitions of accounting have been published by different accounting bodies. The American Institute of Certified Public Accountants (AICPA) defines accounting as:

the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least of financial character, and interpreting the results thereof.

Though I am not a fan of technical definitions, I believe that studying the statement above will give us a better understanding of accounting.

1. Accounting is considered an art

Accounting is considered an art because it requires the use of skills and creative judgment. One has to be trained in this discipline to be able to perform accounting functions well.

Accounting is also considered a *science* because it is a body of knowledge. However, accounting is not an exact science since the rules and principles are constantly changing (improved).

2. Accounting involves interconnected "phases"

Recording pertains to writing down or keeping records of business transactions. *Classifying* involves grouping similar items that have been recorded. Once they are classified, information is *summarized* into reports which we call financial statements.

3. Accounting is especially concerned with **transactions and events having financial character**

For example, hiring an additional employee is qualitative information with no financial character. Hence, it is not recorded. However, the payment of salaries, acquisition of an office building, selling goods, etc. are recorded because they involve *financial* value.

4. Business transactions are expressed **in terms of money**

They are assigned amounts when processed in an accounting system. Using one of the examples above, it is not enough to record that the company paid salaries for April. It must include monetary figures -- say for example, $20,000 salaries expense.

5. Interpreting the results

Interpreting results is part of the *phases of accounting*. Information is useless if they cannot be interpreted and understood. The amounts, figures, and other data in the financial reports have meanings that are useful to the users.

By studying the definition alone, we learned some important concepts in accounting. It also gave us an idea of what accountants do.

You may not notice but the simple things you do and encounter everyday can actually be related to *some level* of accounting. You make budgets, count change and check the receipts from the supermarket. You may even have listed things you spent your money with at one point in your life.

We are surrounded by business -- from managing our own money to seeing profit statements of big corporations. And where there is business, there sure is accounting.

3) Financial Accounting Basics

This article is intended to give an overview of *financial accounting basics* for the non accountant. Its orientation is toward recording financial information about a business.

First, what do we mean by "financial" accounting? This refers to the recordation of information about money. Thus, we will talk about issuing an invoice to someone, as well as their payment of that invoice, but we will not address any change in the value of a company's overall business, since the latter situation does not involve a specific transaction involving money.

A "transaction" is a business event that has a monetary impact, such as selling goods to a customer or buying supplies from a vendor. In financial accounting, a transaction triggers the recording of information about the money involved in the event. For example, we would record in the accounting records such events (transactions) as:

- Incurring debt from a lender
- The receipt of an expense report from an employee

- Selling goods to a customer
- Paying sales taxes to the government
- Paying wages to employees

We record this information in "accounts." An account is a separate, detailed record about a specific item, such as expenditures for office supplies, or accounts receivable, or accounts payable. There can be many accounts, of which the most common are: *Administrative expenses, Accounts receivable, Equity, Accrued expenses, Revenue, Income taxes, Cost of goods sold, Inventory, Debt, Fixed assets, Cash, Accounts payable.*

Match these words with their meanings

- _________________. This is the current balance of cash held by a business, usually in checking or savings accounts.
- _________________. These are sales on credit, which customers must pay for at a later date.
- _________________. This is items held in stock, for eventual sale to customers.
- _________________. These are more expensive assets that the business plans to use for multiple years.
- _________________. These are liabilities payable to suppliers that have not yet been paid.
- _________________. These are liabilities for which the business has not yet been billed, but for which it will eventually have to pay.
- _________________. This is cash loaned to the business by another party.
- _________________. This is the ownership interest in the business, which is the founding capital and any subsequent profits that have been retained in the business.
- _________________. This is sales made to customers (both on credit and in cash).
- _________________. This is the cost of goods or services sold to customers.
- _________________. These are a variety of expenses required to run a business, such as salaries, rent, utilities, and office supplies.
- _________________. These are the taxes paid to the government on any income earned by the business.

How do we enter information about transactions into these accounts? There are two ways to do so:

- *Software module entries*. If you use accounting software to record financial accounting transactions, there will probably be on-line forms that you can fill out for each of the major transactions, such as creating a customer or invoice or recording a supplier invoice. Every time you fill out one of these forms, the software automatically populates the accounts for you.
- *Journal entries*. You can access a journal entry form in your accounting software, or create a journal entry by hand. There is a great deal to journal entries. In brief, a journal entry must always impact a minimum of two

accounts, with a debit entry being recorded against one account and a credit entry against the other. There can be many more than just two accounts, but the total dollar amount of debits must equal the total dollar amount of credits.

The accounts are stored in the general ledger. This is the master set of all accounts, in which are stored all of the business transactions that have been entered into the accounts with journal entries or software module entries. Thus, the general ledger is your go-to document for all of the detailed financial accounting information about a business.

If you want to understand the detail for a particular account, such as the current amount of accounts receivable outstanding, you would access the general ledger for this information. In addition, most accounting software packages provide a number of reports that give you better insights into the business than just reading through the accounts. In particular, there are aged accounts receivable and aged accounts payable reports that are useful for determining the current list of uncollected accounts receivable and unpaid accounts payable, respectively.

The general ledger is also the source document for the financial statements. There are several financial statements, which are:

- Balance sheet. This report lists the assets, liabilities, and equity of the business as of the report date.
- Income statement. This report lists the revenues, expenses, and profit or loss of the business for a specific period of time.
- Statement of cash flows. This report lists the cash inflows and outflows generated by the business for a specific period of time. It may be formatted using the direct or indirect method.

Other less-used elements of the financial statements are the statement of cash flows, the statement of retained earnings, and a large number of accompanying disclosures.

In summary, we have shown that financial accounting involves the recording of business transactions in accounts, which in turn are summarized in the general ledger, which in turn is used to create financial statements. The Related Topics below can provide you with additional information about financial accounting.

4) Brief IFRS Glossary

International Financial Reporting Standards are usually presented in a certain structure. Most of IFRS is clearly subdivided into several chapters that carry their titles, for example: Recognition, Measurement, Derecognition etc. This article defines the main terms as used in IFRS and shows example of their application.

Recognition is recording a business transaction in an entity’s accounting records, including asset, liability, equity component, revenue or expense.

For example, when a company spends cash to buy a property, then it must record the transaction as Debit Property, Credit Cash. It means that the company RECOGNIZES property in its financial statements.

When IFRS talks about recognition, it usually states rules WHEN the element or transaction should be recognized or recorded. In other words, IFRS prescribes WHAT CONDITIONS must be fulfilled to recognize the transaction or item.

Derecognition is the opposite of recognition**.** It is the removal of a previously recognized asset, liability or equity (sometimes revenue and expense) from an entity's financial statements.

For example, a company sells a property. Then, the sale must be recognized as Debit Cash, Credit Property (plus minus some gain or loss). It means that the company DERECOGNIZED the property from its financial statements.

When there is a heading "Derecognition" in IFRS, the rules will state WHEN the element or transaction should be removed from the financial statements—or WHAT CONDITIONS must be fulfilled to derecognize the transaction or item.

In IFRS, ***measurement*** means the financial amount attributed to asset, liability, equity, revenue or expense. IFRSs distinguish initial and subsequent measurement.

Initial Measurement is an AMOUNT in which asset, liability or equity shall be recorded in the financial statements AT ITS INITIAL RECOGNITION—or when it is recorded for the first time.

For example, a company that buys property must recognize the property in certain amount. IFRSprescribes rules HOW this amount shall be determined initially.

Subsequent Measurement is an AMOUNT in which asset, liability or equity shall be recorded in the financial statements AFTER ITS INITIAL RECOGNITION—or in the 2nd, 3rd, 4th year of its recognizing in the financial statements.

Many assets or liabilities change their value with time due to various reasons – wear off, loss of credibility, amortization, etc. So the company owning and actually using the property has to assess the value of this property each year and determine the new, actual value.

It can be done by depreciation, amortization, determining of fair value—by many ways and IFRSusually prescribes the exact way of setting the subsequent measurement for individual types of assets or liabilities. Along with setting HOW the asset or liability shall be subsequently measured, IFRS setsHOW the change (difference between new value and previous year's value = gain or loss) shall be accounted for.

A ***disclosure*** is additional information attached to an entity's financial statements, usually as detailed breakdown of the numbers included in the financial statements, description of various significant events, estimates, judgements and other items that influenced the company's results, etc.

For example, a company buying property would have to disclose in its notes to the financial statements the following items: method of depreciation, useful life, significant purchases, etc.

Each IFRS prescribes specific information that is required for certain items in the section Disclosures. Some IFRS standards talk purely about disclosures, for example standard IFRS 7 deals solely with disclosures related to financial instruments.

A ***presentation*** is often confused with disclosure. However, there is a big difference: disclosure is additional information and presentation is a method of showing the information or numbers.

For example, a company buying property would present this property in a required way—as long term, probably separately showing the cost and accumulated depreciation.

2. Complete the following sentences

2.1. Here are some of the highlights from this major topic:

1. Debit means __________.
2. Credit means ___________.
3. Every transaction affects two __________ or more.
4. At least one account will be __________ and at least one account will be ___________.
5. The total of the amount(s) entered as debits must _________ the total of the amount(s) entered as credits.
6. When cash is received, ________ Cash.
7. When cash is paid out, ________ Cash.
8. To increase an asset, ___________ the asset account.
9. To increase a liability, __________ the liability account.
10. To increase owner's equity, ____________ an owner's equity account.
11. To increase revenues, __________ the revenues account.
12. To increase expenses, ________ the expense account.

2.2. Some general rules about debiting and crediting the accounts are:

1. Expense accounts are _________ and have ________ balances.
2. Revenue accounts are ___________ and have __________ balances.
3. Asset accounts normally have __________ balances.
4. To increase an asset account, __________ the account.
5. To decrease an asset account, __________ the account.
6. Liability accounts normally have __________ balances.
7. To increase a liability account, __________ the account.
8. To decrease a liability account, __________ the account.

2.3. Bookkeeping

1. Liability accounts are decreased with a ________.

2. A credit will increase the balance in a _________ account.

3. Credits are entered on the _________ side of a T-account.

4. The accounting equation remains in balance due to ________-entry bookkeeping.

5. Debits are entered on the ______ side of a T-account.

6. Asset account balances are reduced by a _________ entry.

7. The accounting _________ should always be in balance.

8. The book of original entry. ______________

9. Revenues cause an increase in owner's _________.

10. These cause owner's equity to decrease. ______________

11. The amount entered on the right side of a T-account. ______________

12. _____________ are income statement accounts with debit balances.

13. Accounts _______________ is a balance sheet account with a debit balance.

14. _______________ Depreciation is a balance sheet account with a credit balance.

15. The Retained Earnings account will be reduced with a __________ entry.

16. ______________ are income statement accounts with credit balances.

17. A sole proprietor's ___________ account will have a debit balance.

18. Accounts _____________ is a balance sheet account with a credit balance.

19. A ________ balance is an internal report to show that the general ledger's debit balances add up to the same total as the credit balances.

20. The requirement that each journal entry needs to have at least one debit and one credit is known as __________-entry bookkeeping.

21. These are entered on the left side of an account. ________

22. These are entered on the right side of an account. ________

23. These accounts will normally have a credit balance. ________

24. These accounts will normally have debit balances. ________

25. Sales are an example of retailers' operating __________________.

26. Accounts are contained in the general _________.

27. Entries for depreciation are first written in the general ____________.

28. The credit amount in the depreciation entry is recorded in __________________ Depreciation.

29. Under ________-entry bookkeeping a transaction affects a minimum of two accounts.

30. The accounting or bookkeeping ___________ is Assets = Liabilities + Stockholders' Equity.

31. Bona fide invoices from suppliers that are to be paid in 30 days are reported in Accounts _______.

32. These will reduce stockholders' equity. ________

33. The type of account that is affected by the accrual of an expense. ________

34. Another term for supplier. ________

35. One to whom money is owed. ________
36. __________ Insurance is an asset account.
37. Revenues minus expenses equals _______ _ _______________.
38. Resources owned by a company (such as cash, accounts receivable, vehicles) are reported on the balance sheet and are referred to as _______________ ___
39. Obligations (amounts owed) are reported on the balance sheet and are referred to as________________.
40. Liabilities often have the word ___________ _____ in their account title.
41. The listing of all of the accounts available for use in a company's accounting system is known as the _____________ ___ ___________________.
42. Assets minus liabilities equals ___________________ _____________.
43. Large corporations must follow the _________________ basis of accounting.
44. Corporations whose stock is publicly traded must have their financial statements______________ by independent certified public accountants.
45. _______________ entry bookkeeping will result in at least two accounts being involved in every transaction.
46. Every transaction will have one account being credited and one account being_________________.
47. The accounting equation is Assets = ________________ + Stockholders' (or Owner's) Equity.
48. Matching, cost, and full disclosure are examples of the fundamental or basic accounting__ ____________.
49. The profitability of a company for a specified period of time is reported on the__________________ statement.
50. The main components or elements of the income statement are _________________, expenses, gains, and losses.
51. Prepaid insurance is reported as an ______________ on a company's balance sheet.
52. The word «________________» is often in the title of liability accounts.

3. Choose the correct answer in the table below

1	Which term is associated with «left» or «left-side»?	Debit	Credit
2	Which term is associated with «right» or «right-side»?	Debit	Credit
3	When cash is received, the account Cash will be	Debited	Credited
4	When a company pays a bill, the account Cash will be	Debited	Credited
5	What will usually cause an asset account to increase?	Debit	Credit
6	What will usually cause the liability account Accounts Payable to increase?	Debit	Credit
7	Entries to expenses such as Rent Expense are usually	Debits	Credits
8	Entries to revenues accounts such as Service Revenues are usually	Debits	Credits

2. Use «Debit» or «Credit» to complete the table below

Account Classification	Normal Balance
Assets	
Contra asset	
Liability	
Contra liability	
Owner's Equity	
Stockholders' Equity	
Owner's Drawing or Dividends Account	
Revenues (or Income)	
Expenses	
Gains	
Losses	

1. Fill in the gaps with a suitable word from the box

Accounts Receivable, Cash, Cash, Cash, Cash, Notes Payable, Notes Payable, Supplies, Supplies, Accounts Payable, Rent Expense, Service Revenues

When a company borrows $1,000 from a bank, the transaction will affect the company's _______________account and the company's _______________ account.

When the company repays the bank loan, the ____________ account and the ______________ account are also involved.

If a company buys supplies for cash, its ______________ account and its _______________account will be affected. If the company buys supplies on credit, the accounts involved are _________________ and _______________.

If a company pays the rent for the current month, ____________ and ____________ are the two accounts involved. If a company provides a service and gives the client 30 days in which to pay, the company's ____________ account and are __________________affected.

4. Use «Debit» or «Credit» to complete the table below

Account Title	To Increase
Asset Accounts	
Cash	
Accounts Receivable	
Merchandise Inventory	
Supplies	
Prepaid Insurance	
Land	
Buildings	
Accumulated Depreciation - Buildings	
Equipment	
Accumulated Depreciation - Equipment	

Liability Accounts	
Notes Payable	
Accounts Payable	
Wages Payable	
Interest Payable	
Unearned Revenues	
Mortgage Loan Payable	
Owner's Equity Accounts	
Mary Smith, Capital	
Mary Smith, Drawing	
Operating Revenue Accounts	
Service Revenues	
Operating Expense Accounts	
Salaries Expense	
Wages Expense	
Supplies Expense	
Rent Expense	
Utilities Expense	
Telephone Expense	
Advertising Expense	
Depreciation Expense	
Non-Operating Revenues and Expenses, Gains, and Losses	
Interest Revenues	
Gain on Sale of Assets	
Loss on Sale of Assets	

5. For each of the transactions in items 1 through 12, indicate the two (or more) effects on the accounting equation of the business or company.

1.	The owner invests personal cash in the business.			
	Assets:	Increase	Decrease	No Effect
	Liabilities:	Increase	Decrease	No Effect
	Owner's (or Stockholders') Equity:	Increase	Decrease	No Effect
2.	The owner withdraws business assets for personal use.			
	Assets:	Increase	Decrease	No Effect
	Liabilities:	Increase	Decrease	No Effect
	Owner's (or Stockholders') Equity:	Increase	Decrease	No Effect
3.	The company receives cash from a bank loan.			
	Assets:	Increase	Decrease	No Effect
	Liabilities:	Increase	Decrease	No Effect
	Owner's (or Stockholders') Equity:	Increase	Decrease	No Effect
4.	The company repays the bank that had lent money to the company.			
	Assets:	Increase	Decrease	No Effect
	Liabilities:	Increase	Decrease	No Effect
	Owner's (or Stockholders') Equity:	Increase	Decrease	No Effect
5.	The company purchases equipment with its cash.			
	Assets:	Increase	Decrease	No Effect
	Liabilities:	Increase	Decrease	No Effect

	Owner's (or Stockholders') Equity:	Increase	Decrease	No Effect
6.	The owner contributes her personal truck to the business.			
	Assets:	Increase	Decrease	No Effect
	Liabilities:	Increase	Decrease	No Effect
	Owner's (or Stockholders') Equity:	Increase	Decrease	No Effect
7.	The company purchases a significant amount of supplies on credit.			
	Assets:	Increase	Decrease	No Effect
	Liabilities:	Increase	Decrease	No Effect
	Owner's (or Stockholders') Equity:	Increase	Decrease	No Effect
8.	The company purchases land by paying half in cash and signing a note payable for the other half.			
	Assets:	Increase	Decrease	No Effect
	Liabilities:	Increase	Decrease	No Effect
	Owner's (or Stockholders') Equity:	Increase	Decrease	No Effect

Information for Items 9 through 12:

Company X provides consulting services to Client Q in May. Company X bills Client Q in May for the agreed upon amount of $5,000. The sales invoice shows that the amount will be due in June.

9.	In May, Company X records the transaction by a debit to Accounts Receivable for $5,000 and a credit to Service Revenues for $5,000. What is the effect of this entry upon the accounting equation for Company X?			
	Assets:	Increase	Decrease	No Effect
	Liabilities:	Increase	Decrease	No Effect
	Owner's (or Stockholders') Equity:	Increase	Decrease	No Effect
10.	In June, Company X receives the $5,000. What is the effect on the accounting equation and which accounts are affected at Company X?			
	Assets:	Increase	Decrease	No Effect
	Liabilities:	Increase	Decrease	No Effect
	Owner's (or Stockholders') Equity:	Increase	Decrease	No Effect
11.	What is the effect on Client Q's accounting equation in May when Client Q records the transaction as a debit to Consultant Expense for $5,000 and a credit to Accounts Payablefor $5,000?			
	Assets:	Increase	Decrease	No Effect
	Liabilities:	Increase	Decrease	No Effect
	Owner's (or Stockholders') Equity:	Increase	Decrease	No Effect
12.	What is the effect on Client Q's accounting equation in June when Client Q remits the $5,000? Also, which accounts will be involved?			
	Assets:	Increase	Decrease	No Effect
	Liabilities:	Increase	Decrease	No Effect
	Owner's (or Stockholders') Equity:	Increase	Decrease	No Effect

3. Sample Chart of Accounts For a Large Corporation

Current Assets (account numbers 10000 - 16999)

10100 Cash - Regular Checking

10200 Cash - Payroll Checking

10600 Petty Cash Fund

12100 Accounts Receivable

12500 Allowance for Doubtful Accounts

13100 Inventory
14100 Supplies
15300 Prepaid Insurance
Property, Plant, and Equipment (account numbers 17000 - 18999)
17000 Land
17100 Buildings
17300 Equipment
17800 Vehicles
18100 Accumulated Depreciation – Buildings
18300 Accumulated Depreciation – Equipment
18800 Accumulated Depreciation - Vehicles
Current Liabilities (account numbers 20000 - 24999)
20100 Notes Payable - Credit Line #1
20200 Notes Payable - Credit Line #2
21000 Accounts Payable
22100 Wages Payable
23100 Interest Payable
24500 Unearned Revenues
Long-term Liabilities (account numbers 25000 - 26999)
25100 Mortgage Loan Payable
25600 Bonds Payable
25650 Discount on Bonds Payable
Stockholders' Equity (account numbers 27000 - 29999)
27100 Common Stock, No Par
27500 Retained Earnings
29500 Treasury Stock
Operating Revenues (account numbers 30000 - 39999)
31010 Sales - Division #1, Product Line 010
31022 Sales - Division #1, Product Line 022
32015 Sales - Division #2, Product Line 015
33110 Sales - Division #3, Product Line 110
Cost of Goods Sold (account numbers 40000 - 49999)
41010 COGS - Division #1, Product Line 010
41022 COGS - Division #1, Product Line 022
42015 COGS - Division #2, Product Line 015
43110 COGS - Division #3, Product Line 110
Marketing Expenses (account numbers 50000 - 50999)
50100 Marketing Dept. Salaries
50150 Marketing Dept. Payroll Taxes
50200 Marketing Dept. Supplies
50600 Marketing Dept. Telephone
Payroll Dept. Expenses (account numbers 59000 - 59999)
59100 Payroll Dept. Salaries
59150 Payroll Dept. Payroll Taxes
59200 Payroll Dept. Supplies

59600 Payroll Dept. Telephone
Other (account numbers 90000 - 99999)
91800 Gain on Sale of Assets
96100 Loss on Sale of Assets

4. Match these words with their meanings

Contra-accounts, Equity accounts, Expense accounts, Asset accounts, Liability accounts, Revenue accounts or income

Types of accounts

	represent the different types of economic resources owned or controlled by business, common examples of these accounts are cash, cash in bank, building, inventory, prepaid rent, goodwill, accounts receivable
	represent the different types of economic obligations by a business, such as accounts payable, bank loan, bonds payable, accrued interest
	represent the residual equity of a business (after deducting from Assets all the liabilities) including Retained Earnings and Appropriations
	represent the company's gross earnings and common examples include Sales, Service revenue and Interest Income
	represent the company's expenditures to enable itself to operate. Common examples are electricity and water, rentals, depreciation, doubtful accounts, interest, insurance.
	Some balance sheet items have corresponding contra accounts, with negative balances, that offset them. Examples are accumulated depreciation against equipment, and allowance for bad debts against long-term notes receivable.

5. Complete the following sentences

Revenues and gains are recorded in accounts such as Sales, Service Revenues, Interest Revenues (or Interest Income), and Gain on Sale of Assets. These accounts normally have _____ balances that are increased with a _____ entry.

The exceptions to this rule are the accounts Sales Returns, Sales Allowances, and Sales Discounts - these accounts have _________ balances because they are reductions to sales. Accounts with balances that are the opposite of the normal balance are called contra accounts; hence contra revenue accounts will have ______ balances.

Expenses normally have their account balances on the _______ side (____ side). A debit _________ the balance in an expense account; a credit _________ the balance. Since expenses are usually increasing, think "_______" when expenses are incurred. (We credit expenses only to reduce them, adjust them, or to _______ the expense accounts.) Examples of expense accounts include Salaries Expense, Wages Expense, Rent Expense, Supplies Expense, and Interest Expense.

Asset, liability, and most owner/stockholder equity _______ are referred to as «permanent accounts» (or «real accounts»). Permanent accounts are not closed at the end of the accounting year; their __________ are automatically carried forward to the next accounting year.

«Temporary accounts» (or «nominal accounts») include all of the revenue accounts, expense accounts, the owner drawing account, and the income summary account. Generally speaking, the balances in temporary accounts increase throughout the accounting year and are «zeroed out» and closed at the end of the accounting year.

Balances in the revenue and expense accounts are zeroed out by closing/transferring/clearing their balances to the Income Summary account. The net amount in Income Summary is then closed/transferred/cleared to an ___________________ account, such as Mary Smith, Capital (or to Retained Earnings if the company is a corporation). The owner drawing account (such as Mary Smith, Drawing) is a temporary account and it is closed directly to the ________ capital account (such as Mary Smith, Capital) without going through an income summary account.

Because the balances in the temporary accounts are transferred out of their respective accounts at the end of the accounting year, each temporary account will have a _______ balance when the next accounting year begins. This means that the new accounting year starts with no revenue amounts, no expense amounts, and no amount in the drawing account.

By using many revenue accounts and a huge number of expense accounts, a company is certain to have easy access to detailed information on revenues and expenses throughout the year. This allows the management of the company to monitor the performance of all parts of the company. Once the accounting year has ended, the need to know the balances in these temporary accounts has also ended, so the accounts are closed out and reopened for the next accounting year with ______ balances.

6. Read the article and discuss

Is Accounting a Good Career Choice?

Accounting has been around since the beginning of trade. Through the years of ongoing development, it has become a major player in the professional spectrum.

Today, it continues to accommodate a great number of business professionals around the world. Careers in accounting are flourishing due to the steady demand for its services. It is indeed one of the most promising professions.

And It's an Excellent Choice.

One of the frequently asked questions regarding this matter is: *"Is accounting a good career?"* I hear that a lot especially from my accounting and financial management students. I also see that question posted in accounting forums and around the net.

People have different takes on this and the answer depends upon what you want in life, really. Now that would be a totally different (and quite long) topic so let's not go into that. We'll get into the hard facts instead. If you ask me, well, I'd say *yes*. I think *accounting is a good career choice*. And I'll tell you why.

Stability

Accounting offers a stable rate of employment amidst economic fluctuations. Some professions take a big slap when the economy dives. But not accounting.

Businesses need to keep track of their operations to be able to find ways to survive economic plunges. They need to report their earnings to the state and pay taxes, regardless of the economic situation. Managers need to regularly furnish monthly or quarterly reports to the board. *Get the idea?*

Accounting is a necessity in business. And with the massive business activity we have (and will continue to have), there's just plenty of work for new and seasoned accountants.

Compensation

Accounting professionals enjoy decent remuneration. The salary range varies as to your job description, level of experience, educational background, location and other factors.

Bookkeepers, accounting technicians and clerks receive an average of $15,000 to as high as $35,000 annually. Young certified accountants' salary ranges from $30,000 to $60,000 while seasoned accountants and top management officers receive as high as $200,000 per annum.

Diversity

In accounting, you have a wide selection of fields and areas of practice to choose from. You can work as an employee with steady shifts and routinary tasks if you want. Also, with sufficient qualifications, you can work *freelance* and have your own clients. Business organizations will need your expertise to prepare, analyze, or audit their financial statements. You can also work as an instructor in the academe; become a book author, a fraud investigator, or an information systems specialist.

7. Choose the correct answer

1. Unearned Revenues is what type of account?
a) Asset;
b) Liability;
c) Stockholders' (Owner's) Equity.
2. Accounting entries involve a minimum of how many accounts?
a) one;
b) two;
c) three.
3. Financial accounting is focused on the __________ financial statements of a company.
a) external;
b) internal.
4. Which of the following will cause owner's equity to increase?

a) expenses;
b) owner draws;
c) revenues.

5. Which of the following will cause owner's equity to decrease?
a) net income;
b) net loss;
c) revenues.

6. The accounting equation should remain in balance because every transaction affects how many accounts?
a) only one;
b) only two;
c) two or more.

2. PROPERTY, PLAN AND EQUIPMENT. INVESTMENT PROPERTY

1. Read the article and discuss

What is the difference between amortization and depreciation?

In accounting the terms depreciation, depletion and amortization often involve the movement of costs from the balance sheet to the income statement in a systematic and logical manner.

Because very few assets last forever, one of the main principles of accrual accounting requires that an asset's cost be proportionally expensed based on the time period over which the asset was used. Both depreciation and amortization (as well as depletion) are methods that are used to prorate the cost of a specific type of asset to the asset's life. It is important to mention that these methods are calculated by subtracting the asset's salvage value from its original cost.

Amortization usually refers to spreading an intangible asset's cost over that asset's useful life. For example, a patent on a piece of medical equipment usually has a life of 17 years. The cost involved with creating the medical equipment is spread out over the life of the patent, with each portion being recorded as an expense on the company's income statement.

Depreciation, on the other hand, refers to prorating a tangible asset's cost over that asset's life. For example, an office building can be used for a number of years before it becomes run down and is sold. The cost of the building is spread out over the predicted life of the building, with a portion of the cost being expensed each accounting year.

Depletion refers to the allocation of the cost of natural resources over time. For example, an oil well has a finite life before all of the oil is pumped out. Therefore, the oil well's setup costs are spread out over the predicted life of the oil well.

Depreciation, depletion and amortization are also described as *noncash expenses*, since there is no cash outlay in the years that the expense is reported on the income statement. As a result, these expenses are added back to the net income reported in the operating activities section of the statement of cash flows when it is prepared under the indirect method.

The term amortization is also used to indicate the systematic reduction in a loan balance resulting from a predetermined schedule of interest and principal payments.

It is important to note that in some places, such as Canada, the terms amortization and depreciation are often to used interchangeably to refer to both tangible and intangible assets.

Example 1: start and stop depreciating

On 1 January 20X1 an entity acquires a new machine.

In January the machinery is installed at the entity's premises.

In February the machine is modified to produce products with a particular characteristic.

In March the machine is tested and 'fine-tuned'. By 31 March the machine is ready to operate to the entity's specifications.

In April the entity's staff is trained to use the new machinery.

In May the machine is not operated because the entity's operations close—the staff go on leave and external contractors perform repairs and maintenance on the entity's plant.

In June the machine operates at unprofitable levels due to initial low orders for the product that it produces in its start-up phase.

Management expects to consume the machine's service potential evenly over 10 years.

On 31 December 20X5 the entity stops operating the manufacturing equipment because demand for the product it manufactures declines. However, the equipment is maintained in a workable condition and the entity expects it will be brought back into use when the general economic climate improves and consequently demand for the product increases (ie the entity is not abandoning the plant).

On 1 January 20X7 the entity recommenced operating the manufacturing equipment.

On 31 December 20X8, in response to an unsolicited offer from an independent third party, the entity immediately sells the machine.

Question 1: when should the entity start depreciating the machine?

In accordance with paragraph 55 of IAS 16, the entity would start depreciating the machine from 31 March 20X1—the date on which the machine is ready to operate in the manner intended by management.

Question 2: when, if at all, must the entity suspend the depreciation of the machine?

In accordance with paragraph 55 of IAS 16, depreciation of the machine is not suspended when the asset is temporarily idle.

Question 3: when must the entity stop depreciating the machine?

In accordance with paragraph 55 of IAS 16, depreciation ceases at the earlier of the date that the asset is classified as held for sale in accordance with IFRS 5, the date that the asset is derecognised or when the asset is fully depreciated. In this example, depreciation ceases on 31 December 20X8 when the machine is derecognised (in this example the asset was never classified as held for sale—immediate sale in response to an unsolicited offer—and until its derecognition, the item's useful life was 10 years measured from 1 January 20X1, ie it did not become fully depreciated).

Example 2

On 1 March 20XX Yucca acquired a machine from Plant under the following terms:

List price of machine $82,000

Import duty $1,500

Delivery fees $2,050

Electrical installation costs $9,500
Pre-production testing $4,900
Purchase of a five-year maintenance contract with Plant $7,000

In addition to the above information Yucca was granted a trade discount of 10% on the initial list price of the asset and a settlement discount of 5% if payment for the machine was received within one month of purchase. Yucca paid for the plant on 5 March 20XX.

How should the above information be accounted for in the financial statements?

Solution

In accordance with IAS 16, all costs required to bring an asset to its present location and condition for its intended use should be capitalised. Therefore, the initial purchase price of the asset should be:

List price ____________**$**
Less: _______________________________**$**
Import duty __________**$**
Delivery fees ________**$**
Electrical installation costs _________**$**
Pre-production testing _________**$**
Total amount to be capitalised at 1 March ___________**$**

The maintenance contract of $________ is an expense and therefore should be spread over a five-year period in accordance with the accruals concept and taken to the income statement. If the $___________ has been paid in full, then some of this cost will represent a prepayment.

In addition the settlement discount received of $___________________ is to be shown as other income in the income statement.

