

ARBA MINCH UNIVERSITY
COLLEGE OF BUSINESS AND ECONOMICS
DEPARTMENT OF ACCOUNTING AND FINANCE



ADVANCED FINANCIAL ACCOUNTING (ACFN 3151)

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PREFACE

The principal objectives of this module on Advanced Financial Accounting is to help students acquainted with the advanced concepts of Financial Accounting in a good manner. Firms of different nature use basic concepts and theories of financial accounting for financial report purpose.

This course comprises the broad and advanced level of understandings. This is clearly depicted in the curriculum of department of Accounting and Finance, Arba Minch University. Accordingly, this module is concentrated on relevant concepts and theories related to the discipline and it discusses as well as illustrates each component in most comprehensive and explanatory manner.

Under the module, there are seven chapters which are presumed important to achieve the intended learning objectives. The Over view of accounting for joint ventures and Public enterprises, Accounting for Sales Agencies and principal; Branches and Head office, Installment and Consignment contracts, Business Combinations (Mergers and Acquisitions), Consolidations, Foreign Currency Accounting and Segment Reporting and Interim Reporting are the chapters encompassed in the module.

After completion of the course Advanced Financial Accounting, learners will be able to:

- Understand the concept and basics of Joint Venture Businesses, Public Enterprise and Privatization.
- Know the system of Accounting for Sales agents and Principals.
- Have general overview of Branches and Head Office Accounting system.
- Identify the Installment and Consignment Contracts.
- Identify the method for business Combination and Consolidation.
- Equipped with overview of Foreign Currency Accounting.
- Identify the mechanism of Segment and Interim Reporting of Companies.

AKNOWLEDGEMENT

We would like to extend a special appreciation and gratitude to those Accounting & Finance professionals who wrote various revised and updated books and reference materials on Advanced Financial Accounting that all brings this module in to existence. We also thank Arba Minch University, College of Continuing and Distance Education for expanding education opportunity for the community at large and creating the chance to pile up distance education materials that makes the writers to have broader understanding and experience.

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CHAPTER ONE

OVERVIEW OF ACCOUNTING FOR JOINT VENTURES AND PUBLIC ENTERPRISES

Learning Objectives:

After the completion of this chapter, you will be able to

- Define joint venture;
- Identify features of joint ventures;
- Sort the types of joint ventures and their accounting treatments;
- Account different types of joint ventures;
- Define what public enterprises are and differentiate them from private businesses,
- List and explain briefly the basic characteristics of public enterprises,
- Identify the factors behind the creation of public enterprises,
- Define the term privatization and describe the most common privatization modalities,
- List and explain the benefits and risks of privatization

1.1 ACCOUNTING FOR JOINT VENTURES

1.1.1 Nature of Joint Venture Businesses

A **joint venture** is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control. Joint ventures can take the form of jointly controlled operations, jointly controlled assets, or **jointly controlled entities**.

Joint control is the contractually agreed sharing of **control** over an economic activity, and exists only when the strategic, financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control (the venturers).

Joint ventures may take different forms and structures; however, they all share the following characteristics:

- a. a contractual arrangement exists between the parties involved in the venture; and
- b. the contractual arrangement establishes joint control

In the absence of guidance in the *IFRS for SMEs* an entity is permitted (but is not required) to consider the guidance in full IFRSs. Following is a summary of the guidance in IAS 31 *Interests in Joint Ventures* (as issued at 9 July 2009) on the characteristics of joint ventures. The contractual arrangement may be evidenced in a number of ways, for example by a contract between the

venturers or minutes of discussions between the venturers. In some cases, the arrangement is incorporated in the articles or other by-laws of the joint venture. Whatever its form, the contractual arrangement is usually in writing and deals with such matters as:

- a. the activity, duration and reporting obligations of the joint venture;
- b. the appointment of the board of directors or equivalent governing body of the joint venture and the voting rights of the venturers;
- c. capital contributions by the venturers; and
- d. the sharing by the venturers of the output, income, expenses or results of the joint venture.

The contractual arrangement establishes joint control over the joint venture. Such a requirement ensures that no single venturer is in a position to control the activity unilaterally. Therefore, in evaluating whether an entity has joint control over a venture it must be ascertained:

- ✓ whether the entity and another party together have control (1) over the economic activity that is the subject of the venture; and
- ✓ Whether the entity and that other party have contractually agreed to exercise joint control of the economic activity that is the subject of the venture.

Only if both characteristics are satisfied (ie existence of a contractual arrangement and joint control) is the venture a joint venture.

The contractual arrangement may identify one venturer as the operator or manager of the joint venture. The operator does not control the joint venture but acts within the financial and operating policies that have been agreed by the venturers in accordance with the contractual arrangement and delegated to the operator. If the operator has the power to govern the financial and operating policies of the economic activity, it controls the venture and the venture is a subsidiary of the operator and not a joint venture.

1.1.2 Back Ground Of Joint Venturers

Joint Ventures can be with a company of same industry or can be of some other industry, but with a combination of both, they will generate a competitive advantage over other players in the market.

In short, when two or more organizations join hands together for creating synergy and gain a mutual competitive advantage, the new entity is called a Joint Venture. It can be a private company, public company or even a foreign company.

Mokveld Marketing Joint Ventures was registered in 1993 after the reorganization of Mokveld Compressor gaz Engineering Joint Ventures, which was set up in 1991. The main initiators of the creation of the joint venture were Ministry of gas industry of the USSR (later RAO Gazprom) and Mokveld Valves bv, Gouda, the Netherlands. The basic idea of the creation of the joint venture was the necessity of organizing systemic supply of high-efficiency valves manufactured by Mokveld Valves bv for to be constructed and reconstructed facilities of Soviet Union gas transportation system, which, at that time, was being developed at a high rate involving the most advanced achievements of domestic and world science and engineering.

The city of Sumy was selected as location for the joint venture not coincidentally. From 1983 until 1990 extensive work on technical upgrade of domestic valve industry was being carried out on the base of Sumy Frunze Machine-Building Science and Production Association Joint Stock Company and VNIikompresormash All-USSR Scientific Research Institute. Therefore, Mokveld Marketing JV was staffed by leading specialists from these companies, and Mr. Yu.L. Rukhlov, Chief Designer of VNIikompresormash institute, who had managed the works on the creation of up-to-date ball and check valves for gas and oil facilities of the USSR, was offered a position of General Manager.

1.1.3 Accounting for Investment in Joint Venture Businesses

The objective of general purpose financial statements of a small or medium-sized entity is to provide information about the entity's financial position, performance and cash flows that is useful for economic decision-making by a broad range of users (eg owners who are not involved in managing the business, potential owners, existing and potential lenders and other creditors) who are not in a position to demand reports tailored to meet their particular information needs. The objective of IFRS Section 15 *Investments in Joint Ventures* is to prescribe the financial reporting requirements for investments in joint ventures. A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control.

1.1.3.1 Types of Joint Venture

- a.** Jointly controlled operations;
- b.** Jointly controlled assets; or
- c.** Jointly controlled entities.

The main issues that arise in relation to Section 15 are identification of jointly controlled operations, jointly controlled assets and jointly controlled entities and the measurement of investments in joint ventures.

a) Jointly Controlled Operations

The operation of some joint ventures involves the use of the assets and other resources of the venturers rather than the establishment of a corporation, partnership or other entity, or a financial structure that is separate from the venturers themselves. Each venture uses its own property, plant and equipment and carries its own inventories. It also incurs its own expenses and liabilities and raises its own finance, which represent its own obligations. The joint venture activities may be carried out by the venturer's employees alongside the venturer's similar activities. The joint venture agreement usually provides a means by which the revenue from the sale of the joint product and any expenses incurred in common are shared among the venturers.

Examples – jointly controlled operation

- ✓ Entity A researches and develops drugs. Entity B manufactures drugs and promotes them commercially. Entities A and B enter into a contractual arrangement whereby they equally participate in the results of research and development and the commercial promotion of a particular drug that is yet to be invented.

In accordance with the contractual arrangement entity A undertakes the research and development activities and entity B undertakes the manufacturing and commercial activities. The entities share all costs and revenues arising from the jointly controlled operation.

- ✓ Entities A and B have joint control over the specified research, development, manufacturing and commercial activities—it is a joint venture (jointly controlled operation). Each venturer (i.e. entities A and B) is required to account for its interest in the jointly controlled
- ✓ Entities A and B enter into a contractual arrangement whereby they combine their operations, resources and expertise to manufacture, market and distribute aircraft. Different parts of the manufacturing process are carried out by each of the venturers. Each venturer bears its own costs and takes a share of the revenue from the sale of the aircraft, such share being determined in accordance with the contractual arrangement.

- ❖ In respect of its interests in jointly controlled operations, a venturer shall recognize in its financial statements:
 - a. The assets that it controls and the liabilities that it incurs, and
 - b. The expenses that it incurs and its share of the income that it earns from the Sale of goods or services by the joint venture.

Example – accounting for a jointly controlled operation

Because the scale of the project exceeded the capacity of entities A and B individually, they tendered jointly for a public contract with a government to construct a motorway between two cities. Following the tender process the government awarded the contract jointly to entities A and B. In accordance with the contractual arrangements entities A and B are jointly contracted with the government for delivery of the motorway in return for \$14 million (2) (a fixed price contract). In 2010, in accordance with the agreement between entities A and B:

- ❖ entities A and B each used their own equipment and employees in the construction activity
- ❖ entity A constructed three bridges needed to cross rivers on the route at a cost of \$4 million
- ❖ entity B constructed all of the other elements of the motorway at a cost of \$6 million.
- ❖ entities A and B shared equally in the \$14 million jointly invoiced to (and received from) the government

The arrangement is a jointly controlled operation. Entities A and B have retained control of the assets they use to perform the contract requirements and are responsible for their respective liabilities. They meet their respective contractual obligations by providing construction services to the government.

Entities A and B recognize in their financial statements their own property, plant and equipment and operating assets and their share of any liabilities resulting from the joint arrangement (such as performance guarantees). They also recognize the income and expenses associated with providing construction services to the government.

The venturers account for their interests in the joint venture (jointly controlled operation) as follows

Entity A—in 2010

Construction costs	\$4, 000,000	
Cash		\$4, 000,000

(To recognize the construction costs incurred in 2010)

Dr Cash \$7, 000,000
Cr revenue \$7, 000,000

(To recognize the construction revenue earned in 2010).

Entity B—in 2010

Dr Construction costs \$6, 000,000
Cr Cash \$6, 000,000

(To recognize the construction costs incurred in 2010).

Cash \$7, 000,000
Revenue \$7, 000,000

(To recognize the construction revenue earned in 2010).

b) Jointly Controlled Assets

Some joint ventures involve the joint control, and often the joint ownership, by the venturers of one or more assets contributed to, or acquired for the purpose of, the joint venture and dedicated to the purposes of the joint venture.

Example—jointly controlled asset

Entities A and B are independent oil production companies. They enter into a contractual arrangement to control and operate an oil pipeline jointly.

Each venturer uses the pipeline to transport its own product in return for which it bears an agreed proportion of the expense of operating the pipeline.

The two entities A and B have joint control over the oil pipeline—it is a joint venture (jointly controlled asset). Each venturer (ie entities A and B) is required to account for its interest in the jointly controlled pipeline. In respect of its interest in a jointly controlled asset, a venturer shall recognize in its financial statements:

- a. its share of the jointly controlled assets, classified according to the nature of the assets;
- b. any liabilities that it has incurred;
- c. its share of any liabilities incurred jointly with the other venturers in relation to the joint venture;
- d. any income from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and
- e. Any expenses that it has incurred in respect of its interest in the joint venture.

Example – accounting for a jointly controlled asset

On 1 January 2010 entities A, B, C, D and E (the venturers) jointly buy a jet aircraft for \$10 million cash. The venturers are registered as equal joint owners of the aircraft. They enter into an agreement whereby the aircraft is at the disposal of each venturer for 70 days each year. The aircraft is in maintenance for the remaining days each year. The venturers may decide to use the aircraft, or, for example, lease it to a third party. Decisions regarding maintenance and disposal of the aircraft require the unanimous consent of the venturers.

The contractual arrangement is for the expected life (20 years) of the aircraft and can be changed only if all of the venturers agree. The residual value of the aircraft is nil. In 2010 the venturers each paid \$100,000 to meet the joint costs of maintaining the aircraft (eg hangar rental and aviation license fees). In 2010 each venturer also incurred costs of running the aircraft when they made use of the aircraft (eg entity A incurred costs of \$50,000 on pilot fees, aviation fuel and landing costs). In 2010 entity A also earned rental income of \$10,000 by renting the aircraft to others. The jet aircraft is a jointly controlled asset. The joint venture is a way to share the costs of having access to an aircraft. Each venturer owns a share of the aircraft and benefits from having the aircraft at its disposal for some days each year. Each venturer would recognize its interest in the jointly controlled asset in accordance with paragraph 15.7. For example, in 2016 entity A would record its interest as follows:

1 January 2016

Property, plant and equipment (interest in an aircraft)	\$2,000,000
Cash	\$2,000,000

(To recognize the purchase of an ownership-interest in a jointly controlled aircraft).

In 2016

Cash	\$10,000
Profit or loss (rental income)	\$10,000

(To recognize income earned in renting to others the use of the aircraft in 2016).

Aircraft operating expenses	\$150,000
Cash	\$150,000

(To recognize the costs of running an aircraft in 2016).

Depreciation expense	\$100,000	
Accumulated depreciation (interest in an aircraft)		\$100,000
<i>(To recognize depreciation of an ownership-interest in a jointly controlled aircraft)</i>		

c) Jointly Controlled Entities

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

Section 15 requires an entity to choose one of the following three models to account for its investments in jointly controlled entities:

- a. The cost model, in accordance with which the investment in a joint venture is measured at cost (including transaction costs) less any accumulated impairment losses. However, an investor using the cost model is required to use the fair value model for any investment in a jointly controlled entity for which a published price quotation exists.
- b. the equity method, in accordance with which the investments in a jointly controlled entity is initially recognized at the transaction price (including transaction costs) and adjusted thereafter for the post-acquisition change in the investor's share of profit or loss and other comprehensive income of the jointly controlled entity.
- c. The fair value model, in accordance with which the investment in a jointly controlled entity is initially recognized at the transaction price (excluding transaction costs).

After initial recognition, at each reporting date, the investment in the jointly controlled entity is measured at fair value. Changes in fair value are recognized in profit or loss.

However, an investor using the fair value model is required to use the cost model for any investment in a jointly controlled entity for which it is impracticable to measure fair value reliably without undue cost or effort.

Examples – cost model

On 1 January 2010 entities A and B each acquired 30 per cent of the ordinary shares that carry voting rights at a general meeting of shareholders of entity Z for \$300,000. Entities A and B immediately agreed to share control over entity Z.

For the year ended 31 December 2010 entity Z recognized a profit of \$400,000.

On 30 December 2010 entity Z declared and paid a dividend of \$150,000 for the year 2010. At 31 December 2010 the fair value of each venturers' investment in entity Z is \$425,000. However, there is no published price quotation for entity Z.

Entities A and B (the venturers) must each recognize dividend income of \$45,000 (ie 30% × \$150,000 dividend declared by entity Z) in profit or loss for the year ended 31 December 2010.

At 31 December 2010 the venturers must report their investments in entity Z (a jointly controlled entity) at \$300,000 (ie cost). Each venturer must also consider whether there are any indicators that its investment is impaired and, if so, conduct an impairment test in accordance with Section 27 *Impairment of Assets*. In this case there would not be any impairment loss because the fair value (\$425,000) less costs to sell of the investment exceeds its carrying amount (\$300,000).

➤ **Fair value model**

When an investment in a jointly controlled entity is recognized initially, a venturer shall measure it at transaction price. Transaction price excludes transaction costs.

At each **reporting date**, a venturer shall measure its investments in jointly controlled entities at fair value, with changes in fair value recognized in profit or loss, using the fair valuation guidance in paragraphs 11.27–11.32. A venturer using the fair value model shall use the cost model for any investment in a jointly controlled entity for which it is impracticable to measure fair value reliably without undue cost or effort.

Examples – fair value model

On 1 January 2010 entities A and B each acquired 30 per cent of the ordinary shares that carry voting rights at a general meeting of shareholders of entity Z for \$300,000. Entities A and B immediately agreed to share control over entity Z.

For the year ended 31 December 2010 entity Z recognized a profit of \$400,000.

On 30 December 2010 entity Z declared and paid a dividend of \$150, 000 for the year 2010. At 31 December 2010 the fair value of each venturer’s investment in entity Z is \$425, 000. However, there is no published price quotation for entity Z.

In determining profit or loss for the year ended 31 December 2010 entities A and B must each:

- Recognize dividend income of \$45,000 (ie $30\% \times \$150,000$ dividend declared by entity Z);(7) and
- Recognize the increase in the fair value of its investment in entity Z of \$125,000 (ie \$425,000 fair value at 31 December 2010 less \$300,000 carrying amount on 1 January 2010).

At 31 December 2010 entities A and B must each report their investment in entity Z (a jointly controlled entity) at its fair value of \$425, 000.

Quick Check

- Define the term joint venture
- Identify the types of joint ventures
- What differs one joint venture from the other one?
- What is the difference between joint venture and partnership business?

1.2 ACCOUNTING FOR PUBLIC ENTERPRISE IN ETHIOPIA

Meaning of Public Enterprises

The term public enterprise is used widely, but there is no single, generally accepted definition that attaches to the term. Yet if we are to make any headway in discussing the accountability environment of Public Enterprises it is important to understand what is being referred to. This is because Public Enterprises are hybrids. They have features of both private and public sector organizations. Like private companies, they engage in commercial activity with the goal of profit-making, often in competition with other private sector compares Like public sector agencies, they are required to execute government policies, often in the form of delivering noncommercial services (or ‘community service obligations’). In theory, then, there are choices to be made about adopting primarily public or private styles of accountability regulation for these entities.

1.2.1 Rationales for Creation of Public Enterprise

There is no single rationale that explains the creation of all Public Enterprises. As a general proposition, however, it is safe to say that a public enterprise will be created when Government wishes to conduct some form of commercial enterprise at arm's length from the usual departmental structures and processes.

What this means is that the question why are Public Enterprises created breaks down into two more particular questions: 'why does Government want to engage in that particular commercial activity?' and 'why must it be conducted in the form of a public enterprise?'

Governments became involved in Commercial areas for several reasons:

- The private sector was seen as incapable of delivering the required products or services,
- The community considered it appropriate that government should own a firm that operated as a natural monopoly; or
- The government wanted to fulfill a community service obligation (CSO).

1.2.2 Characteristics of Public Enterprises

The international center for public enterprise (ICPE) identified six essential elements characterizing the public dimension and the enterprise dimension of public enterprises.

1. **Public purposes:** A public enterprise is created for attaining broad Socio- economic development objectives and thus has a public mission
2. **Public Ownership:** Ownership of the enterprise is by the government or public authority.(could be marked 51% or more ownership position)
3. **Public control:** As the enterprise is owned by the government it is subjected to public control.
4. **Field of activity of Business character:** The enterprise operates in a sphere of activity which has business character.
5. **Marketing of output:** It is assumed that the enterprise will have to sell or market its output, not provide output freely.
6. **Investment and Return:** It involves a capital investment and expected return to investor. Accordingly, there is the concept of profitability or surplus

To a considerable extent, the accountability problem for Public Enterprises stems from the fact that they are hybrid organizations; they have features of both private and public sector organizations like private companies, they engage in profit-seeking commercial activity, often in

competition with private sector businesses. Like public sector agencies, they are required to execute government policies, often in the form of delivering non-commercial services (or ‘community service obligations’). We need, however, to go further than listing examples. We need to understand why a particular organization might be included in, or omitted from, such a list. A review of the recent literature suggests that the following three characteristics are considered to be essential in classifying an organization as a public enterprise:

- i. its principal function is to engage in commercial activities in the private sector
- ii. it is controlled by government, and
- iii. it has an independent legal existence from government and the executive

I. Commercial Activities

The term ‘commercial activities’ refers to ‘the sale of goods or services for financial return in an open market, that is, in a market where the consumers of the goods or services are not limited to government-funded bodies.

It should be noted that not all Public Enterprises engage in commercial activities in the same way. Some are monopoly suppliers of goods or services (such as Ethiopian Telecommunications Corporation (ETC), Ethiopian Electric Power Corporation (EEPCO), Ethiopian Air Lines (EAL) etc), while others (such as Meta Abo Brewery) operate in competitive markets with private sector companies. Commercial activity need not be the only activity of a public enterprise but it will be its principal activity. It allows that Public Enterprises will often be required to discharge community service obligations (that is, provide goods or services at subsidized or less than market prices and which might, therefore, not be provided if the public enterprise operated on a purely commercial basis).

II. Government Control

There are also variations on the second factor-Government control. The question of control ties at the heart of accountability.

Control is a nebulous term-it can be exercised generally or in relation to specific issues;

- it can be exercised permanently or intermittently;
- it can come from inside the public enterprise or be imposed from outside,
- it can be actual or potential (sometimes control is exercised by the threat or potential of actual control), and
- it can be a combination of these factors

Two methods of control that have been used in relation to Public Enterprises are:

- the appointment of government officers to the board of management, or
- direct ownership

Some Public Enterprises are controlled by virtue of being wholly owned by the government. Other Public Enterprises are partly owned by private sector interests, often as a step towards the full privatization of the entity.

In partly-owned Public Enterprises there is a question about the level of ownership which is necessary to give the government control over the entity.

There are no precise answers to this question. As we move along the scale from 100 per cent ownership through 50 per cent to minority government ownership we encounter entities which are more properly regarded as private, although the point at which this happens will vary depending on the company.

One attempt at a categorical answer is relying on a test which is similar to that found in the FASB statements for defining the relationship of holding company to subsidiary company.

That is, the Government is said to control a public enterprise if the Government:

- controls the composition of the Public Enterprises board of directors
- can cast, or control the casting of, more than one half of the maximum number of votes that might be cast at a general meeting of the company, or
- holds more than one-half of the issued shares in the public enterprise

However, there are other standards of control that might be used. For example, we could borrow the control threshold which is used in regulating company takeovers, and say that anything over a 20 per cent ownership of voting shares constitutes effective control.

III. Independent Legal Existence

Ethiopian Public Enterprises Proclamation No. 25/1992 in article 7 has put legal personality and Liability of public enterprises. According to this article, sub (1), a public enterprise shall have legal personality stating in sub (2) that it may not be held liable beyond its total assets. It is important to stress that the formal independence of a public enterprise will not be negated by the level of control which government exercises over the public enterprise.

This legal independence has a double edge:

- On the one hand it offers the advantage that the public enterprise can operate with some degree of organizational, operational and budgetary independence from Government

- On the other hand, it creates a barrier to the usual mechanisms of parliamentary accountability and control, necessitating the creation of special accountability mechanisms which will be examined later

Public Enterprises and Accountability

The accountability problems which are posed by Public Enterprises arise from the tension between the first two characteristics: Public Enterprises are public bodies which engage in private sector activity. The difficulties in devising and applying appropriate accountability mechanisms arise from the tension between the last two characteristics.

The legal independence of Public Enterprises has two consequences. On the one hand, it offers the advantage that a public enterprise can operate with some degree of organizational, operational and budgetary independence from government; On the other hand, it creates a barrier to the usual mechanisms of parliamentary accountability and control, necessitating the creation of special accountability mechanisms.

The concept of accountability itself gives rise to a number of questions which must be answered in the particular context of Public Enterprises. For example, what conduct satisfies the criterion of accountability. To whom should accountability be provided? When should accountability be provided? Paragraphs that follow will find answers to these questions.

Regarding the first question, different criteria which can be used in assessing whether a public enterprise is being 'accountable' A public enterprise might be said to be accountable if it provides accurate information about its financial (and possibly its performance) Activities when it is required to do so. Here the demands of accountability and commercialization are likely to conflict because a public enterprise may want to keep commercially sensitive information confidential rather than disclosing it in a public Parliamentary forum. This problem is exacerbated if, on a stronger view of accountability, a public enterprise is required to explain or just' its actions to Parliament.

Secondly, there is an issue as to when the accountability requirements should apply. Should they apply before significant policy or resource decisions are made, during the time policies are being implemented and resources are being used, or after these events? Different accountability timeframes will apply depending upon who the accountability audience is, and on the method by

which that accountability is conveyed. For example, accountability of Public Enterprises to the public will be after the event, while accountability to the portfolio Minister will require disclosures of policies before they are implemented by the public enterprise. Making these accountability choices with regard to Public Enterprises creates a dilemma. The dictates of commercialization, particularly where the entity is required to compete in a private sector & market, will demand that certain issues be kept confidential, and that the entity should be allowed greater freedom than other governmental entities from parliamentary accountability mechanism.

The existing accountability framework for Public Enterprises is constructed from a number of different but interlocking mechanisms. This multiple approach has the advantage of covering different aspects of public enterprise operations but it also has the disadvantage of possible inconsistency and lack of cohesion. Not all of these accountability mechanisms involve the Parliament directly. Indeed, it is more accurate to say that Parliamentary control over Public Enterprises is most often indirect and after the event.

One of the principal methods for ensuring the accountability of Public Enterprises has been to locate them within the general structure of ministerial responsibility to Parliament. In simple terms, this means that staff in a public enterprise is accountable to management who are in turn accountable to the board of directors. The directors are accountable to Parliament for the performance of Public Enterprises in that portfolio. The Auditor-General also has a role in public enterprise accountability, serving as an important public symbol for the public nature of public enterprise activity. There are, however, limitations on this role.

In general, the key public enterprise accountability mechanisms tend to rely on executive monitoring and to under-emphasize the role of Parliamentary control and accountability. This is consistent with the three-pronged requirements of commercialization, corporatization and privatization whether it is consistent with the requirements of public and parliamentary accountability debatable.

Accounting for Public Enterprises

The accounting equations; **Assets = Liabilities + Capital**, could be applicable to the public enterprise. The enterprise is a legal economic entity. Most of assets and liabilities are the same as the private corporate entity. The capital section has a difference.

In a public enterprise;

1. There is no capital stock account: there is only one capital account i.e. paid up capital
2. No paid in capital in excess of par account: there are no shareholders. The money is coming from government
3. Retained earnings in the context of accumulated profits or residual income or other receivables may exist.
4. No dividend to shareholders because no shareholders, however, in the sense of return on investment some amount may be transferred to legal reserves.

Quick Check

- What is public enterprise?
- What is the similarity and differences between public enterprise and private business organizations?
- Why public enterprise?
- What differs accounting for public enterprise from other business organizations?

1.3 PRIVATIZATION

Privatization can be defined as the act of reducing the role of government, or increasing the role of the private sector, in an activity or in the ownership of assets.

The privatization process covers not only the ownership and management transfer of a Public Enterprise to the private sector through sales, but also other forms of privatization such as lease arrangements, management contracts, cutbacks in government activities, denationalization, deregulation etc. Thus, privatization is basically the transfer of government owned assets to the private sector

1.3.1 Public Enterprises and Need for Privatization

In principle, public enterprises (PEs) could operate in much the same way as private enterprises, maximizing or at least concentrating on profits. In practice, however, PEs are rarely pure profit maximizers. This is partly due to the greater weight attached to social objectives rather than financial objectives.

The assertion that the state is relatively inefficient in production, distribution and financial sector is rather without proof; the issue that the private sector is relatively more efficient in this area of activities is inconclusive. Theoretically, with the prevalence of competitive market, a public enterprise, allowed fully to operate competitively in the market is likely to perform as efficient as the corresponding private sector enterprise in that same market.

Generally, the change of ownership from state to private may not necessarily improve the efficiency and profitability of enterprises. But in practice, the new private owners, pushed by the need for more profit and survival in the competitive environment, could invest more on new technologies, make managers accountable for bad performance, as a result inefficiencies could be minimized and profitability improved.

1.3.2 Objectives of Privatization

Different stakeholders are to view the objectives of privatization differently. Economists, civil servants and others tend to view privatization from different point of view. Here we will focus on the economic objectives of privatization as seen by economists.

The economists' case for privatization rests on the expectation that it will enhance efficiency in the supply of a product or service and expect privatized firms to be more efficient than state owned ones. Privatization is designed to substitute the single objective of maximizing profits for the typically mixed objectives of public enterprises, and focuses on the task of raising revenue and lowering costs. In general, the main objectives of privatization often include the following:

- Achieving wider share ownership,
- Introducing more competition,
- Changing the public-private sector mix,
- Improving the performance of public enterprises, and
- Reducing the frequent political interference in the day-to-day activities of public enterprises.

Thus, privatization is widely expected to improve the financial and operating performance. There are several reasons to expect improved performance in a privatized firm. The first is the issue of objectives. A privately owned company knows that it will not survive if it is consistently

unprofitable; lenders will not lend and new equity will not be raised. Pursuing of commercial success is a prerequisite for survival. Profitability is usually a good measure of success.

Related to objective is the issue of accountability. The obligation of the company to account its Board for commercial performance, and the obligation of the Board to account to equity owners for returns on, and enhancement of the value of, that equity, is powerful force.

1.3.3 **Benefits and Risks of Privatization**

1.3.3.1 **Benefits of Privatization**

The major benefits of privatization can be summarized as follows:

Greater Efficiency and Productivity of Enterprises - It has been argued that the main benefits of privatization would come from the greater efficiency and productivity of enterprises after privatization. Freed from government control with its set of incompatible objectives, privatized firms can focus on being competitive to produce, at low cost and acceptable quality. This would lead to more efficient use of resources and improve economic output.

Increased Competition in the Economy - Governments sees privatization as a way to increase competition in the economy, and thereby a private sector that is more flexible, more responsive to customers, and more efficient than the public alternatives.

Revenue to the Government - The government would generate revenue from both the sale of assets in public enterprises as well as from increased tax revenues from restructured and more productive enterprises.

Capital Market Development - Privatization is also believed to have an impact on capital market development, which is a key to economic growth.

Means of Foreign Direct investment (FDI) - Privatization has also a positive impact on attracting foreign direct investment. Many countries that are privatizing would like to attract strategic foreign investor into a public enterprise because such investor can bring capital, new technology, new export market access, and professional management to the enterprise.

1.3.3.2 **Risks of Privatization**

Some of the risks associated with privatization can be summarized as follows:

Monopolistic tendency - Privatization alone without the introduction of competition may simply transform a state monopoly into a private monopoly. The privatized firm may pursuit profits more vigorously, but that pursuit if it took the form of increased prices could worsen allocate efficiency.

Possibility of Failure — If undertaken without careful preparation, and change in major policy elements such as the labor, the trade, the finance and the pricing policy, privatization can cause some firms to fail needlessly. If the transfer of enterprises is made to a private owner with no Vision, Plan and entrepreneurial skill, it will result in unnecessary closure of the privatized firms. The vision, the capacity and potential of the private sector to run the firms to be privatized are necessary preconditions to realize the promises of privatization.

1.3.4 Privatization Modalities

Privatization can be achieved through a number of transactions involving money or not (vouchers). These transactions are called Modalities, which in simple word mean methods of privatization. Selection of modality depends on the characteristics of the enterprise as well as the objectives of the government. Some enterprises may have identifiable needs (investment, management, market, etc.) while others could be managed by any body. The government may want to spread ownership, empower local investor, go out of operation while retaining ownership, etc. The major types of modalities used throughout the world include the following.

Voucher Method - This method also called mass privatization or non-sale distribution method may not raise revenue but it can reduce the level of required subsidies.

Sale of PE shares to the Public - The ownership of the PE is transferred from the public sector to the private sector through partial or total sales of shares. Partial sale of shares refers to cases where the government decides to sell part of its shareholdings to the public at large. The remaining shares may be retained in view of controlling or influencing decisions. Total sales (complete divestiture) involve the outright sale of all shares to a single buyer, to the public or to the workers and management of the PE to be privatized.

Sale of PE Shares to Workers and Management - The selling of shares of the company to its workers and management through direct give way, leveraged buyout or some combination of the two.

Cut Backs in PE's Activities - Cut backs in PE activities are another approach to privatization. The encouragement of private capital to participate in the economy as well as the restriction of PE's activities will enhance competition and the efficient use of resources.

Deregulation - Deregulation refers to the removal of specific monopoly rights and other protective privileges given to PEs. In order to influence the stability of prices or other regulatory purposes the government usually gives special powers and privileges to certain government units.

The restriction as well the removal of their special privileges will enhance the free entry and exit of enterprises in the market and ultimately ensure competition.

Liquidation and Withdrawal - This method is used in cases where no combination of new investment, ownership, and operational changes exist which would give the enterprise a positive net present value in terms of future cash flows. Therefore, in cases where PEs are chronic money losers and their financial investigation reveal that their long-term viability are at stake, liquidation is taken as an option. Other forms of privatization include: joint ventures, management contract for fee, lease arrangements, restitution of property to former owners, debt-equity swaps, and franchising, etc.

Quick Check

- Explain Privatization
- What are the objectives of privatization?
- How do you associate privatization to public enterprises?
- What are the modalities of privatization?
- Do you think privatization is important?

CHAPTER SUMMARY

- ❖ A joint venture is often defined as a contractual arrangement involving the co-operative efforts and the utilization of the resources of two or more ventures to accomplish an agreed –upon goals
- ❖ A joint venture differs from a partnership in that it is limited to carrying out a single project, such as production of a motion picture or construction of a building
- ❖ Considering the nature of joint venture arrangements, joint ventures can be classified as jointly controlled operations jointly controlled assets and jointly controlled entities. On the other hand, we can classify joint ventures also as small and large joint ventures
- ❖ A joint venture does not file income tax. The venturers report the income from the joint venture on their personal tax filings.
- ❖ The complexity of modern business, the emphasis on good organization and strong internal control, the importance of income taxes, the extent of government regulation and the need for preparation and retention of adequate accounting records are strong arguments for establishing a separate set of accounting records for every corporate joint venture of large size and long duration
- ❖ Joint control is a situation in which no one party alone has the power to control its strategic operation, investing, and financing decisions, but two or more parties together can do so, and each of the parties sharing control (joint ventures) must consent.
- ❖ A joint venture is just one of a number of business arrangements which investors can use. It is suitable as an intermediate structure to test a business relationship or where the parties do not want to enter into more permanent and restrictive business arrangement. Investors should consult with their advisors to determine which arrangement is more suitable for their business.
- ❖ A joint venture differs from a limited liability partnership in that it generally is limited to carrying out a single project. Joint ventures may be credited for such purposes as to develop a tract of land, sell agricultural products, explore for natural resources, or undertake construction project.
- ❖ A corporate joint venture is a corporation owned and operated by a small group of joint ventures as a separate business enterprise. The investment in the common stock of a corporate joint venture is accounted for by the equity method of accounting. Supplementary

disclosure of assets, liabilities, and results of operations of the corporate joint venture is made in a note to the financial statements of each venture if the investment in the venture is material.

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

REVIEW QUESTIONS

Part I: **Multiple Choices: Choose the best answer from the following Alternatives**

1. The following alternatives show why government engages in commercial areas **except**:
 - A. The community considered it appropriate that government should own a firm that operated as a natural monopoly.
 - B. The private sector was seen as capable of delivering the required products or services
 - C. The government wanted to fulfill a community service obligation.
 - D. The private sector was seen as incapable of delivering the required products or services
2. Of the following which one is **not** the characteristic of public enterprises?
 - A. Investment and return
 - B. Public control
 - C. Public ownership
 - D. Public purpose
 - E. All
 - F. None
3. Which one is part of the contractual agreement in joint venture?
 - A. The income or expense sharing by the venturers
 - B. The duration and reporting obligations of the joint venture
 - C. The appointment of the board of directors or equivalent governing body of the joint venture
 - D. Capital contributions by the venturers
 - E. All
 - F. None

4. Of the following one indicates the difference between public enterprises and private businesses. Identify it.
- A. In public enterprises there is no capital stock account except paid up capital
 - B. In private business no paid in capital in excess of par account because the money is coming from government
 - C. Retained earnings in the context of accumulated profits in the case of public enterprises.
 - D. No dividend to shareholders because no shareholders.
 - E. All F. None
5. One is not the objective of privatization among the following alternatives. Identify it.
- A. Changing the public-private sector mix
 - B. Increasing the frequent political interference in the day-to-day activities of public enterprises.
 - C. Introducing more competition
 - D. Improving the performance of public enterprises
 - E. All F. None
6. Which one is **not** among the benefits of privatization?
- A. It means of attracting foreign direct investment.
 - B. Greater efficiency and productivity of enterprises
 - C. Decreased competition in the economy
 - D. Increase in government revenue
 - E. All F. None
7. All are privatization modalities **except**:
- A. Franchising
 - B. Management contract for fee.
 - C. Lease arrangements.
 - D. debt-equity swaps,
 - E. All F. None
8. Of the following which one is not considered as public enterprises in Ethiopia?
- A. Ethio telecom
 - B. Ethiopian Electric Service
 - C. Ethiopian Airlines
 - D. Commercial Bank of Ethiopia
 - E. All F. None

CHAPTER TWO
ACCOUNTING FOR SALES AGENCIES AND PRINCIPAL:
BRANCHES, DIVISION AND HEAD OFFICE

Objectives:

At the end of this chapter, you will be able to:

- *Differentiate among sales agency, branch and divisions*
- *Account for sales agency transactions*
- *Account for shipments made at home office cost; at price that exceeds the home office's cost*
- *Prepare working paper for combined financial statements*
- *Prepare combined financial statements for Home Office and Branches*
- *Comprehend the basic procedures for reconciliation of reciprocal accounts*
- *Record transactions between branches*

2.1 DISTINGUISHING BETWEEN AGENCIES, BRANCHES AND DIVISIONS

This chapter distinguishes between sales agency and branch operations, describes accounting procedures for branch operations, and illustrates procedures for combining home office and branch financial statements in the preparation of financial statements for the business entity as a whole.

a. Sales Agency

A technical distinction is commonly made between sales agencies and branches. A branch office usually has more autonomy and provides a greater range of services than a sales agency does, although the degree differs with the individual company. Sales agencies are established to display merchandise and to take customers' orders, but they don't stock merchandise to fill customers' orders or pass on customer credit. The sales agency is not a separate accounting or business entity. Ordinarily, the only accounting records required for sales agencies are for cash receipts and disbursements, which are handled in essentially the same manner as petty cash systems. The central accounting system of the business maintains records of sales made through agency operations and related cost of sales and other expenses.

b. Branches

By contrast, branch operation stocks merchandise, makes sales to customers, passes on customer credit, collects receivables, incurs expenses, and performs other functions normally associated

with the operations of a separate business enterprise. Such activities are accounted for through separate branch accounting systems that parallel the systems of independent businesses except in the manner of accounting for ownership equities and in recording transactions between branches and the main office of the enterprise.

c. Division

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

Differences among Sales Agency, Branch and Division			
Characteristics	Sales Agency	Branch	Division
◆ Degree of Autonomy	No autonomy	Moderate	Very high
◆ Set of accounting records	Not required	Required by Home Office and Branch	Required by the Division
◆ Transactions approved by	Principal	Branches	Division
◆ Accounting Entity	No	Yes	Yes
◆ Legal Entity	No	No	May or May not

Quick Check

- What does it mean sales agent?
- What differs sales agent from branch and division?

2.2 ACCOUNTING SYSTEM FOR A SALES AGENCY AND BRANCHES

A) Accounting System for A Sales Agency

The term sales agency sometimes is applied to a business unit that performs only a small portion of the functions traditionally associated with a branch. For example, a sales agency usually carries samples of products but does not have an inventory of merchandise. Orders are taken from customers and transmitted to the home office, which approves the customers' credits and ship the merchandise directly to customers. The agency's accounts receivable are maintained at the home office, which also performs the collection function. An imprest cash fund generally is maintained

at the sales agency for the payment of operating expenses. Sales agencies do not require complete accounting systems to account for their limited activities. Ordinarily, cash receipts and disbursements records are sufficient for accounting at agency location. Records for sales agency operations must be maintained in the central accounting system of the enterprise. The amount of data accumulated by the enterprise for agency operations may be limited to records of cash and display merchandise at agency offices, on the one hand, or comprise relatively complete asset and income data, on the other.

If detailed information for a sales agency is not deemed necessary, the following entries may suffice to account for agency operations.

1. Creation of an agency working capital fund or establishment of imprest fund:

Agency working capital/Agency imprest fund	xxx
Cash	xxx

(To record transfer of cash to sales agency)

2. Transfer of sample inventory to sales agency:

Sample inventory - agency	xxx
Merchandise Inventory (or purchases)	xxx

(To transfer display merchandise to sales agency)

3. Replenishment of agency working capital/imprest fund at month or year-end:

Salaries expense	xxx
Utilities expense	xxx
Advertising expense	xxx
Miscellaneous expense	xxx
Cash	xxx

(To record expenses incurred by sales agency and replenishment of agency working capital/imprest fund)

4. Adjustment of agency sample inventory at month or year-end:

Advertising expense	xxx
Sample inventory - agency	xxx

(To adjust agency sample inventory to net realizable value and to charge the write-down to advertising expense)

With regard to cost of sales (or cost of goods sold), when the perpetual inventory system is used, shipment to customers of the agency are debited to Cost of Sales (CGS) account maintained for each sales agency. When the periodic system is used, a shipment of goods sold by an agency may be recorded by a debit to Cost of Sales (CGS) of a specific sales agency and a credit to Shipment to Agencies. This journal entry is recorded only at the end of an accounting period if a memorandum record is maintained during the period listing the cost of goods shipped to fill sales orders received from agencies. At the end of the period the Shipment to Agencies ledger account is offset against the total of beginning inventories and purchases to measure the cost of goods available for sale for the home office in its own operations. Office furniture or other assets located at sales agency may be carried in a separate ledger account by the home office, or control over such assets may be achieved by use of a subsidiary ledger with a complete record for each asset showing cost, location, and any other relevant information.

Journal entries for an expanded agency recordkeeping system follow. The entries identify plant assets of the sales agency (Arba Minch Sales Agency) separately. They also show sales, cost of sales (CGS), and expense information on an agency basis, perpetual inventory system is assumed.

1. Purchase of Arba Minch sales agency land and buildings:

Land - Arba Minch sales agency	xxx
Building - Arba Minch sales agency	xxx
Cash	xxx

Purchase of facilities for sales agency.

2. Creation of a sales agency working capital fund/establishment of agency imprest fund:

Arba Minch sales agency working capital/imprest fund	xxx
Cash	xxx

To record transfer of cash to Arba Minch sales agency.

3. Transfer of display merchandise to sales agency:

Arba Minch sales agency sample inventory	xxx
Merchandise inventory	xxx

To record transfer of sample merchandise to sales agency

Other expenses- Arba Minch sales agency	xxx
Depreciation expense- Arba Minch sales agency	xxx
Salaries expense- Arba Minch sales agency	xxx
Income summary- Arba Minch sales agency	xxx (assuming NI)

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

10. Closing revenue and expense accounts:

Income summary- Arba Minch sales agency	xxx
Income summary	xxx

To close net income of sales agency to income summary ledger account

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

B) Accounting System for A Branch

Branch accounting involves segmenting the accounting system of an enterprise into separate accounting systems for home office and branch operations. The home office records constitute the central accounting unit for the enterprise, and branch records constitute adjunct accounting system for each branch operation. Separate home office and branch systems are used for accounting and internal reporting purposes, but the separate financial statements of the home office and branches have to be combined into a single set of financial statements for the enterprise in order to meet external reporting requirements. The process of combining home office and branch financial statements is required because, among other things, reciprocity is established between home office and branch records. Reciprocal accounts are eliminated and nonreciprocal accounts are combined. Unrealized profits from internal transfers between the home office and the branches must, of course, be eliminated in preparing combined financial statements for the enterprise.

Underlying Principles of Decentralized branch accounting

The concept of subsidiary ledger-controlling account relationship could be used in order to describe the relationship between home office and branch. The following chart will help to understand the basic features of the system:

Home Office Ledger (Books)

Investment in Arba Minch Branch

\$100,000

Arba Minch Branch Ledger (Books)

Various Asset Accounts

\$140,000

Various Liability Accounts

\$40,000

Home Office

\$100,000

In the home office record i.e. Home Office Ledger; the account *Investment in Arba Minch Branch* has a debit balance of \$100,000. This balance represents the difference between total assets and total liabilities recorded in the branch ledger. To simplify things, for illustration purposes all assets and liabilities are represented by one account each. The total of all assets is \$140,000 (Debit) and the total of all the liabilities is \$40,000 (Credit). If this record was for an independent company, the capital account would have shown \$100,000 credit balance. However, this is a branch and there is no capital account. Therefore, to make the branch ledger self-balancing, the account *Home Office* is used. The balance shown in this account (*Home office*) in the **Arba Minch** branch ledger is equal to the balance shown in the *Investment in Arba Minch branch* account maintained at home office ledger. The two accounts having equal but opposite balances are known as *reciprocal accounts*.

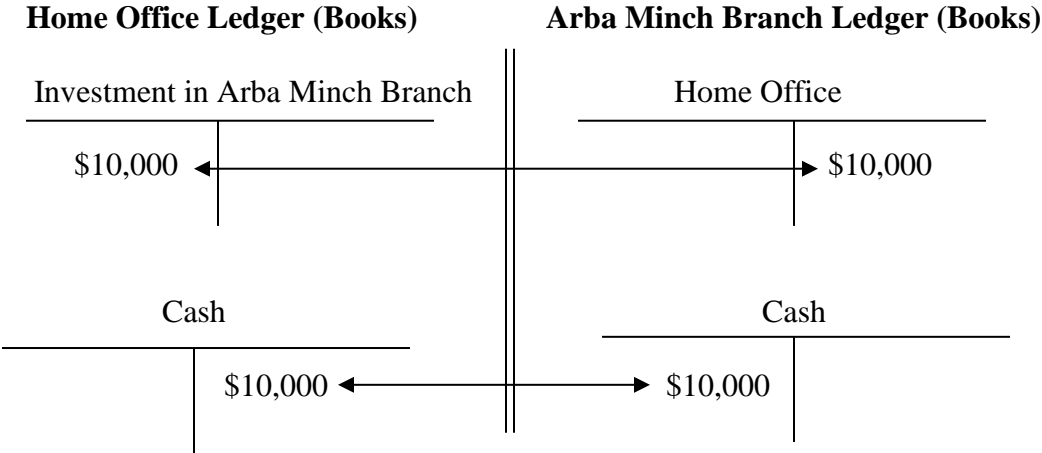
2.3 RECIPROCAL LEDGER ACCOUNTS

The Home Office account in branch ledger is credited for all merchandise, cash, or other resource provided by the home office, and is debited for all cash, merchandise or other assets sent by the branch to the home office or to other branches. The Home Office account is a quasi-ownership equity account that shows the net investment by the home office in the branch or it represents the equity of the home office in the branch net assets. At the end of the accounting period when the branch closes its accounting records, the income summary account is closed to the Home Office account. A net income increases the credit balance of the Home Office account; a net loss decreases this balance.

In the home office accounting records (i.e. Home office ledger), a reciprocal ledger account with a title such as Investment in Branch is maintained. The investment in Branch account is an asset

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

To illustrate the relationship between the reciprocal ledger accounts, assume that the home office opens a new branch in Arba Minch and begins branch operations by sending \$10,000 cash to the branch. The entries in the two ledgers are illustrated as follows:



Expenses incurred by home office and allocated to branches

An expense incurred by the home office and allocated to a branch is recorded by the home office by a debit to Investment in Branch and credit to an appropriate expense ledger account; the branch debits an expense account and credits Home Office.

2.4 BILLING MERCHANDISE SHIPMENTS TO BRANCHES

Typically, branches are established to sell merchandise that is manufactured or purchased through home office operations. A branch manager may or may not have authority to purchase from outside suppliers. In relation to the shipment made from home office to branches, three alternative methods are available to the home office (i.e. for billing merchandise shipped to its branches). The shipment may be billed:

- (1) at cost,
- (2) at a percentage above cost, or
- (3) at the retail selling price.