Example 3

An item of plant was purchased on 1 April 2010 for $200,000 and is being depreciated at 25% on a reducing balance basis.

Prepare the extracts of the financial statements for the year ended 31 March 2012.

Solution

Statement of financial position extract

Working for depreciation:
31/03/11 Cost ________
Depreciation – ____________
Carrying value ____________
31/03/12 Carrying value ___________
Depreciation – _______________
Carrying value _______________
Plant ___________________________

Income statement extract

Depreciation expense $___________

Example 4

A machine was purchased on 1 April 2008 for $120,000. It was estimated that the asset had a residual value of $20,000 and a useful economic life of 10 years at this date. On 1 April 2010 (two years later) the residual value was reassessed as being only $15,000 and the useful economic life remaining was considered to be only five years.

How should the asset be accounted for in the years ending 31 March 2009/2010/2011?

<u>Solution</u>

31 March 2009

At the date of acquisition the cost of the asset of $120,000 would be capitalised. The asset should then be depreciated for the years to 31 March 2009/2010 as:

Cost – residual value = ____________________- per annum

Useful economic life 10 years

Income statement extract 2009

Depreciation $__________

Statement of financial position extract 2009

Machine _______________________

31 March 2010

Income statement extract 2010

Depreciation $______________

Statement of financial position extract 2010

Machine

____

31 March 2011

As the residual value and useful economic life estimates have changed during the year ended 2011, the depreciation charge will need to be recalculated. The carrying value will now be spread according to the revised estimates.

Depreciation charge:

_______________________________ per annum

5 years

Income statement extract 2011

Depreciation $___________

Statement of financial position extract 2011

Machine ______________________

Component depreciation

If an asset comprises two or more major components with different economic lives, then each component should be accounted for separately for depreciation purposes and depreciated over its own useful economic life.

Example 5

A company purchased a property with an overall cost of $100m on 1 April 2009. The property elements are made up as follows:

$000 Estimated life
Land and buildings
(Land element $20,000) 65,000 50 years
Fixtures and fittings 24,000 10 years
Lifts 11,000 20 years
100,000

Calculate the annual depreciation charge for the property for the year ended 31 March 2010

<u>Solution</u>

$000

Land and buildings ______________________
Fixtures and fittings ________________________
Lifts ______________________________
Total property depreciation ___________________

Depreciation

Depreciation is systematic allocation the cost of a fixed asset over its useful life. It is a way of matching the cost of a fixed asset with the revenue (or other economic benefits) it generates over its useful life. Without depreciation accounting, the entire cost of a fixed asset will be recognized in the year of purchase. This will give a misleading view of the profitability of the entity. The observation may be explained by way of an example.

Example 6

ABC LTD purchased a machine costing $1000 on 1st January 2011. It had a useful life of three years over which it generated annual sales of $800. ABC LTD's annual costs during the three years were $300.

If ABC LTD expensed the entire cost of the fixed asset in the year of purchase, its income statement would present the following picture the end of the three years:

Income Statement	2011, $	2012, $	2013, $
Sales	800	800	800
Cost of Sales	(300)	(300)	(300)
Fixed Asset Cost	(1000)	-	-
Net Profit (Loss)	(500)	500	500

As you can see, income statement of ABC LTD shows net loss in the first year even though it earned the same revenue as in the subsequent years. Conversely, no fixed asset will appear in ABC LTD's balance sheet although it had earned revenue from the machine's use through out its useful life of 3 years.

If ABC LTD, instead of charging the entire cost of fixed asset at once, depreciates the capital expenditure over its useful life, its income statement and balance sheet would present the following picture at the end of the three years:

Income Statement	2011, $	2012, $	2013, $
Sales	800	800	800
Cost of Sales	(300)	(300)	(300)
Fixed Asset Cost	(333.3)	(333.3)	(333.3)
Net Profit (Loss)	166.7	166.7	166.7

Balance Sheet (Extract)	2011, $	2012, $	2013, $
Fixed Assets	1,000	1,000	1,000
Accumulated Depreciation	(333.3)	(666.7)	(1,000)
Net Book Value	666.7	333.3	Nill

As you can see, the process of relating cost of a fixed asset to the years in which the economic benefits from its use are realized creates a more balanced view of the profitability of the company. Hence, depreciation is an application of the matching principle whereby costs are matched to the accounting periods to which they relate rather than on the basis of payment.

Accounting Entry

Double entry involved in recoding depreciation may be summarized as follows:

Debit	Depreciation Expense (Income Statement)
Credit	Accumulated Depreciation (Balance Sheet)

Every accounting period, depreciation of asset charged during the year is credited to the Accumulated Depreciation account until the asset is disposed. Accumulated depreciation is subtracted from the asset's cost to arrive at the net book value that appears on the face of the balance sheet. Using the last example, following double entries will be recorded in respect of depreciation:

Depreciation Expense Account					
Debit		**$**	**Credit**		**$**
2011	Accumulated Depreciation	333.3	2011	Income Statement	333.3
2012	Accumulated Depreciation	333.3	2012	Income Statement	333.3
2013	Accumulated Depreciation	333.4	2013	Income Statement	333.4

Accumulated Depreciation Account					
Debit		**$**	**Credit**		**$**
2011	Balance c/d	333.3	2011	Depreciation Expense	333.3
		333.3			333.3
2012	Balance c/d	666.6	2012	Balance b/d	333.3
			2012	Depreciation Expense	333.3
		666.6			666.6
2013	Balance c/d	1000	2013	Balance b/d	666.6
			2013	Depreciation Expense	333.4
		1000			***1000***

Methods of Depreciation

Cost of fixed asset must be charged to the income statement in a manner that best reflects the pattern of economic use of the asset. Most common methods of depreciation include Straight Line Method and Reducing Cost Method.

Straight Line Depreciation Method

Straight line method depreciates cost evenly through out the useful life of the fixed asset. Straight line depreciation is calculated as follows:

Depreciation per annum = (Cost - Residual Value) / Useful Life

Where:

- Cost includes the initial and any subsequent capital expenditure.
- Residual Value is the estimated scrap value at the end of the useful life of the asset. As the residual value is expected to be recovered at the end of an asset's useful life, there is no need to charge the portion of cost equaling the residual value.
- Useful Life is the estimated time period an asset is expected to be used from the time it is available for use to the time of its disposal or termination of use. Useful life is normally calculated in units of years but it may be calculated based on an alternative basis. Useful life of an oil extraction company may for example be the estimated oil reserves.

Example 7

An asset has a useful life of 3 years.

Cost of the asset is $2,000.

Residual Value is $500.

Annual Depreciation cost will be $500 = (2000 - 500) / 3years

Straight line depreciation method is appropriate where economic benefits from the asset are expected to be realized evenly during its useful life. It is also convenient where no reliable estimate can be made regarding the pattern of economic benefits over an asset's useful life.

Reducing Balance Depreciation Method

Reducing Balance Method charges depreciation at a higher rate in the earlier years of an asset. The amount of depreciation reduces as the life of the asset progresses. Depreciation under reducing balance method may be calculated as follows:

Depreciation per annum = (Net Book Value - Residual Value) x Rate%

Where:

- Net Book Value is the asset's net value at the start of an accounting period. It is calculated by deducting the accumulated (total) depreciation from the cost of the fixed asset.
- Residual Value is the estimated scrap value at the end of the useful life of the asset. As the residual value is expected to be recovered at the end of an asset's useful life, there is no need to charge the portion of cost equaling the residual value.
- Rate of depreciation is defined according to the estimated pattern of an asset's use over its life term.

Example 8

An asset has a useful life of 3 years.
Cost of the asset is $2,000.
Residual Value is $500.
Rate of depreciation is 50%.
Depreciation expense for the three years will be as follows:

	NBV		R.V		Rate		Depreciation	Accumalated Depreciation
Year1:	(2000	-	500)	x	50%	=	750	750
Year2:	(1250	-	500)	x	50%	=	375	1125
Year3:	(875	-	500)	x	50%	=	375*	1500

*Under reducing balance method, depreciation for the last year of the asset's useful life is the difference between net book value at the start of the period and the estimated residual value. This is to ensure that depreciation is charged in full.

As you can see from the above example, depreciation expense under reducing balance method progressively declines over the asset's useful life.

Reducing Balance Method is appropriate where an asset has a higher utility in the earlier years of its life. Computer equipment for instance has better functionality in its early years. Computer equipment also becomes obsolete in a span of few years due to technological developments. Using reducing balance method to depreciate computer equipment would ensure that higher depreciation is charged in the earlier years of its operation.

Units of Production Depreciation Method

Units of Production Depreciation Method, also known as Units of Activity and Units of Usage Method of Depreciation, calculates depreciation on the basis of expected output or usage.

For example, a machine may be depreciated on the basis of output produced during a period in proportion to its total expected production capacity. Therefore, useful life of an asset under Units of Production Method is stated in terms of production output or usage rather than years of service.

Depreciation per annum = (Cost - Residual Value) / Useful Life

The Formula for calculation of depreciation under Units of Production Method is as follows:

Stage of Completion % = Value of Work Certified as complete x 100

Total Expected Production or Usage

Where:

- Cost includes the initial and any subsequent capital expenditure.
- Residual Value is the estimated scrap value at the end of the useful life of the asset. Since residual value is expected to be recovered at the end of an asset's useful life, there is no need to charge the portion of asset's cost equaling the residual value.

Example 9

Oil PLC installs a crude oil processing plant costing $12 million with an estimated capacity to process 50 million barrels of crude oil during its entire life. Production during the first year of operation is 2 million barrels. Expected residual value of the processing plant is $2 million.

Depreciation charge for the first year is calculated as follows:

Depreciation Expense = ($12 - $2m) x 2 / 50 = $0.4 million

Example - Units of Usage (Activity) Depreciation

Plastic LTD purchases a steel mould costing $1 million to be used in the production of plastic glasses. The mould could be used in 8 production batches after which it will have a scrap value of $.2 million. During the first year, the company manufactures 2 batches of glasses.

Depreciation charge for the year is calculated as follows:

Depreciation Expense = ($1 - $0.2m) x 2 / 8 = $0.2 million

Considerations - Advantages and Disadvantages

Units of Production Method may be appropriate where there is a high correlation between activity of an asset and its physical wear and tear. As no depreciation under this method is charged when an asset remains idle, it is not appropriate for depreciating assets that suffer a significant decrease in their earning potential with the passage of time for reasons such as technological obsolescence.

Disposal of Fixed Assets

Fixed assets may be sold anytime during their useful life. This gives rise to the need to derecognize the asset from balance sheet and recognize any resulting gain or loss in the income statement.

The accounting for disposal of fixed assets can be summarized as follows:

- Record cash receive or the receivable created from the sale:
- Debit
- Cash/Receivable
- Remove the asset from the balance sheet
- Credit
- Fixed Asset (Net Book Value)
- Recognize the resulting gain or loss
- Debit/credit
- Gain or Loss (Income Statement)

Example 10

ABC LTD purchased a machine for $2000 on 1st January 2011 which had a useful life of 5 years and an estimated residual value of $500. The machine was being depreciated on straight line basis. However, ABC LTD decided to sell the asset on1 January 2013 for $1500 in order to raise cash for the purchase of a new machine.

The disposal of the fixed asset will be recorded as follows:

- Record cash received or the receivable arising from the sale:
- Debit
- Cash
- $1500

- Remove the asset from the balance sheet
- As a fixed asset is recognized in the balance sheet at the Net Book Value (i.e. Cost less Accumulated Depreciation), the machine will be removed from the accounts of ABC LTD in two parts:
- First, the Machine Cost must be removed by crediting the ledger:
- Credit
- Machine Cost
- $2000
- Second, the Accumulated Depreciation in respect of the machine must be removed by debiting the ledger:
- Debit
- Accumalated Depreciation
- $600*
- *Accumulated Depreciation: (2000 - 500)/5 x 2 Years
- The combined effect of the above two transactions would be to remove the machine's net book value of $1400 (2000 - 600) from the balance sheet.
- The combined effect of the above two transactions would be to remove the machine's net book value of $1400 (2000 - 600) from the balance sheet.
- Recognize the resulting gain or loss on the sale of machine
- ABC LTD received $1500 for an asset with a balance sheet worth of $1400. It therefore earned a gain of $100. The gain will be recorded as follows:
- Credit
- Gain on Disposal
- $100

The accounting entries will appear in the ABC LTD's ledger accounts as follows:

Machine Cost					
Debit		**$**	**Credit**		**$**
2011	Cash	2000	2013	Disposal	2000
		2000			2000

Accumalated Depreciation					
Debit		**$**	**Credit**		**$**
2013	Disposal	600	2011	Income Statement	300
			2012	Income Statement	300
		600			600

Cash Book					
Debit		**$**	**Credit**		**$**
2013	Disposal	1500	-	-	-

Disposal Account					
Debit		**$**	**Credit**		**$**
2013	Machine cost	2000	2013	Cash	1500
	Income Statement (Gain)	100		Accumalated Depreciation	600
		2100			2100

Disposal Account acts as a control account for the entries involving the disposal of fixed assets. Balances from all relevant fixed asset account are pooled into the disposal account and the balancing figure is the gain or loss on disposal which is transferred to the income statement.

3. INTANGIBLE ASSETS

1. Read the article and discuss

Example 1

Aston Ltd acquires new energy efficient technology that will significantly reduce its energy costs for manufacturing. Costs incurred include:

Cost of new solar technology 1,500,000

Trade discount provided 200,000

Training course for staff in new technology 70,000

Initial testing of new technology 20,000

Losses incurred while other parts of plant shut down during testing and training. 30,000

The cost that can be recognised and capitalised is:

Cost 1,500,000

Less discount (200,000)

Plus initial testing 20,000

1,320,000

Example 2

Baxter plc is preparing its accounts for the year ended 31 May 2009 and is unsure how to treat the following items.

1. The firm completed a big marketing and advertising campaign costing £2.4m. The finance director had authorised this campaign on the basis that it would create £5m of additional profits over the next three years.

2. A new product was developed during the year. The expenditure totalled £1.5m of which £1m was incurred prior to 30 November 2008, the date on which it became clear that the product was technically viable. The new product will be launched in the next four months and its recoverable amount is estimated at £700,000.

3. Staff participated in a training programme which cost the company £300,000. The training organisation had made a presentation to the directors of Baxter outlining that incremental profits to the business over the next twelve months would be £500,000.

What amounts should appear as assets in Baxter‟s statement of financial position as at 31 May 2009?

Solution

The treatment in Baxter plc‟s statement of financial position at 31 May 2009 will be as follows:

Marketing and advertising campaign: no asset will be recognised, because it is not possible to identify future economic benefits that are attributable only to this campaign. All of the expenditure should be expensed in the statement of comprehensive income.

New product: development expenditure appearing in the statement of financial position will be valued at £500,000. The expenditure prior to the date on which the product becomes technically feasible is recognised in the statement of comprehensive income.

Training programme: no asset will be recognised, because staff are not under the control of Baxter plc and when staff leave the benefits of the training, whatever they may be, also leave.

Example 3

1. Company A acquired an intangible asset on 30 June 2007 for £60,000. The asset was revalued at £80,000 on 30 June 2008 and £45,000 on 30 June 2009.

2. Company B acquired an intangible asset on 30 June 2007 for £90,000. The asset was revalued at £75,000 on 30 June 2008 and at £95,000 on 30 June 2009.

Assuming that the year-end for both companies is 30 June, and that they both use the revaluation model, show how each of these transactions should be dealt with in the financial statements.

Solution

Company A: the £20,000 revaluation increase on 30 June 2008 should be credited to the revaluation reserve and recognised as other comprehensive income. £20,000 of the revaluation decrease on June 2009 should be debited to revaluation reserve and recognised as a (negative figure) in other comprehensive income. The remaining £15,000 should be recognised as an expense.

Company B: the £15,000 revaluation decrease on 30 June 2008 should be recognised as an expense. £15,000 of the £20,000 increase on 30 June 2009 should be recognised as income. The remaining £5,000 should be credited to revaluation reserve and recognised as other comprehensive income.

Example 4

A business is currently undertaking research and development into a new product range. They have spent £245 000 on a new research facility. Additional staff have been employed to operate the facility at an annual salary cost of £55 000 to the business. Land and buildings are depreciated at 2% per annum straight line basis.

Solution

The new research facility represents capital expenditure and can be capitalised as a non-current asset in the balance sheet at a cost of £245 000. It will then be amortised at a cost of £4 900 per annum (£245 000 x 2%). This amount will be deducted from the cost of the facility in the balance sheet to give a net book value of £240 100 and show as an expense in the income statement for the year.

The staff salaries represent revenue expenditure for the research and £55 000 will therefore be shown as an expense in the income statement for the year.

2. Choose the correct answer "True" or "False"

Depreciation

1.	Depreciation Expense shown on a company's income statement must be the same amount as the depreciation expense on the company's income tax return.	True	False
2.	The purpose of depreciation is to have the balance sheet report the current value of an asset.	True	False
3.	Depreciation Expense reflects an allocation of an asset's original cost rather than an allocation based on the economic value that is being consumed.	True	False
4.	An asset's useful life is the same as its physical life?	True	False
5.	One company might depreciate a new computer over three years while another company might depreciate the same model computer over five years...and both companies are right.	True	False
6.	Depreciation Expense is shown on the income statement in order to achieve accounting's matching principle.	True	False
7.	Accumulated Depreciation will appear as a deduction within the section of the balance sheet labeled as Property, Plant and Equipment.	True	False
8.	If a company continues to use equipment past the useful life that was assumed in determining the depreciation, there will be no Depreciation Expense in those additional years.	True	False
9.	A company may depreciate equipment over 10 years on a straight-line basis for its financial statements, but might use an accelerated method of depreciation over a shorter time period on its income tax return?	True	False
10.	Depreciation Expense is sometimes referred to as a noncash expense.	True	False
11.	Both Land and Land Improvements will generally be depreciated.	True	False
12.	Amortization of intangible assets and depletion of natural resources is conceptually similar to depreciation of constructed assets.	True	False
13.	Depreciation Expense shown on the financial statements is a precise amount that is continuously refined.	True	False
14.	Over the life of an asset subject to depreciation, the accelerated method will result in more Depreciation Expense in total than the total Depreciation Expense using the straight-line method.	True	False
15.	When a company purchases a 10-acre parcel of land and a building located on the land, the company will depreciate the entire cost over the useful life of the building.	True	False
16.	The book value of an asset indicates the asset's fair market value at that time.	True	False
17.	If a company revises the estimated useful life of one of its assets being depreciated, the company will need to reissue its earlier financial statements as the earlier depreciation was incorrect.	True	False

3. Choose the correct answer

1. Which of the following depreciation methods is NOT an accelerated method?

a) Double-declining balance
b) Straight-line
c) Sum-of-the-years' digits

2. The book value of an asset is defined as

a) Cost minus Salvage Value
b) Cost minus Accumulated Depreciation
c) Cost minus Salvage Value minus Accumulated Depreciation
d) Estimated fair market value

4. INVENTORIES

1. Read the article and discuss

1) Inventory and Cost of Goods Sold

A retailer's inventory is its merchandise that has not yet been sold. The cost of the inventory is reported on the balance sheet as a current asset. When merchandise is sold, the cost of the items sold is reported on the income statement as the cost of goods sold.

The formula for the retailer's cost of goods sold is the cost of its net purchases minus the increase in inventory, or its cost of net purchases plus the decrease in inventory. This formula assures the matching of costs with revenues.

A manufacturer reports three inventory amounts:

raw materials (at cost),

work-in-process (at cost),

and unsold finished goods (at cost).

The cost of these three inventories is reported on the balance sheet as a current asset. The cost of the finished goods that were sold in the current period is reported on the income statement as the cost of goods sold.

The formula for a manufacturer's cost of goods sold is the cost of goods manufactured minus the increase in the finished goods inventory, or the cost of goods manufactured plus the decrease in finished goods inventory. Again, this formula assists in the matching of costs with revenues.

Costs for inventory include all costs that were necessary to get the items into inventory and ready for sale. For a retailer, the cost of a product is the vendor's invoice amount plus any freight-in on goods purchased FOB shipping point. A manufacturer's cost of finished goods and work-in-process will be the cost of direct material, direct labor, and manufacturing overhead.

When costs of items are increasing, one must decide which costs will be reported as inventory and which costs will be reported as the cost of goods sold. Under the first-in, first-out (FIFO) cost flow assumption, the older (lower) costs will be leaving inventory first and the most recent costs will remain in inventory. The last-in, first-out (LIFO) cost flow assumption has the recent higher costs flowing out of inventory first (and will become the cost of goods sold). The older lower costs will remain in inventory (unless the quantity is drastically reduced).

The LIFO cost flow can be different from the physical movement of goods. In other words, a company can diligently rotate its stock by moving the oldest goods to customers and yet flow the most recent costs to the cost of goods sold on its income statement.

Example 1

The ABC Stationery Company bought 20 boxes of photocopier paper at $5 per box. Following a flood in their stockroom 5 of the boxes were damaged. They were offered for sale at $3 per box. All were unsold at the end of the company’s financial year.

At what price will they be valued in the annual accounts?
_____ boxes will be valued at their cost of $____ per box, a total of $____.
_____ boxes will be valued at $_____ per box, a total of $______.
The total stock value will be $_________.

Example 2

The Good Look Clothing Company carries a variety of stocks. At their year end they produce the following data in respect of it:

Item	Cost Price $	Net Realisable Value $	Selling Price (when new) $
New dresses	1,000	1,500	2,000
Children's clothes	2,000	3,000	3,000
Bargain Fashions*	1,200	900	2,000

What will be the total stock value for the accounts?
New dresses $ ___________
Children's clothes $ _________
Bargain fashions $ ________
Total Stock Value $ __________

***Example* 3**

The XYZ Manufacturing Company manufactures wooden doors for the building trade. For the period under review it manufactured and sold 10,000 doors. At the end of the trading period there were 1,000 completed doors ready for despatch to customers and 200 doors which were half completed as regards direct material, direct labour and production overheads.

Cost for the period under review were, $
Direct material used 20,000
Direct labour 5,000
Production overheads 8,300
Non-production overheads <u>10,000</u>
Total Costs for the period <u>43,300</u>
Calculate the value of work in progress and finished goods.
Total units sold 10,000
Finished goods units 1,000
Half completed units (200 x 0.5) <u>100</u>
Production for the period _________
Attributable costs $____________
Cost per unit __________________
Value of work in progress:
____
Value of finished goods:
____
Note that overheads are excluded from the calculations.

The value of finished goods ($3,000) will be compared with their net realisable value when preparing the final accounts.

2) Methods of calculating inventory cost

As inventory is usually purchased at different rates (or manufactured at different costs) over an accounting period, there is a need to determine what cost needs to be assigned to inventory. For instance, if a company purchased inventory three times in a year at $50, $60 and $70, what cost must be attributed to inventory at the year end? Inventory cost at the end of an accounting period may be determined in the following ways:

- First In First Out (FIFO)
- Last In First Out (LIFO)
- Average Cost Method (AVCO)
- Actual Unit Cost Method

First In First Out (FIFO)

This method assumes that inventory purchased first is sold first. Therefore, inventory cost under FIFO method will be the cost of latest purchases. Consider the following example:

Example 4

Bike LTD purchased 10 bikes during January and sold 6 bikes, details of which are as follows:

January 1 Purchased 5 bikes @ $50 each
January 5 Sold 2 bikes
January 10 Sold 1 bike
January 15 Purchased 5 bikes @ 70 each
January 25 Sold 3 bikes

The value of 4 bikes held as inventory at the end of January may be calculated as follows:

The sales made on January 5 and 10 were clearly made from purchases on 1st January. Of the sales made on January 25, it will be assumed that 2 bikes relate to purchases on January 1 whereas the remaining one bike has been issued from the purchases on 15th January. Therefore, the value of inventory under FIFO is as follows:

Date	Purchase			Issues			Inventory		
	Units	$/Units	$ Total	Units	$/Units	$ Total	Units	$/Units	$ Total
Jan 1	5	50	250				5	50	250
Jan 5				2	50	100	3	50	150
Jan 10				1	50	50	2	50	100
Jan 15	5	70	350				5	70	350
Jan 15							7		450
Jan 25				2	50	100			
				1	70	70	4	70	280

As can be seen from above, the inventory cost under FIFO method relates to the cost of the latest purchases, i.e. $70.

Last In First Out (LIFO)

This method assumes that inventory purchased last is sold first. Therefore, inventory cost under LIFO method will be the cost of **earliest** purchases. Consider the following example:

Example 5

Bike LTD purchased 10 bikes during January and sold 6 bikes, details of which are as follows:

January 1 Purchased 5 bikes @ $50 each
January 5 Sold 2 bikes
January 10 Sold 1 bike
January 15 Purchased 5 bikes @ 70 each
January 25 Sold 3 bikes

The value of 4 bikes held as inventory at the end of January may be calculated as follows:

The sales made on January 5 and 10 were clearly made from purchases on 1st January. However, all sales made on January 25 will be assumed to have been made from the purchases on January 15. Therefore, the value of inventory under LIFO is as follows:

Date	Purchase			Issues			Inventory		
	Units	$/Units	$ Total	Units	$/Units	$ Total	Units	$/Units	$ Total
Jan 1	5	50	250				5	50	250
Jan 5				2	50	100	3	50	150
Jan 10				1	50	50	2	50	100
Jan 15	5	70	350				5	70	350
Jan 15							7		450
Jan 25				3	70	210	2	50	100
							2	70	140
							4		240

As can be seen from above, LIFO method allocates cost on the basis of earliest purchases first and only after inventory from earlier purchases are issued completely is cost from subsequent purchases allocated. Therefore value of inventory using LIFO will be based on outdated prices. This is the reason the use of LIFO method is not allowed for under IAS 2.

Average Cost Method (AVCO)

This method values inventory at the weighted average cost of all purchases. Average cost is calculated each time inventory is issued. Consider the following example:

Example 6

Bike LTD purchased 10 bikes during January and sold 6 bikes, details of which are as follows:

January 1 Purchased 5 bikes @ $50 each

January 5 Sold 2 bikes

January 10 Sold 1 bike

January 15 Purchased 5 bikes @ 70 each

January 25 Sold 3 bikes

The value of 4 bikes held as inventory at the end of January may be calculated as follows:

All issues of inventory will be assumed to carry the average cost of all purchases up to the date of the issue. Average cost will be calculated by dividing total units of inventory by the total cost.

Date	Purchase			Issues			Inventory		
	Units	$/Units	$ Total	Units	$/Units	$ Total	Units	$/Units	$ Total
Jan 1	5	50	250				5	50	250
Jan 5				2	50	100	3	50	150
Jan 10				1	50	50	2	50	100
Jan 15	5	70	350				5	70	350
	Average Cost of Inventory						7	64.286	450
Jan 25				3	64.286	192.858	4	64.286	257.144

As can be seen from above, AVCO method allocates cost on the average cost of purchases during the period. Average cost of inventory changes every time a purchase is made at a different price. Therefore the average cost of inventory changed from $50 to $64.286 after the purchase on January 15.

Actual Unit Cost Method

It may be appropriate to record inventory of very high value at their actual unit costs. This method is only practical where the number of inventory items is very small and distinguishable such as in the property business.

Accounting for Inventory

Opening inventory is brought forward from the previous period's ledger account and charged to the income statement as follows:

Debit	Income Statement
Credit	Inventory

Closing inventory at the period end is recorded as follows:

Debit	Inventory
Credit	Income Statement

The Inventory Ledger Account therefore would appear as follows:

Inventory Account			
Debit	**$**	**Credit**	**$**
Balance b/f	100	Income Statement	100
Income Statement	200	Balance c/d	200
	300		300

The inventory adjustments in respect of opening and closing inventory appear in the Cost of Goods Sold as follows:

Opening Inventory	100
Add: Purchases	500
Less: Closing Inventory	(200)
Cost of Goods Sold	400

Note that the cost of goods sold is not simply the cost of purchases during the period. This is the application of the Matching Concept which requires expenses to be recognized against periods from which associated revenue from the expense is expected to be earned. Therefore, as closing inventory is not consumed at any given accounting period end, it must not be part of expense which is why it is deducted from the cost of sale. Similarly, as opening inventory is consumed in the current accounting period, it must therefore be added to the cost of goods sold.

3) Perpetual vs Periodic Inventory System

Perpetual inventory system and periodic inventory systems are the two systems of keeping records of inventory.

In perpetual inventory system, merchandise inventory and cost of goods sold are updated continuously on each sale and purchase transaction. Some other transactions may also require an update to inventory account for example, sale/purchase return, purchase discounts etc. Purchases are directly debited to inventory account whereas for each sale two journal entries are made: one to record sale value of inventory and other to record cost of goods sold. Purchases account is not used in perpetual inventory system.

In periodic inventory system, merchandise inventory and cost of goods sold are not updated continuously. Instead purchases are recorded in Purchases account and each sale transaction is recorded via a single journal entry. Thus cost of goods sold account does not exist during the accounting period. It is determined at the end of accounting period via a closing entry.

Differences Between Perpetual and Periodic System

Following are the main differences between perpetual and periodic inventory systems:

- **Inventory Account and Cost of Goods Sold Account** are used in both systems but they are updated continuously during the period in perpetual inventory system whereas in periodic inventory system they are updated only at the end of the period.

- **Purchases Account and Purchase Returns and Allowances Account** are only used in periodic inventory system and are updated continuously. In perpetual inventory system purchases are directly debited to inventory account and purchase returns are directly credited to inventory account.
- **Sale Transaction** is recorded via two journal entries in perpetual system. One of them records the sale value of inventory whereas the other records cost of goods sold. In periodic inventory system, only one entry is made.
- **Closing Entries** are only required in periodic inventory system to update inventory and cost of goods sold. Perpetual inventory system does not require closing entries for inventory account.

2. Complete the following sentences

1. Inventory is reported as a _________ asset.
2. Inventory is often reported at the _______ of cost or market.
3. FIFO and LIFO are examples of cost flow ________________.
4. Under this inventory system the balance in the Inventory account changes with each sale. ______
5. Under this inventory system the balance in the Inventory account does not change with each sale. ______
6. A ___________ will report raw materials, work-in-process, and finished goods inventory.
7. The annual cost of goods sold divided by the average inventory balances is the inventory ______________ ratio.
8. The normal selling price minus the estimated cost to complete and sell is the net ___________ value.
9. Net Purchases is Gross Purchases minus Purchase Returns and Allowances and__________ ___________.
10. The difference between the Cost of Goods Available and the Cost of Goods Sold is__________ ___________.

3. Choose the correct answer

1. The inventory cost flow assumption where the cost of the most recent purchase is matched first against sales revenues is
   a) FIFO;
   b) LIFO;
   c) Average.
2. The inventory cost flow assumption where the cost of the most recent purchases are likely to remain in inventory
   a) FIFO;
   b) LIFO;
   c) Average.

3. The inventory cost flow assumption where the oldest cost of inventory items is likely to remain on the balance sheet is

a) FIFO;

b) LIFO;

c) Average.

4. The account Inventory will appear on the balance sheet as a current asset at an amount that often reflects the __________ of the merchandise on hand.

a) cost;

b) sales value.

5. The inventory system that does NOT update the Inventory account automatically at the time of each purchase or sales is the _______________ method/system.

a) periodic;

b) perpetual.

6. If a company is experiencing continuous cost increases for the merchandise that it purchases, which cost flow assumption will result in the least amount of profit and the least amount of income tax expense?

a) FIFO;

b) LIFO;

c) Average.

7. A company in the computer industry is experiencing continuously lower costs. Which cost flow assumption will result in less income tax expense for this company?

a) FIFO;

b) LIFO;

c) Average.