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

Billing shipments to a branch *at a percentage above cost* (such as 110% of cost) may be intended to allocate a reasonable gross profit to the home office. When merchandise is billed to a branch at a price above cost, the net income reported by the branch is understated and the ending inventories are overstated, for the enterprise as a whole. Adjustments must be made by the home office to eliminate the excess of billed prices over cost (intra company profits) in the preparation of combined financial statements for the home office and the branch. Billing shipment to a branch at retail selling prices may be based on a desire to strengthen internal control over inventories. The inventories ledger account of the branch shows the merchandise received and sold at retail selling prices. Consequently, the account will show the ending inventories that should be on hand at retail prices. The home office record of shipments to a branch, when considered along with sales reported by the branch, provides a perpetual inventory stated at selling prices.

ILLUSTRATION OF HOME OFFICE (HO) AND BRANCH ACCOUNTING

Assume that Garad Company created a new branch outlet in Arba Minch, at the beginning of 2009 and that the transactions of the branch during 2009 were as follows:

1. Cash of \$50,000 was forwarded to Arba Minch Branch.

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

Journal entries to record these transactions in both home office and branch books, assuming perpetual inventory system, follow:

Tran	Home Office Ledger (Books)	Arba Minch Branch Ledger (Books)
1	Investment in Arba Minch Branch 50,000 Cash 50,000	Cash 50,000 Home Office 50,000
2	Equipment 20,000 Investment in Arba Minch Branch 20,000	Home Office 20,000 Cash 20,000
3	Investment in Arba Minch Branch 25,000 Inventories 25,000	Inventories 25,000 Home Office 25,000
4	None	Trade A/R* 35,000 CGS** 20,000 Sales 35,000 Inventories 20,000
5	Inventories 2,500 Investment in Arba Minch Branch 2,500	Home Office 2,500 Inventories 2,500
6	None	Operating Expenses 5,000 Cash 5,000
7	None	Cash 18,000 Trade A/R 18,000
8	Cash 10,000 Investment in Arba Minch Branch 10,000	Home Office 10,000 Cash 10,000
9	Investment in Arba Minch Branch 3,000 Operating Expenses 3,000	Operating Expenses 3,000 Home Office 3,000

* A/R = Accounts Receivable

** CGS = Cost of Goods Sold (Cost of Sales)

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

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

This is shown below:

Reciprocal ledger account in accounting records of home office

Investment in Arba Minch Branch

Date	Explanation	Debit	Credit	Balance
2006	Cash sent to branch	50,000		50,000 Dr
Month,	Equipment purchased by branch,			
Day	carried at HO accounting records		20,000	30,000 Dr
	Merchandise billed to branch at cost	25,000		55,000 Dr
	Merchandise returned from branch		2,500	52,500 Dr
	Cash received from branch		10,000	42,500 Dr
	Operating Expenses billed to branch	3,000		45,500 Dr

Reciprocal ledger account in accounting records of Arba Minch branch

Home Office

Date	Explanation	Debit	Credit	Balance
2006	Cash received from home office		50,000	50,000 Cr
Month,	Equipment purchased by branch,			
Day	carried at HO accounting records	20,000		30,000 Cr
	Merchandise received from HO		25,000	55,000 Cr
	Merchandise returned to Home Office	2,500		52,500 Cr
	Cash sent to Home Office	10,000		42,500 Cr
	Operating Expenses billed by HO		3,000	45,500 Cr

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

Home Office Ledger (Books)	Arba Minch Branch Ledger (Books)												
None	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%;">Sales</td> <td style="text-align: right;">35,000</td> </tr> <tr> <td>CGS</td> <td style="text-align: right;">20,000</td> </tr> <tr> <td>Operating Expenses</td> <td style="text-align: right;">8,000</td> </tr> <tr> <td>Income Summary</td> <td style="text-align: right;">7,000</td> </tr> </table>	Sales	35,000	CGS	20,000	Operating Expenses	8,000	Income Summary	7,000				
Sales	35,000												
CGS	20,000												
Operating Expenses	8,000												
Income Summary	7,000												
<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%;">Investment in</td> <td></td> </tr> <tr> <td>Arba Minch Branch</td> <td style="text-align: right;">7,000</td> </tr> <tr> <td>Income: Arba Minch Branch</td> <td style="text-align: right;">7,000</td> </tr> <tr> <td>(or Arba Minch Branch profit)</td> <td></td> </tr> </table>	Investment in		Arba Minch Branch	7,000	Income: Arba Minch Branch	7,000	(or Arba Minch Branch profit)		<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%;">Income Summary</td> <td style="text-align: right;">7,000</td> </tr> <tr> <td>Home Office</td> <td style="text-align: right;">7,000</td> </tr> </table>	Income Summary	7,000	Home Office	7,000
Investment in													
Arba Minch Branch	7,000												
Income: Arba Minch Branch	7,000												
(or Arba Minch Branch profit)													
Income Summary	7,000												
Home Office	7,000												
<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%;">Income: Arba Minch Branch</td> <td style="text-align: right;">7,000</td> </tr> <tr> <td>Income Summary</td> <td style="text-align: right;">7,000</td> </tr> </table>	Income: Arba Minch Branch	7,000	Income Summary	7,000	None								
Income: Arba Minch Branch	7,000												
Income Summary	7,000												

Working paper for Combined Financial Statements

A working paper for combined financial statements has three purposes:

- (1) to combine ledger account balances for like assets and liabilities,
- (2) to eliminate any intra company profits or losses, and
- (3) To eliminate the reciprocal accounts.

The working paper illustrated next is based on adjusted trial balances for Garad Company's home office and its Arba Minch branch and these are shown in the first two columns of the working paper. In addition to the transactions discussed earlier with regard to Arba Minch Branch, assumed data for the home office was taken. All the routine year-end adjusting entries are assumed to have been made, and the working paper is begun with the adjusted trail balances of the home office and Arba Minch Branch. Income taxes are disregarded for this illustration purpose.

Garad Company

Working paper for Combined Financial Statements of Home Office and A/M Branch

For the Year Ended December 31, 2006

(Perpetual Inventory System: Billing at Cost)

	Adjusted trial balances		Elimination	Combined
	Home Office	Arba Minch Branch		
	Dr (Cr)	Dr (Cr)	Dr (Cr)	Dr (Cr)
<i>Income Statement</i>				
Sales	(320,000)	(35,000)		(355,000)
Cost of Goods Sold	210,000	20,000		230,000
Operating Expenses	50,000	8,000		58,000
Net income (to statement of retained earnings below)	<u>60,000</u>	<u>7,000</u>		<u>67,000</u>
Totals	<u>0</u>	<u>0</u>		<u>0</u>
<i>Statement of retained earnings</i>				
Retained earnings, Jan. 1, 2006	(100,000)			(100,000)
Net income (from above)	(60,000)	(7,000)		(67,000)
Dividends	20,000			20,000
Retained Earnings, Dec. 31, 2006 (to balance sheet below)				<u>147,000</u>
Totals				<u>0</u>
<i>Balance Sheet</i>				
Cash	57,000	33,000		90,000
Trade accounts receivable (net)	33,000	17,000		50,000
Inventories	54,500	2,500		57,000
Investment in Arba Minch Branch	45,500		(45,500)	
Equipment	120,000			120,000
Accumulated depreciation	(20,000)			(20,000)
Trade Accounts payable	(30,000)			(30,000)
Home Office		(45,500)	45,500	
Common Stock, \$12 par	(120,000)			(120,000)
Retained Earnings (from above)	<u> .</u>	<u> .</u>	<u> .</u>	<u>(147,000)</u>
Totals	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>

Note that the \$45,500 debit balance of the Investment in Arba Minch Branch account and the \$45,500 credit balance of the Home Office account are the balances before the respective accounting records are closed, that is before the \$7,000 net income of Arba Minch Branch is

entered in these two reciprocal accounts. In the Elimination column, the balance of the Investment in Arba Minch Branch account is offset against the balance of the Home Office account. This elimination appears in the working paper only; it is not recorded in the accounting records of either the home office or branch, because its only purpose is to facilitate the preparation of combined financial statements

Based on the working paper prepared for Garad Company, the following financial statements could be prepared.

**Garad Company
Income Statement**

For the Year Ended December 31, 2006

Sales	\$355,000
Less: Cost of Goods Sold	<u>230,000</u>
Gross profit on sales	125,000
Less: Operating expenses	<u>58,000</u>
Net Income	<u>\$67,000</u>
Earnings per share of common stock	<u>\$6.70</u>

Garad Company

Statement of Retained Earnings

For the Year Ended December 31, 2006

Retained Earnings, January 1, 2006	\$100,000
Add: Net Income	<u>67,000</u>
Subtotal	167,000
Less: Dividends	<u>20,000</u>
Retained Earnings, December 31, 2006	<u>\$147,000</u>

Garad Company
Balance Sheet
December 31, 2006

Assets

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

Liabilities and Stockholders' Equity

Trade Accounts payable		\$ 30,000
Common Stock, \$12 par	\$120,000	
Retained Earnings	<u>147,000</u>	<u>267,000</u>
Total Liability & Stockholders' Equity		<u>\$297,000</u>

Billing of Merchandise to Branches at Prices above Cost

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

Example. As illustrated before, Arba Minch branch received merchandise shipment from home office. The merchandise shipped to branch cost \$25,000 to the home office. Assume, however, that the home office bills merchandise shipped to Arba Minch branch at 20% above cost. The journal entry in both the home office and branch records to record these shipments (\$25,000 + 20% markup = \$30,000) under perpetual inventory system will be as follows:

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

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

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

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

Reciprocal ledger account in accounting records of home office

Investment in Arba Minch Branch;2

Date	Explanation	Debit	Credit	Balance
2006	Cash sent to branch	50,000		50,000 Dr
Month,	Equipment purchased by branch,			
Day	carried at HO accounting records		20,000	30,000 Dr
	Merchandise billed to branch at 20% above cost	30,000		60,000 Dr
	Merchandise returned from branch		3,000	57,000 Dr
	Cash received from branch		10,000	47,000 Dr
	Operating Expenses billed to branch	3,000		50,000 Dr

In the accounting records of Arba Minch branch, the Home Office ledger account now has a credit balance of \$50,000, before the accounting records are closed and the branch net income or loss is entered in the Home Office account, as illustrated next:

Reciprocal ledger account in accounting records of Arba Minch branch

Home Office

Date	Explanation	Debit	Credit	Balance
2006	Cash received from home office		50,000	50,000 Cr
Month,	Equipment purchased by branch,			
Day	carried at HO accounting records	20,000		30,000 Cr
	Merchandise received from HO		30,000	60,000 Cr
	Merchandise returned to Home Office	3,000		57,000 Cr
	Cash sent to Home Office	10,000		47,000 Cr
	Operating Expenses billed by HO		3,000	50,000 Cr

Arba Minch branch recorded the merchandise received from the home office at billed price of \$30,000; the home office recorded the shipment by credits of \$25,000 to Inventories and \$5,000 to Allowance for Overvaluation of inventories: Arba Minch branch. Use of the allowance account enables the home office to maintain a record of the cost of merchandise shipped to Arba Minch branch, as well as the amount of the unrealized gross profit on the shipments. At the end of the accounting period, Arba Minch will report its inventories (at billed prices) at \$3,000. The cost of these inventories is \$2,500 ($\$3,000 \div 1.20 = \$2,500$). In the home office account records, the required balances in the Allowance for Overvaluation of Inventories: Arba Minch branch ledger account is \$500 ($=\$3,000 - \$2,500$); thus, this account balance must be reduced from its present amount of \$4,500 ($=\$5,000 - 500$) to \$500. The reason for this reduction is that the 20% markup of billed prices over cost has become realized gross profit with respect to the merchandise sold by the branch. Consequently, at the end of the year the home office should reduce its allowance for overvaluation of the branch inventories to the \$500 excess valuation contained in the ending inventories. The adjustment of \$4,000 in the allowance account is transferred as a credit to the Income: Arba Minch branch account, because it represents additional gross profit on branch operations over that reported by the branch. Thus, the actual net income for Arba Minch branch is \$7,000, the same as in the prior illustration in which merchandise was billed to the branch at cost. Under the present assumption, however, the branch reports a net income of \$3,000 only. This amount is recorded by the home office and adjusted to a net income of \$7,000 ($4,000 + 3,000$), as shown by the following journal entries at the end of year 2006:

Allowance for Overvaluation of Inventories: Arba Minch branch

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

Income: Arba Minch Branch

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

In a separate balance sheet for the home office, the \$500 credit balance of the Allowance for Overvaluation of Inventories: Arba Minch branch account is deducted from the \$54,000 debit balance of the Investment in Arba Minch branch account, thus reducing the carrying amount of the investment account to a cost basis.

The closing entries for the branch at the end of year 2006 appear below (under perpetual inventories system):

Branch accounting records

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

To close revenue and expense ledger accounts

Income summary	3,000
Home Office	3,000

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

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

Home Office

Date	Explanation	Debit	Credit	Balance
2006	Cash received from home office		50,000	50,000 Cr
Month,	Equipment purchased by branch,			
Day	carried at HO accounting records	20,000		30,000 Cr
	Merchandise received from home office		30,000	60,000 Cr
	Merchandise returned to home office	3,000		57,000 Cr
	Cash sent to home office	10,000		47,000 Cr
	Operating Expenses billed by HO		3,000	50,000 Cr
	Net income for 2006		4,000	54,000 Cr

Garad Company

**Working paper for Combined Financial Statements of Home Office and A/M Branch
For the Year Ended December 31, 2006
(Perpetual Inventory System: Billing above Cost)**

	Adjusted trial balances		Elimination	Combined
	Home Office	Arba Minch Branch		
	Dr (Cr)	Dr (Cr)	Dr (Cr)	Dr (Cr)
<i>Income Statement</i>				
Sales	(320,000)	(35,000)		(355,000)
Cost of Goods Sold	210,000	24,000	(a) (4,000)	230,000
Operating Expenses	50,000	8,000		58,000
Net income (to statement of retained earnings below)	<u>60,000</u>	<u>3,000</u>	(b) 4,000	<u>67,000</u>
Totals	<u><u>0</u></u>	<u><u>0</u></u>		<u><u>0</u></u>

Statement of retained earnings	(100,000)			(100,000)
Retained earnings, Jan. 1, 2006	(60,000)	(3,000)	(b) (4,000)	(67,000)
Net income (from above)	20,000			20,000
Dividends				
Retained Earnings, Dec. 31, 2006 (to balance sheet below)				<u>147,000</u>
Totals				<u>0</u>
Balance Sheet	57,000	33,000		90,000
Cash	33,000	17,000		50,000
Trade accounts receivable (net)	54,500	3,000	(a) (500)	57,000
Inventories	50,000		(c)(50,000)	
Investment in Arba Minch Branch				
Allowance for overvaluation of inventories: Arba Minch branch	(4,500) 120,000		(a) 4,500	120,000
Equipment	(20,000)			(20,000)
Accumulated depreciation	(30,000)			(30,000)
Trade Accounts payable		(50,000)	(c) 50,000	
Home Office	(120,000)			(120,000)
Common Stock, \$12 par	<u> .</u>	<u> .</u>	<u> .</u>	<u>(147,000)</u>
Retained Earnings (from above)	<u> 0</u>	<u> 0</u>	<u> 0</u>	<u> 0</u>
Totals				

(a) To reduce ending inventories and cost of goods sold of branch to cost, and to eliminate balance in Allowance for Overvaluation of inventories: Arba Minch branch ledger account.

(b) To increase net income of branch by portion of merchandise markup that was realized.

(c) To eliminate reciprocal ledger accounts.

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

Treatment of Beginning Inventories Priced above cost

The working paper illustrated earlier for billing shipments at a percentage above cost shows how the ending inventories and the related allowances for overvaluation of the inventories were

handled. However, because this was the first year of operation for Arba Minch branch, no beginning inventories were involved.

Perpetual Inventory system

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

Periodic Inventory system

To demonstrate the handling of beginning inventories carried by Arba Minch branch at an amount above cost, let's continue with the illustration of Garad Company for a second year of operation, i.e. 2007. In the previous illustrations, the assumption was that Garad Company uses periodic inventory system, at home office and branch. However, now assume that both the home office and Arba Minch branch adopted the periodic inventory system in year 2007. When the periodic inventory system is used, the home office credits Shipments to Branch (a contra account to Purchases) for the cost of merchandise shipped and Allowance for Overvaluation of Inventories for the markup over cost. The branch debits Shipments from Home Office (analogous to Purchases account) for the billed price of merchandise received.

The beginning inventories for 2007 were carried by Arba Minch branch at \$3,000, or 120% of the cost of \$2,500 (= \$2,500 x 1.2). Assume that during 2007 the home office shipped merchandise to Arba Minch branch that cost \$100,000 and was billed at \$120,000, and that Arba Minch branch sold merchandise for \$126,000 that was billed at 84,000. The journal entries to record the shipments and sales under the periodic inventory system are illustrated below:

Home Office Ledger (Books)	Arba Minch Branch Ledger (Books)
Investment in Arba Minch Branch 120,000	Shipments from Home Office 120,000
Shipment to Arba Minch Branch 100,000	Home Office 120,000
Allowance for overvaluation	
of inventories: Arba Minch Br. 20,000	
None	Cash (Trade A/R) 126,000
	Sales 126,000

The branch inventories at the end of year 2007 amounted to \$18,000 at billed prices, representing cost of \$15,000 plus a 20% markup. The flow of merchandise for Arba Minch branch during year 2007 is summarized as follows:

Garad Company
Flow of Merchandise for Arba Minch Branch
During 2007

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

The activities of the branch for year 2007 are reflected in the three home office ledger accounts next:

Investment in Arba Minch Branch

Date	Explanation	Debit	Credit	Balance
2007	Balance, December 31, 2006			54,000 Dr
Month,	Equipment purchased by branch,			
Day	carried at HO accounting records		5,000	49,000 Dr
	Merchandise billed to branch at 20% above cost	120,000		169,000 Dr
	Cash received from branch		50,000	119,000 Dr
	Operating Expenses billed to branch	10,000		129,000 Dr
	Net income for 2007 reported by branch	5,000		124,000 Dr

Allowance for Overvaluation of Inventories: Arba Minch branch

Date	Explanation	Debit	Credit	Balance
2006	Balance, December 31, 2006			500 Cr
Month,	Markup of merchandise shipped to			
Day	Arba Minch branch during year 2007 (20% above cost)		20,000	20,500 Cr
	Realization of 20% markup on merchandise sold by branch during 2007	17,500		3,000 Cr

Income: Arba Minch Branch

Date	Explanation	Debit	Credit	Balance
2006	Net income reported by Arba Minch			
Month,	branch for 2007		5,000	5,000 Cr
Day	Realization of 20% markup on			
	merchandise sold by branch		17,500	22,500 Cr
	Net income of branch (as adjusted) closed			
	to Income summary account	22,500		0

In the accounting records of the home office at the end of year 2007, the balance required in the Allowance for Overvaluation of Inventories: Arba Minch branch ledger account is \$3,000, that is, the billed price of \$18,000 less cost of \$15,000 for merchandise in the branch's ending inventories. Therefore, the allowance account balance is reduced from \$20,500 to \$3,000. This reduction of \$17,500 represents the 20% markup of merchandise above cost that was realized by Arba Minch branch during year 2007 and is credited to the Income: Arba Minch branch account.

The Home office account in the branch general ledger shows the following activity for year 2007:

Home Office

Date	Explanation	Debit	Credit	Balance
2006	Balance December 31, 2006			54,000 Cr
Month,	Equipment purchased by branch,			
Day	carried at HO accounting records	5,000		49,000 Cr
	Merchandise received from home office		120,000	169,000 Cr
	Cash sent to home office	50,000		119,000 Cr
	Operating Expenses billed by HO		10,000	129,000 Cr
	Net income for 2007		5,000	124,000 Cr

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

Garad Company
Working paper for Combined Financial Statements of Home Office and A/M Branch
For the Year Ended December 31, 2006
(Periodic Inventory System: Billing above Cost)

	Adjusted trial balances		Elimination	Combined
	H. Office	Arba Minch Br		
	Dr (Cr)	Dr (Cr)	Dr (Cr)	Dr (Cr)
<i>Income Statement</i>				
Sales	(400,000)	(126,000)		(526,000)
Inventories, Dec. 31, 2006	54,500	3,000	(b) (500)	57,000
Purchases	250,000			250,000
Shipments to Arba Minch branch	(100,000)		(a)100,000	
Shipments from home office		120,000	(a)(120,000)	
Inventories, Dec. 31, 2007	(60,000)	(18,000)	(c) 3,000	(75,000)
Operating Expenses	150,000	16,000		166,000
Net income (to statement of retained earnings below)	<u>105,500</u>	<u>5,000</u>	(d) 17,500	<u>128,000</u>
Totals	<u>0</u>	<u>0</u>		<u>0</u>
<i>Statement of retained earnings</i>				
Retained earnings, Jan. 1, 2006	(147,000)			(147,000)
Net income (from above)	(105,500)	(5,000)	(d) (17,500)	(128,000)
Dividends	45,000			45,000
Retained Earnings, Dec. 31, 2006 (to balance sheet below)				<u>230,000</u>
Totals				<u>0</u>
<i>Balance Sheet</i>				
Cash	16,000	79,000		95,000
Trade accounts receivable (net)	93,000	47,000		140,000
Inventories, Dec. 31,2007	50,000	18,000	(c) (3,000)	65,000
Allowance for overvaluation of inventories: Arba Minch branch	(20,500)		(a) (20,000) (b) (500)	
Investment in Arba Minch Branch	139,000		(e)(139,000)	
Equipment	125,000			125,000
Accumulated depreciation	(35,000)			(35,000)
Trade Accounts payable	(40,000)			(40,000)
Home Office		(139,000)	(e) 139,000	
Common Stock, \$12 par	(120,000)			(120,000)
Retained Earnings (from above)	<u>0</u>	<u>0</u>	<u>0</u>	<u>(230,000)</u>
Totals	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>

(a) To eliminate reciprocal ledger accounts for merchandise shipments.

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

Closing entries

The closing entries for the branch and the adjusting and closing entries for the home office at the end of year 2007 are illustrated below:

Inventories, Dec. 31, 2007	18,000	
Sales	126,000	
Inventories, Dec. 31, 2006		3,000
Shipments from Home office		120,000
Operating Expenses		16,000
Income Summary		5,000

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

Income summary	5,000	
Home Office		5,000

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

Home Office accounting records

Investment in Arba Minch branch	5,000	
Income: Arba Minch branch		5,000

To record net income reported by branch

Allowance for Overvaluation of Inventories: Arba Minch branch	17,500	
Income: Arba Minch branch		17,500

To recognize as realized income the markup of merchandise applicable to goods sold by branch during year 2007

Income: Arba Minch branch	22,500	
Income summary		22,500

To close branch income to income summary ledge account.

Inventories, Dec. 31, 2007	60,000
Sales	400,000
Shipments to Arba Minch branch	100,000
Inventories, Dec. 31, 2006	54,500
Purchases	250,000
Operating Expenses	150,000
Income summary	105,500

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

Income summary	128,000
Retained Earnings	128,000

To close income summary ledger account

Retained earnings	45,000
Dividends	45,000

To close dividends ledger account

Reconciliation of Reciprocal ledger Accounts

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

As an illustration of the procedure for reconciling reciprocal ledger account balances at year-end, assume that the home office and branch accounting records of KK Co. contain the following data on December 31, 2005:

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

Date	Explanation	Debit	Credit	Balance
2005				
Nov. 10	Balance			62,500 Dr
Dec. 10	Cash received from branch		20,000	42,500 Dr
27	Collection of branch trade A/R		1,000	41,500 Dr
29	Merchandise billed to branch	8,000		49,500 Dr

Home Office (in account records of Branch A)

Date	Explanation	Debit	Credit	Balance
2005				
Nov. 30	Balance			62,500 Cr
Dec. 7	Cash sent to home office	20,000		42,500 Cr
28	Equipment purchased by branch, carried at HO accounting records	3,000		39,500 Cr
30	Collection of home office trade A/R		2,000	41,500 Cr

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

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

On December 29, the home office shipped merchandise costing \$8,000 to the branch. The home office debits its reciprocal ledger account with the branch on the date merchandise is shipped, but the branch credits its reciprocal account with the home office when the merchandise is received, perhaps a few days later. The required journal entry on December 31, 2005, in the branch accounting records, assuming use of the perpetual inventory system, appears below:

Inventories in Transit	8,000
Home Office	8,000
<i>To record the shipment of merchandise in transit from home office</i>	

In determining its ending inventories, the branch must add to the inventories on hand the \$8,000 of merchandise in transit.