8. A company purchased items for inventory during 2011 at continuously higher costs. Its last two purchases of 2011 were 20 units on December 20 at a cost of $14 per unit and 30 units on December 30 at a cost of $15 per unit. On December 28, 2011 the company made its last sale for the year when it sold 10 units. Which inventory cost flow assumption will cause the $15 cost per unit to be expensed as part of the year 2011's cost of goods sold?

a) LIFO periodic;

b) LIFO perpetual;

c) Neither.

Use the following information for questions 9 through 14:

A company purchased merchandise to be resold at increasing costs during the year 2012. The purchases were made at the following costs...

January 1, 2012 (carried over from 2010)	20 units at $10
January 25, 2012 purchase	40 units at $11
June 20, 2012 purchase	40 units at $12
October 10, 2012 purchase	50 units at $13

The company sold 10 items at the end of each month.

9. What are the number of units and the cost of the goods available for sale?

_____ units $________ cost of goods available for sale

10. Assuming the LIFO periodic cost flow assumption, what will be the company's cost of goods sold for the 120 items sold in 2012?

a) $1,380;

b) $1,386;

c) $1,400;

d) $1,460.

11. Assuming the FIFO periodic cost flow assumption, what will be the company's cost of goods sold for the 120 items sold in 2012?

a) $1,380;

b) $1,386;

c) $1,410;

d) $1,460.

12. Assuming the periodic weighted-average cost flow assumption, what is the company'scost of goods sold for the 120 items sold in 2012?

a) $1,386;

b) $1,410;

c) $1,416;

d) $1,460.

13. Assuming the perpetual moving-average cost flow assumption, what is the company'scost of goods sold for the 120 items sold in 2012?

a) $1,386;

b) $1,410;

c) $1,416;

d) $1,460.

14. A company's inventory was destroyed in a fire on January 28, 2012. The company's December 31, 2011 inventory had a cost of $40,000. The company's gross profit has consistently been 30% of sales. During January the company purchased merchandise costing $36,000 and sales of $50,000 at regular selling prices. What is the estimated cost of the inventory that was destroyed on January 28, 2012?

a) $26,000;

b) $35,000;

c) $41,000.

15. A company has properly recorded all of its purchases of merchandise inventory, but made an error when counting its ending inventory. As a result of the error the company's Inventory account is overstated by $24,000. (This means that the amount in the Inventory account is too high by $24,000.) What is the impact of this error on the company's income statement? Specifically, the company's reported profit (ignoring income tax expense) in the period of the error is....

a) Too High;

b) Too Low;

c) Not Affected.

5. BIOLOGICAL ASSETS

1. Read the article and discuss

1) Is managing animal-related recreational activities agricultural activity?

No. Managing recreational activities – for example, game parks and zoos – is not agricultural activity, as there is no management of the transformation of the biological assets but simply control of the number of animals.

2) Is the natural breeding of animals in zoos and game parks agricultural activity?

No. The natural breeding that takes place is not a managed activity and is incidental to the main activity of providing a recreational facility. A managed breeding programme carried out to produce animals for sale would be considered agricultural activity.

3) Is ocean fishing agricultural activity?

No. Harvesting biological assets from unmanaged sources, such as ocean fishing, is not agricultural activity.

4) Is fish farming agricultural activity?

Yes. Managing the growth of fish for subsequent slaughter or sale is agricultural activity within the scope of IAS 41.

5) Does the development of living organisms such as cultures, cells, bacteria and viruses represent agricultural activity?

It depends. The development of organisms for research purposes does not qualify as agricultural activity, as those organisms are not being developed for sale, or for transformation into agricultural produce or additional biological assets. If the organisms are being developed for those purposes, the activity is agricultural activity in the scope of IAS 41 – for example, the development of cultures for use in dairy products.

6) Is the growing of plants to be used in the production of drugs an activity within the scope of IAS 41?

Yes. If a pharmaceutical or biotechnology entity grows plants from which particular drugs are produced, that activity will fall within IAS 41's scope.

7) Is the produce or harvest from a biological asset another biological asset?

No. The produce or harvest from a biological asset (for example, milk, tea leaves and lumber) is inventory. The harvested produce is transferred to inventory at fair value less costs to sell; it is thereafter accounted for in accordance with IAS 2, 'Inventories'.

However, while the produce is still growing or still attached to the biological asset, its value forms part of the value of the biological asset.

8) Is land related to agricultural activity a biological asset in terms of IAS 41?

No. Land owned by the entity and used for agricultural activity is subject to the recognition and measurement principles of IAS 16, 'Property, plant and equipment'.

Land owned by a third party and rented to the entity for the purposes of agricultural activity is likely to be the third party's investment property and is accounted for in accordance with IAS 40, 'Investment Property'.

9) In an integrated business, are all the activities treated as being in the scope of IAS 41?

No. Consider the following examples.

Example 1: Cattle farm

Entity A raises cattle, slaughters them at its abattoirs and sells the carcasses to the local meat market. Which of these activities are in the scope of IAS 41?

The cattle are biological assets while they are living. When they are slaughtered, biological transformation ceases and the carcasses meet the definition of agricultural produce. Hence, entity A should account for the live cattle in accordance with IAS 41 and the carcasses as inventory in accordance with IAS 2.

Example 2: Vineyard

Entity B grows vines, harvests the grapes and produces wine. Which of these activities are in the scope of IAS 41?

The grapevines are biological assets that continually generate crops of grapes. When the entity harvests the grapes, their biological transformation ceases and they become agricultural produce. The grapevines continue to be living plants and should be recognised as biological assets.

Assets such as wine that are subject to a lengthy maturation period are not biological assets. These processes are analogous to the conversion of raw materials to a finished product rather than biological transformation.

Therefore, the entity should account for the grapevines in accordance with IAS 41 and the harvested grapes and the production of wine, as inventory in accordance with IAS 2.

Example 3: Cattle and farm implements

An entity owns a herd of cattle that forms the breeding stock of its agricultural activities.

The entity also owns a tractor and trailer that are used to transport feed to the cattle.

Although the cattle arguably meet the definition of PPE—they are tangible assets used in the production of calves in more than one accounting period—

because of the specific exemption for biological assets related to agricultural activity they are accounted for as biological assets in accordance with IAS 41 *Agriculture*. They are outside the scope of IAS 16.

Note: even though the tractor and trailer are used in a farming operation they are classified as items of PPE. They are physical assets used in the supply of goods during more than one reporting period. The exception to the PPE classification principle does not apply because the tractor and trailer are not biological assets related to agricultural activity.

Example 4: Land on which trees are grown for timber

An entity owns and manages a pine plantation (the trees and the land on which they are growing).

Although the trees arguably satisfy the definition of PPE—they are tangible assets used in the production of logs in more than one accounting period—because of the specific exemption for biological assets related to agricultural activity they are accounted for as biological assets in accordance with IAS 41 (ie the trees are outside the scope of IAS 16).

Note: even though the trees in the pine plantation are attached to and growing on the entity's farmland, the land is classified as an item of PPE. It is a physical asset used in the supply of goods (logs) during more than one reporting period. The exception from the PPE classification principle does not apply to the land because the land is neither a living animal nor a living plant. Consequently, although it is related to agricultural activity, the land cannot be accounted for in accordance with IAS 41 because it is not a biological asset as defined in paragraph 5 of IAS 41.

Example 5: Guard dogs

A security firm owns guard dogs that work with its security personal to provide personal security services.

The guard dogs meet the definition of biological assets—a living animal (see paragraph 5 of IAS 41)—and the definition of PPE in IAS 16 because they are assets used in the provision of security services in more than one accounting period.

The biological asset exemption from the scope of IAS 16 does not apply to the guard dogs because they are not related to agricultural activity (ie although the dogs are controlled by the entity, their biological transformation—the process of growth, degeneration, production, and procreation that causes qualitative or quantitative changes in a biological asset—is not managed by an entity for harvest of biological assets for sale or for conversion into agricultural produce or into additional biological assets). Consequently, the guard dogs are within the scope of IAS 16.

2. Complete the following table

Sheep, Milk, Wool, Sausages, Picked fruit, Wine, Bushes, Clothing, Grapes, Tea, Dairy cattle, Pigs, Cotton, Processed fruit, Yarn, Plants, Carcass, Cheese, Leaf, Fruit trees, Vines

Biological assets	Agricultural produce	Products that are the result of processing after harvest

3. Complete the following table

Vines, Land used for agricultural activity, Sheep, Grapes, Pigs, guard dogs, Dairy cattle, a trailer that is used in a farming operation, trees, fish farming, Milk, Wool, Carcass, tea leaves, a tractor that is used for agricultural activity

within the scope of IAS 41	within the scope of IAS 2	within the scope of IAS 16

6. CASH AND CASH EQUIVALENTS

1. Read the article and discuss

1) What is the difference between the direct method and the indirect method for the statement of cash flows?

The main difference between the direct method and the indirect method involves the *cash flows from operating activities*, the first section of the statement of cash flows. (There is no difference in the cash flows reported in the investing and financing activities sections.)

Under the direct method, the cash flows from operating activities will include the amounts for lines such as *cash from customers* and *cash paid to suppliers*. In contrast, the indirect method will show net income followed by the adjustments needed to convert the total net income to the cash amount from operating activities.

The direct method must also provide a reconciliation of net income to the cash provided by operating activities. (This is done automatically under the indirect method.)

Nearly all corporations prepare the statement of cash flows using the indirect method.

2) What is the difference between net cash flow and net income?

Under the accrual method of accounting, net income is calculated as follows: *revenues earned* minus the *expenses incurred* in order to earn those revenues. If a company earns revenues in December but allows those customers to pay in 30 days, the cash from the December revenues will likely be received in January. In this situation the December revenues will increase the December net income, but will not increase the company's December net cash flow.

Under accrual accounting, expenses are matched to the accounting period when the related revenues occur or when the costs have expired. For example, a retailer may have purchased and paid for merchandise in October. However, the merchandise remained in inventory until it was sold in December. The company's net cash flow decreases in October when the company pays for the merchandise. However, net income decreases in December when the cost of the goods sold is matched with the December sales.

There are many other examples of expenses occurring in one accounting period but the payments occur in a different accounting period.

In short, the statement of cash flows is a needed financial statement because the income statement does not report cash flows.

3) What is the difference between cash flow and free cash flow?

A corporation's cash flow from operations is available from the first section of the statement of cash flows. Usually the calculation begins with the accrual accounting net income followed by adding back depreciation expense and then adjusting for the changes in the balances of current assets and current liabilities.

Free cash flow is often defined as the cash flow from operations (or net cash flows from operating activities) minus the cash necessary for capital expenditures. Occasionally, dividends to stockholders are also deducted.

4) How can a company have a profit but not have cash?

A company can have a profit but not have cash because *profit* is computed using revenues and expenses, which are different from the company's cash receipts and cash disbursements. In other words, there is a difference between revenues and receipts. There is also a difference between expenses and expenditures.

To illustrate, let's assume that a new company uses the accrual method of accounting. It provides $10,000 of services to its clients in its first month and the clients are allowed to pay in 30 days. The company will have $10,000 of revenues in its first month, but the cash will not be received until the second month. If the company's expenses are $7,000 in the first month, the company will report a profit of $3,000 but will not have received any cash from its clients.

Another company might have a profit of $60,000 in its first year, but during its first year it uses $65,000 of cash to acquire equipment that will be put into service at the beginning of the second year. This company will have a profit, but will not have the cash.

Other examples where cash is paid out, but the profits are not reduced at the time of the payment, include prepayments of insurance, payments to increase the inventory of merchandise on hand, and payments to reduce liabilities.

2. Complete the following sentences

1. The first section of the statement of cash flows reports the cash flows from ___________ activities.

2. The second section of the statement of cash flows reports the cash flows from __________ activities.

3. The third section of the statement of cash flows reports the cash flows from ___________ activities.

4. Under the indirect method, an increase in __________ assets other than cash will cause a decrease in cash from operating activities.

5. Under the indirect method, a decrease in current ____________ will cause a decrease in cash from operating activities.

6. The cash __________ from the sale of a long-term asset will be reported in the investing activities section of the statement of cash flows.

7. A corporation's ___________ on its stock will appear as a deduction in the financing activities section of the statement of cash flows.

8. Capital _______________ are a significant deduction in the investing activities section of the statement of cash flows.

9. The purchase of ____________ stock will cause a negative amount in the financing activities section of the statement of cash flows.

10. The __________ of bonds payable will be reported as a negative amount in the financing activities section of the statement of cash flows.

3. For each of the following items, indicate which part will be affected: Operating, Investing, Financing, Supplemental

1.	Depreciation Expense	
2.	Proceeds from the sale of equipment used in the business	
3.	The Loss on the Sale of Equipment in Question #2.	
4.	Declaration and payment of dividends on company's stock	
5.	Gain on the Sale of Automobile formerly used in the business	
6.	The *proceeds* from the sale of the automobile in Item #5.	
7.	An increase in the balance in a retailer's Merchandise Inventory	
8.	An increase in the balance in Accounts Payable	
9.	Retirement of long-term Bonds Payable	
10.	Purchase of Treasury Stock (company's own stock)	
11.	The purchase of a new delivery truck to be used in the business	
12.	A decrease in the balance of Accounts Receivable	
13.	An increase in Bonds Payable (a long-term liability)	
14.	A decrease in the current asset account Prepaid Insuranc	
15.	A decrease in the current liability Income Taxes Payable	
16.	The proceeds from issuing additional Common Stock	
17.	The amortization of the cost of an intangible asset	
18.	The exchange/conversion of long-term bonds into common stock	

4. For items 1 – 12 indicate whether they will have a positive or negative effect on cash.

A **positive effect** could also be thought of as a *source* of cash, an *increase* in cash, or a *positive amount* on the cash flow statement.

A **negative effect** could also be thought of as a *use* of cash, a *decrease* in cash, or a *negative amount* on the cash flow statement.

1.	An increase in the balance of Prepaid Insurance	
2.	A decrease in Supplies on hand	
3.	The proceeds from the sale of equipment formerly used in the business	
4.	The Loss on the Sale of Equipment in the previous question	
5.	An increase in the current liability Income Taxes Payable	
6.	A decrease in Accounts Payable	
7.	An increase in Accounts Receivable	
8.	An increase in the current liability Warranty Liability	
9.	Dividends declared and paid	
10.	Proceeds from the issuance of Preferred Stock	
11.	The Gain on the Sale of Equipment formerly used in the business	
12.	An increase in the long-term asset Investment in Another Company	

5. Choose the correct answer

1. For a recent year a corporation's financial statements reported the following:

Net Income	$100,000
Depreciation Expense	10,000
Increase in Accounts Receivable	30,000
Decrease in Accounts Payable	15,000

Based on the above information, what amount will the corporation report as Cash Provided by Operating Activities on the cash flow statement?

a) $65,000;

b) $125,000;

c) $155,000.

2. A corporation reported the following information for the past year:

Net Income	$200,000
Depreciation Expense	30,000
Gain on Sale of Truck	5,000
Proceeds from Sale of Truck	8,000
Decrease in Accounts Receivable	10,000

Assuming these are the only facts, what amount will the corporation report as the Cash Provided by Operating Activities on the cash flow statement?

a) $225,000;

b) $235,000;

c) $253,000.

6. Use «Increases» or «Decreases» to complete the table below

1.	When Mary Smith invests her personal money into her new company, what will happen to her company's Cash account?	
2.	When a company purchases inventory (merchandise purchased in order to be resold) what will happen to its Cash account?	
3.	What happens to the company's Cash account if it borrows money from the bank by signing a note payable?	
4.	What happens to a company's Cash account if it declares a dividend on its shares of stock?	
5.	What is the effect on its Cash account when a company pays some of itsAccounts Payable?	
6.	What is the effect on its Cash account when a company prepays a 6-month insurance premium?	
7.	What is the effect on its Cash account when a company sells merchandise, but allows the customer to pay in 30 days?	
8.	What is the effect on its Cash account when a company receives payment from one of its customers 30 days after the sale was recorded?	
9.	If a company's Accounts Payable account decreased, what is the likely effect this will have on Cash?	
10.	If the asset account Prepaid Insurance increased, what is the likely effect on Cash?	
11.	If the asset account Land increased, what's the likely effect on Cash?	
12.	If the asset account Land decreased, what's the likely effect on Cash?	
13.	If the liability account Bonds Payable increases, what is the likely effect on Cash?	
14.	If the liability account Bonds Payable decreases, what is the likely effect on Cash?	

7. Read the article and discuss

Cash transactions are ones that are settled immediately in cash. Cash transactions also include transactions made through cheques. Cash transactions may be classified into cash receipts and cash payments.

Cash receipts are accounted for by debiting cash / bank ledger to recognize the increase in the asset. Following are common types of cash receipt transactions along with relevant accounting entries:

Cash Sale:

Debit	Cash
Credit	Sales

Cash receipt from receivable:

Debit	Cash
Credit	Receivable

Capital contribution from shareholders:

Debit	Bank
Credit	Share Capital

Receipt of loan from a bank:

Debit	Bank
Credit	Loan

Cash Payments

Cash payments are accounted for by crediting the cash / bank ledger to account for the decrease in the asset.

Following are common types of cash payment transactions along with relevant accounting entries:

Cash payment to a payable:

Debit	Payable
Credit	Cash

Purchase of inventory for cash:

Debit	Purchases
Credit	Cash

Purchase of a machine for cash:

Debit	Machinery - Asset
Credit	Cash

Cash Drawings by owner:

Debit	Drawing
Credit	Cash

Repayment of loan installment:

Debit	Loan
Credit	Cash

7. ACCOUNTS RECEIVABLE. REVENUES

1. Read the article and discuss

What is accounts receivable?

Accounts receivable is the balance owed to the entity by its customers in respect of sale of goods and services on credit.

Accounting for Receivables

Credit Sale

As credit sale results in increase in the income (sale revenue) and assets (receivable) of the entity, assets must be debited whereas income must be credited.

In case of a credit sale, the following double entry is recorded:

Debit	Receivable
Credit	Sales Revenue (Income Statement)

The double entry is same as in the case of a cash sale, except that a different asset account is debited (i.e. receivable).

When the receivable pays his due, the receivable balance will have be reduced to nil. The following double entry is recorded:

Debit	Cash
Credit	Recievable

Sales Tax

When a credit sale involves the application of sales tax, the receivable balance includes the amount of sales tax since it will be recovered from the customer. Sales is recorded net of sales tax because any sales tax received on the sales will be returned to tax authorities and hence, does not form part of income. Sales tax account is credited since this is the amount of tax payable that will be paid to tax authorities.

The accounting entry to record a credit sale involving sales tax will therefore be as follows:

Debit	Receivable (Gross Amount)
Debit	Sales (Net Amount)
Credit	Sales Tax (Payable) (Net Amount)

Subsequent receipt of dues from the customer will result in the following double entry:

When the receivable pays his due, the receivable balance will have be reduced to nil. The following double entry is recorded:

Debit	Cash (Gross Amount)
Credit	Receivable (Gross Amount)

Example

Bike LTD sells a mountain bike to XYZ for $115 on credit. Sales tax is

15%.

As the sale of $115 includes an element of sales tax, we need to first separate tax from the gross amount. Sales tax on the transaction may be calculated as follows:

Sales Tax: 115 x 15/115 = $15

Deducting sales tax from the gross sale revenue, we may now arrive at the tax exclusive sale value:

Tax Exclusive Sales: 115 - 15 = $100

This is the amount to be recognized as sales in the income statement. The accounting entry will therefore be as follows:

			$
Debit	XYZ (Receivable)	115	
Credit	Sales		100
Credit	Sales Tax (Payable)		15

Upon receipt of the amount receivable from XYZ, following double entry will be made:

		$	$
Debit	Cash	115	
Credit	XYZ (Receivable)		115

The sales tax payable of $15 will stand until it is paid to the tax authorities.

Allowance Method for Reporting Credit Losses

Accounts receivable are reported as a current asset on a company's balance sheet. Since current assets by definition are expected to turn to cash within one year (or within the operating cycle, whichever is longer), a company's balance sheet could overstate its accounts receivable (and therefore its working capital and stockholders' equity) if any part of its accounts receivable is not collectible.

To guard against overstatement, a company will estimate how much of its accounts receivable will never be collected. This estimate is reported in a balance sheet contra asset account called Allowance for Doubtful Accounts. (Some companies call this account Provision for Doubtful Accounts or Allowance for Uncollectible Accounts.) Any increases to Allowance for Doubtful Accounts are also recorded in the income statement account Bad Debts Expense (or Uncollectible Accounts Expense).

This method of anticipating the uncollectible amount of receivables and recording it in the Allowance for Doubtful Accounts is known as the allowance method. (If a company does not use an allowance account, it is following the direct write-off method)

Writing Off an Account under the Allowance Method

Under the allowance method, if a specific customer's accounts receivable is identified as uncollectible, it is written off by removing the amount from Accounts Receivable. The entry to write off a bad account affects only balance sheet accounts: a debit to Allowance for Doubtful Accounts and a credit to Accounts Receivable. No expense or loss is reported on the income statement because this write-off is "covered" under the earlier adjusting entries for estimated bad debts expense.

Bad Debts Expense as a Percent of Sales

Another way sellers apply the allowance method of recording bad debts expense is by using the percentage of credit sales approach. This approach automatically expenses a percentage of its credit sales based on past history.

Difference between Expense and Allowance

The account Bad Debts Expense reports the credit losses that occur during the period of time covered by the income statement. Bad Debts Expense is a temporary account on the income statement, meaning it is closed at the end of each accounting year. (Closed means the account balance is transferred to retained earnings, perhaps through an income summary account.) By closing Bad Debts Expense and resetting its balance to zero, the account is ready to receive and tally the credit losses for the next accounting year.

The Allowance for Doubtful Accounts reports on the balance sheet the estimated amount of uncollectible accounts that are included in Accounts Receivable. Balance sheet accounts are almost always permanent accounts, meaning their balances carry forward to the next accounting period. In other words, they are not closed and their balances are not reset to zero.

Because the Bad Debts Expense account is closed each year, while the Allowance for Doubtful Accounts is not, these two balances will most likely not be equal after the company's first year of operations.

Pledging or Selling Accounts Receivable

A company's accounts receivable are considered to be a type of asset, and as such can be pledged as collateral for a loan. Asset-based lenders will often lend a company an amount equal to 80% of the value of its accounts receivable.

Some companies sell their accounts receivable to a factor. A factor buys the accounts receivables at a discount and then goes about the business of collecting and keeping the money owed through the receivables. Sometimes the factor will purchase the accounts receivables with recourse. This means the company that sold the receivables remains financially responsible if a customer does not remit the full amount to the factor. When the factor purchases the receivables without recourse, the company selling the receivables is not responsible for unpaid amounts.

2. Complete the following sentences

1. Collections of amounts from customers who had purchased on credit are ____________ to Accounts Receivable.

2. When sales terms are FOB_______________ title passes at the buyer's location.

3. The valuation account associated with Accounts Receivable is the _____________ for Doubtful Accounts.

4. When terms are 2/10, n/30, the seller is allowing a 2% _________ if the invoice is paid within 10 days.

5. Sorting the accounts receivable according to the dates of the sale invoices is the _________ of accounts receivable.

6. The percentage of ______________ method for bad debts focuses on the balance reported in the allowance account.

7. The percentage of ______ method for bad debts focuses on the expense reported on the income statement.

8. The _________ write-off method for bad debts is required for income tax purposes.

9. Accounts receivable is reported as a __________ asset.

10. Annual credit sales divided by the average balances in accounts receivable is the receivables _________________ ratio.

3. Choose the correct answer

1. On June 1, $800 of goods are sold with credit terms of 1/10, n/30. How much should the seller expect to receive if the buyer pays on June 8?

a) $720
b) $784
c) $792
d) $800

2. On June 1, $800 of goods are sold with credit terms of 1/10, n/30. On June 3 the customer returned $100 of the goods. How much should the seller expect to receive if the buyer pays on June 8?

a) $692
b) $693
c) $700
d) $792

3. When the Allowance for Doubtful Accounts appears on a company's financial statements, its balance will be a __________ balance.

a) debit
b) credit

4. On which financial statement would you expect to find Allowance for Doubtful Accounts?

a) balance sheet
b) income statement

5. Which method of reporting losses on accounts receivable is required in the U.S. for income a) a) tax purposes?

b) allowance
c) direct write-off

6. Which method of reporting losses on accounts receivable is to be used for financial reporting?

a) allowance
b) direct write-off

7. The seller of goods that is offering credit terms of net 30 days will likely be one of its customer's _____________ creditors until it receives payment.

a) secured
b) unsecured

8. After several years of operations, a company's Bad Debts Expense for a given year is likely to be the same as its balance in Allowance for Doubtful Accounts.

a) True
b) False

9. A company estimates that $20,000 of its $500,000 of accounts receivable will be uncollectible. Its Allowance for Doubtful Accounts presently has a credit balance of $8,000. The adjusting entry will include a ___________________ to the Allowance for Doubtful Accounts.

a) debit of $12,000
b) credit of $12,000
c) debit of $28,000
d) credit of $28,000

10. A company estimates that $20,000 of its $500,000 of accounts receivable will be uncollectible. Its Allowance for Doubtful Accounts presently has a credit balance of $18,000. The adjusting entry will include a ____________________ to Bad Debts Expense.

a) debit of $2,000
b) credit of $2,000
c) debit of $38,000
d) credit of $38,000

11. A company estimates that $20,000 of its $500,000 of accounts receivable will be uncollectible. Its Allowance for Doubtful Accounts presently has a debit balance of $3,000. The adjusting entry will include a _____________________ to Allowance for Doubtful Accounts.

a) debit of $3,000
b) credit of $3,000
c) debit of $17,000
d) credit of $17,000
e) debit of $23,000
f) credit of $23,000

<u>4. Use the following information for questions 1-5:</u>

A company is expecting thousands of credit sales transactions each week with terms of net 30 days. The company uses the allowance method and it prepares weekly financial statements. It believes that 0.001 of its credit sales will be uncollectible. The company's credit sales for its first week of operations are $500,000. The credit sales for its second week are $600,000.

1. The company's bad debts expense for its first week of operations will be $________.

2. The balance in Allowance for Doubtful Accounts at the end of the first week will likely be $____________.

3. The company's bad debts expense for its second week of operations will be $___________.

4. The amount of accounts receivable that you expect will be written off by the end of the company's second week of operations is $___________.

5. The balance in Allowance for Doubtful Accounts at the end of the second week of operations will likely be $_____________.

Use the following information for questions 6 - 14:

A company's Allowance for Doubtful Accounts has a credit balance of $25,000. It learns that one of its accounts receivable amounting to $1,800 is worthless and needs to be written off.

6. Which account should be debited for $1,800 when writing off the account?

a) Allowance for Doubtful Accounts

b) Accounts Receivable

c) Bad Debts Expense

7. Which account should be credited for $1,800 when writing off the account?

a) Allowance for Doubtful Accounts

b) Accounts Receivable

c) Bad Debts Expense

8. Assuming that after the account is written off, the supplier receives full payment from the customer. Which account will not be involved in the accounting entries made at the time when the payment is received?

a) Allowance for Doubtful Accounts

b) Accounts Receivable

c) Bad Debts Expense

9. Under the direct write off method, which account is debited when a company writes off one of its accounts receivable?

a) Allowance for Doubtful Accounts

b) Accounts Receivable

c) Bad Debts Expense

10. Sorting a company's accounts receivable into classifications such as *current, 1-30 days past due*, and *31-60 days past due* is known as the ________ ___ of accounts receivables.

11. The receivable turnover ratio is computed by dividing the net credit _______ ___ for the year by the average amount of accounts receivable during the year.

12. The days' sales in accounts receivable is calculated by dividing ________ days by the receivables turnover ratio during the year.

13. A company's accounts receivable minus its allowance for doubtful

accounts equals the net ___________ _____ value of the accounts receivable.

14. In some industries, companies often sell their accounts receivable to a firm known as a______________.

5. Read the article and discuss

What are the differences among accounting revenue, gain, and net income?

Sometimes there is confusion when words**revenue,income, gross profit, gain, profit**, and **net income** are used. These are all accounting terms that have different meanings in light of an income statement. Unfortunately, it is not always understood that the word revenue can be used interchangeably with the word profit, for example. To clear up things with these accounting terms, let's review them in detail and then look at an example of an income statement with all these elements.

We will start at the top of income statement and progress downwards by explaining each element.

Revenue is usually understood to be total income of a company resulting from its main operating activities. Main operating activities may be manufacturing and selling goods for a manufacturing company, providing legal services for a law firm, or providing leased assets for a leasing company. Revenue represents the total amount of income before any expenses are subtracted. In pure accounting terms, revenue is an increase in assets or decrease in liabilities on the company's books. Revenues are also called **sales**, especially in context of companies producing or selling tangible products.

Income may have several meanings. First, income can be used interchangeably with revenue. Second, income may refer to revenue from sources other than main operating activities (we will call them secondary revenue types); for example, interest income, rent income, or commission income. Third, income may refer to the excess of revenue over expenses: this excess represents *net income*. In our example in the following section we will use the second meaning of income (i.e., secondary types of revenues).

Gross profit is the difference between revenue and cost of goods sold (cost of sales). Revenue was defined above. Cost of goods sold is the cost of goods which a company sold to generate that revenue. In pure accounting terms, cost of goods sold is the difference between cost of goods available for sale and cost of goods on hand at the end of an accounting period. As we will see in the example presented further, gross profit is an intermediate step in arriving at net income.

Gain is similar to income as a secondary type of revenue, except that gain refers to incidental and nonrecurring transactions. For example, rent income may be received by a company regularly, which is why it will be an income. On the other hand, gain on disposal of fixed assets is called a gain because sale of fixed assets does not take place regularly.

Profit is the difference between revenue and expenses. Profit can also be called **net income, net profit**, or**"bottom line"** because it's usually the last line on an income statement.

2. Example of revenue, income, gross profit, profit, net income, and gain

Let us take a look at an example of a multiple-step income statement with cross-references to the terms we have discussed. Note that in the income statement that we refer to income is a secondary type of revenue.

Company ABC Income Statement For the Year Ended December 31, 20X1		
Sales Revenue	$ 1,000,000	This line is sales revenue (or just revenue).
Cost of Goods Sold	600,000	
Gross Profit	**400,000**	This line is gross profit (difference between revenue and cost of goods sold).
Operating Expenses:		
Selling Expenses	160,000	
Administrative Expenses	140,000	
Income from Operations	**100,000**	
Interest Income	20,000	This is an example of income.
Rental Income	7,000	This is another example of income.
Gain on Sale of Fixed Assets	3,000	This is an example of gain.
Income before Income Tax	**130,000**	
Income Tax	50,700	
Net Income	**79,300**	This is net income (profit, “bottom line”).

8. STOCKHOLDERS' EQUITY

1. Read the article and discuss

1) What Is a Corporation?

Most of the world's largest companies do business as *corporations*. Companies such as Wal-Mart, Exxon Mobil, General Motors, Ford Motor, and General Electric—each with sales in excess of $100 billion annually—are corporations. As opposed to a sole proprietorship or a partnership, a corporation is a business that is recognized by law as a separate legal entity with its own powers, responsibilities, and liabilities. Before the owners/managers of a business choose to *incorporate* their business (become corporations), however, they should examine the advantages and disadvantages of doing so.

Advantages

A corporation has several advantages over the sole proprietorship and the partnership form of business. The four major advantages are: (1) limited liability, (2) ease in transferring ownership, (3) continuity, and (4) ease in raising money.

1. **Limited liability** for the owners. Generally, the owners of a corporation can lose no more than the amount they have invested in that corporation. On the other hand, with a sole proprietorship or partnership, an owner could lose not only her or his investment, but could also lose other personal assets as well. In other words, the corporate form of business "shields" the owners from most creditors. This occurs because corporations are considered to be legal entities, separate and distinct from their owners. (Due to their legal entity status, a corporation can sue others, can be sued, and must pay income taxes on its taxable income.)
2. **Ease in which owners can sell their ownership interest**. If the stock is **publicly traded**, investors can sell their ownership interest in a corporation in a matter of minutes simply by giving instructions to their stockbroker. If the stock is not publicly traded, the stock certificate can be transferred to another owner by signing a transfer statement.
3. **Continuity**. When a stockholder sells shares of stock, the transaction is between the seller and the buyer of the stock. Unless the corporation is the buyer or the seller, the corporation is not involved in the transaction. This means that even if a corporation's stock is the most actively traded stock of the day, the corporation itself will not skip a beat in its day-to-day operations. When notified by a stockbroker of a transfer between stockholders, the corporation merely changes in its records the name of the owner of the shares.
4. **Ease in raising money**. Because of limited liability and the ease of buying/selling shares, it is easy to understand why investors are more attracted to investing in corporations rather than in sole proprietorships or partnerships. This investor attraction allows corporations to raise the capital needed to manage and expand their operations.

Disadvantages

Some view the legal complexity of starting and running a corporation to be a disadvantage. To incorporate, an application must be filed with and approved by one of the fifty states, and once approved, the corporation must comply with that state's regulations. In contrast, a sole proprietorship can be started in minutes, sometimes with nothing more than a tax identification number from the state. Many of the legal requirements imposed on a corporation do not apply to sole proprietorships.

Another disadvantage associated with corporations is the possibility of "double taxation" on the dividends it pays. Some argue that a regular corporation's net income is first taxed on the *corporation's* income tax return. Then, if the corporation distributes some of the net income to the stockholders as a dividend, the dividend will be taxed again on the *stockholders'* personal income tax returns. (To gain more insight into this and to minimize or to avoid this potential problem, you should discuss various forms of business structures with tax and legal professionals.)

Governance

The owners of corporations are referred to as **stockholders** or **shareholders**, because they hold the shares of stock, which serve as the evidence of their ownership. (The term *stockholders* and *shareholders* are used interchangeably. However, we will use the term stockholders.)

Because it would be impossible for 30,000 stockholders to sit around a boardroom table and give meaningful input to the direction of their company, the stockholders elect a board of directors as their representatives in the corporation's affairs. The **board of directors** formulates the corporation's policies and appoints officers of the corporation to carry out those policies. The board of directors also declares the amount and timing of dividend distribution, if any, to the stockholders.

The **officers** of a corporation are appointed by the corporation's board of directors to carry out (or execute) the policies established by the board of directors. The officers include the president, chief executive officer (CEO), chief operating officer (COO), chief financial officer (CFO), vice presidents, treasurer, secretary, and controller.

2) What is stock?

In accounting there are two common uses of the term *stock*. One meaning of stock refers to the goods on hand which is to be sold to customers. In that situation, stock means inventory.

The term *stock* is also used to mean the ownership shares of a corporation. For example, an owner of a corporation will have a stock certificate which provides evidence of his or her ownership of a corporation’s common stock or preferred stock. The owner of the corporation’s common or preferred stock is known as a stockholder.

3) What are the stockholders' equity accounts?

The stockholders' equity accounts are balance sheet accounts and a part of the accounting equation Assets = Liabilities + Stockholders' Equity. In this light you can view the stockholders' equity accounts (along with the liability accounts) as sources of the amounts reported in the asset accounts.

If the source of an asset was an investor purchasing new shares of common stock, the corporation would credit the stockholders' equity account Common Stock and perhaps Paid-in Capital in Excess of Par–Common Stock, or Premium on Common Stock. If the source of an asset was an investor purchasing new shares of preferred stock, the corporation would credit the stockholders' equity account Preferred Stock and perhaps Paid-in Capital in Excess of Par–Preferred Stock, or Premium on Preferred Stock.

If the source of an asset was the net income earned by the corporation, the stockholders' equity account Retained Earnings would be credited. If a corporation reduces its assets by purchasing its stock from its stockholders, the contra-stockholders' equity account Treasury Stock is debited.

4) Treasury Stock — Cost Method

When treasury shares are later reissued, the treasury stock account is credited for the cost at which they were purchased, cash account is debited for the amount actually received and if the amount received on reissuance of treasury stock is:

- more than the cost of treasury stock, the difference between the amount received and the cost of the treasury stock is credited to additional paid-in capital.
- less than the cost of treasury stock, the excess of cost of treasury stock over the amount received is debited to discount on capital account.

The following example illustrates the cost method of accounting for treasury stock:

Example

A company issued 10,000 shares of common stock of $5 par value and received $53,000 cash. The company then purchased back 900 shares out of those at $6 per share. The company then resold 500 shares from treasury stock at $6.50 per share.

Pass journal entries to record the above transactions.

<u>Solution</u>

Issuance of Common Stock:

Cash	53,000	
Common Stock		50,000
Additional Paid-In Capital		3,000

Purchase of Treasury Stock (Cost Method):

Treasury Stock	5,400	
Cash		5,400

Resale of Treasury Stock (Cost Method):

Cash	3,250	
Treasury Stock		3,000
Additional Paid-In Capital		250

5) Treasury Stock — Par Value Method

The resale of treasury stock is recorded by debiting cash account for the actual amount received, crediting treasury stock for the par value of the treasury shares and if the cash received on resale is:

- more than the total par value of treasury shares, the excess is credited to additional paid-in capital account.
- less than the total par value of treasury shares, the difference is debited to additional paid-in capital from treasury stock provided it has sufficient credit balance otherwise retained earnings account is debited.

The following example shows the journal entries to record the purchase and resale of treasury stock under par value method.

Example

A corporation issued 12,000 shares of common stock of $4 par value and received $57,000 from investors. It then bought back 1,000 of the shares and paid a sum of $4,500 for the purchase. Later it resold 500 of the treasury shares at a price of $5 per share.

Journalize the above transactions according the par value method of accounting for treasury stock.

Solution

Issuance of Common Stock:

Cash	57,000	
Common Stock		48,000
Additional Paid-In Capital		9,000

Purchase of Treasury Stock (Par Value Method):

Treasury Stock	4,000	
Additional Paid-in Capital[1]	750	
Cash		4,500
Add. Paid-in Capital from TS[2]		250

1: 9,000 × (1,000 ÷ 12,000)

2: 4,000 + 750 − 4,500

Resale of Treasury Stock (Par Value Method):

Cash	2,500	
Treasury Stock		2,000
Additional Paid-In Capital		500

6) What is retained earnings?

Generally, retained earnings is a corporation's cumulative earnings since the corporation was formed minus the dividends it has declared since it began. In other words, retained earnings represents the corporation's cumulative earnings that have not been distributed to its stockholders.

The amount of retained earnings as of a balance sheet's date is reported as a separate line item in the stockholders' equity section of the balance sheet.

A negative amount of retained earnings is reported as *deficit* or *accumulated deficit*.

Example

IG Plc. has a balance in retained earnings as at 1 January 2011 of $102 million. It earned a net income of $40 million for the year and declared dividends of $45 million in the year.

The statement of retained earnings would look like as follows:

Retained earnings as at 1 January 2011	
Plus: net income for the period	
Less: dividends declared	
Retained earnings as at 31 December 2011	

7) Does a dividend reduce profit?

When a corporation declares and pays a dividend, the dividend does *not* reduce the current accounting period's profit reported on the income statement. In other words, a dividend is *not* an expense.

Dividends will reduce the amount of the corporation's retained earnings. Retained earnings are reported in the stockholders' equity section of the balance sheet.

If a corporation has very profitable uses for its cash, its future profits might be less if it pays dividends instead of reinvesting the cash dividend amounts into profitable projects.

8) What is the difference between stocks and bonds?

Stocks, or shares of stock, represent an ownership interest in a corporation. Bonds are a form of long-term debt in which the issuing corporation promises to pay the principal amount at a specific date.

Stocks pay dividends to the owners, but only if the corporation declares a dividend. Dividends are a distribution of a corporation's profits. Bonds pay interest to the bondholders. Generally, the bond contract requires that a fixed interest payment be made every six months.

Every corporation has common stock. Some corporations issue preferred stock in addition to its common stock. Many corporations do not issue bonds.

The stocks and bonds issued by the largest corporations are often traded on stock and bond exchanges. Stocks and bonds of smaller corporations are often held by investors and are never traded on an exchange.

9) Does the income statement explain the change in the equity section of a balance sheet?

The income statement could explain the change in the equity section of a balance sheet. However, there are likely to be some other explanations as well.

Here is a list of the items that would cause an *increase* in the total amount of a corporation's stockholders' equity:

1. Positive net earnings or net income reported on the corporation's income statement.
2. Some positive Other Comprehensive income items occurred but they are not to be reported on the income statement.
3. Additional shares of stock were issued in exchange for cash or other assets.
4. Donated capital was received.

Here is a list of items that could cause a *decrease* in the total amount of a corporation's stockholders' equity:

1. Negative net earnings or a net loss reported on the corporation's income statement.
2. Some negative Other Comprehensive Income items occurred but they are not to be reported the income statement.
3. The corporation declared cash dividends.

To see all of the explanations for the change in the equity section of a balance sheet, you should review the *statement of stockholders' equity*. This financial statement should be issued along with a corporation's balance sheet, income statement, and statement of cash flows.

10) What is preferred stock?

Preferred stock is a type of capital stock issued by some corporations. Preferred stock is also known as preference stock.

The word "preferred" refers to the dividends paid by the corporation. Each year, the holders of the preferred stock are to receive their dividends before the common stockholders are to receive any dividend. In exchange for this preferential treatment for dividends, the preferred stockholders (or shareholders) generally will never receive more than the stated dividend. For example, the holder of 100 shares of a corporation's 8% $100 par preferred stock will receive annual dividends of $800 (8% X $100 = $8 per share X 100 shares) before the common stockholders are allowed to receive any cash dividends for the year. Unless the preferred stock has a participating feature, this preferred stockholder will never receive more than $8 per share no matter how successful the corporation becomes.

The features of preferred stocks can vary. Examples include cumulative, convertible, callable, participating, and more.

Since the dividend on preferred stock is usually a fixed amount forever, once the preferred stock is issued its market value is likely to move in the opposite direction of inflation. The higher the rate of inflation, the less valuable is the fixed dividend amount. If the inflation rate declines, the value of the preferred stock is likely to increase, but no higher than the stock's call price.

Most corporations do not issue preferred stock. Typically, corporations will issue only common stock and use debt.

11) Why is there a large difference between share value and stockholders' equity?

There can be many reasons why the market value of a corporation's stock is much greater than the amount of stockholders' equity reported on the balance sheet. Let's start by defining stockholders' equity as the difference between the asset amounts reported on the balance sheet minus the liability amounts. Next, the accountant's cost principle requires that only the cost of items purchased can be reported as an asset. This means that valuable trade names that were never purchased (but were developed over time) are not reported on the balance sheet. The same holds for a great management team and an amazing reputation. The cost principle also means that many long-term assets are reported at cost (and not at their current higher market value). Many plant assets are reported at minimal amounts because their costs have been reduced by the cumulative amount of depreciation taken over the years.

Other factors contributing to a high market value might be a corporation's earnings and dividends that are consistently growing and/or a special niche for its products or services that is recognized by the market.

Lastly, a corporation's stockholders' equity may have been reduced from the purchase of treasury stock at a high cost.

Issuance of No Par Stock

Example

A company received $34,000 for issuing 10,000 shares of common stock of $3 par value. Pass the journal entry to record the issuance of shares.

Journal Entry

Cash	34,000	
Common Stock		30,000
Additional Paid-In Capital		4,000

12) Issuance of Shares for Non-Cash Items

Corporations usually issue shares in exchange of cash or cash equivalents since cash can be used to purchase other assets or services. However shares may be issued in exchange of non-cash assets or services if the company actually needs them. For example shares may be issued to the supplier of machinery as purchase price and to attorneys as legal fee.

Generally such transactions of share issuance are recorded at the fair market value of the shares or the non-cash assets/services which ever can be determined more reliably. The determination of fair market value is the right of the board of directors of the company and they may obtain services of professional appraisers for to determine the fair market value.

Example

A company issued 1,000 shares of common stock of $10 par value to its attorney as a consideration for legal services received by the company. The total fair market value of the shares, which was $9,800 at the time of issuance of shares, is to be used as the basis for valuation of the legal services.

Pass a journal entry to record the issuance of shares for non-cash consideration.

Journal Entry

Legal Expense	9,800	
Common Stock		10,000
Additional Paid-In Capital		200

13) Lump-Sum Stock Issuance

A corporation may issue different types of stocks in a single transaction in exchange of a lump-sum of cash or other assets or services. For example, common stock and preferred stock may be issued in exchange of a single sum of cash or machinery. To record such transactions it is necessary to determine the portion of lump-sum cash or the value of property obtained to be allocated to each class of stock.

Usually the lump-sum amount is apportioned to each class of stock issued on the basis of the market values of each class of stock. This method is called the apportionment method. It uses the following formula to calculate the amount of lump-sum to be allocated to each class of stock:

$$\text{Apportionment} = \frac{A}{B} \times C$$

Where,

A is the market value of a particular class of stock issued for lump-sum;

B is the total market value of all the stocks issued for lump-sum; and

C is the lump-sum cash received or, in case of some other asset or service, its fair market value.

When two classes of stocks have been issued for a lump-sum and the market value of one class is known and that of the other is unknown, then the incremental method should be employed. According to incremental method, the portion of lump-sum equal to the stock's market value would be allocated to that class of stock and rest will be allocated to the other class.

Once the amount to be apportioned to each class of stock is calculated, the issuance of stocks is recorded via separate journal entries for each class of stock in such a way as if there had been separate transactions for each class of stock. This is illustrated the following example:

Example

A company issued 3,000 shares of $6 par value common stock and 1,000 shares of $10 par value preferred stock for a lump-sum of $56,000. On the day of issuance of the stocks for lump-sum, the market values per share of common stock and preferred stock were $10 and $20 respectively.

Apportion the lump-sum to common stock and preferred stock.

Solution

	Market Value	
Common Stock	$30,000	3/7 × $56,000 = $24,000
Preferred Stock	$40,000	4/7 × $56,000 = $32,000
	$70,000	

Journal Entries:

Cash	24,000	
Common Stock		18,000
Additional Paid-In Capital		6,000
Cash	32,000	
Preferred Stock		20,000
Additional Paid-In Capital		12,000

14) Stock Dividends

Stock dividends (also called bonus shares) represent the distribution of retained earnings to investors in the form of additional shares in the company instead of cash.

When companies have high retained earning but they do not have necessary excess cash, they resort to issuing stock dividends. Another motivation to issue stock dividends is to bring down the stock price in the market. Introduction of additional shares in the market without any increase in the company's value reduces the company's share price. Companies want to reduce their share price in order to bring down their price to earnings ratio and encourage investors to hold the company's shares.

When the board of directors of a company declares a 10% stock dividend it means that additional shares equivalent to 10% of the current shares are to be issued to the shareholders. The accounting for stock dividend depends on whether it is considered to be a large stock dividend of a small one.

Small Stock Dividend

If the stock dividend is less than 20-25%, it is a small stock dividend and is accounted for by the journal entries explained below:

- At the time of declaration, retained earnings is debited by the amount equal to the product of the share's market price, the stock dividend percentage and the current number of shares outstanding; and stock dividends distributable is credited by the same amount.
- At the time of issuance of stock the stock dividends distributable is debited by the full amount, common stock is credited by amount equal to the product of par value per share, stock dividend percentage and the number of current shares outstanding. Any excess of stock dividends distributable over the amount credited to common stock is credit to additional paid-in capital.

Large Stock Dividend

If the stock dividend declared is more than 20%-25%, it is a large stock dividend and is more like a stock split. In this case, declaration is recorded by debiting retained earnings by the product of par value per share, percentage of stock dividend and number of outstanding shares; and crediting stock dividends distributable. At the time of issuance, the stock dividends distributable are debited and common stock is credited.

Example

A company has 200,000 outstanding shares of common stock of $10 par value. It declares 10% stock dividend. The market price per share of common stock was $15 on the date of declaration.

Record the declaration and payment of the stock dividend using journal entries.

Solution

Journal entry on the date of declaration:

Retained Earnings	300,000	
Stock Dividends Distributable		300,000

Journal entry on the date of distribution:

Stock Dividends Distributable	300,000	
Common Stock		200,000
Addition Paid-In Capital		100,000

Stock Splits

Stock split is the issuance of additional shares by a company to its shareholders without receiving any related contribution from them. Such an issue increases the number of shares issued and outstanding without increasing the total balance of common stock and market capitalization of the company. The effect of stock split is to split the par value and market price per share. In fact, the sole purpose of the stock split is to reduce the market price per share so as to make it more attractive for investors.

Stock splits are designed by companies in regard to their intended effect on the market price. If a company wants to reduce its market price to half it will issue 2-for-1 stock split which means the company shall issue addition 1 share per 1 share currently issued and outstanding thereby doubling the total number of shares. There might be a 3-for-2 stock split, for example, which means that 3 shares are to be issued for each 2 shares of currently issues shares.

Stock split has no effect on balance of any equity account. It just increases the number of shares and reduces par value.

Example

Z Ltd. has 2 million of $10 par value common stock issued and outstanding which is currently trading at $300 per share. The management believes that the share price is too high and it intends to reduce it to its 1/3.

The company would need to issue a 3-for-1 stock split which means that for each of currently issued common shares the company shall issue 3 shares. It will increase the total number of shares issued and outstanding to 6 million (2 million × 3) resulting in a par value of $3.33 ($10 ÷ 3) and a market price of $100 ($300 ÷ 33).

It will not affect balance in any of the accounts.

15) Accounting For Stockholders' Equity

A corporation's balance sheet reports its assets, liabilities, and stockholders' equity. Stockholders' equity is the difference (or residual) of assets minus liabilities.

<u>Stockholders' Equity</u> = <u>Assets</u> – <u>Liabilities</u>

Because of the cost principle (and other accounting principles), assets are generally reported on the balance sheet at cost (or lower) amounts. As a result, it would be incorrect to assume that the total amount of stockholders' equity is equal to the current value, or worth, of the corporation. (For a more thorough discussion of the balance sheet, see **Explanation of Balance Sheet**.)

Because of legal requirements, the *stockholders'* equity section of a corporation's balance sheet is more expansive than the *owner's* equity section of a sole proprietorship's balance sheet. (For example, state laws require that corporations keep separate in their records the amounts received through investors from the amounts *earned* through business activity.) State laws may also require that the par value be reported in a separate account.

Below are the items that a corporation is required to report on its balance sheet in the stockholder's equity section. We will discuss them in the order they would appear on a balance sheet:

1. Paid-in Capital (also referred to as Contributed Capital)
2. Retained Earnings
3. Treasury Stock
4. Accumulated Other Comprehensive Income

16) Paid-in Capital or Contributed Capital

Capital stock is a term that encompasses both common stock and preferred stock. "Paid-in" capital (or "contributed" capital) is that section of stockholders' equity that reports the amount a corporation received when it issued its shares of stock.

State laws often require that a corporation is to record and report separately the par amount of issued shares from the amount received that was greater than the par amount. The par amount is credited to Common Stock. The actual amount received for the stock minus the par value is credited to Paid-in Capital in Excess of Par Value.

To illustrate, let's assume that a corporation's common stock has a par value of $0.10 per share. On March 10, 2012, one share of stock is issued for $13.00. (The $13 amount is the **fair market value** based on supply and demand for the stock.) The accountant makes a journal entry to record the issuance of one share of stock along with the corporation's receipt of the money (note that the "Common Stock" account reflects the par value of $0.10 per share):

Date	Account Name	Debit	Credit
March 10, 2012	Cash	13.00	
	Common Stock		0.10
	Paid-in Capital in Excess of Par Value		12.90

While some states require a par value for common stock, other states do not. If there is no par value, some states require a "stated value." If this is the case, the entry will be the same as the above except that the term "stated" will be used in place of the term "par":

Date	Account Name	Debit	Credit
March 10, 2012	Cash	13.00	
	Common Stock		0.10
	Paid-in Capital in Excess of Stated Value		12.90

If a state does not require a par value or a stated value, the entire proceeds will be credited to the Common Stock account:

Date	Account Name	Debit	Credit
March 10, 2012	Cash	13.00	
	Common Stock		13.00

Generally speaking, the par value of common stock is minimal and has no economic significance. However, if a state law requires a par (or stated) value, the accountant is required to record the par (or stated) value of the common stock in the account Common Stock.

17) Retained Earnings

Over the life of a corporation it has two choices of what to do with its net income: (1) pay it out as dividends to its stockholders, or (2) keep it and use it for business activities. The amount it keeps is the balance in a stockholders' equity account called **Retained Earnings**. This general ledger account is a **real** or **permanent** account with a normal credit balance.

The term retained earnings refers to a corporation's cumulative net income (from the date of incorporation to the current balance sheet date) minus the cumulative amount of dividends declared. An established corporation that has been profitable for many years will often have a very large credit balance in its Retained Earnings account, frequently exceeding the paid-in capital from investors. If, on the other hand, a corporation has experienced significant net losses since it was formed, it could have negative retained earnings (reported as a debit balance instead of the normal credit balance in its Retained Earnings account). When this is the case, the account is described as "Deficit" or "Accumulated Deficit" on the corporation's balance sheet.

It's important to understand that a large credit balance in retained earnings does not necessarily mean a corporation has a large cash balance. To determine the amount of cash, one must look at the Cash account in the current asset section of the balance sheet. (For example, a public utility may have a huge retained earnings balance, but it has reinvested those earnings in a new, expensive power plant. Hence, it has relatively little cash in relationship to its retained earnings balance.)

Let's look at the stockholders' equity section of a balance sheet. We'll assume that a corporation only issues common stock. The stock has a par value of

$0.10 per share. There are 10,000 authorized shares, and of those, 2,000 shares have been issued for $50,000. At the balance sheet date, the corporation had cumulative net income after income taxes of $40,000 and had paid cumulative dividends of $12,000, resulting in retained earnings of $28,000.

Stockholders' Equity	
Paid-in capital	
Common stock, $0.10 par, 10,000 shares authorized, 2,000 shares issued and outstanding	$ 200
Paid-in capital in excess of par - common	49,800
Total paid-in capital	50,000
Retained earnings	28,000
Total stockholders' equity	$ 78,000

18) Treasury Stock

A corporation may choose to reacquire some of its outstanding stock from its shareholders when it has a large amount of idle cash and, in the opinion of its directors, the market price of its stock is too low. If a corporation reacquires a *significant* amount of its own stock, the corporation's **earnings per share** may increase because there are fewer shares outstanding.

If a corporation reacquires some of its stock and does not *retire* those shares, the shares are called treasury stock. Treasury stock reflects the difference between the number of shares *issued* and the number of shares*outstanding*. When a corporation holds treasury stock, a debit balance exists in the general ledger account Treasury Stock (a contra stockholders' equity account). There are two methods of recording treasury stock: (1) the cost method, and (2) the par value method. (We will illustrate the cost method. The par value method is illustrated in intermediate accounting textbooks.)

Under the cost method, the cost of the shares acquired is debited to the account Treasury Stock. For example, if a corporation acquires 100 shares of its stock at $20 each, the following entry is made:

Treasury Stock	2,000	
Cash		2,000

Stockholders' equity will be reported as follows:

Stockholders' Equity	
Paid-in capital	
Common stock, $0.10 par, 10,000 shares authorized, 2,000 shares issued, 1,900 shares outstanding	$ 200
Paid-in capital in excess of par - common	49,800
Total paid-in capital	50,000
Retained earnings	28,000
Subtotal	$ 78,000
Less: Treasury stock, at cost (100 shares at $20)	– 2,000
Total stockholders' equity	$ 76,000

If the corporation were to sell some of its treasury stock, the cash received is debited to Cash, the *cost* of the shares sold is credited to the stockholders' equity account Treasury Stock, and the difference goes to another stockholders' equity account. Note that the difference does *not* go to an income statement account, **as there can be no income statement recognition of gains or losses on treasury stock transactions**. (This, of course, is reasonable since the corporation operates with total "insider" information.)

If the corporation sells 30 of the 100 shares of its treasury stock for $29 per share, the entry will be:

Cash (30 shares at $29 selling price)	870	
Treasury Stock (30 at $20 cost)		600
Paid-in Capital from Treasury Stock		270

Recall that the corporation's cost to purchase those shares at an earlier date was $20 per share. The $20 per share times 30 shares equals the $600 that was credited above to Treasury Stock. This leaves a debit balance in the account Treasury Stock of $1,400 (70 shares at $20 each).

The difference of $9 per share ($29 of proceeds minus the $20 cost) times 30 shares was credited to another stockholders equity account, Paid-in Capital from Treasury Stock. Although the corporation is better off by $9 per share, the corporation cannot report this "gain" on its income statement. Instead the $270 goes directly to stockholders' equity in the paid-in capital section as shown below.

Stockholders' Equity	
Paid-in Capital	
Common stock, $0.10 par, 10,000 shares authorized, 2,000 shares issued, 1,930 shares outstanding	$ 200
Paid-in capital in excess of par - common	49,800
Paid-in capital from treasury stock	270
Total paid-in capital	50,270
Retained earnings	28,000
Subtotal	$ 78,270
Less: Treasury stock, at cost (70 shares at $20)	– 1,400
Total stockholders' equity	$ 76,870

If the corporation sells any of its treasury stock for less than its cost, the cash received is debited to Cash, the cost of the shares sold is credited to Treasury Stock, and the difference ("loss") is debited to Paid-in Capital from Treasury Stock (so long as the balance in that account will not become a debit balance). If the "loss" is larger than the credit balance, part of the "loss" is recorded in Paid-in Capital from Treasury Stock (up to the amount of the credit balance) and the remainder is debited to Retained Earnings. To illustrate this rule, let's look at several transactions where treasury stock is sold for less than cost.

We will continue with our example from above. Recall that the cost of the corporation's treasury stock is $20 per share. The corporation now sells 25 shares of treasury stock for $16 per share and receives cash of $400. As mentioned previously, the $4 "loss" per share ($16 proceeds minus the $20 cost) cannot appear on the income statement. Instead the "loss" goes directly to the account Paid-in Capital from Treasury Stock (if the account's credit balance is greater than the "loss" amount). Since the $270 credit balance in Paid-in Capital from Treasury Stock is greater than the $100 debit, the entire $100 is debited to that account:

Cash (25 shares at $16 selling price)	400	
Paid-in Capital from Treasury Stock ("loss")	100	
Treasury Stock (25 at $20 cost)		500

After making this entry, the stockholders' equity section of the balance sheet appears as follows:

Stockholders' Equity	
Paid-in capital	
Common stock, $0.10 par, 10,000 shares authorized, 2,000 shares issued, 1,955 shares outstanding	$ 200
Paid-in capital in excess of par - common	49,800
Paid-in capital from treasury stock	170
Total paid-in capital	50,170
Retained earnings	28,000
Subtotal	$ 78,170
Less: Treasury stock, at cost (45 shares at $20)	– 900
Total stockholders' equity	$ 77,270

After the 25 shares of treasury stock are sold, the balance in Treasury Stock becomes a debit of $900 (45 shares at their cost of $20 per share). The Paid-in Capital from Treasury Stock now shows a credit balance of $170.

Now let's illustrate what happens when the next sale of treasury stock results in a "loss" and it exceeds the credit balance in Paid-in Capital from Treasury Stock. Let's assume that the remaining 45 shares of treasury stock are sold by the corporation for $12 per share and the proceeds total $540. Since the cost of those treasury shares was $900 (45 shares at a cost of $20 each) there will be a "loss" of $360. This $360 is too large to be absorbed by the $170 credit balance in Paid-in Capital from Treasury Stock. As a result, the first $170 of the "loss" goes to Paid-in Capital from Treasury Stock and the remaining $190 ($360 minus $170) is debited to Retained Earnings as shown in the following journal entry.

Cash (45 shares at $12 selling price)	540	
Paid-in Capital from Treasury Stock ("loss")	170	
Retained Earnings ("loss" too big for PIC TS)	190	
Treasury Stock (45 at $20 cost)		900

Again, no income statement account was involved with the sale of treasury stock, even though the shares were sold for less than their cost. The difference between the cost of the shares sold and their proceeds was debited to stockholders' equity accounts. The debit was applied to Paid-in Capital from Treasury Stock for as much as that account's credit balance. Any "loss" greater than the credit balance was debited to Retained Earnings. The stockholders' equity section of the balance sheet now appears as follows.

Stockholders' Equity

Paid-in capital	
Common stock, $0.10 par, 10,000 shares authorized, 2,000 shares issued and outstanding	$ 200
Paid-in capital in excess of par - common	49,800
Total paid-in capital	50,000
Retained earnings	27,810
Total stockholders' equity	$ 77,810

19) Accumulated Other Comprehensive Income

Accumulated other comprehensive income refers to income not reported as net income on a corporation's income statement. These items involve things such as foreign currency transactions, hedges, pension liabilities, and unrealized gains and losses on certain investments. Because these items are not common to most corporations, we will not discuss this topic in depth.

Below is an example of the reporting of Accumulated Other Comprehensive Income of $8,000. Notice that it is reported separately from retained earnings and separately from paid-in capital.

Stockholders' Equity	
Paid-in capital	
Common stock, $0.10 par, 10,000 shares authorized, 2,000 shares issued and outstanding	$ 200
Paid-in capital in excess of par - common	49,800
Total paid-in capital	50,000
Retained earnings	27,810
Accumulated other comprehensive income	**8,000**
Total stockholders' equity	$ 85,810

20) Stock Splits and Stock Dividends

Stock splits

Let's say that a board of directors feels it is useful to the corporation if investors know they can buy 100 shares of stock for under $5,000. This means that the directors will work to keep the selling price of a share between $40 and $50 per share. If the market price of the stock rises to $80 per share, the board of directors can move the market price of the stock back into the range of $40 to $50 per share by approving a 2-for-1 stock split. Such an action will cause the total number of shares outstanding to double and, in the process, cause the market price to drop from $80 down to $40 per share. For example, if a corporation has 100,000 shares outstanding, a 2-for-1 stock split will result in 200,000 shares outstanding. Since the corporation's assets, liabilities, and total stockholders' equity are the same as before the stock split, doubling the number of shares should bring the market value per share down to approximately half of its pre-split value.

After a 2-for-1 stock split, an individual investor who had owned 1,000 shares might be elated at the prospect of suddenly being the owner of 2,000 shares. However, every stockholder's number of shares has doubled—causing the value of each share to be worth only half of what it was before the split. For example, if a corporation had 100,000 shares outstanding, a stockholder who owned 1,000 shares owned 1% of the corporation (1,000 ÷ 100,000). After a 2-for-1 stock split, the same stockholder still owns just 1% of the corporation (2,000 ÷ 200,000). Before the split, 1,000 shares at $80 each totaled $80,000; after the split, 2,000 shares at $40 each still totals $80,000.

A stock split will not change the general ledger account balances and therefore will not change the dollar amounts reported in the stockholders' equity section of the balance sheet. (Although the number of shares will double, the total dollar amounts will not change.)

Although the 2-for-1 stock split is typical, directors may authorize other stock split ratios, such as a 3-for-2 stock split or a 4-for-1 stock split.

While account balances do not change after a stock split, there is one change that should be noted: **the par value *per share* decreases with a stock split**. Even though there are more shares of stock, the *total*par value is unchanged. For example, if the par value is $1.00 per share and there are 100,000 shares outstanding, the total par value is $100,000. After a 2-for-1 split, the par value is $0.50 per share and there are 200,000 shares outstanding for a total par value of $100,000. Note that the total par value remained at the same amount. A **memo entry** is made to indicate that the split occurred and that the par value per share has changed.

Stock Dividends

A *stock* dividend does not involve cash. Rather, it is the distribution of more shares of the corporation's stock. Perhaps a corporation does not want to part with its cash, but wants to give something to its stockholders. If the board of directors approves a 10% stock dividend, each stockholder will get an additional share for each 10 shares held.