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

On December 27, trade accounts receivable of the branch was collected by the home office. The collection was recorded by the home office by a debit to Cash and a credit to Investment in Branch A. No journal entry was made by Branch A; therefore, the following journal entry is required in the accounting records of Branch A on December 31, 2005.

Home Office	1,000
Trade accounts receivable	1,000

To record collection of accounts receivable by home office

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

On December 28, the branch acquired equipment for \$3,000. Because the equipment used by the branch is carried in the accounting records of the home office, the journal entry made by the branch was a debit to Home Office and a credit to Cash. No journal entry was made by the home office; therefore, the following journal entry is required on December 31, 2005, in the accounting records of the home office:

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

To record equipment acquired by branch

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

On December 30, trade accounts receivable of the home office was collected by Branch A. The collection was recorded by Branch A by a debit to Cash and a credit to Home Office. No journal entry was made by the home office; therefore, the following journal entry is required in the accounting records of the home office on December 31, 2005.

Investment in Branch A	2,000
Trade accounts receivable	2,000

To record collection of accounts receivable by Branch A

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

KK Co - Home Office and Branch A
Reconciliation of Reciprocal Ledger Accounts
December 31, 2005

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

Quick Check

- How do you understand the accounting system of sales agent?
- Identify the mechanism of billing inventories by the home office to the branch and explain them with due care.

2.5 TRANSACTIONS BETWEEN BRANCHES

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

The transfer of merchandise from one branch to another does not justify increasing the carrying amount of inventories by the freight costs incurred because of the indirect routing. The amount of freight costs properly included in inventories at a branch is limited to the cost of shipping the merchandise directly from the home office to its present location. Excess freight costs incurred as a result of such transfers should be recorded as expenses of the home office because the home office makes the decision to transfer the merchandise.

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

In accounting records of home office:

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

To record shipment of merchandise and payment of freight costs

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

To record the transfer of merchandise from Branch D to Branch E under instruction of home office. Inter branch freight of \$300 paid by Branch D caused total freight costs on this merchandise to exceed direct shipment costs by \$200 ($\$400 + \$300 - \$500 = \200)

In accounting records of Branch D:

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

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

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

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

In accounting records of Branch E

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

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

Recording excess freight cost on merchandise transferred from one branch to another as expense is an example of the accounting principle that "losses" should be given prompt recognition. The excess freight costs from such shipments generally result from inefficient planning of original shipments and should not be included in inventories.

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

Quick Check

- Properly identify transactions between branches.
- What differs the accounting between branches and accounting between branch and home office?

CHAPTER SUMMARY

- ❖ Sales agency is a term applied to a business unit that performs only a small portion of the functions associated branch. The term Branch is used to describe a business unit located at some distance from the Home Office. Branches are economic and accounting entities. Division is a business segment or a business enterprise which generally has more autonomy than a branch
- ❖ The accounting records maintained by a branch include a **Home Office** ledger account. In the Home Office accounting records, a **reciprocal ledger account** with a title such as **Investment in Branch** is maintained.
- ❖ Three alternative methods are available to the Home Office for billing merchandise shipped to its branches. The shipments may be billed: At Home Office cost, at a percentage above Home Office cost, or at the branch's retail selling price
- ❖ When merchandise is billed to a branch at a price above Home Office cost, the net income reported by the branch is understated and the ending inventories are over-stated for the enterprise as a whole. Adjustments must be made by the Home Office to eliminate the excess of billed prices over cost (*intracompany profits*) in the preparation of combined financial statements for the Home Office and the branch.
- ❖ Separate financial statements of the Home Office and of the branch are prepared **for internal use only**; they do not meet the needs of investors or other external users of financial statements.
- ❖ In the preparation of a combined balance sheet, reciprocal ledger accounts are eliminated because they have no significance when the branch and Home Office report as a single entity.
- ❖ At the end of an accounting period, the balance of the Investment in Branch ledger account in the accounting records of the Home Office may not agree with the balance of the Home Office account in the accounting records of the branch because certain transactions may have been recorded by **one office** but not by **the other office**.
- ❖ Efficient operations may on occasion require that merchandise or other assets be transferred from one branch to another. Generally, a branch does not carry a reciprocal ledger account with another branch but records the transfer in the Home Office ledger account.

REVIEW QUESTIONS

MULTIPLE CHOICES: Choose the best answer

9. Of the following which one shows **true** statement about sales agent?

- A. Sales agency established to make sales on credit or cash basis
- B. Sales agency is autonomous branch.
- C. Centralized accounting system is maintained for sales agent.
- D. Stocking merchandise to meet customer demand.

Data A: Equatorial Business Group (EGB) is opening sales agent in **Jinka** town assuming sales will increase after all. Then consider the following transactions.

- EGB sent Cash of Br. 10, 000
- Inventory transferred to Jinka sales agent with cost of Br. 15,000
- Building purchased at cost of Br. 100,000 for the agent to be established in the town.
- Furnitures purchased at Br. 80,000 on account.
- Others also facilitated accordingly.

Based on the above **Data A:** answer **Qn. 2 – 3.**

10. How cash sent to Jinka sales agent is to be recorded?

- A. Debiting cash and crediting expense
- B. Crediting cash and debiting sales agent
- C. Crediting cash and debiting working capital Jinka sales agent
- D. Debiting cash and crediting imperust fund Jinka sales agent.
- E. All F. None

11. How the acquisition of building and furniture is recorded?

- A. Debiting building and furniture- sales agent and crediting cash by 100, 000 and Br. 80,000 respectively.
- B. Crediting Accounts payable for Br. 100, 000 & 80,000 and debiting Building-sales agent.
- C. Debiting Furniture and Crediting Cash br. 80,000

- D. Crediting Cash for Br. 100,000 & Accounts payable for Br. 80, 000 and debiting building and furniture-sales agent
- E. None

Data B: Assume that EGB also opened branch in **Konso town** at the beginning of 2016 and that the transactions of the branch during 2016 were as follows:

1. EBG sent Br.100,000 cash to Konso branch.
2. The branch purchased equipment of Br.40,000 and Br. 20,000 other fixed assets for cash.
3. The branch received merchandise from EBG at Br.50,000 at cost.
4. The sales by branch amount to Br.80,000 to be collected after 20 days. The cost of merchandise sold showed 40% of sales.
5. Br.5,000 of the merchandise acquired from the EBG forwarded back.
6. The branch covered expense of Br.10,000 for operation.
7. Konso branch collected receivable of Br.42,000.
8. Other expenses incurred by branch amounts to Br. 5,000
9. The Konso effected payment to EBG of Br.20,000.
10. EBG incurred expense Br. 6,000 but this expense covered by the branch.

Based on the above **Data B:** answer question **4 to 9** assuming EBG uses accrual basis of accounting.

12. The journal entry for **given no.1** above in the book of EBG ledger is:

- A. Home office debited and cash credited
- B. Cash debited and Home office credited
- C. Cash debited and Investment in branch is credited.
- D. Investment in Konso branch debited and Home office credited
- E. All F. None

13. The journal entry for **given no.1** above in the book of konso ledger is:

- A. Home office debited and cash credited
- B. Cash debited and Home office credited
- C. Cash debited and Investment in branch is credited.
- D. Investment in Konso branch debited and Home office credited
- E. All F. None

14. The journal entry for **given no. 6** in the book of home office ledger is:
- A. Operating expenses debited and cash credited.
 - B. Cash debited and operating expenses credited.
 - C. Cash debited and inventory credited.
 - D. Unnecessary
 - E. All F. None
15. Collection of Br. 42, 000 on from above should be recorded by:
- A. EBG
 - B. Konso branch
 - C. Both of them
 - D. Neither of them
16. What is the ledger balance of both reciprocal accounts (**head to branch respectively**) on the above data?
- A. Br. 25,000 debit and Br. 25,000 credit
 - B. Br. 216,000 debit and Br. 216,000 credit
 - C. Br. 190,000 debit and Br. 190,000 credit
 - D. Br. 191,000 credit and 191,000 debit
 - E. All F. None
17. How much is to be reported to EBG by Konso branch as net income on reporting date?
- A. Br. 48,000
 - B. Br. 27,000
 - C. Br. 80,000
 - D. Br. 21,000
 - E. None

Based on **Data B** above, assume that inventory is billed and shipped to Konso branch at 30% above cost. Based on this, answer **Qn. 10 to 12:**

18. What is the amount of inventory forwarded back to home and how it is recorded by Konso branch, respectively?
- A. Br. 5,000, debited to inventory and credited to home office.
 - B. Br. 5,600, debited to investment in branch and credited to inventory.
 - C. Br. 6,000, debited inventory and credited to home office
 - D. Br. 6,500, debited to home office and credited to inventory
 - E. None.
19. What is the ledger balance of the reciprocal accounts (**from branch to head, respectively**) on the basis cost plus margin?

- A. Br. 190,000 credit and Br.190,000 debit
 - B. Br. 198,000 debit and Br. 198,000 credit
 - C. Br. 198,500 credit and Br. 198,500 debit
 - D. Br. 198,500 debit and Br. 198,500 credit
 - E. None
20. What is the amount of net income to be received by EBG when cost plus margin applied and how the report is recorded by Konso branch?
- A. Br. 41,000, debited to income summary and credited to home office.
 - B. Br. 17,000 debited to home office and credited income summary.
 - C. Br. 17,400 debited to income summary and credited to home office.
 - D. Br. 20,500 debited to income summary and credited to home office.
 - E. None
21. **Based on Qn.12**, how closing entry is recorded by EBG after receiving the net income?
- A. Investment in Konso branch credited and Income konso branch credited.
 - B. Income from konso branch debited and income summary credited
 - C. Investment in konso branch credited and allowance for over valuation of inventory debited
 - D. Income summary credited and home office debited
 - E. All F. None

CHAPTER THREE

ACCOUNTING FOR INSTALLMENT & CONSIGNMENT SALES CONTRACTS

Objectives:

At the end of this chapter, you will be able to:

- Define installment sales;
- Understand the characteristic for installment sales;
- Discuss the profit measurement under installment method
- Define consignment sales;
- Discuss the features of consignment sales;
- Discuss the accounting for consignment by consignor and consignee records

3.1 ACCOUNTING FOR INSTALLMENT SALES

Introduction-Installment Sales

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

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

The unique issues related to installment sales are:

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

Characteristics of Installment Sales

An installment sale provides for a *series of payments* over a period of months or years. A *down payment* generally is required. Because the seller must wait a considerable period of time to collect the entire selling price, it is customary to provide for *interest and carrying charges* on the unpaid balance.

The risk of non-collection to the seller is increased greatly when sales are made on the installment plan. Customers generally are in weaker financial condition than those who

buy on open account; furthermore, the credit rating of the customers and their ability to pay may change significantly during the period covered by an installment contract. To protect themselves against this greater risk of non-collection, sellers of real or personal property generally select a form of contract called a ***security agreement*** that enables them to repossess the property if the purchaser fails to make payments.

The sellers' right to protect their security interest (uncollected balance of a sales contract) and to repossess the item sold varies by type of industry, the form of the contract, and the statutes relating to repossessions. For the service-type enterprises, repossession obviously is not available as a safeguard against the failure to collect. For sales of certain types of merchandise, the sellers' right to repossess may be more of a treat than a real assurance against loss. The merchandise sold may have been damaged or may have depreciated to a point that it is worth less than the balance due on the installment contract. A basic rule designed to minimize losses from nonpayment of installment contracts is to require a significant down payment to cover the loss of value when the merchandise moves out of the "new" category. A **corollary rule** is that the cash payment by the purchaser should not be outstripped by the projected decline in value of the merchandise sold. For example, if a customer who purchases a used car on the installment plan finds after a year or so that the car is currently worth less than the balance owed on the contract, the customer's motivation to continue the payment may be reduced.

Competitive pressures in an industry often will not permit a business enterprise to adhere to rigid credit standards. Furthermore, repossession may be a difficult and expensive process. **Reconditioning and repair** maybe necessary to make the repossessed merchandise salable, and the resale of such merchandise maybe difficult. For these reasons, doubtful installment receivables expense is likely to be significantly higher on installment sales than on regular credit sales.

A related problem is the increased collection costs incurred when payment for sales are spread over an extended period. Accounting costs also are increased when sales are made on the installment plan, and large amount of working capital are tied up in installment receivables. In recognition of these problems, many retailers sell installment receivables to finance companies that specialize in credit and collection activities.

Realization of Gross Profit on Installment Sales

The measurement of income from installment sales is complicated by the fact that the amounts of revenue and related costs and expenses seldom are known in the accounting period when installment sales are made. Substantial costs (as for collection, accounting, repairs, and repossession) may be incurred in subsequent accounting periods. In some situations, the risk of non-collection may be so great as to raise doubt that any revenue or profit is realized at the time of sale.

The first objective in the development of accounting policies for installment sales should be a reasonable matching of expenses and revenue. However, in consideration of the diverse business conditions under which installment sales are made, accountants use the following three approaches for the recognition of gross profit on installment sales.

Three approaches for recognition of gross profit on installment sales:

- (1) The accrual basis of accounting,
- (2) The cost recovery method of accounting, and
- (3) The installment method of accounting.

Accrual Basis of Accounting

- To recognize the entire gross profit as realized at the time of an installment sale (similar to sales on credit)

The merchandise has been delivered to customers, and installment receivables of definite amount have been acquired. The excess of the installment receivables over the cost of merchandise sold is realized gross profit in the traditional meaning of the term.

- the entry will include

Installment receivables	xxx	
Installment Sales		xxx
Cost of installment sales account	xxx	
Inventories		xxx

(under perpetual system)

No recognition is given to the seller's retention of the title to the merchandise because the normal expectation is completion of the contract through collection of the receivables. Implicit in this recognition of the gross profit at the time of sale is that assumption that most expenses relating to the sale will be recognized in the same accounting period.

The expenses relating to the sale include collection expense and doubtful installment receivables expense. Recognition of these expenses in the period of the sale requires estimates of the customer's performance over the entire term of the installment contract. Such estimates may be considerably more difficult to make than the normal provisions for doubtful accounts expense from regular sales. However, with careful analysis of experience in the industry and in the particular business enterprise, reasonably satisfactory estimates maybe made in most situations. The journal entries to recognize such expenses consist of debit to expense ledger account and credit to asset valuation accounts such as Allowance for Doubtful Installment Receivables and Allowance for Collection costs. The allowance accounts are debited in later periods when uncollectible installment contract become known and when collection costs are incurred.

Cost Recovery Method of accounting

If receivable is collectible over long period, terms of sale are not definite, and the financial position of customers is unpredictable, it will become impossible to find a reasonable basis for estimating the degree of collectability of the receivables.

- In such cases either installment method or the cost recovery method of accounting may be used for installment sales.

Under ***Cost recovery method***, *no profit* is recognized until all costs of the merchandise sold have been recovered. After all costs have been recovered, additional collections on the installment receivables are recognized as revenue (gross profit on the sale and interest revenue), and only current collection costs are recognized as expenses.

Installment Method of Accounting

- Recognizes gross profit in installments over the term of the contract as cash is collected.
- Emphasis is shifted from the acquisition of installment receivables to the collection of the receivables as the basis for realization of gross profit.
- The modified cash basis of accounting (here referred to as installment method of accounting) is substituted for the accrual basis of accounting.

Example1: At the beginning of Year 3, **ABC Company** sold merchandise on installment basis for \$300,000 that have cost of \$180,000. The cash collection performances are as follows:

Year1.....\$100,000
 Year2.....\$100,000
 Year3.....\$100,000

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

1. Accrual Method

Year 1 Installment Sales.....\$300,000 100%
 Cost of Installment Sales.....180,000 60%
 Realized Gross Profit\$120,000 40%

Year 2 Realized Gross Profit.....-0-

Year 3 Realized Gross Profits.....-0

The entire \$120,000 gross profit is realized in Year 1. Therefore, there is no gross profit to be realized in Year 2 and Year 3 from this installment sale.

2. Cost Recovery Method

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

	Cash Collection	Unrecovered cost	Realized Gross Profit	Remark
Year 1	\$100,000	\$180,000	\$100,000 \$180,000=(\$80,000)	\$80,000 is not recovered
Year 2	\$100,000	\$80,000	\$100,000- \$80,000= \$20,000	Cost is fully Recovered
Year 3	\$100,000	0	\$100,000-0= \$100,000	Cost is fully Recovered
Total	\$300,000		\$120,000	

3. Installment Method

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

	Cash Collection	Percentage of Gross Profit	Realized Gross Profit
Year 1	\$100,000	40%	\$100,000@40%= \$40,000
Year 2	\$100,000	40%	\$100,000@40%= \$40,000
Year 3	\$100,000	40%	\$100,000@40%= \$40,000
Total	\$300,000		\$120,000

The Installment Method of Accounting

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

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

This method is acceptable for *income tax reporting* purposes. However, it couldn't be used for financial reporting unless:

- (1) Collection of installment receivables is not reasonably assured,
- (2) Installment receivables are collectible over an extended period of time, and
- (3) There is no reasonable basis for estimating the degree of collectability of the installment receivables.

Single Sale of Land on the Installment Plan

The owner of land that has appreciated in value often is willing to sell only on the installment plan so that the gain maybe spread over several years for income tax purposes. In the United States, federal income tax regulations permit the use of the installment method if the contract price will be collected in two or more installments spanning two or more years.

Example 2: - XYZ Company which maintains accounting records on a calendar year basis sold for \$100,000 a parcel of land with a carrying amount of \$52,000 on Dec 31, 2002. Commission and other costs of the sale totaling \$8,000 were charged to XYZ Company. The gain on the sale of the land was \$40,000 (\$100,000-\$52,000-\$8,000) and all collection of cash from the purchaser was regarded as consisting of 60% cost of recovery and 40% realization of gain. The contract of sales required down payment of \$25,000 and a promissory note in the amount of \$75,000 with principal payment every six month for five years in the amount of \$7,500 plus interest at 10% on the unpaid principal amount of the notes. A portion of \$8,000 birr of the down payment was applied in the statement to pay the commission & other costs of sales.

Required: Prepare necessary journal eateries for the above transaction for the first and second years of operation.

1st year

Dec. 31, 2002

1. Cash (\$25,000-\$8,000)	17,000
Note Receivable (\$100,000 -\$25,000)	75,000
Land installment sale.....	52,000
Deferred gain on installment sale of land	40,000

(To record sales of land on installment plan, notes receivable are due \$7,500 every six months plus 10% interest on the unpaid principal balance commission & other costs of sales of \$8,000 were deducted in the computation of net cash received & deferred given).

Dec 31, 2002

2. Deferred gain on installment sale of land.....	10,000
Realized gain on installment sale of land	10,000

(To record realized gain, computed at 40% of cash collected as down payment in year 1 (\$25000x 40%)

2nd year

- 1. Cash (\$7500+\$3750)11,250
 - Interest Revenue (\$75,000x 10% x 6/12).....3,750
 - Notes Receivables.....7,500

(To record collection of semiannual principal payment on notes receivable \$7500 +interest for six month)

2. Dec 31,2003

- Cash (\$7,500 +\$3,375)10875
- Interest Revenue (75000-7500x10% x 6/12)3,375
- Notes Receivable7,500

(To record collection of semi-annual principal payment on notes receivable on unpaid balance)

3. Dec, 31,2003

- Deferred gain on installment sale of land6,000
 - (\$7,500+\$7,500x40%)
 - Realized gain on installment sale of hand6,000

(To record realized gain computed at 40% of amount collected in year 2 (\$15,000 x40%)

Exercise: On December 31, 2005, ABC Co. sold a parcel of land with a carrying amount of \$200,000 for \$300,000. Commission and other costs of the sale totaling \$10,000 were covered by ABC Co. The down payment is 20% and the remaining to be paid in 6 equal annual installments. Promissory notes were issued to this effect. The buyer will also make 5% interest payment on the unpaid principal amount of the notes.

Required: Prepare the necessary journal entries for year 2005 and 2006.

Retail Sale of Merchandise on the Installment Plan

If a merchandising company sale on installment basis, separate records should be kept for installment sales and regular sales. The accounting records for installment receivable usually are maintained by contract rather than by customer, if a customer makes several purchases on the installment plan. However, it is not necessary to compute the rate of gross

profit on each sale or to apply a different profit rate to collections on each sale. the average rate of gross profit on all installment sale during a year generally is computed and applied to all cash collections (excluding interest and carrying charges) on installment receivables originating in that year.

Example 3: Assume **LMN Company** sales merchandise on the installment plan, as well as on regular terms (cash or 30-day open accounts), and uses the perpetual inventory system. For an installment sale, the customer's account is debited for the full amount of the selling price, including interest and carrying charges, and is credited for the amount of the down payment. The Installment Receivables ledger account thus provides a complete record of the transaction. Doubtful installment receivables expense is recognized at the time the installment receivables are known to be uncollectible.

Assume that on January 1, 2005, **LMN Co's** account records included the following ledger account balances:

Installment Receivables - year 2003	\$20,000 Dr
Installment Receivables - year 2004	\$85,000 Dr
Deferred interest and carrying charges on installment sales	17,500 Cr
Deferred Gross profit - year 2003 installment sales	4,500 Cr
Deferred Gross profit - year 2004 installment sales	19,460 Cr

The gross profit rate on installment sales (excluding interest and carrying charges) was 25% in 2003 and 28% in 2004. During 2005, the following transactions or events were completed by LMN Co.:

(1) Installment sales (excluding \$30,000 deferred interest & carrying charges)	
.....	\$200,000
Cost of installment sales.....	138,000
Deferred gross profit -2005 installment sales (\$200,000 - \$138,000)	62,000
Rate of gross profit on installment sales (\$62,000 ÷ \$200,000)	31%

(2) Cash collections on installment receivables during 2005 are summarized below:

	Selling price	Interest & carrying charges	Total cash collected
Installment receivables – 2005	\$80,000	\$10,000	\$90,000
Installment receivables - 2004	44,500	12,500	57,000
Installment receivables - 2003	<u>17,000</u>	<u>1,850</u>	<u>18,850</u>
Total	<u>141,500</u>	<u>24,350</u>	<u>165,850</u>

(3) Customers who purchased merchandise in 2003 were unable to pay the balance of their contracts, \$1,150. The contract consisted of \$1,000 sales price and \$150 of interest and carrying charges, and included \$250 ($\$1,000 \times 0.25 = \250) of deferred gross profit. The net realizable value of the merchandise repossessed was \$650.

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

Relating to Year 5 sales, \$80, 000 @ 31%..... \$24,800

Relating to Year 4 sales, \$44, 500 @ 28%.....12,460

Relating to Year 3 sales, \$17, 000 @ 25%.....4,250

Total..... \$ 41,510

Recording transactions and events:- The journal entries to record the transactions and events for LMN Co. relating to installment sales for 2005 are as follows:

**LMN Company
General Journal**

- (1) Installment receivables – 2005.....230,000
 Cost of Installment sales.....138,000
 Installment sales.....200,000
 Deferred interest and carrying charges on installment sales30,000
 Inventories.....138,000
 (To record installment sales and cost of installment sales for 2005)
- (2) Cash.....165,850
 Installment receivables – 2005.....90,000
 Installment receivables – 2004.....57,000

Installment receivables – 2003.....18,850
 (To record collections on installment contracts during 2005)

(3) Inventories (repossessed).....650
 Deferred Gross profit – 2003.....250
 Deferred interest and carrying charges on installment sales.....150
 Doubtful installment receivables expense.....100
 Installment receivables – 2003.....1,150
 (To record default on 2003 installment receivables and repossession of merchandise)

Adjusting entries

The adjusting entries for LMN Co. on December 31, 2005, are as follows:

Installment sales.....200,000
 Cost of installment sales.....138,000
 Deferred gross profit - 2005 installment sales..... 62,000
 (To record deferred gross profit on 2005 installment sales)

Deferred Gross profit - year 2005 installment sales24,800
 Deferred Gross profit - year 2004 installment sales12,460
 Deferred Gross profit - year 2003 installment sales 4,250
 Realized Gross profit on installment sales41,510
 (To record realized gross profit on installment sales)

Realized Gross profit on installment sales is determined as follows:

2005 (80,000 x .31)	\$24,800
2004 (44,500 x 0.28)	12,460
2003 (17,000 x 0.25)	<u>4,250</u>
Total realized gross profit	<u>\$41,510</u>

Deferred interest and carrying charges on installment sales24,350
 Revenue from interest and carrying charges24,350

To record revenue from interest and carrying charges for 2005

The Realized Gross Profit on Installment Sales and the revenue from Interest and Carrying Charges ledger accounts are closed to the Income Summary account at the end of 2005.

The ledger accounts relating to installment sales appear in LMN Co.'s accounting records on December 31, 2005 as follows:

<u>Ledger Accounts</u>	<u>Balances</u>
Installment receivables - 2004 (\$85,000 - 57,000)	\$28,000 Dr
Installment receivables - 2005 (\$230,000 - 90,000)	140,000 Dr
Deferred interest and carrying charges installment sales (\$17,500 + 30,000 - 150 - 24,350)	23,000 Cr
Deferred Gross Profit - 2004 installment sales (19,460 - 12,460)	7,000 Cr
Deferred Gross profit - 2005 installment sales (62,000 - 24,800)	37,200 Cr

These ledger account balances may be arranged as illustrated below to prove the accuracy of the deferred gross profit on installment receivables on December 31, 2005:

LMN Co.
Proof of Deferred Gross Profit
December 31, 2005

	Installment receivables	Deferred interest & charges	Net Installment receivables	Gross profit percentage	Deferred gross profit
2004 receivables	\$28,000	\$3,000	\$25,000	28%	\$7,000
2005 receivables	<u>140,000</u>	<u>20,000</u>	<u>120,000</u>	31	<u>37,200</u>
Total	<u>168,000</u>	<u>23,000</u>	<u>145,000</u>		<u>44,200</u>

Alternative computation of gross profit percentage

Instead of segregating the collections applicable to the selling price and to the interest and carrying charges a retailing enterprise may determine the gross profit percentage by inclusion of the interest and carrying charges in the selling price. The resulting larger gross profit percentage then is applied to the total amount of cash collected in each accounting period to determine the realized gross profit. Application of this method to the year 5 installment sales of LMN Company is illustrated below:

Sales, including interest and carrying charges of \$30,000.....	\$230,000
Gross profit on installment sales;	
(\$230,000-\$138, 000 cost of installment sales)	\$92,000
Gross profit percentage on installment sales (\$92,000 ÷ \$230,000).....	40%

The 40% gross profit percentage thus determined is applied to the total cash collections on installment contracts receivable in each year to compute the realized gross profit on installment sales. Under this approach, the realized gross profit on installment sales for Year 5 is \$36,000 ($\$90,000 \times 0.40 = \$36,000$).

The use of the installment method of accounting requires installment contracts receivable and cash collections to be segregated by year of origin. In addition, the gross profit rate must be computed separately for each year. However, a single controlling account for installment contracts receivable may be used if the accounting records are computerized or if the installment contracts receivable are analyzed at the end of each year to ascertain uncollected balances by year of origin

Defaults and Repossessions

If a customer defaults on an installment contract for *services* and no further collection can be made, we have an example of defaults *without* the possibility of *repossession*. A similar situation exists for merchandise that has not significant resale value. The journal entry required in such cases is to *write off* the *uncollectible installment receivable*, cancel the *deferred gross profit* related to the receivable, and debit *Doubtful Installment Receivable Expense* for the difference. Thus, the doubtful installment receivable expense is equal to the unrecovered cost included in the balance of the installment receivable. However, in most cases a default by a customer leads to repossession of merchandise. The *doubtful installment receivable expense* is *reduced* by the *net realizable value* of the merchandise repossessed, and it is possible for the repossession to result in a gain.

Example 4:- In continuation of example 3 the reconditioning expense incurred for repossessed stock during the year 3 is \$250 and it is sold for \$1,200

Required: - Journalize the above transaction

1. Repossessed goods250
 Cash250
 (To Record for payment of reconditioning expense)
 Cash1200
 Repossessed goods1200
 (To record sales of repossessed stock at a profit)
2. Repossessed goods300
 Gross profit300

(To record the profit from sales of repossessed stocks)

Other Accounting Issues related to Installment sales

- Other accounting issues with respect to installment sales includes
 1. The acceptance of used property as a trade-in
 2. The computation of interest on installment receivables and
 3. The use of the installment method of accounting solely for income tax purposes.

1. **Trade Ins.** A familiar example of the use of trade-ins is the acceptance by dealer of as used car as partial payment for a new car. An accounting problem exists only if the dealer grants an over allowance on the used car taken in trade. An over allowance is the excess of the trade-ins allowance over net realizable value of the used car items of the dealer's ability to resell it at a price that will recover all direct costs and result in normal gross profit. A rough approximation of the net realizable value of the used car to the dealer may be the currently quoted wholesale price for used cars of the particular make or model.

An over allowance on trade-ins is significant because it represents a reduction in the stated selling price of the new merchandise. The stated selling price must be reduced by the amount of the over allowance to compute the net selling price. The gross profit on the sale of the new merchandise is the difference between the net selling price and cost.

2. **Interest on installment receivables:-** contracts for sale on the installment plan usually provide for interest and carrying charges to be paid concurrently with each installment payment. Such deferred payment charges, regardless of the label placed on them, represent a cost of borrowing to the purchaser and may be referred to collectively as "interest". only the portion of the payment that is applied to reduce the principal; of the installment receivables is considered in the measurement of realized gross profit under the installment method of accounting.

3. **Installment method for income taxes purposes only:-** The installment method of accounting is widely used for income tax purposes because it postpones the payment of income taxes.

Example1:- Assume that a merchandise with a cost of \$2,400 is sold on the installment plan for \$3,300. Used merchandise is accepted as a trade-ins a "value" of \$1,100 but the dealer expects to spend \$50 in reconditioning the used merchandise before reselling it for only \$1,000. Assume that the customary gross profit percentage on used merchandise of

this type is 15% of the selling price, all amounts that will cover the selling and overhead cost and also provide a normal gross profit on the resale.

- Required:** - 1 compute net realizable –value, trade-ins.
2. Make necessary journal entries

Sol≈ 1. Trade in amount given to customer.....		\$1,100
Less net realizable value of trade-ins		
Estimated resale value of merchandise trade in \$1,000		
Less:- reconditioning cost expected 50		
Normal gross profit (\$1,000x15%) 150	<u>200</u>	
Net realizable value of merchandise trade-ins.....	<u>800</u>	<u>800</u>
Over allowance on trade ins.....		<u>\$300</u>

Journal entries

- a) Installment receivable (\$3,300-\$1,100).....2,200
Inventories trade in (old merchandise)800
 Installment sales (3300-300).....3,000
(To record sale of merchandise for \$3,000 consisting of selling price \$3,300 minus \$300 over allowance of the trade- ins)
- b) Cost of installment sales2,400
 Inventories2,400
(To record transfer from inventories to cost of installment sales)

Example 2:-Assume that M Co., a retailing enterprise, uses the accrual basis of accounting for financial accounting and the installment method for income tax purposes. The pre-tax accounting income for 1990 was \$200,000, as indicated by the following partial income statement (revenue from interest and carrying charges is disregarded in this example):

M Company	
Partial income statement (accrual basis of accounting)	
For year ended December 31, 1990	
Sales	\$800,000
Cost of goods sold	<u>500,000</u>
Gross profit on sales	300,000
Operating expenses	<u>100,000</u>
Income before income taxes	<u>200,00</u>

Assume that the deferred gross profit on installment sales was \$55,000 on January 1, 1990, and \$105,000 on December 31, 1990. The taxable income for 1990 is computed as follows;

Pre-tax accounting income for 1990 (accrual basis of accounting)		\$200,000
Less: Deferred gross profit on installment sales, Dec. 31, 1990	\$105,000	
Add: Deferred gross profit on installment sales, Jan. 1, 1990	<u>55,000</u>	<u>(50,000)</u>
Taxable income for 1990 (installment method of accounting)		<u>\$150,000</u>

Income taxes for 1990 would be recorded as follows, assuming that the income tax rate for M Co. is 40%:

Income taxes expense	80,000
Income taxes payable	60,000
Deferred income tax payable	20,000
(To record income taxes for 1990)	

The income tax for 1990 is computed as follows;

Income tax expense (\$200,000 x 0.4 = 80,000)
Income tax payable (\$150,000 x 0.4 = 60,000)
Deferred income tax liability (\$50,000 x 0.4 = 20,000)

Presentation of Installment Sales Data in Financial Statements

Income Statement

If the accrual basis of accounting is used for all sales, the overall gross profit of the company will be determined by simply adding the gross profit on sales for installment sales and regular sales. However, if installment sales method is used for financial reporting purposes, the gross profit on installment sales should be adjusted for deferred gross profits of installment sales of the current year and this will give the realized gross profit for installment sales of the same period. This amount should be added with the gross profit from regular sales to give total realized gross profit of the company as a whole.

Balance Sheet

Although the collection period often extends more than a year beyond the balance sheet date, installment receivables, net of deferred interest and carrying charges, are classified as current assets. A justification for this could be the normal operating cycle of the business enterprise.

Classification of the deferred gross profit on installment sales, when installment method of accounting is used for financial accounting is still problematic.

- it used to be included as current liabilities (although no obligation)
- as asset valuation account (theoretically preferable)
- subdividing the differed gross profit in three parts: (a) an allowance for collection costs and doubtful receivables that would be deducted from installment receivables, (2) a liability representing future income taxes on the gross profit not yet realized, and (3) a residual income element (some accountants prefer to classify it as a separate item in the stockholders' equity section and some other in an undefined section between liability and stockholders' equity.)-But such detailed classification is not necessary, as it doesn't have a significant added value.

Quick Check

- ✓ What is installment sale?
- ✓ What differs Installment Sales from other types of sales mechanism?
- ✓ Identify the characteristics of Installment Sales
- ✓ What are the approaches for recognition of gross profit on installment sales?

3.2 ACCOUNTING FOR CONSIGNMENT SALES

The term consignment means a *transfer of possession* of merchandise from the owner to another person who acts as the sales agent of the owner. *Title* to the merchandise remains with the owner, who is called a *consignor*; the sales agent who has possession of the merchandise is called a *consignee*. The relationship between the consignor & the consignee is that of principal and agent. Consignees are responsible to consignors for the merchandise placed in their custody until it is sold or returned. As the title to merchandise is retained by the consignor, the consignees do *neither* include the *inventories* in their records, nor include a *trade accounts payable* or other liability. The only obligation of consignees is to *give reasonable care* to the consigned merchandise & to account for it to consignor. When the consigned merchandise is sold, the consignor records the sale, & the receivable is the

property of the consignor. As a result the consignor bears any *credit losses*, provided that the consignee has exercised due care in granting credit & making collections. However, the consignee may guarantee the collection of consignment trade account receivable; under this type of consignment contract, the consignee is said to be a *del credere agent*.

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

Distinguishing Between a Consignment and a Sale

Although both consignment and sale involve shipment of inventories, they are not one and same. Unlike the case with sales, the title for the consigned goods is retained by the consignor and the consigned goods are carried as part of the inventories of the consignor. Therefore, no revenue should be recognized at the time of the consignment shipment.

Why Consignments (why not sale)?

From the consignor's side:

- It could be easier to persuade dealers to stock the items on a consignment basis (as the dealers may not be willing to purchase the merchandise outright)
- The consignor avoids the risk inherent in selling on credit to dealers of questionable financial strength.

From the consignee's side

- The acquisition of merchandise on consignment rather than by purchase requires less capital investment
- Avoids the risk of loss if the merchandise cannot be sold.

Rights and Duties of the Consignee

Rights of Consignee

- To *receive compensation* for merchandise sold for the account of the consignor.
- To *receive reimbursement* for expenditures (such as freight and insurance) made in connection with the consignment.
- To *sell consigned merchandise on credit* if the consignor has not forbidden credit sales.
- To *make the usual warranties* as to the *quality* of the consigned merchandise and to bind the consignor to honor such warranties.

Duties of Consignee

- To *give care and protection reasonable* in relation to the nature of the consigned merchandise.
- To *keep the consigned merchandise separate* from owned inventories or *be able to identify the consigned merchandise*. Similarly, the consignee must *identify and segregate the consignment trade accounts receivable* from other receivables.
- To *use care in extending credit* on the sales of consigned merchandise and to *be diligent in setting prices* on consigned merchandise and *in collecting* consignment *trade accounts receivable*.
- To *render complete reports* of sales of consigned merchandise and to make *appropriate* and *timely payment* to the consignor.

The Account Sales

The report rendered by the consignee is called an account sale; it includes the quantity of merchandise received and sold, expenditures made, advances made, and amounts owed or remitted. Payments may be made as portions of the consigned merchandise are sold or may not be required until the merchandise either has been sold or has been returned to the consignor.

Example: Assume that Arba Minch Co (the Consignor) ships on consignment to Roha Co (the consignee) 10 television sets to be sold at \$400 each. Roha Co. is to be reimbursed for freight costs of \$135 and is to receive a commission of 20% of the stipulated selling price. After selling all the consigned merchandise, Roha sends Arba Minch Co. an *account sale* similar to the one below, accompanied by a check for the amount due:

Roha Co.		
Addis Ababa, Ethiopia		
Account sales		
Aug. 31, 1999		
Sales for account and risk of:		
Arba minch Co.		
Arba MInch, Ethiopia		
Sales; 10 TV sets @ \$400		\$4,000
Charges:		
Freight costs	\$135	
Commission (4,000 x 0.20)	<u>800</u>	<u>935</u>
Balance (remittance to consignor)		<u>\$3,065</u>
Consigned TV sets on hand		<u>none</u>

Accounting for the Consignee

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

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

Consignment In – Arba Minch Co.....135
 Cash.....135
 To record payment of freight costs on shipment from consignor

b) Sold 10 TV Sets at a stipulated selling price

Cash.....4,000
 Consignment In - Arba Minch Co.....4,000
 To record sale of 10 TV sets at \$400 each

The journal entry to record the 20% commission charged by the consignee consists of a debit to the Consignment In ledger account and a credit to a revenue account, as follows;

c) Commission of 10% earned on TV sets sold

Consignment In - Arba Minch Co.800
 Commission Revenue800
 To record commission of 20% earned on TV sets sold

d) Payment in full to Consignor

Consignment In - Arba Minch Co.....3,065
 Cash.....3,065
 To record payment in full to consignor

After the posting of this journal entry, the ledger account for the consignment appears as follows in the consignee's accounting records:

Consignment In - Arba Minch Co.

Date	Explanation	Debit	Credit	Balance
	Received 10 TV sets to be sold for \$400 each at a commission of 20% of selling price			
	Freight costs	135		135 Dr
	Sales (10 x \$400)		4,000	3,865 Cr
	Commission (\$4,000 x 0.20)	800		3,065 Cr
	Payment to consignor	3,065		- 0 -

On the other hand, if the *consignee doesn't measure profits from consignment sales separately* from regular sales, the sale of the consigned merchandise is credited to the regular Sales ledger account. Concurrently, a journal entry is made debiting Cost of Goods Sold (or purchases) and crediting the consignment In ledger account for the amount payable to the consignor for each unit sold (sales price minus the commission). Costs chargeable to the consignor are recorded by debits to the Consignment In ledger account and credit to Cash or expense accounts, if the costs previously were recorded in expense accounts. No journal entry is made for commission revenue, because the profit element is measured by the difference between the amount credited to Sales and the amount debited to Cost of Goods Sold (or purchase). The Consignment In ledger account is closed by a debit for the payment made to the consignor in settlement.

At the end of the accounting period when financial statements are prepared, some Consignment In accounts in the subsidiary consignment ledger may have debit balances and other may have credit balances. A debit balance will exist in a Consignment In account if the total of expenditures, commission, and advance to the consignor is larger than the proceeds of sale of that particular lot of consigned merchandise; a credit balance will exist if the proceeds of sales are in excess of the expenditures, commission, and advance to the consignor. The total of the Consignment In account with debit balances is included among the current assets in the balance sheet; the total of the Consignment In accounts with credit balances is included among current liability.

Accounting for Consignor

When a consignor ship merchandise to consignees, it is essential to have a record of the location of this portion of inventories. Therefore, the consignor may establish in the general ledger a Consignment Out account for every consignee (or every shipment on consignment). The *Consignment Out ledger account* represents special category of *inventories*.

Separate Measurement of Gross Profit

Separate measurement of gross profit on consignment sales is not same as separate measurement of net income on consignment sales. Separate measurement of net income from consignment sales is not justifiable, as it requires arbitrary allocation of many operating expenses. However, the measurement of gross profits from consignment sales as distinguished from gross profits on regular sales is much simpler, because it is based on the identification of direct costs associated with consignment sales. The choice of accounting method by a consignor depends on whether (1) consignment gross profits are measured separately from gross profits on regular sales or (2) sales on consignment are combined with regular sales without any effort to measure gross profits separately for the two categories of sales.

The choice of accounting methods by a consignor depends on whether (1) consignment gross profits are measured separately from gross profits on regular sales or (2) sales on consignment are combined with regular sales without any effort to measure gross profits separately for the two categories of sales.

The journal entries required under these alternative methods of accounting for consignment shipment now are illustrated, first under the assumption that gross profits on consignment sales are measured separately, and second without a separate measurement of gross profits. The assumed transactions for these illustrations already have been described from the consignee's view point, but now are restated to include the data relating to the consignor. In all remaining illustrations, assume that the consignor uses the perpetual inventory system.

Example:

Arba Minch Co. (the consignor) shipped on consignment to Roha Co. (the consignee) 10 TV sets that cost \$250 each. the selling price was set at \$400 each. The cost of packing was \$30; all costs incurred in the packing department were debited by Arba Minch Co. to the Packing Expense ledger account. Freight costs of \$135 by an independent truck line to deliver the merchandise to Roha Co. were paid by Roha. All 10 sets were sold by Roha for \$400 each. After deducting the commission of 20% and the freight costs of \$135, Roha sent Arba Minch Co. a check for \$3,065, along with the account sales illustrated previously.

The journal entries for the consignor, assuming that gross profits on consignment sales are determined separately, and gross profits on consignment sales are not determined separately, are summarized as shown in the next page. If the consigned merchandise is sold on credit, the consignee may send the consignor an account sales but no check. In this case the consignor's debit would be to Trade accounts receivable rather than to the Cash ledger account. When sales are reported by the consignee and gross profits are not measured separately by the consignor, the account credited is Sales rather than Consignment Sales, because there is no intent to separate regular sales from consignment sales. Similarly, the commission paid to consignees is combined with other commission expenses, and freight costs applicable to sales on consignment are recorded in the Freight Out Expense ledger account.

Arba Minch Company.

Journal entries, ledger account, an income statement presentation for a completed consignment

Explanations	Gross profits determined separately	Gross profits not determined separately
(1) Shipments of merchandise costing \$2,500 on consignment; consigned merchandise is transferred to a separate inventories ledger account. Consignor uses the perpetual inventory system.	Consignment Out - Roha Co.....2,500 Inventories2,500	Consignment Out - Roha Co.....2,500 Inventories 2,500
(2) Packing expense of \$30 allocated to consigned merchandise; this expense previously was recorded in the Packing expense ledger account.	Consignment Out - Roha Co.....30 Packing expense30	No journal entry required; total packing expense is reported among operating expenses.
(3) Consignment sales of \$4,000 reported by consignee and payment of \$3,065 received. Charges by consignee; freight costs, \$135; commission, \$800.	Cash 3,065 Consignment Out - Roha Co. 135 Commission Exp. - Consignment sales 800 Consignment Sales 4,000	Cash 3,065 Freight Out expense 135 Commission Expense 800 Sales 4,000
(4) Cost of consignment sales recorded, \$2,665 (=2,500 + 30 + 135)	Cost of Consignment sales2,665 ConsignmentOut - Roha Co.....2,665	Cost of goods sold2,500 Consignment Out - Roha Co.....2,500

(5) Summary of Consignment Out ledger account:	<u>Consignment Out - Roha Co.</u>		<u>Consignment Out - Roha Co.</u>	
	2,500	2,665	<u>2,500</u>	<u>2,500</u>
	30			
	<u>135</u>	<u> </u>		
	<u><u>2,665</u></u>	<u><u>2,665</u></u>		
(6) Presentation in the income statement:	Consignment sales		\$4,000	
	Less: Cost of consignment sales	2,665		Included in total sales \$4,000
	Commission	<u>800</u>	<u>3,465</u>	Included in cot of all goods sold 2,500
	Gross profit on consignment sales		<u><u>\$ 535</u></u>	Included in total packing expense 30
				Included in total freight-out expense 135
			Included in total commission exp. 800	

Accounting for Partial Sale of Consigned Merchandise

In the preceding example, the assumption was that the consignor received an account sales showing that all the merchandise shipped on consignment had been sold by the consignee. The account sales was accompanied by remittance in full, and the consignor's journal entries were designed to recognize the gross profit from the completed consignment. However, it is possible for the consignee to sell only some of the consigned goods and remit the partial amount collected from partial sales.

Example: Assume that only four of the ten TV sets (instead of all ten) consigned by Arba Minch Co. to Roha Co. had been sold by the end of the accounting period. To prepare financial statements, the consignor must determine the amount of gross profit realized on the four units sold and the inventory value of the six unsold units. The account sales received by Arba Minch Co. at the end of the current period include the following information:

Roha Co.		
Account sales to Arba Minch Co.		
Sales: 4 TV sets @ \$400		\$1,600
Charges: Freight costs	135	
Commission (1,600 x 0.2)	<u>320</u>	<u>455</u>
Total payable to consignor		\$1,145
Less: Check enclosed		<u>500</u>
Balance payable to consignor		<u>\$645</u>
Consigned merchandise on hand		<u>6 TV sets</u>

The journal entries for the consignor to account for this uncompleted consignment are presented in the next page.

Arba Minch Co.

Journal entries, ledger account, a Balance Sheet presentation for a partial sale of Consigned merchandise

Explanations	Gross profits determined separately	Gross profits not determined separately
<p>(1) Shipments of merchandise costing \$2,500 on consignment; consigned merchandise is transferred to a separate inventories ledger account. Consignor uses the perpetual inventory system.</p>	<p>Consignment Out - Roha Co.....2,500 Inventories2,500</p>	<p>Consignment Out - Roha Co..... 2,500 Inventories 2,500</p>
<p>(2) Packing expense of \$30 allocated to consigned merchandise; this expense previously was recorded in the Packing expense ledger account.</p>	<p>Consignment Out - Roha Co.....30 Packing expense..... 30</p>	<p>No journal entry required; total packing expense is reported among operating expenses.</p>
<p>(3) Consignment sales of \$1,600 reported by consignee and payment of \$500 received. Charges by consignee; freight costs, \$135; commission, \$320.</p>	<p>Cash..... 500 Trade A/R 645 Consignment Out - Roha Co. . 135 Commission Exp. - Consignment sales..... 320 Consignment Sales 1,600</p>	<p>Cash500 Trade A/R645 Freight Out expense135 Commission Expense320 Sales1,600</p>
<p>(4) Cost of consignment sales recorded, $[(\\$250 + \\$3 + \\$13.5) \times 4 = \\$1,066; \\$250 \times 4 = \\$1,000]$</p>	<p>Cost of consignment sales1,066 Consignment out -Roha Co.....1,066</p>	<p>Cost of goods sold.....1,000 Consignment Out - Roha Co.....1,000</p>
<p>(5) Direct costs relating to unsold merchandise held by consignee deferred when profits are not determined separately;</p> <p style="padding-left: 40px;">Parking costs (\$3x6) \$18 Freight costs (13.5 x 6) <u>81</u> Total <u>\$99</u></p>	<p>No journal entry required</p>	<p>Consignment Out - Roha Co.99 Packing expense..... 18 Freight out expense81</p>
<p>(6) Summary of Consignment Out ledger account:</p>		

(7) Presentation in the balance sheet:	<u>Consignment Out - Roha Co.</u>		<u>Consignment Out - Roha Co.</u>	
	2,500	1,066	2,500	1,000
	30		<u>99</u>	<u>1,599</u>
	<u>135</u>	Bal. <u>1,599</u>	<u>2,599</u>	<u>2,599</u>
	<u><u>2,665</u></u>	<u><u>2,665</u></u>	Balance 1,599	
	Balance 1,599			
	Current assets:		Current assets:	
	Inventories on consignment	\$1,599	Inventories on consignment	\$1,599

Return of Unsold Merchandise by Consignee

When the consignee returns merchandise to the consignor, the ***place utility*** originally created by the costs (such as packing and freight costs) is ***lost***. As a result all the packing and freight cost incurred to get the merchandise in the consignee's premises should be considered as expense of the current accounting period. The same is true for the costs incurred by the consignor on the return shipments, including any repair costs necessary to place the merchandise in a salable condition.