Since every stockholder received additional shares, and since the corporation is no better off after the stock dividend, the value of each share should decrease. In other words, since the corporation is the same before and after the stock dividend, the total market value of the corporation remains the same. Because there are 10% more shares outstanding, however, each share should drop in value. With each stockholder receiving a percentage of the additional shares and the market value of each share decreasing in value, each stockholder should end up with the same total market value as before the stock dividend. (If this reminds you of a stock split, you are very perceptive. A stockholder of 100 shares would end up with 150 shares whether it were a 50% stock dividend or a 3-for-2 stock split. However, there will be a difference in the accounting.)

Even though the total amount of stockholders' equity remains the same, a stock dividend requires a journal entry to transfer an amount from the retained earnings section of the balance sheet to the paid-in capital section of the balance sheet. The amount transferred depends on whether the stock dividend is (1) a small stock dividend, or (2) a large stock dividend.

1. **Small stock dividend.** A stock dividend is considered to be small if the new shares being issued are**less than** 20-25% of the total number of shares outstanding prior to the stock dividend.

On the declaration date of a small stock dividend, a journal entry is made to transfer the ***market value* of the shares being issued** from retained earnings to the paid-in capital section of stockholders' equity.

To illustrate, let's assume a corporation has 2,000 shares of common stock outstanding when it declares a 5% stock dividend. This means that 100 (2,000 shares times 5%) new shares of stock will be issued to existing stockholders. Assuming the stock has a par value of $0.10 per share and a market value of $12 per share on the declaration date, the following entry is made on the declaration date:

Retained Earnings (100 shares X $12)	1,200	
Common Stock Dividend Distributable		10
Paid-in Capital in Excess of Par		1,190

When the 100 shares are distributed to the stockholders, the following journal entry is made:

Common Stock Dividend Distributable	10	
Common Stock		10

2. **Large stock dividend**. A stock dividend is considered to be large if the new shares being issued are**more than** 20-25% of the total value of shares outstanding prior to the stock dividend.

On the declaration date of a large stock dividend, a journal entry is made to transfer the ***par value* of the shares being issued** from retained earnings to the paid-in capital section of stockholders' equity.

To illustrate, let's assume a corporation has 2,000 shares of common stock outstanding when it declares a 50% stock dividend. This means that 1,000 new shares of stock will be issued to existing stockholders. The stock has a par value of $0.10 per share and the stock has a market value of $12 per share on the declaration date. The following entry should be made on the declaration date:

Retained Earnings (1,000 shares X $0.10)	100	
Common Stock Dividend Distributable		100

When the 1,000 shares are distributed to the stockholders, the following journal entry should be made:

Common Stock Dividend Distributable	100	
Common Stock		100

Cash Dividends on Common Stock

Cash dividends (usually referred to as "dividends") are a distribution of the corporation's net income. Dividends are analogous to draws/withdrawals by the owner of a sole proprietorship. As such, dividends are not expenses and do not appear on the corporation's income statement.

Corporations routinely need cash in order to replace inventory and other assets whose replacement costs have increased or to expand capacity. As a result, corporations rarely distribute all of their net income to stockholders. Young, growing corporations may pay no dividends at all, while more mature corporations may distribute a significant percentage of their profits to stockholders as dividends.

Before dividends can be distributed, the corporation's board of directors must *declare* a dividend. The date the board declares the dividend is known as the **declaration date** and it is on this date that the liability for the dividend is created. Legally, corporations must have a credit balance in Retained Earnings in order to declare a dividend. Practically, a corporation must also have a cash balance large enough to pay the dividend and still meet upcoming needs, such as asset growth and payments on existing liabilities.

Let's look at an example: On March 15 a board of directors approves a motion directing the corporation to pay its regular quarterly dividend of $0.40 per share on May 1 to stockholders of record on April 15. The following entry is made on the declaration date of March 15 assuming that 2,000 shares of common stock are outstanding:

Retained Earnings (2,000 X $0.40)	800	
Dividends Payable		800

If the corporation wants to keep a general ledger record of the current year dividends, it could use a temporary, contra retained earnings account, Dividends Declared. At the end of the year, the balance in Dividends Declared will be closed to Retained Earnings. If such an account is used, the entry on the declaration date is:

Dividends Declared	800	
Dividends Payable		800

It is important to note that there is no entry to record the liability for dividends until the board declares them. Also, there is no entry on the record date (April 15 in this case). The **record date** merely determines the names of the stockholders that will receive the dividends. Dividends are only paid on **outstanding shares** of stock; no dividends are paid on the **treasury stock**.

On May 1, when the dividends are paid, the following journal entry is made.

Dividends Payable	800	
Cash		800

21) Preferred Stock

When it comes to dividends and liquidation, the owners of preferred stock have preferential treatment over the owners of common stock. Preferred stockholders receive their dividends before the common stockholders receive theirs. In other words, if the corporation does not declare and pay the dividends to preferred stock, there cannot be a dividend on the common stock. In return for these preferences, the preferred stockholders usually give up the right to share in the corporation's earnings that are in excess of their dividends.

To illustrate how preferred stock works, let's assume a corporation has issued preferred stock with a stated annual dividend of $9 per year. The holders of these preferred shares must receive the $9 per share dividend each year *before* the common stockholders can receive a penny in dividends. But the preferred shareholders will get no more than the $9 dividend, even if the corporation's net income increases a hundredfold. (Participating preferred stock is an exception and will be discussed later.) In times of inflation, owning preferred stock with a fixed dividend and no maturity or redemption date makes preferred shares less attractive than its name implies.

22) Par Value of Preferred Stock

The dividend on preferred stock is usually stated as a percentage of par value. Hence, the par value of preferred stock has some economic significance. For example, if a corporation issues 9% preferred stock with a par value of $100, the preferred stockholder will receive a dividend of $9 (9% times $100) per share per year. If the corporation issues 10% preferred stock having a par value of $25, the stock will pay a dividend of $2.50 (10% times $25) per year. In each of these examples the par value is meaningful because it is a factor in determining the dividend amounts.

If the dividend percentage on the preferred stock is close to the rate demanded by the financial markets, the preferred stock will sell at a price that is close to its par value. In other words, a 9% preferred stock with a par value of $50 being issued or traded in a market demanding 9% would sell for $50. On the other hand, if the market demands 8.9% and the stock is a 9% preferred stock with a par value of $50, then the stock will sell for slightly more than $50 as investors see an advantage in these shares.

23) Issuing Preferred Stock

To comply with state regulations, the par value of preferred stock is recorded in its own paid-in capital account Preferred Stock. If the corporation receives more than the par amount, the amount greater than par will be recorded in another account such as Paid-in Capital in Excess of Par - Preferred Stock. For example, if one share of 9% preferred stock having a par value of $100 is sold for $101, the following entry will be made.

Cash	101	
Preferred Stock $100 Par		100
Paid-in Capital in Excess of Par - Preferred Stock		1

24) Features Offered in Preferred Stock

Corporations are able to offer a variety of features in their preferred stock, with the goal of making the stock more attractive to potential investors. All of the characteristics of each preferred stock issue are contained in a document called an **indenture**.

1. **Nonparticipating vs. Participating**

Generally speaking, preferred stockholders only receive their stated dividends and nothing more. If a preferred stock is described as 10% preferred stock with a par value of $100, then its dividend will be $10 per year (whether the corporation's earnings were $10 million or $10 billion). Preferred stock that earns no more than its stated dividend is the norm; it is known as **nonparticipating** preferred stock.

Occasionally a corporation issues **participating** preferred stock. Participating preferred stock allows for dividends greater than the stated dividend. Since this feature is unusual, it is prudent to assume that all preferred stock is nonparticipating unless it is clearly stated otherwise.

2. **Cumulative vs. Noncumulative**

If a preferred stock is designated as **cumulative**, its holders must receive any past dividends that had been omitted on the preferred stock and its current year dividend, before common stockholders are paid any dividends. (A corporation might omit its dividends because it is suffering operating losses and has little cash available.) If a corporation omits a dividend on its cumulative preferred stock, the past, omitted dividends are said to be "in arrears" and this must be disclosed in the notes to the financial statements.

If a preferred stock is **noncumulative**, its dividends will not be in arrears if a corporation omits dividends. That is, the corporation need not make up any omitted dividends on noncumulative preferred stock before declaring dividends. However, the noncumulative preferred stock must be given its current year dividend before the common stock can get a dividend.

3. **Callable**

If a corporation has 10% preferred stock outstanding and market rates decline to 8%, it makes sense that the corporation would like to eliminate the 10% preferred stock and replace it with 8% preferred stock. On the other hand, the holders of the 10% preferred stock bought it with the assumption of getting the 10% indefinitely. Anticipating such a situation, the preferred stock will usually have a stipulation that the corporation can "call in" (retire) the preferred stock at a certain price. This price is referred to as the **call price** and it might be 110% of the par amount (par plus one year's dividend).

4. **Convertible**

Occasionally, a corporation's preferred stock states that it can be exchanged for a stated number of shares of the corporation's common stock. If that is the case, the preferred stock is said to be**convertible preferred**. For example, a corporation might issue shares of 8% convertible preferred stock which can be converted at any time into three shares of common stock. The preferred stockholder receives the usual preferences, but in addition has the potential to share in the success of the corporation. If the common stock is selling for $20 per share at the time the preferred shares are issued, the preferred stock is more valuable because of its dividend. However, if the company's success increases the value of the common stock to $40 per share, the convertibility feature is more valuable since the preferred stock is now worth $120 per share. (The preferred stock can be exchanged for 3 shares of common stock worth $40 each). The preferred stockholder could sell the preferred stock at the market price of $120 per share, or, could have the corporation issue three shares of common stock in exchange for each share of preferred stock.

5. **Combination of Features**

The strength of the corporation, coupled with the status of key financial markets, all influence the features that are offered with a given preferred stock. If a corporation is not attractive to potential investors, the preferred stock might need both the cumulative and the fully participating features in order to sell. On the other hand, a successful blue chip corporation might easily sell its preferred stock as noncumulative and nonparticipating. If a corporation wants to conserve its cash, it may offer a convertibility feature in order to have a lower dividend rate.

25) Entries to the Retained Earnings Account

Net Income or Loss

The closing entries of a corporation include closing the income summary account to the Retained Earnings account. If the corporation was profitable in the accounting period, the Retained Earnings account will be credited; if the corporation suffered a net loss, Retained Earnings will be debited.

Dividends

When dividends are declared by a corporation's board of directors, a journal entry is made on the declaration date to debit **Retained Earnings** and credit the current liability **<u>Dividends Payable</u>**. As stated earlier, it is the *declaration* of cash dividends that reduces Retained Earnings.

Appropriations or Restrictions of Retained Earnings

A board of directors can vote to appropriate, or restrict, some of the corporation's retained earnings. An appropriation (or restriction) will result in two retained earnings accounts instead of one:

(1) **<u>Retained Earnings</u>** (or **<u>Unappropriated Retained Earnings</u>**) and

(2) **<u>Appropriated Retained Earnings</u>**.

The subdividing of retained earnings is a way of disclosing the appropriation on the face of the balance sheet. (An appropriation might occur when a corporation is expanding its factory and its cash must be preserved.) By displaying the appropriated retained earnings account on the balance sheet, the corporation is communicating a certain situation and is potentially limiting itself from declaring dividends by having reduced the balance in its regular (the unappropriated) retained earnings. (Legally, dividends can be declared only if there is a credit balance in Retained Earnings.)

To record an appropriation of retained earnings, the account Retained Earnings is debited (causing this account to decrease), and Appropriated Retained Earnings is credited (causing this account to increase).

An alternative to having Appropriated Retained Earnings appearing on the balance sheet is to disclose the specific situation in the notes to the financial statements. The board of directors can simply not declare dividends or dividend increases.

26) Prior Period Adjustments

If an *error* is made on a previously issued income statement (as opposed to a change in estimate), a corporation must restate its beginning retained earnings balance. If the error *understated* the corporation's net income, the beginning retained earnings balance must be increased (a credit to Retained Earnings). If the error had *overstated* the corporation's net income, the beginning retained earnings balance must be decreased (a debit to Retained Earnings). The adjustment to the beginning balance is shown on the current retained earnings statement as follows:

Beginning retained earnings balance, as previously reported	XXX
Adjustment: Correction of error in prior period	**X**
Beginning retained earnings balance restated	XXX

27) Book Value

The term "book value" is used in a number of ways: book value of an asset, book value of bonds payable, book value of a corporation, and the book value per share of stock. We will focus on the last two.

Book Value of the Corporation

The book value of an entire corporation is the total of the stockholders' equity section as shown on the balance sheet. In other words, the book value of a corporation is the balance sheet assets minus the liabilities.

Since the balance sheet amounts reflect the cost and matching principles, a corporation's book value is not the same amount as its market *value*. For example, the most successful brand names of a consumer products company may have been developed in-house, meaning they would not be included in the company's assets since they were not purchased. Other long-term assets may have actually appreciated in value at the same time the accountant has been properly depreciating them; as a result, they are listed on the balance sheet at a small fraction of their fair market value.

As these examples suggest, a corporation could have a market value far greater than its book value. In contrast, a corporation that has recently purchased many assets, but is unable to operate profitably, may have a market value that is less than its book value. Although we can calculate a corporation's book value from its stockholders' equity, we cannot calculate a corporation's market value from its balance sheet. We must look to appraisers, financial analysts, and/or the stock market to help determine an approximation of a corporation's fair market value.

Book Value: Common Stock Only

Let's use the following stockholders' equity information to calculate (1) the book value of a corporation, and (2) the book value per share of common stock:

Stockholders' Equity

Paid-in capital	
Common stock, $0.10 par, 10,000 shares authorized, 2,000 shares issued and outstanding	$ 200
Paid-in capital in excess of par - common	49,800
Total paid-in capital	50,000
Retained earnings	28,000
Total stockholders' equity	$ 78,000

1. The **book value of a corporation** having only one class of stock–common stock–is equal to the total amount of stockholders equity: $78,000.

2. If common stock is the only class of stock issued by the corporation, the **book value per share of common stock** is $39. It is calculated as follows:

Total stockholders' equity of $78,000 divided by the 2,000 shares of common stock that are outstanding: $78,000/2,000 shares = **$39.00 per share of common stock**

Book Value: Preferred Stock and Common Stock

When a corporation has both common stock and preferred stock, the corporation's stockholders' equity must be divided between the preferred stock and the common stock. To arrive at the total book value of the common stock, compute the total book value of the preferred stock, and then subtract that amount from the total stockholders' equity.

28) Preferred Stock's Book Value

The book value of one share of preferred stock is its **call price** plus any **dividends in arrears**. If a 10%**cumulative** preferred stock having a par value of $100 has a call price of $110, and the corporation owes a total of two years of dividends, the book value of this preferred stock is $130 per share. If the corporation has 9% **noncumulative** preferred stock having a par value of $50, a call price of $54, and the corporation owes a total of three years of dividends, its book value is $54 per share (call price of $54 and no dividends in arrears since the stock is noncumulative).

The total book value of the preferred stock is the book value per share times the total number of shares outstanding. If the book value per share of preferred is $130 and there are 1,000 shares of the preferred stock outstanding, then the total book value of the preferred stock is $130,000.

Let's compute the total book value of preferred stock by using the following information:

Stockholders' Equity	
Paid-in capital	
9% preferred stock, $100 par, 300 shares authorized and issued	$ 30,000
Common stock, $0.10 par, 10,000 shares authorized, 2,000 shares issued and outstanding	200
Paid-in capital in excess of par - common	49,800
Total paid-in capital	80,000
Retained earnings	28,000
Total stockholders' equity	$108,000

The call price of the preferred stock is $109. It is **cumulative preferred** and three years of dividends are owed.

The **book value per share of the preferred stock** equals the call price of $109 plus three years of dividends at $9 each, or **$136** ($109 + $27 = $136).

The **total book value for all of the preferred stock** equals the book value per share of preferred stock times the number of shares of preferred stock outstanding, or $40,800 ($136 X 300 = **$40,800**).

29) Common Stock's Book Value

When a corporation has both common stock and preferred stock, the book value of the preferred stock is subtracted from the corporation's total stockholders' equity to arrive at the total book value of the common stock. Using the information above, we have:

Corporation's total stockholders' equity	$ 108,000
Less: Preferred stock's total book value	– 40,800
Common stock's total book value	$ 67,200
Number of shares of common stock outstanding	2,000 shares
Common stock's book value per share	**$ 33.60**

Earnings per share is not part of stockholders' equity. Nonetheless, we are including an introduction to the topic here because the calculation for earnings per share involves the stock of a corporation.

Earnings per share must appear on the face of the income statement if the corporation's stock is publicly traded. The earnings per share calculation is the after-tax net income (earnings) available for the common stockholders divided by the weighted-average number of common shares outstanding during that period.

30) Earnings Available for Common Stock

Let's assume that a corporation has the following stockholders' equity at December 31:

Stockholders' Equity	
Paid-in capital	
9% preferred stock, $100 par, 300 shares authorized and issued	$ 30,000
Common stock, $0.10 par, 10,000 shares authorized, 2,000 shares issued and outstanding	200
Paid-in capital in excess of par - common	49,800
Total paid-in capital	80,000
Retained earnings	28,000
Total stockholders' equity	$108,000

Additional information:

1. The corporation's accounting year is the calendar year.
2. The corporation's net income after taxes is $10,000.
3. The number of shares of common stock outstanding was 600 shares for the first four months of the year. On May 1 the corporation issued an additional 900 shares. On October 1 it issued an additional 500 shares.

4. The shares of preferred stock were outstanding for the entire year.

The earnings (net income after income taxes) available for the common stockholders is:

Corporation's net income after income taxes	$ 10,000
Less: Preferred dividend requirement*	− 2,700
Earnings available for common stock	**$ 7,300**

*The preferred dividend requirement is the annual dividend of $9 per share (9% times $100 par value) times the 300 shares of preferred stock outstanding.

31) Weighted-Average Number of Shares of Common Stock

Since the earnings occurred throughout the entire year, we need to divide them by the number of shares that were outstanding throughout the entire year. During the first four months only 600 shares were outstanding, during the next five months 1,500 shares were outstanding, and for the final three months of the year 2,000 shares of common stock were outstanding. This situation requires that we come up with an average number of shares of common stock for the year.

Shares of Common Outstanding	Months Outstanding	No. of Months Divided by 12	Weighted Average No. of Common Shares
600	Jan, Feb, Mar, Apr	4/12	200
1,500	May, Jun, Jul, Aug, Sep	5/12	625
2,000	Oct, Nov, Dec	3/12	500
			1,325

As the calculation shows, the weighted-average number of shares of common stock for the year was 1,325.

It's a good idea to test this answer to be sure it's reasonable. During five of the months (May - Sep.) the number of shares of common stock outstanding was 1,500 shares. During the remainder of the year, there were more months with less than 1,500 shares outstanding. Thus, the figure of 1,325 looks reasonable.

32) Earnings per Share of Common Stock

After recognizing the preferred stockholders' required dividend, there was $7,300 ($10,000 minus $2,700) of**earnings available for the common stockholders**. The $7,300 was earned throughout the year, so we need to divide that amount by the weighted-average number of shares of common stock outstanding throughout the year:

The **earnings per share** (EPS) of common stock = earnings available for common stock *divided* by the weighted-average number of common shares outstanding:

EPS = $7,300 ÷ 1,325 shares of common stock

EPS = **$ 5.51** per share of common stock

33) Other

Stock Issued for Other Than Cash

If a corporation has a limited amount of cash, but needs an asset or some services, the corporation might issue some new stock in exchange for the items needed. When stock is issued for noncash items, the items and the stock must be recorded on the books at the fair market value at the time of the exchange. Since both the stock given up and the asset or services received may have market values, accountants record the fair market value of the one that is more clearly determinable (more objective and verifiable).

For example, if a corporation exchanges 1,000 of its **publicly-traded** shares of common stock for 40 acres of land, the fair market value of the stock is likely to be more clear and objective. (The stock might trade daily while similar parcels of land in the area may sell once every few years.) In other situations, the common stock might rarely trade while the value of the received service is well-established.

To illustrate, let's assume that 1,000 shares of common stock are exchanged for a parcel of land. The stock is publicly traded and recent trades have been at $35 per share. The par value is $0.50 per share. The land's fair market value is not as clear since there has not been a comparable sale during the past four years.

The entry made to record the exchange will show the land at the fair market value of the common stock, since the stock's fair market value is more clear and objective than someone's estimate of the current value of the land:

Land (1,000 shares X $35)	35,000	
Common Stock (1,000 shares X $0.50 Par)		500
Paid-in Capital in Excess of Par - Common Stock		34,500

Differences in Accounting for Stock Splits Vs. Stock Dividends

Stock Split	Stock Dividend
No transfer from retained earnings to paid-in capital	Transfer of market value or par value from retained earnings to paid-in capital
Par value per share is changed	Par value per share is not changed
Total par value is unchanged	Total par value is increased

2. Complete the following sentences

1. The proceeds from issuing common or preferred stock is reported as paid-in or contributed ____________.
2. A major section of stockholders' equity is ___________ earnings.
3. If a corporation has only one type of stock it will be __________ stock.
4. A corporation's income statement will not report a gain or loss from transactions involving its own ___________.
5. The cumulative amount of other ______________ income is reported as a separate amount within stockholders' equity.
6. A corporation's own stock that it has repurchased, but has not retired is ______________ stock.
7. At the time that a corporation's board of directors declares a cash dividend, a current _____________ is created.
8. When a small stock (not cash) dividend is declared, the _________ value of the new shares is transferred from retained earnings to paid-in capital.
9. A 100% stock dividend will provide stockholders with the same number

of shares as a 2-for-1 stock _________.

10. A cash dividend is based on the number of __________________ shares of stock.

11. Stockholders' equity is the total ________ value of a corporation.

12. Stockholders' equity reports the owners' residual interest in the corporation's _________.

13. A major advantage of the corporation as a form of business is the stockholders' _________ liability.

14. The cumulative amount of the corporation's earnings minus the cumulative amount of dividends declared is a general description of __________ earnings.

15. A distribution of a part of a corporation's earnings to its stockholders.

16. A corporation might ___________ its retained earnings because of a future cash need.

17. A stock ________ will not cause a change in the balances of the stockholders' equity accounts.

18. A corporation that has omitted the dividends on its cumulative preferred stock needs to disclose that it has dividends in __________.

19. The difference in the number of issued shares of common stock and the number of outstanding shares of common stock is related to the number of shares of ___________ stock.

20. Preferred stock will have preferential treatment over common stock in liquidation and _____________.

9. LIABILITIES AND EMPLOYEE BENEFITS

1. Read the article and discuss

Employee benefits represent the compensation paid to employees in return of the services they provide to the company.

A few categories of employee benefits include: short-term employee benefits, post-employment benefit plan, termination benefits, etc.

Short-term employee benefits are 'current' employee benefits i.e. these are expected to be settled within 12 months of the end of the period in which the related services were received from employees. These include wages, salaries and social security contributions, paid annual leave, paid sick leave, profit-sharing arrangements, bonuses (if current). These also include certain non-monetary benefits such as housing, transportation, subsidized services, medical care, etc.

Post-employment benefits (also called post-retirement medical benefits) are employee benefits which are payable after retirement. However, they do not include termination benefits. They include pensions, retirement benefits and post-retirement medical facility.

Post-employment benefit plans (also called post-retirement employee benefit plans) are arrangements between a company and its employees under which it provides retirement benefits to its employees. There are normally two types of post-employment benefit plans: the defined contribution plan and the defined benefit plan.

Termination benefits are employee benefits paid to an employee when his employment is prematurity terminated or he opts for a voluntary redundancy scheme by himself.

1) Defined Contribution Plan

Defined contribution plan is an employee benefit plan in which the employer undertakes to contribute a specific amount each period to the fund. Since the employer is responsible only for his contributions and nothing else, he does not bear the risks related to the plan rather those risks are borne by employees. The contributions made by the employer are based on the current number of employees and their current salary levels.

Accounting for a defined contribution plan

Accounting for defined contribution plan is straight forward. The employer records pension expense equal to the contributions which it is required to make to the plan in accordance with the fund characteristics. The pension plan has no further accounting complications for the employer because the contributions are managed by a trust representing the employees and the employer shares no gain or loss on those funds.

Example

Company DCP has a defined contribution plan. According to employment contracts it has entered into with its 100 employee it is required to contribute an amount one average monthly salary per employee to the plan. Average salary for the financial year ended 31 December 2012 is $60,000.

The yearly contribution which DCP should record as pension expense amounts to $6,000,000 ($60,000 multiplied by 100). The contributions are collected by a trust which represents employees and manages the contributions received for DCP on their behalf. Any future increase in salary level, decrease in mortality rate, increase in expected inflation and expected return and prevailing market return, etc. has no impact on the company's expense and liability related to the plan.

2) Defined Benefit Plan

Defined benefit plan is an employee benefit plan in which the employer commits to pay its employees a defined amount in future which is based on the employee's salary and years of service. IAS 19 Employee Benefits defines defined benefit plan simply as all employee benefit plans other than defined contribution plan.

Example

EBP Ltd. has post-retirement benefits plan which entitles its employees to an amount equivalent to the product of its basic salary and number of years of service at the time of retirement. DCP Ltd. too has a pension plan but its agreement with the employees requires DCP to contribute an amount equal to the sum of current basic salaries of current employees to the fund.

EBP's plan is a defined benefit plan because it entitles employees to a defined amount in future (which is based on future salary). This is a defined contribution plan because the employees only receive an amount equal to their salaries today.

3) Net pension asset/liability

On the balance sheet the employee presents a net pension asset or a net pension liability. A net pension asset arises when the plan assets are higher than the present value of debit benefit obligation (PVDBO) (also known as projected benefit obligation) while a net pension liability arises when the PVDBO (or PBO) is higher than the plan assets.

Example

Actuaries have calculated that project benefit obligation of EBP's pension plan is $30 million and $36 million in 2010 and 2011 respectively. At the end of 2010, EBP had plan assets of $32 million. During 2011, EBP contributed as amount of $2 million to the fund and paid out benefits of $5 million.

EBP will report a net pension asset of $2 million for the financial year 2010 ($32 million plan assets minus $30 million obligation). At the end of financial year 2011, its obligation is $36 million and its plan assets are $29 million ($32 million + 2 million (contribution) − 5 million (benefits paid out)). It will report a net pension liability of $7 million at the end of financial year 2011 (difference between plan assets of $29 million and obligation of $36 million).

4) Pension expense

A company with a defined benefit plan reports service cost, interest cost, actual return on plan assets, amortization of prior service cost, and actuarial gains and losses on its income statement. Each expense line item is classified according to its nature.

Projected Benefit Obligation

Projected benefit obligation is the present value of the expected future payments to employees in accordance with the plan terms keeping in view the expected future increases in salaries, discount rate and a number of other factors.

Projected benefit obligation (PBO) is a terminology used by US GAAP while IFRS calls it present value of defined benefit obligation (PVDBO).

PBO is estimated by actuaries by applying complex statistical modelling.

Projected benefit obligation (PBO) at the start of a year is reconciled with the PBO at the end of the year as follows:

Opening projected benefit obligation (PBO)	XXX
Service cost	XXX
Interest cost	XXX
Contributions made	(XXX)
Actuarial gains	(XXX)
Actuarial losses	XXX
Closing projected benefit obligation	XXX

Example

OBP Ltd. had a PBO of $400 million as at 1 January 2011. Their actuaries estimated that the company's employees earned benefits worth a present value of $20 million as a result of the services they provided during the financial year ended 31 December 2011. The interest rate is 8% and the company contribution an amount of $30 million to the fund. The fresh actuarial estimate of PBO as at 31 December 2011 is of $415 million. Reconcile the opening PBO with closing PBO.

The opening projected benefit obligation is $400 million. The service cost represents PV of benefits earned during the current year and it equals $20 million. Interest expense equals product of opening PBO and interest rate and in this situation it equals $32 million. Since the closing PBO is $435 million, the actuarial gains should equal $7 million (=$415 million + $30 million − $400 million − $20 million − $32 million)

The closing PBO reconciles with opening PBO as follows:

	USD in million
Opening projected benefit obligation (PBO)	400
Service cost	20
Interest cost	32
Contributions made	(30)
Actuarial gains	(7)
Actuarial losses	-
Closing projected benefit obligation	415

Plan Assets

Plan assets are the assets of a funded defined benefit plan. A funded defined benefit plan is one in which the employer contributes an amount periodically to the fund and the amounts are managed by a pension fund manager and invested in different asset classes.

The value of plan assets increase due to additional contributions received from the employer and due to returns earned by the assets and decrease due to benefits paid out to employees. The return on plan assets include interest earned, dividends earned, realized and unrealized gains or losses less taxes payable by the plan less administrative costs of the plan. They are carried at fair value at the balance sheet date.

Reconciliation between opening plan assets and closing plan assets would look like follows:

Opening plan assets	XXX
Add: contributions received from employer	XXX
Add: actual return on plan assets	XXX
Less: Benefits paid	(XXX)
Add/Less: actuarial gains and losses	XXX
Closing plan assets	XXX

Example

CE Ltd. has a funded defined benefit plan. Its plan assets had a fair value of $25 million as at 1 January 2011. They include $15 million equity investments and $10 investment in bonds. Equity investments are expected to pay a dividend of $1 million during the year. Bonds are expected to pay an interest of 6%. The fund received contributions of $5 million during the year and paid out $3 million to employees. The fair value of the investments as at 31 December 2011 is $30 million. Reconcile the opening balance of plan assets with closing balance.

Pension Expense

Pension expense is the amount reported in the income statement related to a company's pension plan.

Pension expense under defined contribution plan

Under the defined contribution plan, the periodic contribution which the company is required to pay is expensed out on accrual basis.

Example

CPE Ltd. has a defined contribution plan which required the company to contribute $20 million to the fund each year. In the financial year 2011, the company pay $25 million while in financial year 2012, it paid $15 million.

The company will recognize a pension expense of $20 million each in 2011 and 2012. The first year payment will result in $5 prepayment of contribution which will expire in 2012.

Pension expense under defined benefit plan

The pension expense under the defined benefit plan is made up as follows:

1. Service cost
2. Interest cost
3. Expected return on plan assets
4. Amortization of prior service cost
5. Amortization of actuarial gains and losses

Amortization of actuarial gain and a positive expected return on plan assets result in a decrease in pension expense.

Service cost represents the portion of projected benefit obligation (PBO) earned by the employees in the current year.

Interest cost represents the increase in projected benefit obligation (PBO) on account of unwinding of discount. It equals the product of opening defined benefit obligation (PBO) multiplied by the interest rate.

Expected return on plan assets is the return which is expected to be earned by the plan assets over the next period.

Amortization of prior service cost represents the additional service cost resulting from changes to plan structure, which is expensed in the current period.

Amortization of actuarial gains and losses represent the amount of actuarial gains or loss that are written off in the current period.

5) Funded Status

Funded status is the net liability or net asset related to a company's defined benefit plans. At any point of time it equals the fair value of total plan assets minus the projected defined benefit obligation. Plan assets are the investments of the pension fund. These may include investment in the company's stock, other stocks listed on any stock exchange, exchange-traded funds, bonds, real estate, etc.

Projected defined benefit obligations (also known as present value of defined benefit plan) is the present value of expected pension payments which the employees are entitled to receive based on the service they have accumulated to date.

Under US GAAP, when the fair value of plan assets exceeds the projected defined benefit obligation, a net pension asset equal to the excess of fair value of plan assets over the projected benefit obligation is reported on the balance sheet. On the other hand, if the projected defined benefit obligation exceeds the fair value of plan assets, a net liability equal to the excess of defined benefit obligation over the fair value of plan assets is reported on the balance sheet.

Example

FS Ltd. has a defined benefit plan. As at 31 December 2011, its plan assets had a book value of $140 million and fair value of $160 million. The PBO at the time was $150 million. During the year, the company contributed an amount of $20 million to the fund, the fund paid out $15 million while the return on plan assets was $10 million. Service costs were $30 million, interest cost amounted to $12 million while actuarial gains were $3 million.

Solution

The funded status = fair value of plan assets − projected defined benefit obligation

As at 31 December 2011, the funded status was $10 million (calculated as $160 of fair value of plan assets minus $150 million of projected defined benefit obligation) and it would be reported as an asset on the balance sheet.

After one year, i.e. as at 31 December 2012, new fair value of plan assets is:

Opening fair value of plan assets	160
Contributions received	20
Benefits paid	(15)
Actual return on plan assets	10
Closing fair value of plan assets	175

The projected defined benefit obligation as at 31 December 2012 will equal $180 million as calculated below:

Opening PBO	150
Service cost	35
Interest cost	12
Benefits paid	(15)
Actuarial gain	(2)
Closing PBO	180

Funded status as at 31 December 2012 would be -$5 million which represents a net pension liability of $5 million to be reported on the balance sheet.

10. CONCEPTS THAT UNDERLIE THE PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

<u>1. Read the articles and discuss</u>

1. Accounting Qualities

Financial information is useful when it is *relevant* and *represents faithfully* what it purports to represent.
The usefulness of financial information is enhanced if it is *comparable*, *verifiable*, *timely* and *understandable*.

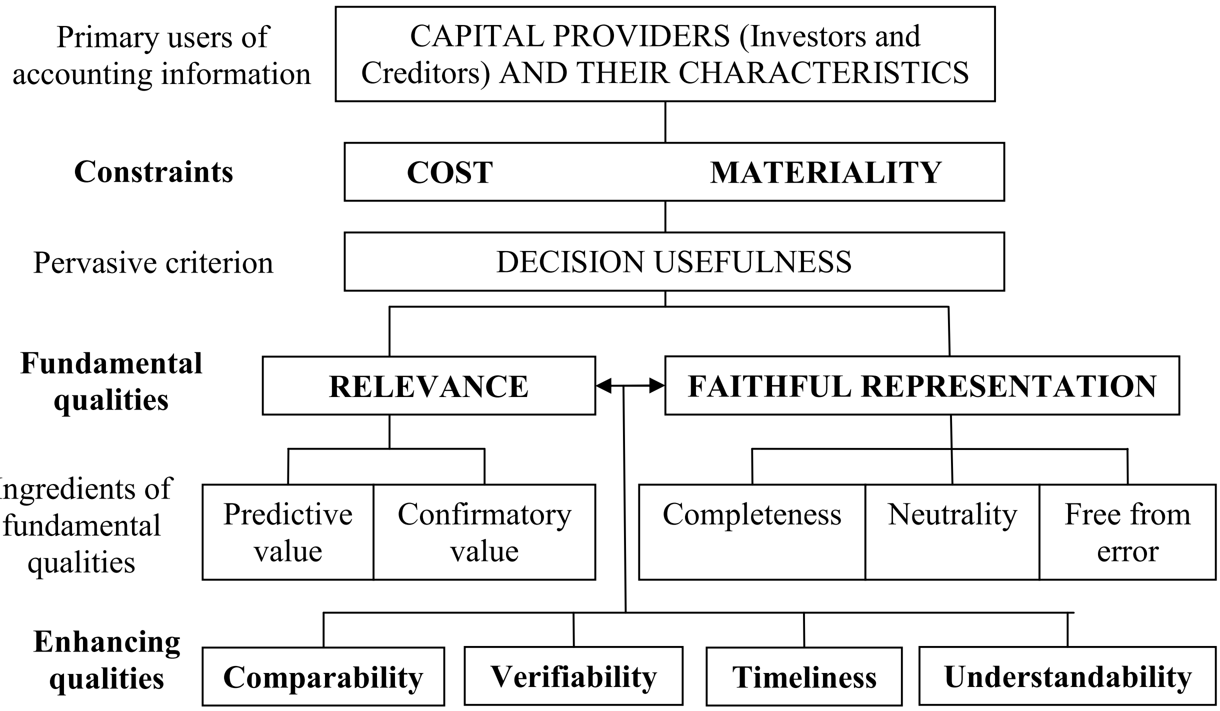


ILLUSTRATION Hierarchy of Accounting Qualities

<u>Fundamental Qualitative Characteristics</u>

1) ________________

_____________ information is capable of making a difference in the decisions made by users. ____________ requires financial information to be related to an economic decision. Otherwise, the information is useless.

Financial information is useful if it has *predictive value* and *confirmatory value*. Predictive value helps users in predicting or anticipating future outcomes. Confirmatory value enables users to check and confirm earlier predictions or evaluations.

Materiality is an aspect of relevance which is entity-specific. It means that what is material to one entity may not be material to another. It is relative. Information is material if it is significant enough to influence the decision of users. Materiality is affected by the *nature* and *magnitude (or size)* of the item.

2) ____________________

The financial information in the financial reports should represent what it purports to represent. Meaning, it should show what really are present and what really happened, as the case may be.

There are three characteristics of faithful representation: 1. Completeness (adequate or full disclosure of all necessary information), 2. Neutrality (fairness and freedom from bias), and 3. Free from error (no inaccuracies and omissions).

Enhancing Qualitative Characteristics

1) _______________

___________ information enables comparisons within the entity and across entities. When comparisons are made *within the entity*, information is compared from one accounting period to another. For example: income is compared for the years 2012, 2013, and 2014. Comparability of information *across entities* enables analysis of similarities and differences between different companies.

2) _____________

___________ helps to assure users that information represents faithfully what it purports to represent. Financial information is supported by evidence and independent individuals can check them to see whether such information is faithfully represented. In other words, information is verifiable if it can be audited.

3) ______________

____________ means providing information to decision-makers in time to be capable of influencing their decisions. It shouldn't be significantly delayed or else it will be of little or no value.

4) ____________

___________________ requires financial information to be understandable or comprehensible to users with reasonable knowledge of business and economic activities. To be understandable, information should be presented clearly and concisely. However, it is improper to exclude complex items just to make the reports simple and understandable.

Other Characteristics of Accounting Information

When financial reports are generated by professional accountants, we have certain expectations of the information they present to us:

1. We expect the accounting information to be **reliable, verifiable, and objective**.
2. We expect **consistency** in the accounting information.
3. We expect **comparability** in the accounting information.

1. Reliable, Verifiable, and Objective

In addition to the basic accounting principles and guidelines listed in Part 1, accounting information should be reliable, verifiable, and objective. For example, showing land at its original cost of $10,000 (when it was purchased 50 years ago) is considered to be more **reliable, verifiable,** and **objective** than showing it at its current market value of $250,000. Eight different accountants will wholly agree that the original cost of the land was $10,000—they can read the offer and acceptance for $10,000, see a transfer tax based on $10,000, and review documents that confirm the cost was $10,000. If you ask the same eight accountants to give you the land's *current* value, you will likely receive eight different estimates.

Because the current value amount is less reliable, less verifiable, and less objective than the original cost, the original cost is used.

The accounting profession has been willing to move away from the **cost principle** if there are reliable, verifiable, and objective amounts involved. For example, if a company has an investment in stock that is actively traded on a stock exchange, the company may be required to show the current value of the stock instead of its original cost.

2. Consistency

Accountants are expected to be **consistent** when applying accounting principles, procedures, and practices. For example, if a company has a history of using the **FIFO cost flow assumption**, readers of the company's most current financial statements have every reason to expect that the company is continuing to use the FIFO cost flow assumption. If the company changes this practice and begins using the **LIFO cost flow assumption**, that change must be clearly disclosed.

3. Comparability

Investors, lenders, and other users of financial statements expect that financial statements of one company can be compared to the financial statements of another company in the same industry. **Generally accepted accounting principles** may provide for **comparability** between the financial statements of different companies. For example, the **FASB** requires that expenses related to research and development (R&D) be expensed when incurred. Prior to its rule, some companies expensed R&D when incurred while other companies deferred R&D to the balance sheet and expensed them at a later date.

2. Match these words with their meanings

Revenue Recognition Principle; Economic Entity Assumption; Going Concern Principle; Monetary Unit Assumption; Matching Principle; Materiality; Time Period Assumption; Conservatism; Cost Principle; Full Disclosure Principle

Basic Accounting Principle	What It Means in Relationship to a Financial Statement
1.	The accountant keeps all of the *business* transactions of a sole proprietorship separate from the business owner's *personal* transactions. For *legal* purposes, a sole proprietorship and its owner are considered to be one entity, but for accounting purposes they are considered to be two separate entities.
2.	Economic activity is measured in U.S. dollars, and only transactions that can be expressed in U.S. dollars are recorded. Because of this basic accounting principle, it is assumed that the dollar's purchasing power has not changed over time. As a result accountants ignore the effect of inflation on recorded amounts. For example, dollars from a 1960 transaction are combined (or shown with) dollars from a 2012 transaction.
3.	This accounting principle assumes that it is possible to report the complex and ongoing activities of a business in relatively short, distinct time intervals such as the five months ended May 31, 2012, or the 5 weeks ended May 1, 2012. The shorter the time interval, the more likely the need for the accountant

	to estimate amounts relevant to that period. For example, the property tax bill is received on December 15 of each year. On the income statement for the year ended December 31, 2011, the amount is known; but for the income statement for the three months ended March 31, 2012, the amount was not known and an estimate had to be used. It is *imperative* that the time interval (or period of time) be shown in the heading of each income statement, statement of stockholders' equity, and statement of cash flows. Labeling one of these financial statements with "December 31" is not good enough—the reader needs to know if the statement covers the *one week* ended December 31, 2011 the *month* ended December 31, 2011 the*three months* ended December 31, 2011 or the *year ended* December 31, 2011.
4.	From an accountant's point of view, the term "cost" refers to the amount spent (cash or the cash equivalent) when an item was *originally* obtained, whether that purchase happened last year or thirty years ago. For this reason, the amounts shown on financial statements are referred to as *historical* cost amounts. Because of this accounting principle asset amounts are *not* adjusted upward for inflation. In fact, as a general rule, asset amounts are not adjusted to reflect *any* type of increase in value. Hence, an asset amount does not reflect the amount of money a company would receive if it were to sell the asset at today's market value. (An exception is certain investments in stocks and bonds that are actively traded on a stock exchange.) If you want to know the current value of a company's long-term assets, you will not get this information from a company's financial statements - you need to look elsewhere, perhaps to a third-party appraiser.
5.	If certain information is important to an investor or lender using the financial statements, that information should be disclosed within the statement or in the notes to the statement. It is because of this basic accounting principle that numerous pages of "footnotes" are often attached to financial statements. As an example, let's say a company is named in a lawsuit that demands a significant amount of money. When the financial statements are prepared it is not clear whether the company will be able to defend itself or whether it might lose the lawsuit. As a result of these conditions and because of the full disclosure principle the lawsuit will be described in the notes to the financial statements. A company usually lists its significant accounting policies as the first note to its financial statements.
6.	This accounting principle assumes that a company will continue to exist long enough to carry out its objectives and commitments and will not liquidate in the foreseeable future. If the company's financial situation is such that the accountant believes the company will *not* be able to continue on, the accountant is required to disclose this assessment. The going concern principle allows the company to defer some of its prepaid expenses until future accounting periods.
7.	This accounting principle requires companies to use the accrual basis of accounting. The matching principle requires that expenses be matched with revenues. For example, sales commissions expense should be reported in the period when the sales were made (and not reported in the period when the commissions were paid). Wages to employees are reported as an expense in the week when the employees worked and not in the week when the employees are paid. If a company agrees to give its employees 1% of its 2012 revenues as a

	bonus on January 15, 2013, the company should report the bonus as an expense in 2012 and the amount unpaid at December 31, 2012 as a liability. (The expense is occurring as the sales are occurring.) Because we cannot measure the future economic benefit of things such as advertisements (and thereby we cannot match the ad expense with related future revenues), the accountant charges the ad amount to expense in the period that the ad is run.
8.	Under the accrual basis of accounting (as opposed to the cash basis of accounting), revenues are recognized as soon as a product has been sold or a service has been performed, regardless of when the money is actually received. Under this basic accounting principle, a company could earn and report \$20,000 of revenue in its first month of operation but receive \$0 in actual cash in that month. For example, if ABC Consulting completes its service at an agreed price of \$1,000, ABC should recognize \$1,000 of revenue as soon as its work is done - it does not matter whether the client pays the \$1,000 immediately or in 30 days. Do not confuse *revenue* with a *cash receipt*.
9.	Because of this basic accounting principle or guideline, an accountant might be allowed to violate another accounting principle if an amount is insignificant. Professional judgement is needed to decide whether an amount is insignificant or immaterial. An example of an obviously immaterial item is the purchase of a \$150 printer by a highly profitable multi-million dollar company. Because the printer will be used for five years, the *matching* principle directs the accountant to expense the cost over the five-year period. The materiality guideline allows this company to violate the matching principle and to expense the entire cost of \$150 in the year it is purchased. The justification is that no one would consider it misleading if \$150 is expensed in the first year instead of \$30 being expensed in each of the five years that it is used. Because of materiality, financial statements usually show amounts rounded to the nearest dollar, to the nearest thousand, or to the nearest million dollars depending on the size of the company.
10.	If a situation arises where there are two acceptable alternatives for reporting an item, conservatism directs the accountant to choose the alternative that will result in less net income and/or less asset amount. Conservatism helps the accountant to "break a tie." It does not direct accountants to be conservative. Accountants are expected to be unbiased and objective. The basic accounting principle of conservatism leads accountants to anticipate or disclose losses, but it does not allow a similar action for gains. For example, *potential* losses from lawsuits will be reported on the financial statements or in the notes, but *potential* gains will not be reported. Also, an accountant may write inventory *down* to an amount that is lower than the original cost, but will not write inventory *up* to an amount higher than the original cost.

<u>3. Read the articles and discuss</u>

Concepts of capital and capital maintenance

1. Financial capital maintenance

A financial concept of capital is whereby the capital of the entity is linked t the net assets, which is the equity of the entity.

When a financial concept of capital is used, a profit is earned only if the financial amount of the net assets at the and of the period is greater than the net assets at the beginning of the period, adjusted of course for any distributions paid to the owners during the period, or any equity capital raised.

The main concern of the users of the financial statements is with the maintenance of the financial capital of the entity.

Assets – Liabilities = Equity

Opening equity (net assets) + Profit – Distributions = Closing equity (net assets)

There are also two ways of looking at financial capital maintenance:

- money financial capital maintenance, and
- real financial capital maintenance

Under the money financial capital maintenance, the profit is measured if the closing net assets is greater than the opening net assets, and the net assets in both cases are measured at historical cost.

This method doesn't take into consideration any inflation or the time value of money.

Therefore under the real financial capital maintenance, the entity makes a net profit if the closing net assets are greater than the opening net assets, and both of these figures are measured at current prices.

To do this we increase the opening net asset figure by the inflation rate.

2. Physical capital maintenance

A physical concept of capital is one where the capital of an entity is regarded as its production capacity, which could be based on its units of output.

When a physical concept of capital is used, a profit is earned only if the physical production capacity (or operating capability) of the entity at the end of the period is greater than the production capacity at the beginning of the period, adjusted for any distributions paid to the owners during the period, or any equity capital raised.

The main concern of users of its financial statements is with the maintenance of the operating capability of the entity.

A financial concept of capital should be used if the users of the financial statements are mostly concerned with the maintenance of their invested capital, or the purchasing power of the invested capital.

A physical concept of capital should be used if the users of the financial statements are mostly concerned with the operating capacity of the entity, and current value accounting.

NB. Profits will usually be higher when the financial concept of capital is used compared to the physical concept of capital. This is due to the inflation adjustment.

Exam Tip: worked out example

Let's look at an example of the physical concept of capital in use.

Scenario:

- An entity is established on 1 January 20X1 with 20,000 ordinary shares at €1 each.

- It then buys €20,000 worth of stock, which is sells during the year for €25,000.
- There were no other transactions during the period.
- At the end of the year the purchase price of the stock increased on €23,000.

Answer:

- Using the physical maintenance concept, the profit for the reporting period is _________________.
- If the financial capital maintenance concept is used, the profit for the year is €5,000, but if the company paid out the €5,000 profit to shareholders, it would be unable to buy the same stock again as the purchase price has risen.
- To keep the operating capability of the entity the same, profit is measured as sales less the replacement cost of the goods sold.

4. Complete the following sentences

1) Accounting Principles

1. General guidelines. _____________
2. The __________ unit assumption means transactions of U.S. companies are reported in dollars.
3. The cost principle is often described as the __________ cost principle.
4. The concept of _________________ allows for the violation of an accounting principle when the amounts are insignificant.
5. The __________ entity assumption results in business transactions being kept separate from a sole proprietor's personal transactions.
6. Full __________ is achieved through the notes to the financial statements.
7. This assumption justifies quarterly financial statements. __________
8. Defined as the cash or cash equivalent amount at the time of a transaction. __________
9. Accrual accounting is related to this principle. __________
10. The __________ concern assumption is that an enterprise will continue on long enough to carry out its objectives and commitments.
11. Communicating the significant accounting policies in the first note to the financial statements is related to the full ______________ principle.
12. Under the __________-basis of accounting, revenues are reported on the income statement in the period in which they are earned.
13. Part of the _______________ unit assumption is that the U.S. dollar retains its purchasing power over time.

2) Elements of Financial Statements

1. Probable future economic benefits is part of the definition of __________.
2. Inflows from delivering goods or services and other activities that are part of a company's main operations. __________
3. The residual interest in the assets of an entity after deducting liabilities. __________

4. _______________ by owners increase their ownership interest.

5. Probable future sacrifices resulting from a past transaction or event. ___________

6. Outflows, using up of assets, or incurring a liability as the result of earning revenues. ___________

7. Other ____________________ income includes unrealized gains or losses on available-for-sale securities.

8. The net outflows resulting from peripheral transactions. ___________

9. ___________________ to owners will decrease owner's equity.

10. The net increases in equity from peripheral transactions. ___________

11. PRESENTATION OF FINANCIAL STATEMENTS

1. Read this article to learn about the features, importance and limitations of financial statements.

Features of Financial Statements:

1. The Financial Statements should be relevant for the purpose for which they are prepared. Unnecessary and confusing disclosures should be avoided and all those that are relevant and material should be reported to the public.

2. They should convey full and accurate information about the performance, position, progress and prospects of an enterprise. It is also important that those who prepare and present the financial statements should not allow their personal prejudices to distort the facts.

3. They should be easily comparable with previous statements or with those of similar concerns or industry. Comparability increases the utility of financial statements.

4. They should be prepared in a classified form so that a better and meaningful analysis could be made.

5. The financial statements should be prepared and presented at the right time. Undue delay in their preparation would reduce the significance and utility of these statements.

6. The financial statements must have general acceptability and understanding. This can be achieved only by applying certain "generally accepted accounting principles" in their preparation.

7. The financial statements should not be affected by inconsistencies arising out of personal judgment and procedural choices exercised by the accountant.

8. Financial Statements should comply with the legal requirements if any, as regards form, contents, and disclosures and methods. In India, companies are required to present their financial statements according to the Companies Act, 1956.

Importance of Financial Statements:

The importance of financial statements lies in their utility to satisfy the varied interest of different categories of parties such as management, creditors, public, etc.

1. Importance to Management:

Increase in size and complexities of factors affecting the business operations necessitate a scientific and analytical approach in the management of modern business enterprises.

The management team requires up to date, accurate and systematic financial information for the purposes. Financial statements help the management to understand the position, progress and prospects of business vis-a-vis the industry.

By providing the management with the causes of business results, they enable them to formulate appropriate policies and courses of action for the future. The management communicates only through these financial statements, their performance to various parties and justify their activities and thereby their existence.

A comparative analysis of financial statements reveals the trend in the progress and position of enterprise and enables the management to make suitable changes in the policies to avert unfavorable situations.

2. Importance to the Shareholders:

Management is separated from ownership in the case of companies. Shareholders cannot, directly, take part in the day-to-day activities of business. However, the results of these activities should be reported to shareholders at the annual general body meeting in the form of financial statements.

These statements enable the shareholders to know about the efficiency and effectiveness of the management and also the earning capacity and financial strength of the company.

By analyzing the financial statements, the prospective shareholders could ascertain the profit earning capacity, present position and future prospects of the company and decide about making their investments in this company.

Published financial statements are the main source of information for the prospective investors.

3. Importance to Lenders/Creditors:

The financial statements serve as a useful guide for the present and future suppliers and probable lenders of a company.

It is through a critical examination of the financial statements that these groups can come to know about the liquidity, profitability and long-term solvency position of a company. This would help them to decide about their future course of action.

4. Importance to Labour:

Workers are entitled to bonus depending upon the size of profit as disclosed by audited profit and loss account. Thus, P & L a/c becomes greatly important to the workers. In wages negotiations also, the size of profits and profitability achieved are greatly relevant.

5. Importance to the Public:

Business is a social entity. Various groups of society, though directly not connected with business, are interested in knowing the position, progress and prospects of a business enterprise.

They are financial analysts, lawyers, trade associations, trade unions, financial press, research scholars and teachers, etc. It is only through these published financial statements these people can analyze, judge and comment upon business enterprise.

6. Importance to National Economy:

The rise and growth of corporate sector, to a great extent, influence the economic progress of a country. Unscrupulous and fraudulent corporate managements shatter the confidence of the general public in joint stock companies, which is essential for economic progress and retard the economic growth of the country.

Financial Statements come to the rescue of general public by providing information by which they can examine and assess the real worth of the company and avoid being cheated by unscrupulous persons.

The law endeavors to raise the level of business morality by compelling the companies to prepare financial statements in a clear and systematic form and disclose material information.

This has increased the confidence of the public in companies. Financial statements are also essential for the various regulatory bodies such as tax authorities, Registrar of companies, etc. They can judge whether the regulations are being strictly followed and also whether the regulations are producing the desired effect or not, by evaluating the financial statements.

Limitations of Financial Statements:

Most of the limitations are mainly due to the cumulative effect of recorded facts, accounting conventions and personal judgment on financial statements. Unless they are prepared specially they fail to reflect the current economic picture of business. As such, financial statements have a number of limitations.

The important limitations are as follows:

1. Information is Incomplete and Inexact:

The financial statements are interim reports usually prepared for an accounting period. Hence, the financial information as revealed by them is neither complete nor exact.

The true financial position or ultimate gain or loss, can be known only when the business is closed down.

2. Qualitative Information is Ignored:

Financial statements depict only those items of quantitative information that are expressed in monetary terms.

But, a number of qualitative factors, such as the reputation and prestige of the management with the public, cordial industrial relations and efficiency of workers, customer satisfaction, competitive strength, etc., which cannot be expressed in monetary terms , are not depicted by the financial statements.

However, these factors are essential for understanding the real financial condition and the operating results of the business.

3. Financial Statements Mainly Show Historical Information:

As the financial statements are compiled on the basis of historical costs, they fail to take into account such factors as the decrease in money value or increase in the price level changes. Since these statements deal with past data only, they are of little value in decision-making.

4. Financial Statements are Based on Accounting Concepts and Conventions.

Accounting concepts and conventions used the preparation of financial statements make them unrealistic.

For example the income statement prepared on the basis of the convention of conservatism fails to disclose the true income, for it includes probable losses and ignores probable income.

Similarly the value of fixed asset is shown in the balance sheet on the ‘going concern concept’. This means that the value of the asset rarely represents the amount of cash, which would be realized on liquidation.

5. Personal Judgment Influence Financial Statements:

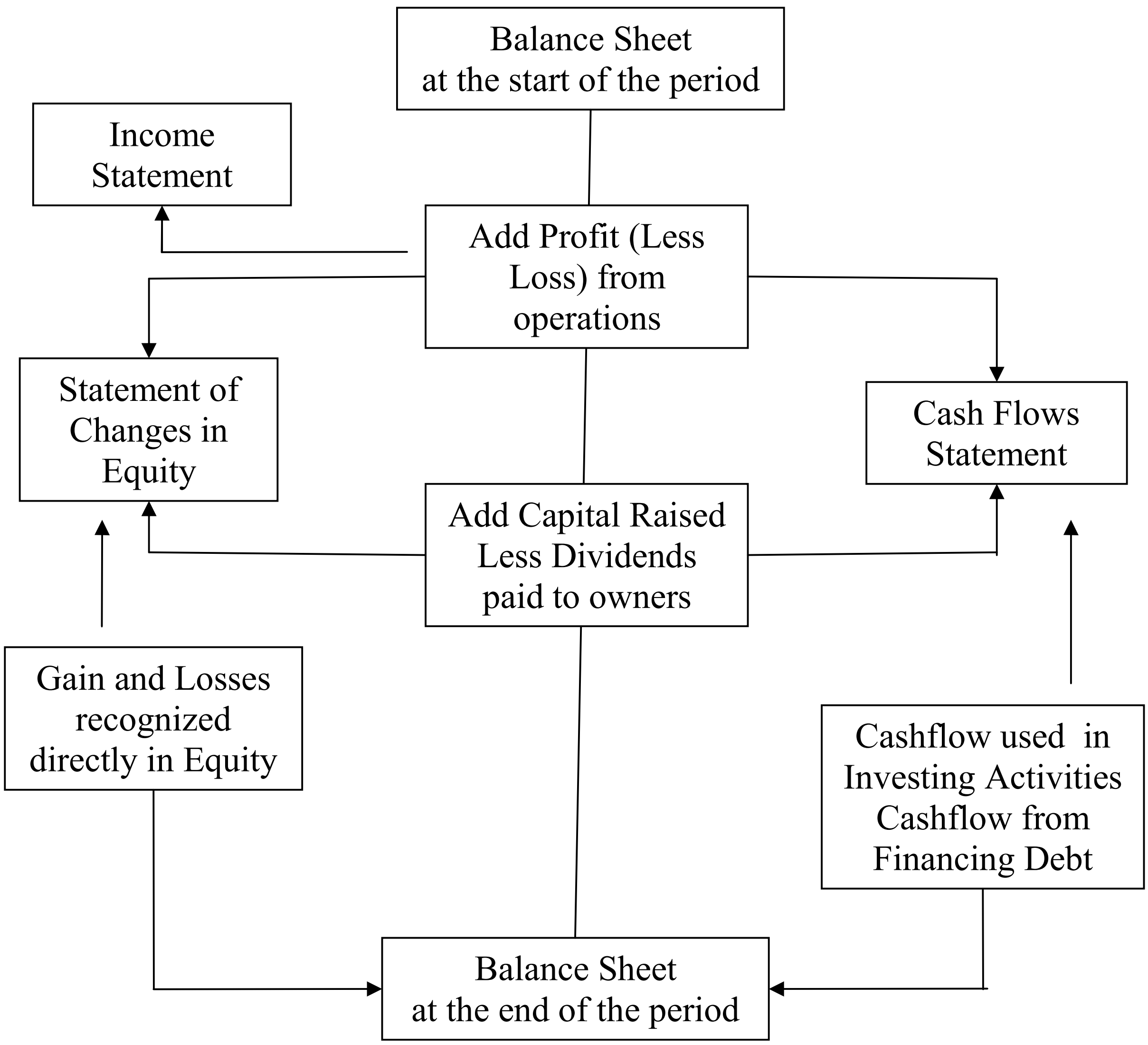
Many items in the financial statements are left to the personal judgment of the accountant. For example, the method of inventory valuation, the method of depreciation the treatment of deferred revenue expenditure, etc., depend on the personal judgment of the accountant.

If it goes wrong, the real picture may be distorted. However, such indiscreet personal judgments are controlled to a certain extent by the convention of conservatism.

2. Read the articles and discuss

Relationship between Financial Statements
Explanation

Financial Statements reflect the effects of business transactions and events on the entity. The different types of financial statements are not isolated from one another but are closely related to one another as is illustrated in the following diagram.



Balance Sheet

Balance Sheet, or Statement of Financial Position, is directly related to the income statement, cash flow statement and statement of changes in equity.

Assets, liabilities and equity balances reported in the Balance Sheet at the period end consist of:

- Balances at the start of the period;
- The increase (or decrease) in net assets as a result of the net profit (or loss) reported in the income statement;
- The increase (or decrease) in net assets as a result of the net gains (or losses) recognized outside the income statement and directly in the statement of changes in equity (e.g. revaluation surplus);
- The increase in net assets and equity arising from the issue of share capital as reported in the statement of changes in equity;
- The decrease in net assets and equity arising from the payment of dividends as presented in the statement of changes in equity;
- The change in composition of balances arising from inter balance sheet transactions not included above (e.g. purchase of fixed assets, receipt of bank loan, etc).
- Accruals and Prepayments
- Receivables and Payables

Income Statement

Income Statement, or Profit and Loss Statement, is directly linked to balance sheet, cash flow statement and statement of changes in equity.

The increase or decrease in net assets of an entity arising from the profit or loss reported in the income statement is incorporated in the balances reported in the balance sheet at the period end.

The profit and loss recognized in income statement is included in the cash flow statement under the segment of cash flows from operation after adjustment of non-cash transactions. Net profit or loss during the year is also presented in the statement of changes in equity.

Statement of Changes in Equity

Statement of Changes in Equity is directly related to balance sheet and income statement.

Statement of changes in equity shows the movement in equity reserves as reported in the entity's balance sheet at the start of the period and the end of the period. The statement therefore includes the change in equity reserves arising from share capital issues and redemptions, the payments of dividends, net profit or loss reported in the income statement along with any gains or losses recognized directly in equity (e.g. revaluation surplus).

Cash Flow Statement

Statement of Cash Flows is primarily linked to balance sheet as it explains the effects of change in cash and cash equivalents balance at the beginning and end of the reporting period in terms of the cash flow impact of changes in the components of balance sheet including assets, liabilities and equity reserves.

Cash flow statement therefore reflects the increase or decrease in cash flow arising from:

- Change in share capital reserves arising from share capital issues and redemption;
- Change in retained earnings as a result of net profit or loss recognized in the income statement (after adjusting non-cash items) and dividend payments;
- Change in long term loans due to receipt or repayment of loans;
- Working capital changes as reflected in the increase or decrease in net current assets recognized in the balance sheet;
- Change in non current assets due to receipts and payments upon the acquisitions and disposals of assets (i.e. investing activities)

3. Choose the correct answer

1. Assets to be sold, consumed or realised as part of the entity's normal operating cycle are:

a) current assets;
b) non-current assets;
c) classified as current or non-current in accordance with other criteria.

2. When there is much variability in the duration of the entity's normal operating cycle, the operating cycle is measured at:

a) its mean value;
b) its median value;
c) twelve months;
d) three years.

3. Liabilities that an entity expects to settle in its normal operating cycle are:

a) classified as non-current liabilities;
b) classified as current or non-current liabilities in accordance with other criteria;
c) classified as current liabilities.

4. A dividend declared by the entity before its year-end and payable to its shareholders three months after the end of the reporting period is classified as:

a) a non-current liability;
b) a current liability;
c) equity;
d) a current asset.

5. Staff costs are:

a) administrative expenses;
b) distribution expenses;
c) cost of sales;
d) allocated to categories (a)–(c) above according to the function of the employee to which the particular staff cost relates.

6. Cash receipts from customers for the sale of goods are cash flows from:
a) operating activities;
b) investing activities;
c) operating or financing activities;
d) financing activities.

7. Payment of non-refundable purchase taxes on the purchase of property, plant and equipment are allocated as cash flows from:
a) operating activities;
b) investing activities;
c) financing activities;
d) operating or financing activities.

8. Cash payments to acquire the entity’s own shares (ie treasury shares) are:
a) cash outflows from operating activities;
b) cash outflows from investing activities;
c) cash outflows from financing activities.

9. Cash proceeds from long-term borrowings are:
a) cash inflows from operating activities;
b) cash inflows from investing activities;
c) cash inflows from financing activities.