Advances from Consignees

Although cash advance from a consignee sometimes are credited to the Consignment Out ledger account, a better practice is to credit a liability account- Advance from consignees.

Nature of the Consignment Out ledger Account

This account belongs in the asset category- ***current asset***.

This account is debited for the cost of merchandise shipped to a consignee; when the consignee reports sale of all or a portion of the merchandise, the cost is transferred from Consignment Out to Cost of Consignment Sales.

Quick Check

- ✓ What is consignee and consignor?
- ✓ Differentiate Consignment and a Sale
- ✓ What are the rights and duties of the Consignee?
- ✓ Identify the accounting treatment for the Consignee

CHAPTER SUMMARY

Real or personal property is often sold on contract under which a down payment is made and the remainder of the sales price is collected in a series of installment payments. Because payments may be deferred for an extended period, there may be uncertainty as to the collectability of the sales price. Uncertainty about collectability may justify departure from the accrual basis of accounting.

The first objective in development of accounting policies for installment sales should be reasonable matching of costs and revenue.

The risk of non-collection to the seller is greatly increased when sales are made on the installment plan

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

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

Because of the length of the collection period and the deferral of much of the cash to be received, the risk exists from installment sales is normally greater than that from ordinary sales. Thus the installment method or the cost recovery method can be used as an alternative to the accrual (point of sale) method.

Transactions involving installment sales introduce several problems in respect to informative reporting. As with other special types of transactions, adequacy of disclosure is a compelling consideration. Installment sales transactions can be separately disclosed in the income statement, balance sheet, and footnotes accompanying the financial statements.

Trade-in is acceptance of a used property as partial payment for a new one.

Installment contracts usually provide for interest and other so-called "carrying charges" to be paid concurrently with each installment payment. Such deferred payment charges, regardless of the label placed on them, represent a cost of borrowing to the buyer and logically may be referred to as "Interest".

Wide-scale distribution of products also can be achieved through consignment marketing. A manufacturer or distributor (a consignor) transfers physical possession of merchandise to a retailer (a consignee) while continuing to maintain legal title. Since the Consignee is not required to

purchase the inventory, that party faces little risk of loss, The consignee normally holds the goods until sold and then forwards the receipts (less a commission and any reimbursable costs) to the consignor. If any of the inventories fails to sell, it is normally returned after a specified time.

The costs of packing and shipping merchandise to a consignee, whether paid directly by the consignor or by the consignee, properly are included in inventories

Although cash advances from a consignee sometimes are credited to the Consignment Out account, a better practice is to credit a liability account, Advances from consignees.

As the owner, the consignor should account for the cost of consigned inventory until the time of sale. In addition, all related expenses as well as the resulting revenues must be properly monitored.

Many consignors establish a Consignment-Out account in which all transactions are recorded initially. A detailed analysis is periodically required of the resulting balance so that the various components can be reclassified for reporting purposes. This approach is easy to apply, although accurate interim information is not always readily available.

A consignor can adopt an alternative accounting approach by using a Consignment Inventory account, Under this method, each consignment transaction is properly classified at the time of the event: sales are recorded as sales, expenses as expenses, and so on. More effort is required to record this data; but accurate information is constantly maintained. For reporting purposes, an adjusting entry to record ending inventory and cost of goods sold is still necessary.

The consignee may guarantee fee collection of consignment account receivable; under this type of consignment contract, the consignee is said to be a **Del credere** agent.

Proper accounting procedures must also be established by the consignee. Since title to the goods is not being held, the consignee need not record inventory costs. Many companies do, however, set up a Consignment-In account for the recording of all sales, commissions, reimbursable costs, and the like. The components of this balance can then be analyzed and adjusted at any time that report (or payment) is to be made to the consignor.

REVIEW QUESTIONS

1. Of the following one **does not** show the responsibility of consignee. Identify:
 - A. Giving reasonable care in relation to the nature of the consigned merchandise.
 - B. Providing complete reports of sales of consigned merchandise
 - C. The consignee must identify and segregate the consignment receivable from other receivables.
 - D. Keeping the presentation of consigned merchandise on its annual separate balance sheet.
 - E. None
2. Which one does not characterize installment sales?
 - A. Less credit worthy customers
 - B. Time value of money consideration
 - C. Full payment up on maturity.
 - D. Series of payment
 - E. All F. None
3. Of the following alternatives which shows advantage of consignment?
 - A. The consignee avoids the risk inherent in selling on credit to dealers of questionable financial strength.
 - B. The acquisition of merchandise on consignment rather than by purchase requires less capital investment for consignor.
 - C. Avoids the risk of loss if the merchandise cannot be sold for consignor.
 - D. The acquisition of merchandise on consignment rather than by purchase requires less capital investment for consignee.
 - E. None

Based on Data A: below, answer Qn. 4 to 10.

Data A: Assume that Gudar Company sold merchandise inventory on installment basis January 1, 2010, acquired by Br. 500,000. The cash collection is planned to be on four years and 40% of sales covered by the first installment payment and the remaining ledger balance equally distributed on the reimaging period. The company's gross profit percentage is 45% of total cost. (hint: Use the full decimal point)

4. What is the amount of installment receivable on the date of sale?
A. Br. 500,000 B. Br. 775,000 C. Br. 700,000 D. None
5. What is the percentage of gross profit to sale?
A. 45% B. 31.03% C. 68.9% D. 70.03% E. None
6. What is the amount of realized gross profit on the first year if accrual basis of accounting is applied?
A. Br. 725,000 B. Br. 225,000 C. Br. 326,250 D. Br.500,000 E. None
7. What is the deferred gross profit on the second year of installment if cost recovery method is applied?
A. Br. 290,000 B. Br. 435,000 C. Br. 225,000 D. Br. 0 E. None
8. What is ledger balance of deferred gross profit at the end of first installment if installment basis applied?
A. Br. 135,000 B. Br. 90,000 C.Br. 225,000 D. Br. 0 E. None
9. What is the amount of realized gross profit at the at the end of third year installment if cost recovery method is applied?
A. Br. 580,000 B. Br. 225,000 C. Br. 80,000 D. Br. 0 E. None
10. How the realized gross profit of second year installment sales is recorded if accrual basis is applied?
A. Debiting realized gross profit and crediting deferred gross profit for Br. 290,000
B. Crediting realized gross profit and debiting deferred gross profit for Br. 290,000
C. Debiting cash and crediting deferred gross profit for Br. 90,000
D. Crediting cash and debiting deferred gross profit for Br.45,000
E. None of the above

CHAPTER FOUR

BUSINESS COMBINATIONS (MERGERS AND ACQUISITIONS)

4.1 INTRODUCTION

Business combinations arise when one or more companies become subsidiaries of another company. As with any other economic activity, business combination can be part of an overall managerial activity to maximize shareholder value. Business combination is bringing together two or more separate businesses under common ownership.

4.1.1 Definition of Important Terminology

A **business combination**: refers to any set of conditions in which two or more organizations are joined together through common control. The company whose business is being sought is after called the **target company**. The company attempting to acquire the target company's business is referred to as the **acquiring company**. The legal agreement that specifies the terms and provisions of the business combination is known as the **acquisition, purchase, or merger agreement**. The process of attempting to acquire a target company's business is often called a **takeover** attempt.

Business combinations can be categorized as vertical, horizontal, or conglomerate.

- ✓ **Vertical**: combinations take place between companies involved in the same industry but at different levels.
- ✓ **Horizontal**: combinations take place between companies that are competitors at the same level in a given industry.
- ✓ **Conglomerate**: combinations involve companies in totally unrelated industries.

The Financial Accounting Standards Board has provided the following working definition of business combination:

Business combination occurs when an entity acquires net assets that constitute a business or acquires equity interests of one or more other entities and obtains control over that entity or entities.

- **Entity**: A business enterprise, a new entity formed to complete a business combination, or a mutual enterprise an entity, not investor-owned, that provides dividends, lower costs, or other economic benefits directly to its owners, members, or participants.

- **Business:** An asset group that constitutes a business as characterized by the Emerging Issues Task Force (EITF) in *EITF Issue No. 98-3*, “Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business.”
- **Control:** Ownership by one company, directly or indirectly, of the outstanding voting shares of another company.

The Financial Accounting Standards Board has suggested the following definitions for terms commonly used in discussions of business combinations.

- ✓ **Combined enterprise:** The accounting entity that **results** from a business combination.
- ✓ **Constituent companies:** The business enterprises that enter into a business combination.
- ✓ **Combinor:** A constituent company entering in to a business combination whose owners as a group ends up with control of the ownership interests in the combined enterprise.
- ✓ **Combinee:** A constituent company other than the combiner in a business combination.

In common parlance, business combinations are often referred to as ***mergers and acquisitions***.

- ❖ **Merger** is a combination of two or more companies in to a single company where one survives and the other lose their corporate existence. The survivor acquires the asset as well as liabilities of the merged company. It is a combination of two or more companies in to a single company.
- ❖ **Acquisition** is the purchase of by one company controlling interest in the share capitals of another existing company.
- ❖ **Business combination** is a general term that encompasses all forms of combining previously separate business entities. Such combinations are **acquisitions** when one corporation acquires the productive assets of another business entity and integrates those assets into its own operations.
- ❖ **Business combinations** are also acquisitions when one corporation obtains operating control over the productive facilities of another entity by acquiring a majority of its outstanding voting stock.

The acquired company need not be dissolved; that is, the acquired company does not have to go out of existence.

The terms **merger** and **consolidation** are often used as synonyms for acquisitions. However, legally and in accounting there is a difference.

- ✓ A merger entails the dissolution of all but one of the business entities involved.
- ✓ A consolidation entails the dissolution of all the business entities involved and the formation of a new corporation.

A **merger** occurs when one corporation takes over all the operations of another business entity and that entity is dissolved. For example, Company A purchases the assets of Company B directly from Company B for cash, other assets, or Company A securities (stocks, bonds, or notes). This business combination is an acquisition, but it is not a merger unless Company B goes out of existence. Alternatively, Company A may purchase the stock of Company B directly from Company B's stockholders for cash, other assets, or Company A securities. This acquisition will give Company A operating control over Company B's assets. It will not give Company a legal ownership of the assets unless it acquires all the stock of Company B and elects to dissolve Company B (again, a merger).

A **consolidation** occurs when a new corporation is formed to take over the assets and operations of two or more separate business entities and dissolves the previously separate entities. For example, Company D, a newly formed corporation, may acquire the net assets of Companies E and F by issuing stock directly to Companies E and F. In this case, Companies E and F may continue to hold Company D stock for the benefit of their stockholders (an acquisition), or they may distribute the Company D stock to their stockholders and go out of existence (a consolidation).

In either case, Company D acquires ownership of the assets of Companies E and F. Alternatively; Company D could issue its stock directly to the stockholders of Companies E and F in exchange for a majority of their shares. In this case, Company D controls the assets of Company E and Company F, but it does not obtain legal title unless Companies E and F are dissolved. Company D must acquire all the stock of Companies E and F and dissolve those companies if their business combination is to be a consolidation. If Companies E and F are not dissolved, Company D will operate as a holding company, and Companies E and F will be its subsidiaries.

4.1.2 Reasons or Motives for Business Combination

Among the many possible reasons, some of the following are as follows:

- ❖ **Cost Advantage:** It is frequently less expensive for a firm to obtain needed facilities through combination than through development. This is particularly true in periods of inflation.
- ❖ **Lower Risk:** The purchase of established product lines and markets is usually less risky than developing new products and markets. The risk is especially low when the goal is diversification.
- ❖ **Fewer Operating Delays:** Plant facilities acquired in a business combination are operative and already meet environmental and other governmental regulations.
- ❖ **Avoidance of Takeovers:** Many companies combine to avoid being acquired themselves. Smaller companies tend to be more vulnerable to corporate takeovers; therefore, many of them adopt aggressive buyer strategies to defend against takeover attempts by other companies.
- ❖ **Acquisition of Intangible Assets:** Business combinations bring together both intangible and tangible resources. The acquisition of patents, mineral rights, research, customer databases, or management expertise may be a primary motivating factor in a business combination.
- ❖ **Growth:** Why do business enterprises enter into a business combination? Although a number of reasons have been cited, probably the overriding one for *combinors* in recent years has been *growth*.
- ❖ **Expansion and diversification** of product lines, or enlarging the market share for current products.
- ❖ To obtaining new management strength or better use of existing management and achieving manufacturing or other operating economies.
- ❖ **Other Reasons:** Firms may choose a business combination over other forms of expansion for business tax advantages (for example, tax-loss carry forwards), for personal income and estate-tax advantages, or for personal reasons.

4.1.3 Types of Business Combination

Business combinations may be divided into two classes. These are:

1. Friendly takeovers and
 2. Hostile (aggressive or unfriendly) takeovers.
- ❖ In a **friendly takeover**, the boards of directors of the constituent companies generally work out the terms of the business combination agreeably (politely) and submit the proposal to stockholders of all constituent companies for approval.
 - ❖ A target combinee in a **hostile (aggressive or unfriendly) takeover** typically resists the proposed business combination by resorting to one or more **defensive tactics** with the following colorful designations:
 - **Pac-man defense**: A threat to undertake a hostile takeover of the prospective combinator.
 - **White knight**: A search for a candidate to be the combinator in a friendly takeover.
 - **Scorched earth**: The disposal, by sale or by a spin-off to stockholders, of one or more profitable business segments.
 - **Shark repellent**: An acquisition of substantial amounts of outstanding common stock for the treasury or for retirement, or the incurring of substantial long-term debt in exchange for outstanding common stock.
 - **Poison pill**: An amendment of the articles of incorporation or bylaws to make it more difficult to obtain stockholder approval for a takeover.
 - **Greenmail**: An acquisition of common stock presently owned by the prospective combinator at a price substantially in excess of the prospective combinator's cost, with the stock thus acquired placed in the treasury or retired.

4.2 METHODS FOR ARRANGING BUSINESS COMBINATIONS

The four common methods for carrying out a business combination are statutory merger, statutory consolidation, acquisition of common stock, and acquisition of assets.

Statutory Merger

- ❖ As its name implies, a statutory merger is executed under provisions of applicable state laws.
- ❖ In a statutory merger, the boards of directors of the constituent companies approve a plan for the exchange of voting common stock (and perhaps some preferred stock, cash, or long-

term debt) of one of the corporation (the *survivor*) for all the outstanding voting common stock of the other corporations.

- ❖ Stockholders of all constituent companies must approve the terms of the merger; some states require approval by two-thirds of the stockholders. The survivor corporation issues its common stock or other consideration to the stockholders of the other corporations in exchange for all their holdings, thus acquiring ownership of those corporations. The other corporations *then are dissolved and liquidated and thus cease to exist as separate legal entities*, and their activities often are continued as *divisions* of the survivor, which now owns the *net assets* (assets minus liabilities), rather than the outstanding common stock, of the liquidated corporations.

To summarize, the procedures in a statutory merger are:

1. The boards of directors of the constituent companies work out the terms of the merger.
2. Stockholders of the constituent companies approve the terms of the merger, in accordance with applicable corporate bylaws and state laws.
3. The survivor issues its common stock or other consideration to the stockholders of the other constituent companies in exchange for all their outstanding voting common stock of those companies.
4. The survivor dissolves and liquidates the other constituent companies, receiving in exchange for its common stock investments the net assets of those companies.

Statutory Consolidation

A statutory consolidation also is consummated in accordance with applicable state laws.

However, in a consolidation a *new corporation is formed to issue its common stock* for the outstanding common stock of two or more existing corporations, *which then go out of existence*. The new corporation thus acquires the net assets of the defunct corporations, whose activities may be continued as divisions of the new corporation.

To summarize, the procedures in a statutory consolidation are:

1. The boards of directors of the constituent companies work out the terms of the consolidation.
2. Stockholders of the constituent companies approve the terms of the consolidation, in accordance with applicable corporate bylaws and state laws.

3. A new corporation is formed to issue its common stock to the stockholders of the constituent companies in exchange for all their outstanding voting common stock of those companies.
4. The new corporation dissolves and liquidates the constituent companies, receiving in exchange for its common stock investments the net assets of those companies.

Acquisition of Common Stock

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

Acquisition of Assets

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

Quick Check

- ✓ What is business combination?
- ✓ What is the rationality for business combination?
- ✓ Distinguish the methods of business combinations
- ✓ List and explain the types of business combination
- ✓ Identify methods for arranging business combinations

4.3 ACCOUNTING METHODS AND PROCEDURES FOR BUSINESS COMBINATIONS

4.3.1 Purchase Method of Accounting for Business Combinations

In *FASB Statement No. 141*, “Business Combinations,” the FASB mandated *purchase accounting* for all business combinations entered into after **June 30, 2001**. The key components of purchase accounting were identified as follows by the FASB:

- **Initial recognition:** Assets are commonly acquired in exchange transactions that trigger the initial recognition of the assets acquired and any liabilities assumed.
- **Initial measurement:** Like other exchange transactions generally, acquisitions are measured on the basis of the fair values exchanged.
- **Allocating cost:** Acquiring assets in groups requires not only ascertaining the cost of the asset (or net asset) group but also allocating that cost to the individual assets (or individual assets and liabilities) that make up the group.
- **Accounting after acquisition:** The nature of an asset and not the manner of its acquisitions determines an acquiring entity’s subsequent accounting for the asset. The foregoing provides the foundation for applying the purchase method of accounting for business combinations.

Determination of the Combinor

Because the carrying amounts of the net assets of the combinator are not affected by a business combination, the combinator must be accurately identified. The FASB stated that in a business combination effected solely by the distribution of cash or other assets or by incurring liabilities,

the combinator is the distributing or incurring constituent company. For combinations effected by the issuance of equity securities, consideration of all the facts and circumstances is required to identify the combinator. However, a common theme is that the combinator is the constituent company whose stockholders as a group retain or receive the largest portion of the voting rights of the combined enterprise and thereby can elect a majority of the governing board of directors or other group of the combined enterprise.

Computation of Cost of a Combinee

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

1. the amount of consideration paid by the combinator,
2. the combinator's *direct* "out-of-pocket" costs of the combination, and
3. Any *contingent consideration* that is determinable on the date of the business combination.

Amount of Consideration

This is the total amount of cash paid, the current fair value of other assets distributed, the present value of debt securities issued, and the current fair (or market) value of equity securities issued by the combinator.

Direct Out-of-Pocket Costs

Included in this category are some legal fees, some accounting fees, and finder's fees. A *finder's fee* is paid to the investment banking firm or other organization or individuals that investigated the combinee, assisted in determining the price of the business combination, and otherwise rendered services to bring about the combination.

Costs of registering with the SEC and issuing *debt securities* in a business combination are debited to Bond Issue Costs; they are not part of the cost of the combinee. Costs of registering with the SEC and issuing *equity securities* are not direct costs of the business combination but are offset against the proceeds from the issuance of the securities. *Indirect* out-of-pocket costs of the combination, such as salaries of officers of constituent companies involved in negotiation and completion of the combination, are recognized as expenses incurred by the constituent companies.

Contingent Consideration

Contingent consideration is additional cash, other assets, or securities that may be issuable in the future, contingent on future events such as a specified level of earnings or a designated market price for a security that had been issued to complete the business combination. Contingent consideration that is ***determinable*** on the consummation date of a combination is recorded as part of the cost of the combination; contingent consideration ***not determinable*** on the date of the combination is recorded when the contingency is resolved and the additional consideration is paid or issued (or becomes payable or issuable).

Allocation of Cost of a Combinee

- ❖ The FASB required that the cost of a combinee in a business combination be allocated to assets (other than goodwill) acquired and liabilities assumed based on their **estimated fair values** on the date of the combination.
- ❖ Any excess of total costs over the amounts thus allocated is assigned to goodwill. Methods for determining fair values included present values for receivables and most liabilities; net realizable value less a reasonable profit for work in process and finished goods inventories; and appraised values for land, natural resources, and nonmarketable securities. In addition, the following combinee intangible assets were to be recognized individually and valued at fair value: Assets arising from contractual or legal rights, such as patents, copyrights, and franchises. Other assets that are separable from the combinee entity and can be sold, licensed, exchanged, and the like, such as customer lists and unpatented technology. Other matters involved in the allocation of the cost of a combinee in a business combination are:
 1. A part of the cost of a combinee is allocable to identifiable tangible and intangible assets that resulted from research and development activities of the combinee or are to be used in research and development activities of the combined enterprise. Subsequently, such assets are to be expensed, as required by ***FASB Statement No. 2***, “Accounting for Research and Development Costs,” unless they may be used for other than research and development activities in the future.
 2. In a business combination, leases of the combinee-lessee are classified by the combined enterprise as they were by the combinee unless the provisions of a lease are modified to the extent it must be considered a new lease. Thus, unmodified capital leases of the

combinee are treated as capital leases by the combined enterprise, and the leased property and related liability are recognized in accordance with the guidelines of *FASB Statement No. 141*.

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

Goodwill

Goodwill frequently is recognized in business combinations because the total cost of the combinee exceeds the current fair value of identifiable net assets of the combinee. The amount of goodwill recognized on the date the business combination is consummated maybe adjusted subsequently when contingent consideration becomes issuable.

“Negative Goodwill”

In some business combinations (known as *bargain purchases*), the current fair values assigned to the identifiable net assets acquired exceed the total cost of the combinee. A bargain purchase is most likely to occur for a combinee with a history of losses or when common stock prices are extremely low. The excess of the current fair values over total cost is applied pro rata to reduce (but not below zero) the amounts initially assigned to all the acquired assets except financial assets other than investments accounted for by the equity method; assets to be disposed of by sale; deferred tax assets; prepaid assets relating to pension or other postretirement benefits; and any other current assets. If any excess of current fair values over cost of the combinee’s net assets remains after the foregoing reduction, it is recognized as an extraordinary gain by the combinator.

Illustration of Purchase Accounting for Statutory Merger, with Goodwill

On December 31, 2005, Mason Company (the combinee) was merged into Saxon Corporation (the combinator or survivor). Both companies used the same accounting principles for assets, liabilities, revenue, and expenses and both had a December 31 fiscal year. Saxon issued 150,000 shares of its \$10 par common stock (current fair value \$25 a share) to Mason's stockholders for all 100,000 issued and outstanding shares of Mason's no-par, \$10 stated value common stock. In addition, Saxon paid the following out-of-pocket costs associated with the business combination:

Accounting fees:

For investigation of Mason Company as prospective combinee.....	\$ 5,000
For SEC registration statement for Saxon common stock.....	60,000

Legal fees:

For the business combination.....	10,000
For SEC registration statement for Saxon common stock.....	50,000
Finder's fee.....	51,250
Printer's charges for printing securities and SEC registration statement.....	23,000
SEC registration statement fee	<u>750</u>
Total out-of-pocket costs of business combination	<u>\$200,000</u>

There was no contingent consideration in the merger contract.

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

MASON COMPANY (Combinee)
Balance Sheet (prior to business combination)
December 31, 2005

Assets

Current assets.....	\$1,000,000
Plant assets (net).....	3,000,000
Other assets.....	<u>600,000</u>
Total assets.....	<u>\$4,600,000</u>

Liabilities and Stockholders' Equity

Current liabilities	\$ 500,000
Long-term debt.....	1,000,000
Common stock, no-par, \$10 stated value.....	1,000,000
Additional paid-in capital	700,000
Retained earnings.....	<u>1,400,000</u>
Total liabilities and stockholders' equity.....	<u>\$4,600,000</u>

Using the guidelines in *FASB Statement No. 141*, "Business Combinations", the board of directors of Saxon Corporation determined the current fair values of Mason Company's identifiable assets and liabilities (identifiable net assets) as follows:

Current fair values

Current assets.....	\$1,150,000
Plant assets.....	3,400,000
Other assets.....	600,000
Current liabilities.....	(500,000)
Long-term debt (present value).....	(950,000)
Identifiable net assets of combinee.....	<u>\$3,700,000</u>

The condensed journal entries that follow are required for Saxon Corporation (the combinator) to record the merger with Mason Company on December 31, 2005, as a business combination. Saxon uses an investment ledger account to accumulate the total cost of Mason Company prior to assigning the cost to identifiable net assets and goodwill.

SAXON CORPORATION (combinor)
Journal Entries
December 31, 2005

Investment in Mason Company Common Stock
 (150,000 x \$25)3,750,000
 Common Stock (150,000 x \$10)..... 1,500,000
 Paid-in Capital in Excess of Par2,250,000
 (To record merger with Mason Company.)

Investment in Mason Company Common Stock
 (\$5,000 + \$10,000 + \$51,250)66,250
 Paid-in Capital in Excess of Par
 (\$60,000 + \$50,000 + \$23,000 +75k20)..... 133,750
 Cash..... 200,000

(To record payment of out-of-pocket costs incurred in merger with Mason Company. Accounting, legal, and finder's fees in connection with the merger are recognized as an investment cost; other out-of-pocket costs are recorded as a reduction in the proceeds received from issuance of common stock.)

Current Assets1,150,000
 Plant Assets3,400,000
 Other Assets600,000
 Discount on Long-Term Debt50,000
 Goodwill..... 116,250
 Current Liabilities 500,000
 Long-Term Debt..... 1,000,000

Investment in Mason Company Common Stock
 (\$3,750,000 + \$66,250)3,816,250

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

Amount of goodwill is computed as follows:

Total cost of Mason Company (\$3,750,000 + \$66,250)	\$3,816,250
Less: Carrying amount of Mason's identifiable net assets (\$4,600,000 - \$1,500,000)	\$3,100,000
Excess (deficiency) of Current fair values of Identifiable net assets Over carrying amounts:	
Current assets	150,000
Plant assets.....	400,000
Long-term debt	50,000
	<u>3,700,000</u>
Amount of goodwill.....	<u>\$ 116,250</u>

Note that no adjustments are made in the foregoing journal entries to reflect the current fair values of Saxon's identifiable net assets or goodwill, *because Saxon is the combinator in the business combination.*

Mason Company (the combinee) prepares the condensed journal entry below to record the dissolution and liquidation of the company on December 31, 2005.

MASON COMPANY (combinee)

Journal Entry

December 31, 2005

Current Liabilities.....	500,000
Long-Term Debt.....	1,000,000
Common Stock, \$10 stated value.....	1,000,000
Paid-in Capital in Excess of Stated Value.....	700,000
Retained Earnings	1,400,000
Current Assets.....	1,000,000
Plant Assets (net)	3,000,000
Other Assets	600,000

(To record liquidation of company in conjunction with merger with Saxon Corporation.)

Illustration:**Purchase Accounting for Acquisition of Net Assets, with Bargain-Purchase Excess**

On December 31, 2005, Davis Corporation acquired all the net assets of Fairmont Corporation directly from Fairmont for \$400,000 cash, in a business combination. Davis paid legal fees of \$40,000 in connection with the combination. The condensed balance sheet of Fairmont prior to the business combination, with related current fair value data, is presented below:

FAIRMONT CORPORATION (Combinee)
Balance Sheet (prior to business combination)
December 31, 2005

	Carrying Amounts	Current Fair Values
Assets		
Current assets	\$190,000	\$200,000
Investment in marketable debt securities (held to maturity)	50,000	60,000
Plant assets (net)	870,000	900,000
Intangible assets (net)	<u>90,000</u>	<u>100,000</u>
Total assets	<u>\$1,200,000</u>	<u>\$1,260,000</u>
Liabilities and Stockholder's Equity		
Current liabilities	\$240,000	\$240,000
Long term debt	<u>500,000</u>	<u>520,000</u>
Total liabilities	<u>\$740,000</u>	<u>\$760,000</u>
Common stock, \$1 par	\$600,000	
Deficit	<u>(\$140,000)</u>	
Total Stockholder's Equity	\$460,000	
Total liabilities and SHE	<u>\$1,200,000</u>	

Thus, Davis acquired identifiable net assets with a current fair value of \$500,000 (\$1,260,000 - \$760,000 = \$500,000) for a total cost of \$440,000 (\$400,000 + \$40,000 = \$440,000). The \$60,000 excess of current fair value of the net assets over their cost to Davis (\$500,000 - \$440,000

=\$60,000) is prorated to the plant assets and intangible assets in the ratio of their respective current fair values, as follows:

To plant assets: $60,000 \times \frac{900,000}{900,000 + 100,000} = \underline{\$54,000}$

To intangible assets: $60,000 \times \frac{100,000}{900,000 + 100,000} = \underline{\$6,000}$

Total excess of current fair value of identifiable net assets over combinator's cost **\$60,000**

No part of the \$60,000 bargain-purchase excess is allocated to current assets or to the investment in marketable securities.

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

DAVIS CORPORATION (Combinor)

Journal Entries

December 31, 2005

Investment in Net Assets of Fairmont Corporation..... 400,000
 Cash..... 400,000

(To record acquisition of net assets of Fairmont Corporation.)

Investment in Net Assets of Fairmont Corporation40,000
 Cash..... 40,000

(To record payment of legal fees incurred in acquisition of net assets of Fairmont Corporation.)

Current Assets.....	200,000
Investments in Marketable Debt Securities.....	60,000
Plant Assets (\$900,000 _ \$54,000).....	846,000
Intangible Assets (\$100,000 _ \$6,000).....	94,000
Current Liabilities	240,000
Long-Term Debt.....	500,000
Premium on Long-Term Debt (\$520,000 _ \$500,000).....	20,000
Investment in Net Assets of Fairmont Corporation	
(\$400,000 + \$40,000)	440,000

(To allocate total cost of net assets acquired to identifiable net assets, with excess of current fair value of the net assets over their cost prorated to noncurrent assets other than investment in marketable debt securities). (Income tax effects are disregarded.)

Other Topics in Accounting for Business Combinations

Statutory Consolidation

Because a new corporation issues common stock to effect a statutory consolidation, one of the constituent companies in a statutory consolidation must be identified as the combinator. Once the combinator has been identified, the new corporation recognizes net assets acquired from the combinator at their *carrying amount* in the combinator's accounting records; however, net assets acquired from the combinee are recognized by the new corporation at their *current fair value*.

To illustrate, assume the following balance sheets of the constituent companies involved in a statutory consolidation on December 31, 2005:

LAMSON CORPORATION AND DONALD COMPANY

Separate Balance Sheets (prior to business combination)

December 31, 2005

	Lamson Corporation	Donald Company
Assets		
Current assets	\$600,000	\$400,000
Plant Assets (net)	1,800,000	1,200,000
Others assets	400,000	300,000
Total assets	<u>2,800,000</u>	<u>1,900,000</u>
Liabilities and Stockholder's 'Equity		
Current liabilities	\$400,000	\$300,000
Long term debt	500,000	200,000
Common stock,\$10 par	430,000	620,000
Additional paid in Capital	\$300,000	400,000
Retained Earnings	<u>\$1,170,000</u>	<u>380,000</u>
Total liabilities and SHE	<u>\$2,800,000</u>	<u>\$1,900,000</u>

The current fair values of both companies' liabilities were equal to carrying amounts. Current fair values of identifiable assets were as follows for Lamson and Donald, respectively: current assets, \$800,000 and \$500,000; plant assets, \$2,000,000 and \$1,400,000; other assets, \$500,000 and \$400,000.

On December 31, 2005, in a statutory consolidation approved by shareholders of both constituent companies, a new corporation, LamDon Corporation, issued 74,000 shares of no-par, no-stated-value common stock with an agreed value of \$60 a share, based on the following valuations assigned by the negotiating directors to the two constituent companies' identifiable net assets and goodwill:

	<u>Lamson Corporation</u>	<u>Donald Company</u>
Current fair value of identifiable net assets:		
Lamson: \$800,000 + \$2,000,000 + \$500,000 -\$400,000 - \$500,000		\$2,400,000
Donald: \$500,000 + \$1,400,000 + \$400,000 -\$300,000 - \$200,000.....		\$1,800,000
Goodwill.....	<u>180,000</u>	<u>60,000</u>
Net assets' current fair value	<u>\$2,580,000</u>	<u>\$1,860,000</u>
Number of shares of LamDon common stock to be issued to constituent companies' stockholders, at \$60 a share agreed value.....	43,000	31,000
(Computation of Number of Shares of Common Stock Issued in Statutory Consolidation)		

Because the former stockholders of Lamson Corporation receive the larger interest in the common stock of LamDon Corporation (43/74, or 58%), Lamson is the combinator in the business combination. Assuming that LamDon paid \$200,000 out-of-pocket costs of the statutory consolidation after it was consummated on December 31, 2005, LamDon's journal entries would be as follows

LAMDON CORPORATION

Journal Entries

December 31, 2005

Investment in Lamson Corporation and Donald Company

Common Stock (74,000 x \$60)4, 440,000

 Common Stock, no par..... 4,440,000

(To record consolidation of Lamson Corporation and Donald Company as a purchase.)

Investment in Lamson Corporation and Donald Company Common Stock... 110,000

Common Stock, no par90,000

 Cash..... 200,000

(To record payment of costs incurred in consolidation of Lamson Corporation and Donald Company. Accounting, legal, and finder's fees in connection with the consolidation are recorded as investment cost; other out-of-pocket costs are recorded as a reduction in the proceeds received from the issuance of common stock.)

Current Assets (\$600,000 + \$500,000).....1,100,000

Plant Assets (\$1,800,000 + \$1,400,000).....3,200,000

Other Assets (\$400,000 + \$400,000)..... 800,000

Goodwill850,000

Current Liabilities (\$400,000 + \$300,000)700,000

Long-Term Debt (\$500,000 + \$200,000) 700,000

Investment in Lamson Corporation and Donald Company

Common Stock (\$4,440,000 + \$110,000)4,550,000

(To allocate total cost of investment to identifiable assets and liabilities, at carrying amount for combinator Lamson Corporation's net assets and at current fair value for combinee Donald Company's net assets. (Income tax effects are disregarded.)

Amount of goodwill is computed as follows:

Total cost of investment (\$4,440,000 + \$110,000)..... \$4,550,000

Less: Carrying amount of Lamson's identifiable net assets..... (1,900,000)

Current fair value of Donald's identifiable net assets..... (1,800,000)

Amount of goodwill\$ 850,000

Note in the foregoing journal entry that because of the combinator's net assets' being recognized at carrying amount and because of the \$110,000 direct out-of-pocket costs of the business combination, the amount of goodwill is \$850,000, rather than \$240,000 ($\$180,000 + \$60,000 = \$240,000$), the amount assigned by the negotiating directors to goodwill in the determination of the number of shares of common stock to be issued in the combination.

IFRS3, "Business Combinations"

The International Accounting Standards Board (IASB) *formerly* required purchase-type accounting for all business combinations except those deemed a *uniting of interests*, defined as a combination in which the stockholders of the constituent companies combine into one entity, the whole of the net assets and operations of those companies to achieve a continuing mutual sharing of the risks and benefits of the combined enterprise. However, in 2004 the IASB mandated, in *International Financial Reporting Standard 3*, "Business Combinations," purchase-type accounting for *all* business combinations, and periodic testing of goodwill for impairment. *Accounting for Acquired Intangible Assets Subsequent to a Business Combination*. In *FASB Statement No. 142*, "Goodwill and Other Intangible Assets," the Financial Accounting Standards Board provided that intangible assets with finite useful lives were to be amortized over those estimated useful lives. In contrast, goodwill and other intangible assets with indefinite useful lives were *not* to be amortized but were to be tested for *impairment* at least annually. The FASB also provided detailed procedures for impairment tests.

Quick Check

- ❖ Identify properly accounting methods and procedures for business combinations
- ❖ How the Combinor is determined?
- ❖ What are the considerations taken in to account when calculating Cost of a Combinee?

CHAPTER SUMMARY

Business combinations arise when one or more companies become subsidiaries of another company. As with any other economic activity, business combination can be part of an overall managerial activity to maximize shareholder value. Business combination is bringing together two or more separate businesses under common ownership.

The Financial Accounting Standards Board has provided the following working definition of business combination: Because the carrying amounts of the net assets of the combinator are not affected by a business combination, the combinator must be accurately identified. The FASB stated that in a business combination effected solely by the distribution of cash or other assets or by incurring liabilities, the combinator is the distributing or incurring constituent company. For combinations effected by the issuance of equity securities, consideration of all the facts and circumstances is required to identify the combinator. However, a common theme is that the combinator is the constituent company whose stockholders as a group retain or receive the largest portion of the voting rights of the combined enterprise and thereby can elect a majority of the governing board of directors or other group of the combined enterprise.

The International Accounting Standards Board (IASB) *formerly* required purchase-type accounting for all business combinations except those deemed a *uniting of interests*, defined as a combination in which the stockholders of the constituent companies combine into one entity, the whole of the net assets and operations of those companies to achieve a continuing mutual sharing of the risks and benefits of the combined enterprise. However, in 2004 the IASB mandated, in *International Financial Reporting Standard 3*, “Business Combinations,” purchase-type accounting for *all* business combinations, and periodic testing of goodwill for impairment. *Accounting for Acquired Intangible Assets Subsequent to a Business Combination*. In *FASB Statement No. 142*, “Goodwill and Other Intangible Assets,” the Financial Accounting Standards Board provided that intangible assets with finite useful lives were to be amortized over those estimated useful lives. In contrast, goodwill and other intangible assets with indefinite useful lives were *not* to be amortized but were to be tested for *impairment* at least annually. The FASB also provided detailed procedures for impairment tests.

REVIEW QUESTIONS

11. Of the following one does **not** show the rationality for combination. Identify:

- A. For escaping from takeovers.
- B. Diversification
- C. Cost opportunities
- D. To bring tangible and intangible assets together.
- E. All F. None

Based on Data B: below, answer Qn. 2 to 5

Data B: Assume that the following businesses are constituent companies for combination.

- a. Ghion Transport Company possess the total asset estimated for Br. 100 billion.
- b. Dashen Manufacturing Company possess the total asset estimated for Br. 130 billion.
- c. Hawassa Real Estate possess the total asset estimated for Br. 200 billion.
- d. Zewud Transport Company possess the total asset estimated for Br. 50 billion.
- e. Ras Transport Company possess the total asset estimated for Br. 100 billion.

12. If companies combined, which combination is horizontal?

- A. 1 & 2 B. 4 & 5 C. 1 & 5 D. 3 & 5 E. All F. None

13. Which combination is conglomerate?

- A. 3 & 4 B. 5 & 2 C. 2 & 3 D. 3 & 5 E. All F. None

14. Which combination is **not** vertical?

- A. 2 & 4 B. 2 & 1 C. 5 & 1 D. 3 & 4 E. All F. None

15. One of the defense mechanisms for aggressive takeover is an amendment of the articles of incorporation to make it more difficult to obtain stockholder approval for a takeover. Which term define this statement?

- A. Greenmail B. Shark repellent C. Poison pill D. White knight

16. Identify the **false** statement among the following alternatives.

- A. Dividends declared by the subsidiary subsequent to the business combination are revenue to parent company as per cost method.
- B. Net income or net loss of subsidiary is not recorded by parent company when the cost method of accounting is used.

- C. Dividends declared subsequent to combination by subsidiary are revenues to the parent company when equity method is applied.
- D. The cost method accounts for investments when the investor has no ability to exercise control over the investee's operations.
- E. None

Based on **Data D:** below answer **Qn. No. 7 to 12** considering full acquisition

Data D: Assume that **Gidole Corporation** and **Sawla Commercial** Company proposed to consolidate. The current fair value of plant asset of Sawla Commercial on December 31,2012 is Br. 750,000. On December 31, 2012, **Gidole Corporation** acquired all the outstanding Common stock of **Sawla Company** for Br. 1,000,000 cash. The following data shows their balance sheet before their combination.

**Gidole Corporations and Sawla Commercial
Separate Balance sheet
December 31, 2012**

	<u>Gidole Corporation</u>	<u>Sawla Commercial</u>
Assets		
Cash.....	Br. 1,500,000	Br. 500,000
Inventories.....	1,000,000	100,000
Plant assets (net)	<u>2,500,000</u>	<u>350,000</u>
Total Assets.....	<u>Br. 5,000,000</u>	<u>Br. 950,000</u>
Liabilities and Equity		
Current Liabilities	300,000	50,000
Common Stock Br. Par	500,000	500,000
Additional paid-in Capital	1,500,000	100,000
Retained earnings	<u>2,700,000</u>	<u>300,000</u>
Total Liabilities and SHE	<u>Br.5, 000, 000</u>	<u>Br. 950,000</u>

17. What is the amount of current fair value of identifiable net assets of Sawla Commercial?

- A. Br. 700,000
- B. Br. 1,000,000
- C. Br. 850,000
- D. Br. 800,000
- E. None









18. What is the amount of good will from the consolidation process?

- A. Br. 500,000 positive goodwill

- B. Br. 100,000 negative goodwill
 - C. Br. 150,000 negative goodwill
 - D. Br. 200,000 Positive goodwill
 - E. None
19. What is the amount of cash and plant asset balance on consolidated balance sheet of the two company respectively?
- A. 100, 000 and 350,000
 - B. Br. 2,500,000 and 350,000
 - C. Br. 1,000,000 and 3,250,000
 - D. 2,000,000 and 2,850,00
 - E. None
20. What is the amount of consolidated Common stock and retained earnings respectively after combination?
- A. Br. 1,000,000 and 3,000,000
 - B. Br. 1,500,000 and 100,000
 - C. Br. 500,000 and 300,000
 - D. Br. 500, 000 and 2,700,000
 - E. None
21. Which financial statement is **odd** on the date of acquisition of consolidated financial statements?
- A. Retained earnings
 - B. Income statement
 - C. Balance sheet
 - D. Statements of cash flow
 - E. None.
22. If the total cost of combine become Br. 800,000 considering the fair value of the Sawla Commercial, what result do you investigate?
- A. Negative goodwill
 - B. Consolidated plant asset will overstate by Br. 100,000
 - C. Consolidated plant asset will understate by Br. 100,000
 - D. Consolidated cash balance will understate by Br. 800,000
 - E. B & D
 - F. A & C.







CHAPTER FIVE
CONSOLIDATED FINANCIAL STATEMENTS:
AT THE DATE AND SUBSEQUENT TO DATE OF ACQUISITION

LEARNING OBJECTIVES:

-  *Recognize the benefits and limitations of consolidated financial statements.*
-  *Understand requirements for including a subsidiary in consolidated financial statements.*
-  *Apply consolidation concepts to parent company recording of an investment in a subsidiary company at the date of acquisition.*
-  *Record the fair value of the subsidiary at the date of acquisition.*
-  *Learn the concept of noncontrolling interest when a parent company acquires less than 100 percent of a subsidiary's outstanding common stock.*
-  *Prepare consolidated balance sheets subsequent to the acquisition date, including preparation of eliminating entries.*
-  *Amortize the excess of the fair value over the book value in periods subsequent to the acquisition.*
-  *Apply the concepts underlying preparation of a consolidated income statement.*

5.1 Consolidated Financial Statement

Statements prepared for a parent company and its subsidiaries are called **consolidated financial statements**.

-  Ignore legal aspects of separate entities, focus on economic entity under “control” of management.
-  Substance rather than form.
-  Not substitute for statements prepared by separate subsidiaries, which may be used by:
 - Creditors
 -  Noncontrolling stockholders
 -  Regulatory agencies
-  The fair value, and hence acquisition price, of a subsidiary might exceed the book value for several reasons:

- ✚ Errors or omissions on the books of the subsidiary
- ✚ Excess of fair value over the book value of the subsidiary's net identifiable assets □ Existence of goodwill

➤ ***Errors or omissions on the books of the subsidiary***

- ✚ Corrections should be made directly on the subsidiary's books as of the date of acquisition

➤ ***Excess of fair value over book value of subsidiary's net identifiable assets***

- ✚ The assets and liabilities of the subsidiary may be revalued directly on the books of the subsidiary
- ✚ The accounting basis of the subsidiary may be maintained and the revaluations made each period in the consolidation working paper

5.2 Consolidated Financial Statements on The Date of Business Combination Under Purchase Accounting (Acquisition Method)

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

When one company controls another company through direct or indirect ownership of its voting stock.

- *Acquiring company referred to as the parent.*
- *Acquired company referred to as the subsidiary.*
- *Other shareholders considered noncontrolling interest.*
- *Parent records interest in subsidiary as an investment.*
- *If a subsidiary owns a controlling interest in one or more other companies, a chain of ownership is forged by which the parent company controls other companies.*

5.2.1 The Parent and Subsidiary Relationships

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

5.2.2 Nature of Consolidated Financial Statements

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

Should all subsidiaries be consolidated?

There is no reason for excluding from consolidation any subsidiary that is controlled. This is because the purpose of consolidation is to present for a single entity the combined resources, obligations and operating results of a family of related corporations. In **FASB statement No.94** Consolidation of all majority-owned subsidiaries issued in 1987, FASB required the

consolidation of nearly all subsidiaries. Only subsidiaries not actual controlled were excluded from consolidation.

5.2.3 The Meaning of Controlling Interest

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

For Example:

1. **Subsidiary in liquidation** or reorganization in court and supervised by bankruptcy proceedings is not controlled by its parent.
2. A **foreign subsidiary** in a country having severe production, monetary or income tax restrictions may be subject to the authority of the foreign country rather than the parent company.
3. If **minority shareholders** of a subsidiary have the right to participate effectively in the financial and operating activities of the subsidiary in the ordinary course of business, the subsidiary's financial statements should not be consolidated with those of the parent company.

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

Example: If XX Company owns 80% of outstanding common stock of YY Company and 40% of ZZ Company's common stock and also YY Company owns 40% of ZZ Company's common stock, XX Company controls both YY and ZZ company because XX Co. owns 72% of ZZ Co. (40% directly and 32% indirectly).

Criticism of Transitional Concept of Control

- Many accountants criticize the traditional definition of control described above which emphasizes legal form.
- They argue that an investor **owning less than 50% of an investee's voting** common stock in substance may control the affiliate, especially if the remaining stock is

scattered among a large number of shareholders who do not attend shareholder's meetings or give proxies

- Effective control of an investee is also possible **if individuals comprising management** of the investor corporation own a substantial number of shares of the investee or successfully solicit proxies from the investee's other shareholders.
- The SEC in financial reporting Release No 25 required companies to emphasize economic substance over legal form in adopting a consolidation policy.
- The FASB also issued a discussion memorandum which dealt at length with the question of ownership (legal form) versus control (economic substance) as a basis for consolidation.

FASB'S Proposed Redefinition of Control

- Based on the discussion memorandum FASB issued a proposed statement that would have defined control of an entity as power over its assets. That is power to use or direct the use of the individual assets of another entity in essentially the same way as the controlling entity can use its own assets.
- In 1999, the FASB issued a revised proposed statement that would define *control* as a parent company's **non-shared decision-making ability that enables** it to guide the ongoing activities of its subsidiary and to use that power to increase the benefits that it derives and limit the losses that it suffers from the activities of that subsidiary.
- The proposed statement further stated that in the absence of evidence that demonstrated otherwise, the existence of control of a corporation shall be presumed if an entity (including its subsidiaries):
 - Has a majority voting interest in the election of a corporation's governing body or a right to appoint a majority of the members of its governing body.
 - Has a large minority voting interest in the election of a corporation's governing body and no other party or organized group of parties has a significant voting interest.
 - Has a unilateral ability to (1) Obtain a majority voting interest in the election of a corporation's governing body or (2) Obtain a right to appoint a majority of the corporation's governing body through the present ownership of convertible securities or other rights that are currently exercisable at the option of the holder and the expected

benefit from converting those securities or exercising that right exceeds its expected cost.

- By the latter proposal, the FASB planned to repeal the long-standing requirement of majority ownership of an investee's outstanding common stock as a prerequisite for consolidation.
- Objectively determined legal form was to be replaced by subjectivity determined economic substance as the basis for consolidated financial statements.