10. Interest and dividends received:
a) are cash inflows from operating activities;
b) are cash inflows from financing activities;
c) could be classified as operating or financing cash flows;
d) could be classified as operating or investing cash flows.

11. Cash receipts from the sale of an owner-operated plant are:
a) cash flows from financing activities;
b) cash flows from investing activities;
c) cash flows from operating activities.

12. The financial statement that reports the revenues and expenses for a period of time such as a year or a month is the
a) balance sheet;
b) income statement;
c) statement of cash flows.

13. The financial statement that reports the assets, liabilities, and stockholders' (owner's) equity at a specific date is the
a) balance sheet;
b) income statement;
c) statement of cash flows.

14. Under the accrual basis of accounting, revenues are reported in the accounting period when the

a) cash is received;

b) service or goods have been delivered.

15. Under the accrual basis of accounting, expenses are reported in the accounting period when the

a) cash is paid;

b) expense matches the revenues or is used up.

16. Assets are usually reported on the balance sheet at which amount?

a) cost;

b)current market value;

c) expected selling price.

17. Financial statements report the fair market value of a company.

a) True;

b) False.

12. STRUCTURE AND CONTENT OF FINANCIAL STATEMENTS

1. Fill in the table with a suitable word from the box

Additional Paid in Capital, Accumulated Depreciation, Investments, Goodwill, Accounts Receivable, Inventory, Intangible Assets, Unearned Revenues, Common Stock or Contributed Capital, Notes Receivable, Prepaid Expenses, Accounts Payable, Treasury Stock, Bonds Payable, Operating cycle, Retained Earnings, Property, Plant and Equipment, Supplies, Accrued Expense / Accrued Liabilities, ________ Payable, Current Maturities of Long Term Debt, Long Term Notes Payable and Long-term Debt

Name	Meaning
1.	Amounts customers owe the company for goods or services provided; normally collected in 30 to 90 days
2.	Items held only for sale to the customer
3.	Paid in advance before the service is provided; gives future benefit (rent, insurance)
4.	Items that are used up in day to day operations
5.	Amounts owed to the company; normally interest is charged and the note is repaid in longer than 3 months
6.	The company takes their excess cash and invests it in stocks or bonds to earn a return.
7.	Assets used long-term to generate revenues; they have physical substance (Buildings, Equipment, Autos, Land, Computers)
8.	The total amount for all prior years (cumulative) of depreciation expense for all prior periods. This is a contra account subtracted from plant, and equipment
9.	No physical substance - used long-term to generate revenues The company has the exclusive right to do something; Includes trademarks, copyrights, patents, franchises, goodwill
10.	Cash paid to purchase a company less Fair market value of net assets acquired
11.	Amounts owed to suppliers, normally paid in 30-60 days Suppliers are those who provide inventory or goods and services over and over again
12.	Both of these are expenses that have not yet been paid that the company owes – examples are: employee taxes, legal, advertising, bonuses, retirement plans
13.	Expenses incurred that have not yet been paid (Salaries, Rent, Interest, Taxes) If an amount is large enough, it gets its own line. If it is not large enough it will be included in accrued expenses.

14.	Cash received from customers before the good or service is provided. The company owes the customer a good/service
15.	The portion of long –term debt that will be repaid within 1 year
16.	Amounts owed to banks and other financing companies that will be paid later than one year from now Amounts due within a year are reported as current maturities of long term debt
17.	Amounts borrowed from investors; normally long-term
18.	Funds received from investors in exchange for ownership – common stock is reported at par value
19.	Amounts over and above par raised from investors from the sale of stock (ownership)
20.	Total of all (cumulative) profits and losses less dividends paid to owners
21.	The company buys and holds its own stock
22.	the time it takes a company to spend cash to do business and get the cash back again (buy inventory, pay expenses, sell to the customer and collect from the customer). Usually less than one year.

2. Read the articles and discuss

1. Statement of Financial Position

The statement of financial position, often called the balance sheet, is a financial statement that reports the assets, liabilities, and equity of a company on a given date. In other words, it lists the resources, obligations, and ownership details of a company on a specific day. You can think of this like a snapshot of what the company looked like at a certain time in history.

This definition is true in the sense that this statement is a historical report. It only shows the items that were present on the day of the report. This is in contrast with other financial reports like the income statement that presents company activities over a period of time. The statement of financial position only records the company account information on the last day of an accounting period.

In this sense, investors and creditors can go back in time to see what the financial position of a company was on a given date by looking at the balance sheet.

Example

Let's take a look at a statement of financial position example.

Paul's Guitar Shop, Inc.
Statement of Financial Position
December 31, 2016

Assets	
Current Assets	
Cash	32800
Inventory	39800
Total Current Assets	72600
Fixed Assets	
Leasehold Improvements	100000
Accumulated Depreciation	(2000)
Total Fixed Assets	98000
Other Assets	
Trademarks	20000
Accumulated Amortization	?
Total Other Assets	?
Total Assets	182600
Liabilities	
Current Liabilities	
Accounts Payable	49000
Accrued Expenses	?
Total Current Liabilities	?
Long-term Liabilities	25000
Total Liabilities	75000
Owner's Equity	
Owner's Equity	
Common Stock	20000
Retained Earnings	87600
Total Owner's Equity	107600
Total Liabilities and Owner's Equity	182600

As you can see from our example template, each balance sheet account is listed in the accounting equation order. This organization gives investors and creditors a clean and easy view of the company's resources, debts, and economic position that can be used for financial analysis purposes.

Investors use this information to compare the company's current performance with past performance to gauge the growth and health of the business. They also compare this information with other companies' reports to decide where the opportune place is to invest their money.

Creditors, on the other hand, are not typically concerned with comparing companies in the sense of investment decision-making. They are more concerned with the health of a business and the company's ability to pay its loan payments. Analyzing the leverage ratios, debt levels, and overall risk of the company gives creditors a good understanding of the risk involving in loaning a company money.

Obviously, internal management also uses the financial position statement to track and improve operations over time.

Now that we know what the purpose of this financial statement is, let's analyze how this report is formatted in a little more detail.

Format

The statement of financial position is formatted like the accounting equation (assets = liabilities + owner's equity). Thus, the assets are always listed first.

Assets

Assets are resources that the company can use to create goods or provide services and generate revenues. There are many ways to format the assets section, but the most common size balance sheet divides the assets into two sub-categories: current and non-current. The current assets include cash, accounts receivable, and inventory. These resources are typically consumed in the current period or within the next 12 months. The non-current assets section includes resources with useful lives of more than 12 months. In other words, these assets last longer than one year and can be used to benefit the company beyond the current period. The most common non-current assets include property, plant, and equipment.

Liabilities

Liabilities are debt obligations that the company owes other companies, individuals, or institutions. These range from commercial loans, personal loans, or mortgages. This section is typically split into two main sub-categories to show the difference between obligations that are due in the next 12 months, current liabilities, and obligations that mature in future years, long-term liabilities. Current debt usually includes accounts payable and accrued expenses. Both of these types of debts typically become due in less than 12 months. The long-term section includes all other debts that mature more than a year into the future like mortgages and long-term notes.

Equity

Equity consists of the ownership of the company. In other words, this measures their stake in the company and how much the shareholders or partners actually own. This section is displayed slightly different depending on the type of entity. For example a corporation would list the common stock, preferred stock, additional paid-in capital, treasury stock, and retained earnings. Meanwhile, a partnership would simply list the members' capital account balances including the current earnings, contributions, and distributions.

In the world of nonprofit accounting, this section of the statement of financial position is called the net assets section because it shows the assets that the organization actually owns after all the debts have been paid off. It's easier to understand this concept by going back to an accounting equation example. If we rearrange the accounting equation to state equity = assets – liabilities, we can see that the equity of a non-profit is equal to the assets less any outstanding liabilities.

2. Does the Balance Sheet always balance?

Notice that the balance sheet is always in balance. Just like the accounting equation, the assets must always equal the sum of the liabilities and owner's equity. This makes sense when you think about it because the company has only three ways of acquiring new assets.

It can use an asset to purchase and a new one (spend cash for something else). It can also take out a loan for a new purchase (take out a mortgage to purchase a building). Lastly, it can take money from the owners for a purchase (sell stock to raise cash for an expansion). All three of these business events follow the accounting equation and the double entry accounting system where both sides of the equation are always in balance.

3. Why the balance sheet always balances?

The balance sheet is structured in a manner that the total assets of an entity equal to the sum of liabilities and equity. This may lead you to wonder as to why the balance sheet must always be in equilibrium.

Assets of an entity may be financed from internal sources (i.e. share capital and profits) or from external credit (e.g. bank loan, trade creditors, etc.). Since the total assets of a business must be equal to the amount of capital invested by the owners (i.e. in the form of share capital and profits not withdrawn) and any borrowings, the total assets of a business must equal to the sum of equity and liabilities.

This leads us to the Accounting Equation: Assets = Liabilities + Equity

4. Purpose & Importance

Statement of financial position helps users of financial statements to assess the financial health of an entity. When analyzed over several accounting periods, balance sheets may assist in identifying underlying trends in the financial position of the entity. It is particularly helpful in determining the state of the entity's liquidity risk, financial risk, credit risk and business risk. When used in conjunction with other financial statements of the entity and the financial statements of its competitors, balance sheet may help to identify relationships and trends which are indicative of potential problems or areas for further improvement. Analysis of the statement of financial position could therefore assist the users of financial statements to predict the amount, timing and volatility of entity's future earnings.

The Format of the Balance Sheet:

Assets:	**Liabilities:**
Current:	Current:
Cash	Accounts Payable
Accounts Receivable	Accrued Expenses (Liabilities)
Inventory	Unearned Revenues
Prepaid Expenses	"_______" Payables
Short-term Investments	Income Taxes Payable
Short-term Notes Receivable	Short-term Notes Payable
Supplies	Current Portion of Long-term Debt
Total Current Assets	**Total Current Liabilities**
Long-term Investments	Bonds Payable
Long-term Notes Receivable	Long-term Debt
Property/Plant/Equipment (P/P/E):	Long term Notes Payable
Land	**Total Liabilities**
Building	
Equipment	**Stockholder's Equity:**
Less Accumulated Depreciation	Common Stock
Net P/P/E	Additional Paid in Capital

Intangible Assets	Retained Earnings
Goodwill	less Treasury Stock
Patents, net	**Total Stockholder's Equity**
Trademarks, net	
Copyrights, net	
Total Intangible Assets	
Other Assets	
Total Assets **must =**	Total Liabilities & Stockholder's Equity

Example – presentation of a statement of financial position

Ex 1 A group prepares its consolidated financial statements in accordance with the *IFRS*. The group's consolidated statement of financial position is set out below.

<u>Prepare the Statement of Financial Position under the following information</u>

A Group's consolidated statement of financial position at 31 December 20XX (in currency units)

	31 December 20X7
ASSETS	
Current assets:	
Total current assets	
Non-current assets:	
Total non-current assets	
Total assets	**1,466,500**
LIABILITIES AND EQUITY	
Current liabilities:	

Total current liabilities	
Non-current liabilities:	
Total non-current liabilities	
Total liabilities	**492,750**
Equity:	
Total equity attributable to owners of the parent	
Non-controlling interests	
Total equity	
Total equity and liabilities	

	31 December 20X7
Investment property—carried at fair value	150,000
Long-term employee benefit obligations	78,000
Cash and cash equivalents	312,400
Trade receivables	91,600
Current portion of obligations under finance leases	1,500
Trade and other payables	90,100
Other financial assets—derivative hedging instruments	2,000
Retained earnings	243,500
Property, plant and equipment—carried at cost less accumulated depreciation	200,700
Inventories	135,230
Other current assets	23,650
Share capital	650,000
Other intangible assets	107,070
Actuarial gains on defined benefit pension plan	8,200
Financial assets—investments in shares	100,150
Investments in associates:	100,500
– carried at fair value	60,000
– carried at cost less impairment	40,500
Investments in jointly controlled entities:	42,000
– carried at fair value	20,000
– carried at cost less impairment	22,000
Bank loans	65,000
Short-term borrowings	150,000

Biological assets	70,000
– carried at fair value	30,000
– carried at cost less impairment	40,000
Bank overdrafts	10,000
Goodwill	80,800
Current tax payable	23,500
Deferred tax assets	50,400
Current portion of bank loans	20,000
Current portion of employee benefit obligations	15,000
Non-controlling interests	70,050
Short-term provisions	5,000
Obligations under finance leases	2,300
Environmental restoration provision	26,550
Deferred tax liabilities	5,800
Gains on hedges of foreign exchange risks of firm commitments	2,000

Example – current/non-current distinction

Ex 2 The entity in example 1 presents current and non-current assets and current and non-current liabilities separately. The entity in this example presents assets and liabilities in order of approximate liquidity.

<u>**Prepare the Statement of Financial Position under the following information**</u>

An entity's statement of financial position at 31 December 20X8

(in thousands of currency units)

	31 December 20X7
ASSETS:	
Total assets	
Liabilities:	
Total liabilities	
Shareholders' equity:	
Total shareholders' equity	
Total equity and liabilities	

	31 December 20X7
Interest payable	230
Cash and cash equivalents	230
Long-term debt	2,300
Trade receivables	1,900
Inventory	1,000
Retained earnings	3,230
Share capital	1,500
Portfolio investments cost	2,500
Property, plant and equipment:	
Property, plant and equipment: cost	3,730
Property, plant and equipment: accumulated depreciation	(1,450)
Income taxes payable	400
Trade payables	250

Prepare the Statement of Financial Position under the following information

	31 December 20XX
ASSETS	
Non-current assets	
Total non-current assets	
Current assets	
Total current assets	
Total assets	
EQUITY AND LIABILITIES	
Equity attributable to owners of the parent:	
Total equity	
Non-current liabilities:	
Total non-current liabilities	
Current liabilities	
Total current liabilities	

Total liabilities	**3,564**
Total equity and liabilities	

	31 December 20XX
Warranty provision	400
Retained earnings	2,690
Property, plant and equipment	2,874
Trade and other receivables	1,700
Investment property	2,500
Long-term provisions (environmental restoration)	280
Share capital	1,500
Current portion of long-term debt	500
Inventory	1,180
Non-controlling interests	730
Cash and cash equivalents	230
Other short-term provisions	1
Long-term debt	1,800
Trade and other payables	253
Interest accrued on long-term debt	230
Dividends declared	100

5. Income Statement

The income statement, also called the profit and loss statement, is a report that shows the income, expenses, and resulting profits or losses of a company during a specific time period. The income statement is the first financial statement typically prepared during the accounting cycle because the net income or loss must be calculated and carried over to the statement of owner's equity before other financial statements can be prepared.

The income statement calculates the net income of a company by subtracting total expensesfrom total income. This calculation shows investors and creditors the overall profitability of the company as well as how efficiently the company is at generating profits from total revenues.

The income and expense accounts can also be subdivided to calculate gross profit and the income or loss from operations. These two calculations are best shown on a multi-step income statement. Gross profit is calculated by subtracting cost of goods sold from net sales. Operating income is calculated by subtracting operating expenses from the gross profit.

Unlike the balance sheet, the income statement calculates net income or loss over a range of time. For example annual statements use revenues and expenses over a 12-month period, while quarterly statements focus on revenues and expenses incurred during a 3-month period.

Format

There are two income statement formats that are generally prepared.

Single-step income statement – the single step statement only shows one category of income and one category of expenses. This format is less useful of external users because they can't calculate many efficiency and profitability ratios with this limited data.

Multi-step income statement - the multi-step statement separates expense accounts into more relevant and usable accounts based on their function. Cost of goods sold, operating and non-operating expenses are separated out and used to calculate gross profit, operating income, and net income.

In both income statement formats, revenues are always presented before expenses. Expenses can be listed alphabetically or by total dollar amount. Either presentation is acceptable.

Income statement expenses can also be formatted by the nature and the function of the expense.

All income statements have a heading that display's the company name, title of the statement and the time period of the report. For example, an annual income statement issued by Paul's Guitar Shop, Inc. would have the following heading:

- Paul’s Guitar Shop, Inc.
- Income Statement
- For the Year Ended December 31, 2016

Example

Here is an example of how to prepare an income statement from Paul’s adjusted trial balance in our earlier accounting cycle examples.

Single Step Income Statement

Paul’s Guitar Shop, Inc.
Income Statement
For the Year Ended December 31, 2016

Revenues	
Merchandise Sales	?
Music Lesson Income	3000
Total Revenues	?
Expenses	
Cost of Goods Sold	10200
Depreciation expense	2000
Wage expense	750
Rent expense	500
Interest expense	500
Supplies expense	500
Utilities expense	400
Total Expenses	14850
Net Income	12950

As you can see, this example income statement is a single-step statement because it only lists expenses in one main category. Although this statement might not be extremely useful for investors looking for detailed information, it does accurately calculate the net income for the year.

This net income calculation can be transferred to Paul's statement of owner's equity for preparation.

Multi Step Income Statement

A simple multiple step income statement separates income, expenses, gains, and losses into two meaningful sub-categories called operating and non-operating. Unlike the single step income statement format where all revenues are combined in one main income listing and all expenses are totaled together, the multiple step statement lists these activities in separate sections, so users can better understand of the core business operations.

This is particularly helpful for analyzing the performance of the business. Investors and creditors can evaluate how well a company performs its main functions separate from any other activities the business is involved in. For instance, a retailer's main function is to sell merchandise. Investors and creditors want to know how efficiently the retailer sells its merchandise without diluting the numbers with other gains and losses from non-merchandise related sales.

To do this, all income and expenses cannot be listed together. They must be separated into meaningful categories.

Format

The multistep income statement format is broken down into two main sections: operating and non-operating.

Operating Section

The operating section is subdivided into two main sections that list the primary business income and expenses. The first section computes the gross profit of the business by subtracting the cost of goods sold from the total sales. This is a key figure for investors, creditors, and internal management because it shows how profitable the company is at selling its goods or making its products.

Jazz Music Shop, Inc.
Income Statement
For the Year Ended December 31, 2016

Sales	6400
Cost of Goods Sold	1400
Gross Profit	5000

Going back to our retailer example, the total sales figure would include all merchandise sales made during the period and the cost of goods sold would include all expenses paid to purchase, ship, and get the merchandise ready for sale. The gross margin computes the amount of money the company profits from the sales of its merchandise. Keep in mind, no other expenses are taken into account yet. This is simply the cash flow in from the sales of merchandise and the cash flow out from the purchase of that merchandise. This section not only helps measure the profitability of the core business activities, it also helps measure the health of the business.

The second part of the operating section lists all of the operating expenses in two separate categories: selling and administrative. Selling expenses are exactly what they sound like: costs incurred to sell products. These expenditures typically include advertising, salesmen salaries, commissions, and freight. The administrative expenses include expenditures that aren't directly related to selling product like rent, office staff salaries, and supplies.

The selling and administrative expense sections are added together to compute the total operating expenses. This total expense line is subtracted from the gross profit computed in the first section to arrive at the company's operating income.

Operating Expenses	
Selling expense	334
Advertising expense	100
Sales commissions	234
Administrative expenses	981
Rent expense	950
Supplies expense	31
Total Operating Expenses	1315
Income From Operations	3685

Non-Operating and Other

The non-operating and other section lists all business revenues and expenses that don't relate to the business' principle activities. For example, our retailer isn't in the business of receiving insurance proceeds. If a tree hit the building and the insurance company paid out a small settlement, the income would not be reported with total sales. It would be reported in the non-operating and other section because it doesn't have anything to do with sales.

Non-Operating Income and Expenses	
Insurance proceeds	1000
Interest expense	250
Total Operating	750
Net Income	4435

Other income and expenses like interest, lawsuit settlements, extraordinary items, and gains or losses from investments are also listed in this section. Unlike the operating section, the non-operating section is not split into subcategories. It simply lists all of the activities and totals them at the bottom.

Once the non-operating section is totaled, it is subtracted from or added to the income from operations to compute the net income for the period.

Example

Let's take a look at a multi step income statement example.

Jazz Music Shop, Inc.
Income Statement
For the Year Ended December 31, 2016

Sales	6400
Cost of Goods Sold	1400
Gross Profit	5000
Operating Expenses	
Selling expense	334
Advertising expense	100
Sales commissions	234

Administrative expenses	981
Rent expense	950
Supplies expense	31
Total Operating Expenses	1315
Income From Operations	3685
Non-Operating Income and Expenses	
Insurance proceeds	1000
Interest expense	250
Total Operating	750
Net Income	4435

As you can see, this multi step income statement template computes net income in three steps.

Step 1: Compute Gross Profit (Total sales – Cost of goods sold)

Step 2: Compute Income From Operations (Gross profit – operating expenses)

Step 3: Compute Net Income (Income from operations – non-operating and other)

The cost of goods sold is separated from the operating expenses and listed in the gross margin section. This is particularly important because it gives investors, creditors, and management the ability to analyze the financial statement sales and purchasing efficiency.

The operating section clearly lists the operating income of the company. This is the amount of money the company made from selling its products after all operating expenses have been paid. This is a key figure because it shows the health of the business. If a company's operations are strong, it will almost always show a profit at the bottom line, but not all companies with a profitable bottom line have strong operations. Take our retailer for example. It might have lost money from its operations but had a huge insurance settlement that pushed a profit to the bottom line. Is this business healthy? Probably not. That's why this section is so important.

Lastly, you can see the non-operating and other section being subtracted to compute the net income.

The multistep income statement gives far more detail than the single step statement, but it can also be more misleading if not prepared correctly. For instance, management might shift expenses out of cost of goods sold and into operations to artificially improve their margins. It's always important to view comparative financial statements over time, so you can see trends and possibly catch misleading placement of expenses.

During 20X7, after the entity's 20X6 financial statements were approved for issue, the entity discovered a computational error in the calculation of depreciation expense for the year ended 31 December 20X6 (ie profit before tax for the year ended 31 December 20X6 is overstated by CU7,800, with a resultant CU1,950 overstatement of income tax expense).

The entity's statement of comprehensive income for the year ended 31 December 20X7 could be presented as follows:

An entity – statement of comprehensive income for the year ended 31 December 20X7

	31 December 20XX
Revenue	?
Other income	54,000
Changes in inventories of finished goods and work in progress	23,520
Raw material and consumables used	(428,000)
Employee benefits expense	(78,000)
Depreciation and amortisation expense	(25,600)
Impairment of property, plant and equipment	–
Other expenses	(4,500)
Finance costs	(22,300)
Share of profit of associates	42,100
Profit before tax	**241,220**
Income tax expense	(60,305)
Profit/Total comprehensive income for the year	**180,915**

The statement of comprehensive income of an entity could be presented in a single statement as follows:

An entity's statement of comprehensive income for the year ended 31 December 20XX

	31 December 20XX
Revenue	645,000
Cost of sales	(500,000)
Distribution costs	?
Administrative expenses	(30,000)
Finance costs	(10,000)
Profit before tax	**55,000**
Income tax expense	(13,750)
Profit for the year	**41,250**
Other comprehensive income:	
Exchange differences on translating foreign operations, net of tax	10,260
Change in the fair value of hedging instruments, net of tax	(3,800)
Reclassified losses on hedging instrument to profit or loss	(720)
Other comprehensive income for the year, net of tax	**5,740**
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	**46,990**

A group (a parent and its wholly-owned subsidiary) that follows a single-statement approach to present its financial performance could prepare its statement of comprehensive income as follows:

A group's statement of comprehensive income for the year ended 31 December 20XX

	31 December 20XX
Revenue	680,000
Cost of sales	(400,000)
Distribution costs	(8,580)
Administrative expenses	(50,000)
Finance costs	?
Share of profit of associates	42,100
Profit before tax	**241,220**
Income tax expense	(60,305)
Profit for the year from continuing operations	**180,915**
Loss for the year from discontinued operations	(24,780)
Profit for the year	**156,135**
Other comprehensive income:	
Exchange differences on translating foreign operations, net of tax	10,260
Actuarial gains on defined benefit pension obligations, net of tax	(720)
Share of associates' other comprehensive income	(3,800)
Other comprehensive income for the year, net of tax	**5,740**
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	**161,875**

The group could prepare its separate income statement and separate statement of comprehensive income as follows:

A group's consolidated income statement for the year ended 31 December 20XX	
	31 December 20XX
Revenue	680,000
Cost of sales	(400,000)
Distribution costs	(8,580)
Administrative expenses	(50,000)
Finance costs	(22,300)
Share of profit of associates	42,100
Profit before tax	241,220
Income tax expense	(60,305)
Profit for the year from continuing operations	**180,915**
Loss for the year from discontinued operations	(24,780)
PROFIT FOR THE YEAR	**?**
Profit for the year is attributable to:	
Owners of the parent	151,135
Non-controlling interests	5,000
	156,135

A Group – consolidated statement of comprehensive income for the year ended 31 December 20XX	
Profit for the year	156,135
Other comprehensive income:	
Exchange differences on translating foreign operations, net of tax	10,260
Actuarial gains on defined benefit pension obligations, net of tax	(720)
Share of associates other comprehensive income	(3,800)
Other comprehensive income for the year, net of tax	**5,740**
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	**161,875**
Total comprehensive income for the year is attributable to:	
Owners of the parent	156,575
Non-controlling interests	5,300
	161,875

Example – additional line items, headings and subtotals

Ex 10 A retailer may present additional line items (eg gross profit, profit before tax and profit from continuing operations) in its consolidated statement of comprehensive income because the group's management believes that such presentation is relevant to an understanding of the entity's financial performance.

An entity's statement of comprehensive income for the year ended 31 December 20XX	
	31 December 20XX
Revenue	680,000
Cost of sales	(400,000)
Gross profit	**?**
Distribution costs	(8,580)
Administrative expenses	(50,000)
Finance costs	(22,300)
Share of profit of associates	42,100
Profit before tax	**?**
Income tax expense	(60,305)
Profit for the year from continuing operations	**180,915**
Loss for the year from discontinued operations	(24,780)
Profit for the year	**156,135**
Other comprehensive income:	
Exchange differences on translating foreign operations, net of tax	10,260
Actuarial gains on defined benefit pension obligations, net of tax	(720)

Share of associates other comprehensive income	(3,800)
Other comprehensive income for the year, net of tax	**5,740**
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	**161,875**

A group (a parent and its wholly-owned subsidiary) that presents its financial performance using the single-statement approach and presents an analysis by nature of expenses in its statement of comprehensive income could present its statement of comprehensive income as follows:

A group's consolidated statement of comprehensive income for the year ended 31 December 20X

	31 December 20XX
Revenue	734,000
Gain in the fair value of investment property	1,000
Changes in inventories of finished goods and work in progress	(26,480)
Raw material and consumables used	(378,000)
Employee benefits expense	(78,000)
Depreciation and amortisation expense	(25,600)
Impairment of property, plant and equipment	–
Advertising costs	(3,000)
Raw material freight costs	(2,000)
Operating lease expense	?
Finance costs	(22,300)
Share of associate's losses	(100)
Profit before tax	**199,120**
Income tax expense	(49,780)
Profit for the year from continuing operations	**149,340**
Loss for the year from discontinued operations	(24,780)
PROFIT FOR THE YEAR	**124,560**
Other comprehensive income:	
Exchange differences on translating foreign operations, net of tax	10,260
Actuarial losses on defined benefit pension plans, net of tax	(720)
Change in the fair value of hedging instruments, net of tax	(3,800)
Reclassified gains (losses) on hedging instruments to profit or loss	1,560
Other comprehensive income for the year, net of tax	**7,300**
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	**131,860**

6. Cash Flow Statement

The statement of cash flows, also called the cash flow statement, is the fourth general-purpose financial statement and summarizes how changes in balance sheet accounts affect the cash account during the accounting period. It also reconciles beginning and ending cash and cash equivalents account balances.

This statement shows investors and creditors what transactions affected the cash accounts and how effectively and efficiently a company can use its cash to finance its operations and expansions. This is particularly important because investors want to know the company is financially sound while creditors want to know the company is liquid enough to pay its bills as they come due. In other words, does the company have good cash flow?

The term cash flow generally refers to a company's ability to collect and maintain adequate amounts of cash to pay its upcoming bills. In other words, a company with good cash flow can collect enough cash to pay for its operations and fund its debt service without making late payments.

Format and Template

The cash flow statement format is divided into three main sections: cash flows from operating activities, investing activities, and financing activities.

Operating Activities

Cash flows from operating activities include transactions from the operations of the business. In other words, the operating section represent the cash collected from the primary revenue generating activities of the business like sales and service income. Operating activities are short-term and only affect the current period. For example, payment of supplies is an operating activity because it relates to the company operations and is expected to be used in the current period.

Operating cash flows are calculated by adjusting net income by the changes in current asset and liability accounts.

Investing Activities

Cash flows from investing activities consist of cash inflows and outflows from sales and purchases of long-term assets. In other words, the investing section of the statement represents the cash that the company either collected from the sale of a long-term asset or the amount of money spent on purchasing a new long-term asset. You can think of this section as the company investing in itself. The investments are long-term in nature and expected to last more than one accounting period.

Investing cash flows are calculated by adding up the changes in long-term asset accounts.

Financing Activities

Cash flows from financing consists of cash transactions that affect the long-term liabilities and equity accounts. In other words, the financing section on the statement represents the amount of cash collected from issuing stock or taking out loans and the amount of cash disbursed to pay dividends and long-term debt. You can think of financing activities as the ways a company finances its operations either through long-term debt or equity financing.

Financing cash flows are calculated by adding up the changes in all the long-term liability and equity accounts.

Here's a tip!

Here is a tip on how I keep track of what transactions go in each cash flow section.

Operating Activities: includes all activities that are reported on the income statement under operating income or expenses.

Investing Activities: includes all cash transactions used to buy or sell long-term assets. Think of these as the company investing in itself.

Financing Activities: includes all cash transactions that affect long-term liabilities and equity. Whenever long-term debt or equity is involved, it is considered a financing activity.

Like all financial statements, the statement of cash flows has a heading that display's the company name, title of the statement and the time period of the report. For example, an annual income statement issued by Paul's Guitar Shop, Inc. would have the following heading:

- Paul's Guitar Shop, Inc.
- Cash Flow Statement
- December 31, 2015

Example

Here is the statement of cash flows example from our unadjusted trial balance and financial statements used in the accounting cycle examples for Paul's Guitar Shop.

Paul's Guitar Shop, Inc.
Statement of Cash Flows
For the Year Ended December 31, 2016

CASH FLOWS FROM OPERATING ACTIVITIES	
Net income	12950
Adjustments to reconcile net income to	
net cash provided by operating activities:	
Depreciation on fixed assets	2000
(Increase) decrese in current assets:	
Accounts receivable	(300)
Inventory	(39800)
Prepaid expenses	(1000)
Increase (decrese) in current liabilities:	
Accounts payable	49000
Accrued expenses and unearned revenues	1450
NET CASH PROVIDED BY OPERATING ACTIVITIES	24300
CASH FLOWS FROM INVESTING ACTIVITIES	
Purchase of property and equipment	(101000)
NET CASH USED IN INVESTING ACTIVITIES	(101000)
CASH FLOWS FROM FINANCING ACTIVITIES	
Proceeds from line of credit	-
Payments on line of credit	10000
Proceeds from long-term debt	99500

Payments on long-term debt	-
NET CASH PROVIDED (USED) FINANCING ACTIVITIES	109500
NET INCREASE (DECRESE) IN CASH	32800
BEGINNING CASH BALANCE	-
ENDING CASH BALANCE	32800

Preparation

The statement of cash flows is generally prepared using two different methods: the direct method and the indirect method. Both result in the same financial statement showing how financial transacations affected would have affected the bank account of the company. Each method is used for a slightly different reason and typically used for different sized companies. Let's take a look at how to create a statement using both the direct and the indirect methods in the next aritcles.

Statement of Cash Flows Direct Method

The cash flow statement presented using the direct method is easy to read because it lists all of the major operating cash receipts and payments during the period by source. In other words, it lists where the cash inflows came from, usually customers, and where the cash outflows went, typically employees, vendors, etc.

After all of the sources are listed, the total cash payments are then subtracted from the cash receipts to compute the net cash flow from operating activities. Then the investing and financing activities added to arrive at the net cash increase or decrease. Let's take a look at how this report is formatted and structured.

Format

Here's a list of the most common types of receipts and payments used in the direct method format:

- Receipts received from Customers
- Payments paid to Suppliers
- Payments paid to Employees
- Interest Payments
- Income Tax Payments

As you can see, listing these payments gives the financial statement user a great deal of information where receipts are coming from and where payments are going to. This is one of the main advantages of the direct method compared with the indirect method. Investors, creditors, and management can actually see where the company is collecting funds from and whom it is paying funds to. The indirect method doesn't list these types of details. That's exactly why FASB recommends that all companies issue their statement of cash flows in the direct method.

The problem with this method is it's difficult and time consuming to create. Most companies don't record and store accounting and transactional information by customer, supplier, or vendor. Business events are recorded with income statement and balance sheet accounts like sales, materials, and inventory. It's laborious for most companies to compile the information with this method.

For example, in order to figure out the receipts and payments from each source, you have to use a unique formula. The receipts from customers equals net sales for the period plus the beginning accounts receivable less the ending accounts receivable. Similarly the payments made to suppliers is calculated by adding the purchases, ending inventory, and beginning accounts payable then subtracting the beginning inventory and ending accounts payable.

Keep in mind that these formulas only work if accounts receivable is only used for credit sales and accounts payable is only used for credit account purchases. This is why most companies don't issue this method. It's difficult to gather the information.

Plus, the direct method also requires a reconciliation report be created to check the accuracy of the operating activities. The reconciliation itself is very similar to the indirect method of reporting operating activities. It stars with net income and adjusts non-cash transaction like depreciation and changes in balance sheet accounts. Since creating this reconciliation is about as much work as just preparing an indirect statement, most companies simply choose not to use the direct method.

I know what you are probably thinking. If you have to do an additional reconciliation, why is it called the direct method. It seems like a whole like more work. Well, it is. The reason why it's called that has nothing to do with how much work is involved in preparing the report. It has to do with how the operating cash flows are derived. This method looks directly at the source of the cash flows and reports it on the statement. The indirect method, on the other hand, computes the operating cash flows by adjusting the current year's net income for changes in balance sheet accounts.

This is the only difference between the direct and indirect methods. The investing and financing activities are reported exactly the same on both reports.

Let's look at an example.

Example

Here's an example of a cash flow statement prepared using the direct method.

Paul's Guitar Shop, Inc.
Statement of Cash Flows
For the Year Ended December 31, 2016

CASH FLOWS FROM OPERATING ACTIVITIES	
Cash received from customers	51300
Cash paid for merchandise	(15000)
Cash paid to employees	(10000)
Cash paid for interest	(500)
Cash paid for income taxes	(1500)
NET CASH PROVIDED BY OPERATING ACTIVITIES	24300
CASH FLOWS FROM INVESTING ACTIVITIES	

Purchase of property and equipment	(101000)
NET CASH USED IN INVESTING ACTIVITIES	(101000)
CASH FLOWS FROM FINANCING ACTIVITIES	
Proceeds from line of credit	-
Payments on line of credit	10000
Proceeds from long-term debt	99500
Payments on long-term debt	-
NET CASH PROVIDED (USED) FINANCING ACTIVITIES	109500
NET INCREASE (DECRESE) IN CASH	32800
BEGINNING CASH BALANCE	-
ENDING CASH BALANCE	32800

As you can see, all of the operating activities are clearly listed by their sources. This categorization does make it useful to read, but the costs of producing it for outweigh the benefits to the external users. This is why FASB has never made it a requirement to issue statements using this method.

Statement of Cash Flows Indirect Method

The statement of cash flows prepared using the indirect method adjusts net income for the changes in balance sheet accounts to calculate the cash from operating activities. In other words, changes in asset and liability accounts that affect cash balances throughout the year are added to or subtracted from net income at the end of the period to arrive at the operating cash flow.

The operating activities section is the only difference between the direct and indirect methods. The direct method lists all receipts and payments of cash from individual sources to compute operating cash flows. This is not only difficult to create; it also requires a completely separate reconciliation that looks very similar to the indirect method to prove the operating activities section is accurate.

Companies tend to prefer the indirect presentation to the direct method because the information needed to create this report is readily available in any accounting system. In fact, you don't even need to go into the bookkeeping software to create this report. All you need is a comparative income statement. Let's take a look at the format and how to prepare an indirect method cash flow statement.

Format

The indirect operating activities section always starts out with the net income for the period followed by non-cash expenses, gains, and losses that need to be added back to or subtracted from net income. These non-cash activities typically include:

- Depreciation expense
- Amortization expense

- Depletion expense
- Gains or Losses from sale of assets
- Losses from accounts receivable

The non-cash expenses and losses must be added back in and the gains must be subtracted.

The next section of the operating activities adjusts net income for the changes in asset accounts that affected cash. These accounts typically include:

- Accounts receivable
- Inventory
- Prepaid expenses
- Receivables from employees and owners

This is where preparing the indirect method can get a little confusing. You need to think about how changes in these accounts affect cash in order to identify what way income needs to be adjusted. When an asset increases during the year, cash must have been used to purchase the new asset. Thus, a net increase in an asset account actually decreased cash, so we need to subtract this increase from the net income. The opposite is true about decreases. If an asset account decreases, we will need to add this amount back into the income. Here's a general rule of thumb when preparing an indirect cash flow statement:

Asset account increases: subtract amount from income
Asset account decreases: add amount to income

The last section of the operating activities adjusts net income for changes in liability accountsaffected by cash during the year. Here are some of the accounts that usually are used:

- Accounts payable
- Accrued expenses

Get ready. If you weren't confused by the assets part, you might be for the liabilities section. Since liabilities have a credit balance instead of a debit balance like asset accounts, the liabilities section works the opposite of the assets section. In other words, an increase in a liability needs to be added back into income. This makes sense. Take accounts payable for example. If accounts payable increased during the year, it means we purchased something without using cash. Thus, this amount should be added back. Here's a basic tip that you can use for all liability accounts:

Liability account increases: add amount from income
Liability account decreases: subtract amount to income

All of these adjustments are totaled to adjust the net income for the period to match the cash provided by operating activities.

Example

It might be helpful to look at an example of what the indirect method actually looks like.

Paul's Guitar Shop, Inc.
Statement of Cash Flows
For the Year Ended December 31, 2016

CASH FLOWS FROM OPERATING ACTIVITIES	
Net income	12950
Adjustments to reconcile net income to	
net cash provided by operating activities:	
Depreciation on fixed assets	2000
(Increase) decrese in current assets:	
Accounts receivable	(300)
Inventory	(39800)
Prepaid expenses	(1000)
Increase (decrese) in current liabilities:	
Accounts payable	49000
Accrued expenses and unearned revenues	1450
NET CASH PROVIDED BY OPERATING ACTIVITIES	24300
CASH FLOWS FROM INVESTING ACTIVITIES	
Purchase of property and equipment	(101000)
NET CASH USED IN INVESTING ACTIVITIES	(101000)
CASH FLOWS FROM FINANCING ACTIVITIES	
Proceeds from line of credit	-
Payments on line of credit	10000
Proceeds from long-term debt	99500
Payments on long-term debt	-
NET CASH PROVIDED (USED) FINANCING ACTIVITIES	109500
NET INCREASE (DECRESE) IN CASH	32800
BEGINNING CASH BALANCE	-
ENDING CASH BALANCE	32800

As you can see, the operating section always lists net income first followed by the adjustments for expenses, gains, losses, asset accounts, and liability accounts respectively.

Although most standard setting bodies prefer the direct method, companies use the indirect method almost exclusively. It's easier to prepare, less costly to report, and less time consuming to create than the direct method. Standard setting bodies prefer the direct because it provides more information for the external users, but companies don't like it because it requires an additional reconciliation be included in the report. Since the indirect method acts as a reconciliation itself, it's far less work for companies to simply prepare this report instead.

Financial effects of the entity's operations for the year ended 31 December 20X3:

	(Income) or Expense	Cash	Trade receivables	Trade payables	Accrued employee benefits	Inventory	Investment property	Furniture and equipment
Carrying amount at 01/01/20X3		600	200	(150)	(60)	1,000	800	500
Credit sales	(6,000)		6,000					
Credit purchases				(2,200)		2,200		
Cost of goods sold	3,000					(3,000)		
Cash receipts from customers		3,600	(3,600)					
Rental income	(40)	40						
Cash payments to suppliers		(2,000)		2,000				
Cash payments to employees	1,500	(1,560)			60			
Depreciation	50							(50)
Sale of computer	(110)	210						(100)
Change in fair value	(100)						100	
Profit/carrying amount at 31/12/20X3	(1,700)	890	2,600	(350)	–	200	900	350

Part A: Prepare the entity's statement of cash flows for the year ended 31 December 20X3 using the indirect method.

Part B: Prepare the entity's statement of cash flows for the year ended 31 December 20X3 using the direct method.

Part A: indirect method of presenting operating cash flows

Extract from the statement of cash flows of the entity for the year ended 31 December 20X3

Cash flows from operating activities	
Profit for the year	
Adjustments for non-cash income and expenses:	
Depreciation expense	
Increase in fair value of investment property	
Adjustment for item included in investing activities:	
Profit on sale of equipment	
Changes in working capital:	
Increase in trade and other receivables	
Decrease in inventories	
Increase in trade and other payables	

Net cash from operating activities	
Cash flows from investing activities	
Proceeds on sale of equipment	
Net cash from investing activities	
Cash and cash equivalents	
Increase in cash for the year ended 31 December 20X3	
Cash at 1 January 20X3	
Cash at 31 December 20X3	

Calculations that do not form part of the statement of cash flows presented above:

(a) CU2,600 closing balance less CU200 opening balance = CU2,400.

(b) CU200 closing balance less CU1,000 opening balance = CU800.

(c) CU350 closing balance less CU210 (ie 150 trade payables + CU60 accrued employee benefits)

opening balance = CU140.

(d) CU80 net cash flow from operating activities + CU210 net cash flow from investing activities

= CU290.

Part B: direct method of presenting operating cash flows

Entity X statement of cash flows for the year ended 31 December 20X3

Cash flows from operating activities	
Cash receipts from customers	
Rentals received from tenants	
Cash paid to suppliers and employees	
Net cash from operating activities	
Cash flows from investing activities	
Proceeds on sale of equipment	
Net cash from investing activities	
Cash and cash equivalents	
Increase in cash for the year ended 31 December 20X3	
Cash at 1 January 20X3	
Cash at 31 December 20X3	

7. **A statement of changes in equity**

A statement of changes in equity reflects all changes in equity between the beginning and the end of the reporting period arising from transactions with owners in their capacity as owners (ie owner changes in equity) reflecting the increase or decrease in net assets in the period. This statement provides a linkage between the entity’s statement of financial position and its statement of comprehensive income.

The statement of changes in equity presents the user with information about each component of equity, including:

 a reconciliation between the carrying amount at the beginning and the end of the period of each component of equity;

 the effects of retrospective application of accounting policies; and

 the effects of retrospective restatement of prior period errors.

The consolidated statement of changes in equity (of a group that includes one or more partly-owned subsidiaries) also provides information about the share of equity attributable to the owners of the parent and that attributable to the non-controlling interests and information about changes in such interests.

A group’s statement of changes in equity for the year ended 31 December 20XX (in currency units)

	Share capital	*Share premium*	*Retained earnings*	*Total equity (attributable to owners of the parent)*
Balance at 1 Jan 20X3	2,500,000	1,900,000	2,150,000	6,550,000
Correction of prior period error	–	–	(230,000)	(230,000)
Restated balance at 1 Jan 20X3	2,500,000	1,900,000	1,920,000	6,320,000
Changes in equity for 20X3				
Total comprehensive income for the year	–	–	567,100	567,100
Profit for the year	–	–	507,000	507,000
Actuarial losses on defined benefit plans for the year, net of tax	–	–	(6,900)	(6,900)
Gain on translation of foreign operation, net of tax	–	–	67,000	67,000
Dividends	–	–	(220,000)	(220,000)
Balance at 31 Dec 20X3	2,500,000	1,900,000	2,267,100	6,667,100
Changes in equity for 20X4				
Total comprehensive income for the year	–	–	619,100	619,100
Profit for the year (e)	–	–	667,300	667,300
Actuarial losses on defined benefit plans for the year, net of tax	–	–	(2,000)	(2,000)
Loss on translation of foreign operation, net of tax	–	–	(46,200)	(46,200)
Issue of Shares	1,000,000	5,000,000	–	6,000,000
Dividends	–	–	(320,000)	(320,000)
Balance at 31 Dec 20X4	3,500,000	6,900,000	2,566,200	12,966,200

	Share capital	*Share premium*	*Retained earnings*	*Attributable to owners of the parent*	*Noncontrolling interest*	*Total equity*
Balance at 1 Jan 20X3	2,500,000	,900,000	12,130,000	6,530,000	22,500	6,552,500
Correction of prior period error	–	–	(30,000)	(30,000)	(10,000)	(40,000)
Restated balance at 1 Jan 20X3	2,500,000	1,900,000	2,100,000	6,500,000	12,500	6,512,500
Changes in equity for 20X3						
Total comprehensive income for the year	–	–	566,600	566,600	6,750	573,350
Profit for the year	–	–	505,250	505,250	8,000	513,250
Actuarial losses on defined benefit plans for the year, net of tax	–	–	(5,650)	(5,650)	(1,250)	(6,900)
Gain on translation of foreign operation, net of tax	–	–	67,000	67,000	–	67,000
Dividends	–	–	(220,000)	(220,000)	(6,250)	(226,250)
Balance at 31 Dec 20X3	2,500,000	1,900,000	2,446,600	6,846,600	13,000	6,859,600
Changes in equity for 20X4						
Total comprehensive income for the year	–	–	616,600	616,600	10,250	626,850
Profit for the year	–	–	665,050	665,050	10,000	675,050
Actuarial gains and (losses) on defined benefit plans for the year, net of tax	–	–	(2,250)	(2,250)	250	(2,000)
Loss on translation of foreign operation, net of tax	–	–	(46,200)	(46,200)	–	(46,200)
Issue of shares	1,000,000	5,000,000	–	6,000,000	–	6,000,000
Dividends	–	–	(320,000)	(320,000)	(7,750)	(327,750)
Sale of shares in subsidiary	–	–	25,700	25,700	9,300	35,000
Balance at 31 Dec 20X4	3,500,000	6,900,000	2,768,900	13,168,900	24,800	13,193,700

A group's consolidated statement of changes in equity for the year ended 31 December 20X7

(in thousands of currency units)

	Share capital	*Retained earnings*	*Hedges of foreign currency risk in forecast transactions*	*Hedge of commodity price risk in forecast transactions*	*Attributable to owners of the parent*	*Noncontrolling interests*	*Total equity*
Balance at 1 Jan 20X6	500,000	256,000	(4,000)	2,000	754,000	83,778	837,778
Correction of a prior period error	–	5,000	–	–	5,000	500	5,500
Changes in accounting policy	–	5,500	–	–	5,500	667	6,167
Restated balance at 1 Jan 20X6	500,000	266,500	(4,000)	2,000	764,500	84,945	849,445
Total Comprehensive income	–	64,000	2,600	(1,100)	65,500	7,111	72,611
Profit or loss	–	60,000	–	–	60,000	6,000	66,000
Translation of foreign operations	–	6,400	–	–	6,400	2,110	8,510
Actuarial losses—defined benefit plans	–	(2,400)	–	–	(2,400)	(999)	(3,399)
Changes in the fair value of the hedging instrument, net of tax	–	–	3,000	(2,000)	1,000	–	1,000
Reclassified to profit or loss	–	–	(400)	900	500	–	500
Transactions with owners							
Dividends	–	(8,000)	–	–	(8,000)	(889)	(8,889)
Restated balance at 31 Dec 20X6	500,000	322,500	(1,400)	900	822,000	91,167	913,167
Restated balance at 31 Dec 20X6	500,000	322,500	(1,400)	900	822,000	91,167	913,167
Total comprehensive income	–	101,100	800	(500)	101,400	11,233	112,633
Profit or loss	–	98,300	–	–	98,300	10,000	108,300
Translation of Foreign operations	–	3,200	–	–	3,200	1,333	4,533

Actuarial losses—defined benefit plans	–	(400)	–	–	(400)	(100)	(500)
Changes in the fair value of the hedging instrument, net of tax	–	–	1,000	(800)	200	–	200
Reclassified to profit or loss	–	–	(200)	300	100	–	100
Transactions with owners							
Issues of share capital	100,000	–	–	–	100,000	–	100,000
Dividends	–	(12,000)	–	–	(12,000)	(1,333)	(13,333)
Transactions Between owners							
Acquired shares in a subsidiary from the non-controlling interest	–	(3,000)	–	–	(3,000)	(5,000)	(8,000)
Balance at 31 Dec 20X7	600,000	408,600	(600)	400	1,008,400	96,067	1,104,467

Example - Change in Accounting Policy IAS 8

ABC LTD until now has valued inventory using LIFO method. However, following changes to IAS 2 *Inventories*, the use of LIFO method has been disallowed. Therefore, management of the company intends to use FIFO method for the valuation of the company's stock.

Following are extracts of ABC LTD's most recent financial statements before the application of FIFO method.

Statement of Financial Position as at 31 December 20X2		
	20X2, $M	**20X1, $M**
Current Assets		
Cash and Bank	6	4
Short Term Investments	5	8
Inventory	10	12
	21	24

Income Statement for the year ended 31 December 20X2		
	20X2, $M	**20X1, $M**
Cost of Sales		
Opening Inventory	12	8

Purchases	48	44
Closing Inventory	(10)	(12)
	50	40

Statement of Changes in Equity for the year ended 31 December 20X2		
	20X2, $M	**20X1, $M**
Retained Earnings		
Opening Reserves	40	30
Net Profit	30	20
Divident	(10)	(10)
Closing Reserve	60	40

Accounting Treatment

The switch from LIFO method to FIFO method represents a change in accounting policy which must be accounted for retrospectively in the financial statements. Therefore, the change must be applied as if the new accounting policy was always in place.

Consequently, entity shall adjust all comparative amounts presented in the financial statements affected by the change in accounting policy for each prior period presented.

Management estimates that the value of its inventory using FIFO method would be as follows:

	20X2, $M	**20X1, $M**	**20X0, $M**
Inventory	12	13	10

Management further believes that the valuation of inventory using FIFO method for periods prior to 20X0 would produce materially similar results.

The financial statement extracts of ABC LTD would appear as follows after the retrospective application of the change in accounting policy.

Statement of Financial Position as at 31 December 20X2		
	20X2, $M	**20X1, $M**
Current Assets		
Cash and Bank	6	4
Short Term Investments	5	8
Inventory	12	13
	23	25

The amount of inventory is adjusted for current period as well as the prior period.

Income Statement for the year ended 31 December 20X2		
	20X2, $M	**20X1, $M**

Cost of Sales		
Opening Inventory	13	10
Purchases	48	44
Closing Inventory	(12)	(13)
	49	41

Statement of Changes in Equity for the year ended 31 December 20X2		
	20X2, $M	**20X1, $M**
Retained Earnings		
Opening Reserves	40	31
Net Profit	31	19
Divident	(10)	(10)
Closing Reserve	61	40

Note that the change is applied to both current period and prior period comparative amounts presented (i.e. retrospectively). The estimated effect of the change in accounting policy relating to the prior periods that are not presented (i.e. before 20X1) is adjusted in the opening reserves of 20X1.

The nature of the change in accounting policy must be disclosed in the financial statements of ABC LTD.

The example is for illustration purpose only and is just a simplified view of how a change in accounting policy is accounted for. In practice, the effects of changes in accounting policy may be hard to determine. Transitional provisions for adoption of policies specified by new standards must also be considered when applying a change in accounting policy due to changes in the requirements of the reporting standards.

Example Changes in Accounting Estimates

ABC LTD has depreciated a machine over its expected useful life of 5 years. The cost of machine was $100,000 and annual depreciation charge was therefore $25,000. No residual value is expected at the end of the machine's useful life.

Three years later, the remaining useful life of the machine was estimated to be only 1 years.

ABC LTD should account for the change in estimate prospectively by allocating the net carrying amount of the asset over its remaining useful life. No adjustment is required to restate the depreciation charge in previous accounting periods.

Depreciation expense for the machine would therefore be as follows:

	Depreciation Expense	**Accumulated Depreciation**	**Working**
Year 1	20,000	20,000	(100,000/5)

Year 2	20,000	40,000	(80,000/4)
Year 3	30,000	70,000	(60,000/2)
Year 4	30,000	100,000	(30,000/1)

Although expected useful life of the machine has reduced at the end of third year, depreciation expense recorded in previous years is not affected. Instead, the depreciation expense is increased accordingly in years 3 and 4.

Example - Correction of Prior Period Accounting Errors IAS 8

Management of ABC LTD, while preparing financial statements of the company for the period ended 31st December 20X2, noticed that they had failed to account for depreciation in last year's accounts in respect of an office building acquired in the preceding year.

Following are extracts of ABC LTD's most recent financial statements before the application of FIFO method.

Statement of Financial Position as at 31 December 20X2		
	20X2, $M	**20X1, $M**
Non Current Assets		
Cost	50	50
Accumulated Depreciation	(10)	(8)
	40	42

Income Statement for the year ended 31 December 20X2		
	20X2, $M	**20X1, $M**
Administration Expenses		
Depreciation	2	1

Statement of Changes in Equity for the year ended 31 December 20X2		
	20X2, $M	**20X1, $M**
Retained Earnings		
Opening Reserves	40	30
Net Profit	30	20
Divident	(10)	(10)
Closing Reserve	60	40

Accounting Treatment

The omission of depreciation of office building in the previous year's financial statements represents a **prior period accounting error** which must be accounted for **retrospectively** in the financial statements. Consequently, ABC LTD shall adjust all comparative amounts presented in the current period's financial statements affected by the accounting error.

Management estimates that depreciation charge for the year 20X1 was under booked by $1 million.

Financial statement extracts of ABC LTD would appear as follows after the retrospective correction of the prior period accounting error.

Statement of Financial Position as at 31 December 20X2		
	20X2, $M	**20X1, $M**
Non Current Assets		
Cost	50	50
Accumulated Depreciation	(11)	(9)
	39	41

Income Statement for the year ended 31 December 20X2		
	20X2, $M	**20X1, $M**
Administration Expenses		
Depreciation	2	2

Statement of Changes in Equity for the year ended 31 December 20X2		
	20X2, $M	**20X1, $M**
Retained Earnings		
Opening Reserves	39	30
Net Profit	30	19
Divident	(10)	(10)
Closing Reserve	59	39

Note that the correction of the error is applied to all prior period comparative amounts affected by the omission (i.e. retrospectively). Current year's profit is therefore unaffected by the correction of prior period error.

The nature of the correction of prior period error must be disclosed in the financial statements of ABC LTD.

2. Complete the following sentences

1) Financial Statements

1. The ______________ will report the total amount of a corporation's retained earnings.

2. The financial statement that reports the liabilities is sometimes known as the statement of ___________________________.

3. The balance sheet reports amounts at a _________ in time.

4. The amount of working __________ can be calculated quickly from a classified balance sheet.

5. The income statement reports amounts for a _________ of time.

6. The amounts earned from a company's main activities. __________

7. The costs that are matched with revenues. __________

8. Sales minus the cost of goods sold equals _______ profit.

9. The financial statement that reports the change in cash and cash equivalents is the statement ___________________.

10. The income statement is often referred to as the ________________________________.

11. Bonds payable will be reported as a long-term ____________.

12. Financial statements are best prepared under the __________ basis of accounting.

13. Paid-in capital is one section of ________________' equity

14. The current period's net income is part of the corporation's ___________ earnings reported on the balance sheet.

15. The costs expiring during the current accounting period. __________

16. Prepaid expenses are reported as ________.

17. Customer deposits are reported as _____________.

18. The statement of cash flows explains the changes in cash and cash___________________ during the specified time interval.

19. The first section of the statement of cash flows is the _________________ activities.

20. The financial statement with a structure that is similar to the accounting equation is the _____________ _____________.

21. The financial statement that reports the portion of change in owner's equity resulting from revenues and expenses during a specified time interval is the ____________ ________________.

2) Balance Sheet

1. The amounts reported on the balance sheet are as of a _________ in time.

2. Resources. ________

3. Obligations. ________

4. Sales on account that have not yet been collected are accounts ________________.

5. Merchandise on hand. ________

6. The total depreciation since an asset was acquired is ______________ depreciation.

7. Amounts owed for goods and services received on account are accounts __________.

8. A corporation's owner's equity is referred to as __________________' equity.

9. The cumulative amount of a corporation's earnings less its cumulative dividends is _____________ earnings.

10. ________ stock is a corporation's own stock that it has purchased but has not retired.

11. The company that has paid insurance premiums in advance should report the *unexpired* cost in the account __________ Insurance.

12. A small amount of cash available to make small outlays is known as the

_________ cash fund.

13. Inventory is reported as a __________ asset.

14. One section of stockholders' equity is paid-in or contributed _________.

15. The declaration of dividends will reduce the balance in __________ earnings.

16. Inventories are often reported at the lower of cost or __________.

17. Cash that is restricted for the construction of a plant asset is reported in the balance sheet section labeled as _________________.

18. Sometimes an ______________ will require that a plant asset be written down to an amount smaller than its carrying value.

19. Patents, trademarks, and goodwill are examples of ________________.

20. The accounts Allowance for Doubtful Accounts and Accumulated Depreciation are known as _____________ accounts.

3) Income Statement

1. Amounts earned through a company's main activities. __________

2. A retailer's revenues. __________

3. Costs used up in order to earn revenues. __________

4. The __________ basis of accounting is better than the cash basis for measuring profitability in a limited time period.

5. The expense associated with debt.

6. At the end of the accounting year, income statement accounts are _______________.

7. Sales minus the cost of goods sold is gross _________.

8. Selling, general and administrative expenses are referred to as _____________ expenses.

9. The heading of the income statement discloses the _________ of time covered.

10. An accounting year beginning on July 1 and ending on June 30 is referred to as a _________ year.

11. Earnings per share must be reported on the income statement when a corporation's stock is publicly ___________.

12. An increase in net assets from a peripheral activity. __________

13. On a multiple-step income statement, interest expense is reported as a ________________ or other expense.

14. An extraordinary item is both 1) ______________ in occurrence, and 2) unusual in nature.

15. If a corporation sells a plant asset for less than its ___________ value, the difference will be reported as a loss on the ______________.

16. The largest expense on a retailer's income statement is usually its _____ of goods sold.

17. Accrual accounting requires that expenses be __________ with revenues.

18. Changes in accounting ___________ such as depreciation are not viewed as errors.

19. The few gains or losses that are not included in net income will be reported as part of other ______________________ income.

SUGGESTED READING

International Financial Reporting Standards (IFRS)

№	Name	Issued
IFRS 1	First-time Adoption of International Financial Standards	2008*
IFRS 2	Share-based Payment	2004
IFRS 3	Business Combinations	2008*
IFRS 4	Insurance Contracts	2004
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations	2004
IFRS 6	Exploration for and Evaluation of Mineral Assets	2004
IFRS 7	Financial Instruments: Disclosures	2005
IFRS 8	Operating Segments	2006
IFRS 9	Financial Instruments	2013*
IFRS 10	Consolidated Financial Statements	2011
IFRS 11	Joint Arrangements	2011
IFRS 12	Disclosure of Interests in Other Entities	2011
IFRS 13	Fair Value Measurement	2011
IFRS 14	Regulatory Deferral Accounts	2014
IFRS 15	Revenue from Contracts with Customers	2014
IFRS 16	Leases	2016
IFRS 17	Insurance Contracts	2017

International Accounting Standards (IASs)

№	Name	Issued
IAS 1	Presentation of Financial Statements	2007*
IAS 2	Inventories	2005*
IAS 7	Statement of Cash Flows	1992
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors	2003
IAS 10	Events After the Reporting Period	2003
IAS 11	Construction Contracts	1993
IAS 12	Income Taxes	1996*
IAS 16	Property, Plant and Equipment	2003*
IAS 17	Leases	2003*
IAS 18	Revenue	1993*
IAS 19	Employee Benefits (2011)	2011*
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance	1983
IAS 21	The Effects of Changes in Foreign Exchange Rates	2003*
IAS 23	Borrowing Costs	2007*
IAS 24	Related Party Disclosures	2009*
IAS 26	Accounting and Reporting by Retirement Benefit Plans	1987
IAS 27	Separate Financial Statements (2011)	2011
IAS 28	Investments in Associates and Joint Ventures (2011)	2011
IAS 29	Financial Reporting in Hyperinflationary Economies	1989
IAS 32	Financial Instruments: Presentation	2003*
IAS 33	Earnings Per Share	2003*

IAS 34	Interim Financial Reporting	1998
IAS 36	Impairment of Assets	2004*
IAS 37	Provisions, Contingent Liabilities and Contingent Assets	1998
IAS 38	Intangible Assets	2004*
IAS 40	Investment Property	2003*
IAS 41	Agriculture	2001

IFRIC Interpretations

№	Name	Issued
IFRIC 1	Changes in Existing Decommissioning, Restoration and Similar Liabilities	2004
IFRIC 2	Members' Shares in Co-operative Entities and Similar Instruments	2004
IFRIC 4	Determining Whether an Arrangement Contains a Lease	2004
IFRIC 5	Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds	2004
IFRIC 6	Liabilities Arising from Participating in a Specific Market - Waste Electrical and Electronic Equipment	2005
IFRIC 7	Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies	2005
IFRIC 9	Reassessment of Embedded Derivatives	2006
IFRIC 10	Interim Financial Reporting and Impairment	2006
IFRIC 12	Service Concession Arrangements	2006
IFRIC 13	Customer Loyalty Programmes	2007
IFRIC 14	IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction	2007
IFRIC 15	Agreements for the Construction of Real Estate	2008
IFRIC 16	Hedges of a Net Investment in a Foreign Operation	2008
IFRIC 17	Distributions of Non-cash Assets to Owners	2008
IFRIC 18	Transfers of Assets from Customers	2009
IFRIC 19	Extinguishing Financial Liabilities with Equity Instruments	2009
IFRIC 20	Stripping Costs in the Production Phase of a Surface Mine	2011
IFRIC 21	Levies	2013

IFRIC 22	Foreign Currency Transactions and Advance Consideration	2016
IFRIC 23	Uncertainty over Income Tax Treatments	2017

SIC Interpretations

№	Name	Issued
SIC-7	Introduction of the Euro	1998
SIC-10	Government Assistance – No Specific Relation to Operating Activities	1998
SIC-15	Operating Leases – Incentives	1999
SIC-25	Income Taxes – Changes in the Tax Status of an Enterprise or its Shareholders	2000
SIC-27	Evaluating the Substance of Transactions in the Legal Form of a Lease	2000
SIC-29	Disclosure – Service Concession Arrangements	2001
SIC-31	Revenue – Barter Transactions Involving Advertising Services	2001
SIC-32	Intangible Assets – Web Site Costs	2001

Other pronouncements

Name	Issued
Conceptual Framework for Financial Statements 2010	2010
Preface to International Financial Reporting Standards	2002*
IFRS for Small and Medium Sized Entities	2009
IFRS Practice Statement Management Commentary	2010

The IFRS® Foundation [Electronic resource]. – Mode of access: http://www.ifrs.org

The #1 website for global accounting news [Electronic resource]. – Mode of access: https://www.iasplus.com/en

Навчальне видання

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Методичні рекомендації

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