Steps for Consolidation

1. Updating the balances of accounts affected by business combination transaction
2. Record the financial information for both Parent and Subsidiary on the worksheet
3. Remove the Investment in Subsidiary balance.
4. Remove the Subsidiary's equity account balances.
5. Remove Intercompany transactions
6. Adjust the Sub's net assets to CFV.
7. Allocate any excess of cost over CFV to identifiable intangible assets or goodwill
8. Combine all account balances.

5.2.4 Consolidation Working Papers and Eliminating Entries

Accountants generally use a **working paper for consolidated balance sheet** and **working paper eliminations** to facilitate the preparation of a consolidated balance sheet on the date of a business combination. A consolidated income statement, a consolidated statement of stockholders' equity, and a consolidated statement of cash flows are not appropriate for the accounting period ended on the date of a business combination, because the combining companies were separate **economic** as well as **legal** entities prior to the combination.

Working paper eliminations are **working paper entries only**; they are not entered in the accounting records of either the parent company or the subsidiaries. Working paper eliminations on the date of a business combination include differences between current fair

values and carrying amounts of the subsidiary’s identifiable assets and liabilities because a subsidiary prepares no journal entries for a business combination.

The consolidated paid-in capital amounts in a consolidated balance sheet are those of the parent company only. Subsidiaries’ paid-in capital amounts **always** are eliminated in consolidation. In addition, consolidated retained earnings on the date of a business combination include the retained earnings of the **parent company only**.

Intercompany Accounts to be Eliminated

Parent’s Accounts		Subsidiary’s Accounts
Investment in subsidiary	<i>Against</i>	Equity accounts
Intercompany receivable (payable)	<i>Against</i>	Intercompany payable (receivable)
Advances to subsidiary (from subsidiary)	<i>Against</i>	Advances from parent (to parent)
Interest revenue (interest expense)	<i>Against</i>	Interest expense (interest revenue)
Dividend revenue (dividends declared)	<i>Against</i>	Dividends declared (dividend revenue)
Management fee received from subsidiary	<i>Against</i>	Management fee paid to parent
Sales to subsidiary (purchases of inventory from subsidiary)	<i>Against</i>	Purchases of inventory from parent (sales to parent)

Why we eliminate the above accounts?

“You Can’t Own Yourself”

The investment account must be eliminated because, from a single entity viewpoint, a company cannot hold an investment in itself. The subsidiary’s stock and the related stockholders’ equity accounts must be eliminated because the stock of the subsidiary is held entirely within the consolidated entity and none represents claims by outsiders.

“You Can’t Owe Yourself Money”

All forms of intercorporate receivables and payables need to be eliminated when a consolidated balance sheet is prepared. From a single-company viewpoint, a company cannot owe itself money. If a company owes an affiliate \$1,000 on account, one company carries a \$1,000 receivable on its separate books, and the other has a payable for the same amount. When consolidated financial statements are prepared, the following elimination entry is needed in the consolidation workpaper:

<i>Accounts Payable</i>	<i>\$1,000</i>
<i>Accounts Receivable</i>	<i>\$1,000</i>

Example: Following are the December 31, 2002 balance sheets of two companies prior to their business combinations

Pelerin Corporations and south Company
Separate Balance sheet (Prior to business combinations)
December 31, 2002

<u>Assets</u>	<u>Pelerin Corporation</u>	<u>South Company</u>
Cash	\$3,000,000	\$100,000
Inventories.....	2,000,000	200,000
Plant assets (net)	<u>5,000,000</u>	<u>700,000</u>
Total Assets.....	<u>\$10,000,000</u>	<u>\$1,000,000</u>

Liabilities and Equity

Current Liabilities	600,000	100,000
Common Stock Br. Par	1,000,000	100,000
Additional paid-in Capital	3,000,000	200,000
Retained earnings	<u>5,400,000</u>	<u>600,000</u>
Total Liaband SHE	<u>10, 000, 000</u>	<u>1,000,000</u>

Current Fair value of plant Asset of South Company on December 31,2002 is Br. 1,500,000

Required

- a) On December 31, 2002 pelerine Corporation acquired all the outstanding common stock of South Company for Br. 2,000,000 cash. Prepare a working paper to compute the amount of good will to be displayed in the consolidated balance sheet of pelerine Corporation and subsidiary on December 31, 2002. Also prepare consolidated balance sheet of parent and subsidiary without preparing a working paper.
- b) On December 31, 2002, pelerine Corporation acquired all the outstanding common stock of South Company for Br. 1,600,000 cash. Prepare a working paper to compute the amount of goodwill to be displayed in the consolidated balance sheet of pelerine

Corporation and Subsidiary on December 31, 2002. Also prepare consolidated balance sheet of parent and subsidiary without preparing a working paper.

Solution

Step1. Calculation of consideration amount paid

$$\text{Consideration Amount} = \underline{\underline{2,000,000}}$$

Step2. Calculation of Direct out of pocket costs

$$\text{Direct-out-of pocket} = \text{NIL}$$

Step3. Calculation of total cost of a cost of a combine

$$\text{Total Cost} = \underline{\underline{2,000,000}}$$

Step4. Calculation of CFV of identifiable NA of a Combinee

$$\begin{aligned} \text{CFV of Identifiable NA} &= [\text{CFV of CA} + \text{CFV of PA} + \text{CFV of OA}] - [\text{CFV of CL} + \text{CFV of LTD}] \\ &= [100,000 + 2,000,000 + 1,500,000 + \text{NIL}] - [100,000 + \text{NIL}] \\ &= 1,800,000 - 100,000 \\ &= \underline{\underline{1,700,000}} \end{aligned}$$

Step5. Calculation of Good will

$$\begin{aligned} &= \text{Cost} > \text{CFV of identifiable NA} \\ &= 2,000,000 > 1,700,000 \end{aligned}$$

$$\text{Good will} = \underline{\underline{300,000}}$$

Journal Entries on the Books of parent

1. Investment in wholly owned subsidiary A/C Dr 200,000

Cash A/c 200,000

[To record the combination as purchase]

2. No Journal Entries

3. To allocate the total cost of a Combinee

Cash..... A/C Dr. 100,000

Inventories A/C Dr. 200,000

Plant assetsA/C Dr. 1,500,000

Good will A/C Dr. 300,000

Current liabilities A/C 100,000

Inv't in wholly owned Co. A/C 2,000,000

Preparation of cash ledger account

Date	Items	P/R	Dr.	Cr.	Balance	
					Dr.	Cr.
	Balance				3,000,000	
	Investment in wholly Owned company			2,000,000	1,000,000	

Preparation of Consolidated Balance Sheet

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

1. The operating results of the two companies prior to combination are those of two separate economic- as well as legal – entities. Accordingly, a consolidated balance sheet is the only consolidated financial statement issued by the investor (Palm Corporation) on the date of the business combination. This can be done with the use of a working paper.
2. The parent company's investment account and the subsidiary's stockholder's equity accounts do not appear in the consolidated Balance sheet because they are reciprocal or intercompany accounts.
3. Under purchase accounting theory, the parent company (combinor) assets and liabilities are reflected at **carrying amount** and that of the subsidiary (the combinee's) at **current fair values** except inter company accounts, in the consolidated balance sheet.
4. **Goodwill** is recognized to the extent the cost of the parent company's investment in 100% of the subsidiary's outstanding common stock exceeds the current fair value of the subsidiary's identifiable net assets.

Preparation of cash ledger account

Date	Item	P/R	Dr	Cr	Balances	
					Dr	Cr
	Balance b/d				3,000,000	
1.	Investment in wholly owned company			1,600,000	1,400,000	

Without preparing working paper or worksheet, Prepare consolidated balance sheet

Pelerine and Wholly Owned Company Consolidated

Balance Sheet

As on December 31st, 2002.

Assets	Amount	Liability & Equities	Amount
Cash (1, 400,000+100,000)	1,500,000	Current Liabilities	
Inventory (2,000,000+200,000)	2,200,000	(600,000+100,000)	700,000
Plant Asset (5,000,000+1,400,000)	6,400,000	Common Stock	1,000,000
		Additional paid in	3,000,000
		Retained earning	5,400,000
Total Asset	10,100,000	Total Liab. & Equities	<u>10,100,000</u>

Working Paper for Consolidated Balance Sheet

- Preparation of consolidated balance sheet on the date of purchase type business combination usually requires the use of a **working paper** for consolidated balance sheet, even for a parent company and a wholly owned subsidiary.

- A consolidated balance sheet is prepared using a working paper for Palm Corporation a shown below.

- The working paper for consolidated balance sheet on the date of purchase-type business combination has the following features:

- 1.The elimination is not entered in either the parent company's or the subsidiary's accounting records; it is only a part of the working paper for preparation of the consolidated balance sheet.

2. The elimination is used to reflect differences between current fair values and carrying amounts of the subsidiary's identifiable net assets because the subsidiary did not write up its assets to current fair values on the date of the business combination.

3. The Elimination column in the working paper for consolidated balance sheet reflects increases and decreases, rather than debits and credits. Debits and credits are not appropriate in a working paper dealing with financial statements rather than trial balances.

4. Intercompany receivables and payables are placed on the same line of the working paper for consolidated balance sheet and are combined to produce a consolidated amount of zero.

5. The respective corporations are identified in the working paper elimination. The reason for precise identification is to deal with the eliminations of intercompany profits (or gains).

6. The consolidated paid-in capital amounts are those of the parent company only. Subsidiaries. Paid-in capital amounts always are eliminated in the process of consolidation.

7. Consolidated retained earnings on the date of purchase-type business combination include only the retained earnings of the parent company. This treatment is consistent with the theory that purchase accounting reflects a fresh start in an acquisition of net assets (assets less liabilities), not a combining of existing stockholder interest.

8. The amounts in the consolidated column of the working paper for consolidated balance sheet reflects the financial position of a single economic entity comprising two legal entities, with all intercompany balances of the two entities eliminated.

Quick Check

- ✚ What does it mean consolidation and consolidated financial statement?
- ✚ What is the nature of consolidated financial statements?
- ✚ Should all subsidiaries be consolidated?
- ✚ How do you understand controlling interest in business combination?

5.3 CONSOLIDATION OF PARTIALLY OWNED SUBSIDIARY ON DATE OF BUSINESS COMBINATION UNDER PURCHASE METHOD OF ACCOUNTING

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

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

Example: On September 30, 2002 Philly Corporation issued 100,000 shares of its no-par, no-stated value common stock (current fair value. Br. 12 a share) for 18,800 stocks of the outstanding Br. 20 a par common stock of Stype Company. The Br. 150,000 out-of-pocket costs of the business combination paid by Philly on September 30, 2002, were allocable as follows: 60% to finder's legal, and accounting fess directly related to the business combination; 40% to the SEC registration statement for Philly's common stock issued in the business combination. There was no contingent consideration.

Immediately prior to the business combination, separate balance sheets of the constituent companies were as following:

Philly Corporation and Stype Company Separate Balance Sheet (following Business combination) September 30,2002					
Assets	Philly	Stype	Liability and SHE	Philly	Stype
Cash	200,000	100,000	Current Liability	800,000	400,000
A/R	400,000	200,000	Long term Debt		100,000
Inventories	600,000	300,000	Common stock	1,200,000	
Plant Assets	1,300,00	1,000,000	Common Stock Br. 20		400,000
			Retained Earnings	500,000	700,000
Totals Assets	<u>2,500,000</u>	<u>1,600,000</u>	Total liab and SHE	<u>2,500,000</u>	<u>1,600,000</u>

Current fair values of Stype's identifiable net assets different from their carrying amounts as follows: inventories Br.340,000 Plant assets Br.1,100,000 and Long-term debt Br90,000

Required:

- A. Prepare journal entries for Philly corporation to record the business combination with Stype company as purchase type of combination
- B. prepare the consolidated balance sheet of Philly an and subsidiary on Sept. 31,2002 without preparing working paper for consolidated balance sheet
- C. prepare the consolidated balance sheet of Philly and subsidiary on Sept. 31,2002 with preparing working paper for consolidated balance sheet

Solution: Working Notes

1. N^o of stocks outstanding in "s" company

$$= \frac{400,000 \text{ birr}}{20} = \underline{\underline{20,000 \text{ stocks}}}$$

20 birr each

2. No of stocks acquired by "p"

= 18,800 stocks therefore p's share of acquisition

$$= \frac{18,800}{20,000} \times 100 = \underline{\underline{94\%}}$$

20,000

3.No of stocks with minority interest = 1200 stocks therefore, minority interest

$$= \frac{1200}{20,000} \times 100 = \underline{\underline{6\%}}$$

20,000

Step 1: - calculation of consideration amount

$$\begin{aligned} &= \text{cash} + \text{CFV of Assets distributed} + \text{CFV of Debts issued} + \text{CFV of stocks} \\ &\text{issued} = \text{Nil} + \text{Nil} + \text{Nil} + (100,000 \times 20) \\ &= \underline{\underline{1,200,000}} \end{aligned}$$

Step 2: - Calculation of Direct out of pocket cost

$$= \text{legal fee} + \text{Accounting fee} + \text{Finder's fee} + \text{Appraisal Fee}$$

Given total out of pocket cost = 150,000

Direct out of pocket cost = 60% there fore

$$\text{Direct out of pocket cost} = 150,000 \times 60\% = \underline{\underline{90,000}}$$

Therefore, Registration cost will be $(150,000 - 90,000)$ or $(150,000 \times 40\%) = \underline{\underline{60,000}}$

Step 3 = calculation of total cost of a combine

$$\begin{aligned} &= \text{consideration} + \text{Direct out of pocket cost} + \text{consideration configure} \\ &= 1,200,000 + 90,000 + N/L \\ &= \underline{\underline{1,290,000}} \end{aligned}$$

Step 4 = calculation of CFV of identifiable NA

$$\begin{aligned} &= [\text{CFV of CA} + \text{CFV of PA} + \text{CFV of OA}] - [\text{CFV of CL} + \text{CFV of LTD}] \\ &= [100,000 + 200,000 + 340,000 + 1,100,000] - [400,000 + 90,000] \\ &= 1,740,000 - 490,000 \\ &= \underline{\underline{1,250,000}} \end{aligned}$$

Step 5: Adjusted CFV of identifiable NA

$$\begin{aligned} \text{Minority interest} &= [\text{CFV of identifiable NA} \times \frac{6}{100}] \\ &= 1,250,000 \times 6\% \\ &= \underline{\underline{75,000}} \end{aligned}$$

$$\begin{aligned} \text{Therefore Adjusted CFV of identifiable NA} &= \text{CFV of identifiable NA} - \text{Minority interest} \\ &= 1,250,000 - 75,000 = \underline{\underline{1,175,000}} \end{aligned}$$

Step 6 Good will /Negative Good will

$$\begin{aligned} \text{Good will} &= \text{total cost of} > \text{Adjusted CFV of Combinee identifiable NA} \\ &= 1,290,000 > 1,175,000 \\ \text{Good will} &= \underline{\underline{115,000}} \end{aligned}$$

Journal Entries in the Books of “p”

1. To Record the combination as purchase

Investment in “partially owned subsidiary” A/C Dr 1,200,000
Common stocks A/C 1,200,000

****If there is no par or stated value for the stock issued the market value taken as par value or we simply multiply by CFV of stocks.**

2. To record out of pocket cost

Inv't in partially owned subsidiary A/CDr 90,000
 Paid in capital in excess of par A/C Dr60,000
 Cash A/C150,000

3. To allocate total cost of a combine

Cash A/CDr. 100,000
 Accounts Receivables Dr. 200,000
 Inventories A/C Dr. 340,000
 Plant Assets A/C Dr. 1,100,000
 Good will A/CDr. 115,000
 Discount of LTD A/C Dr. 10,000
 Current liability A/C400,000
 Long term debts A/C100,000
 Inv't in partially owned subs. A/C1,290,000
 Minority interest A/C75, 000

Prepare the necessary ledger Accounts

Cash ledger accounts

Date	Item	P/R	Dr	Cr	Balance	
					Dr	Cr
	Balance b/d				200,000	
	Inv't in partially owned			90,000	110,000	
	Paid in capital in excess of par			60,000	<u>50,000</u>	

Common stock ledger account

Date	Item	P/R	Dr	Cr	Balance	
					Dr	Cr
	Balance b/d				1,200,000	
	Inv't in partially owned			1,200,000	<u>2,400,000</u>	

Paid in capital in excess of par

Date	Item	P/R	Dr	Cr	Balance	
					Dr	Cr
	Balance b/d				-	-
	Paid up capital		60,000		60,000	

Philly and partially of owned subsidiary

Consolidated Balance sheet

As on September 30, 2002

Assets	Amount	Liability and Equity	Amount
Cash [50,000 + 100,000)	150,000	Current liability (800,000+400,000)	1,200,000
A/R [400,000 +200,000)	600,000	Long-term debt (Nil+90,000)	90,000
Inventories (600,000+340,000)	940,000	Common stock(2,400,000-60,000)	2,340,000
Plant Assets (1,300,000+1,100,000)	2,400,000	Retained earnings	500,000
Goodwill	115,000	Minority interest	75,000
Total Assets	<u>4,205,000</u>	Total Liability & Equity	<u>4,205,000</u>

****When paid in capital in excess of par has debit balance, it has to be deducted from common stock balance in the consolidated balance sheet.**

Note:-

- If paid in capital in excess of par shows credit balance – then show it on the liabilities side of the consolidated balance sheet separately.
- If it shows the debit balance- then deduct from the parents common stock balance (Which is from the ledger account) on the liabilities side of the balance sheet.

Items	Philly	Stype (Book value)	Elimination		Consolidated Amount
			Increase (Dr)/Decrease (Cr)	Decrease (Cr)/Increase (Dr)	
<u>Assets</u>					
Cash	50,000	100,000	-	-	150,000
Accounts Receivable	400,000	200,000	-	-	600,000
Inventories	600,000	300,000	40,000	-	940,000
Plant Assets	1,300,000	1,000,000	100,000	-	2,400,000
Investment in partially owned subsidiary	1,290,000	-	-	1,290,000	-
Goodwill			115,000	-	115,000
Total Asset	<u>3,640,000</u>	<u>1,600,000</u>	-		<u>4,205,000</u>
<u>Liabilities</u>					
Current liabilities	800,000	400,000	-	-	1,200,000
Long term debt	-	100,000	10,000	-	90,000
Common stock (2,400,000-60,000)	2,340,000	-	-	-	2,340,000
Common stock		400,000	400,000		-
Retained earnings	500,000	700,000	700,000		500,000
Minority Interest	-	-	-	75,000	75,000
Total	<u>3,640,000</u>	<u>1,600,000</u>	<u>1,365,000</u>	<u>1,365,000</u>	<u>4,205,000</u>

Nature of Minority Interest

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

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

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

1. Parent Company Concept
2. Economic Unit Concept

Parent Company Concept

The parent company concept emphasizes the interests of the parent's shareholders. This concept treats the minority interest in net assets of a subsidiary as a liability. This liability is

increased each accounting period subsequent to the date of a business combination by an expense representing the minority's share of the **subsidiary's net income**.

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

To summarize, the Parent Company concept:

- ❖ Treats the minority interest in subsidiary's net assets as a liability
- ❖ The liability increases by minority's share of net income or
- ❖ The liability decreases by minority's share of net losses
- ❖ Dividends declared by the subsidiary to minority stockholders decreases the liability

Economic Unit Concept

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

Economic Unit Concept Characteristics:

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

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

no ledger account for minority interest in net assets of subsidiary, in either the parent company's or subsidiary's records.

Disclosure policy

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

Advantages and Shortcomings of Consolidated Financial Statement

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

Push-Down Accounting for a purchased subsidiary

Significant problem (question) is the appropriate basis of accounting for assets and liabilities of purchased subsidiaries that issue separate statements to outsiders. Some accountants argue that they should report in their separate statement based on carrying values before the combination because GAAPs do not allow writing up of assets by a going concern. Others recommend that the values assigned to purchase subsidiary's net assets in the consolidated statements shall be pushed down to the subsidiary for incorporation in its separate statements. They argue the combination is an event warranting recognition of current fair values. The SEC sanctioned (requires use of) push down accounting for purchased subsidiaries.

In some situations when common stock is acquired, the subsidiary will adjust its books to reflect the current values at date of acquisition. In other words, adjusting entries are made on the subsidiaries books rather than just working paper entries. Therefore, subsequent working papers will not have to deal with the excess value elements as they will be taken care of by the subsidiary's accounting department (depreciation, amortization, etc.). SEC Staff Bulletin No. 54 requires pushdown accounting in the **separate financial statements** of a subsidiary acquired in a purchase transaction

Parent's Ownership %	Guidelines
<input type="checkbox"/> 90% or more	<input type="checkbox"/> Substantially owned – push-down accounting is required
<input type="checkbox"/> 80 to 89%	<input type="checkbox"/> Push-down accounting is encouraged but not required
<input type="checkbox"/> Below 80%	<input type="checkbox"/> Push-down accounting may not be appropriate (e.g., subsidiary has substantial preferred stock or public debt outstanding)

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

On the date of acquisition, the only relevant financial statement is the consolidated balance sheet. After acquisition, a complete set of consolidated financial statements must be prepared for the affiliated group:

- Income statement,
- Retained earnings statement,
- Balance sheet, and
- Statement of cash flows

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

- Net income or net loss, and
- Dividends declared paid by subsidiary

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

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

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

5.4 ACCOUNTING FOR OPERATING RESULTS OF WHOLLY OWNED PURCHASED SUBSIDIARIES

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

1. Cost Method (owned 20% or less)

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

2. Equity Method (owned 21-50%)

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

3. Consolidated Method (owned more than 50%)

The consolidation method is a type of investment accounting used for consolidating the financial statements of majority ownership investments. This method can only be used when the investor possesses effective control of the investee or subsidiary which often, but not always, assumes the investor owns at least 50.1% of the subsidiary's shares or voting rights.

The consolidation method works by reporting the subsidiaries balances in a combined statement along with the parent company's balances, hence 'consolidated'. Under the consolidation method, a parent company combines its own revenue with 100% of the revenue of the subsidiary.

Difference Between Cost, Consolidated and Equity Methods

Unlike the equity method, the cost method accounts for investments when the investor has no ability to exercise control over the investee's operations. Under the equity method, the initial investment is recorded at cost and this investment is increased or decreased

periodically to account for dividends and the earnings or losses of the investee. In contrast, the cost method accounts for the initial investment as a debit to an investments account and the dividends as a credit to a revenues account. Unlike the equity method, cash distributions under the cost method do not affect the carrying balance of the investment. Consolidating the financial statements involves combining the firms' income statements and balance sheets together to form one statement. Internal reporting of financial statements does not need to be consolidated. If a firm owns more than 50 percent of another company, the firm must consolidate externally, but internally may choose between the equity method or the cost method.

Choosing Between the Two Methods

- Consolidated financial statement amounts are the same regardless of the methods used. But the working paper eliminations are different
- The equity method is appropriate for pooled subsidiaries as well purchased subsidiaries.

Goodwill Impairment

- ✚ Goodwill is not amortized.
- ✚ Generally, goodwill will be carried at its acquisition-date assigned value.
- ✚ At some future point in time, goodwill may become either partially or completely impaired.

Two Step Process:

Step 1: If fair value is less than the carrying amount of the net assets (including goodwill), then perform a second step to determine possible impairment.

Step 2: Determine the fair value of the goodwill (implied value of goodwill) and compare to carrying amount.

Cash	\$ 50
Receivables	200
Property, plant, and equipment, net	2,600
Goodwill	200
Less: Notes payable	(2,700)
Net assets	<u>\$ 350</u>

Goodwill presented below is net asset information related to Carlos Division of Santana, Inc. as of December 31, 2007 (in millions).

Example: *(Goodwill Impairment) Presented below is net asset information related to the Carlos Division of Santana, Inc. as of December 31, 2007 (in millions):*

Management estimated its future net cash flows from the division to be \$400 million. Management has also received an offer to purchase the division for \$335 million. All identifiable assets' and liabilities' book and fair value amounts are the same.

Required

- a) Prepare the journal entry (if any) to record the impairment at December 31, 2007.

Step 1: The fair value of the reporting unit is below its carrying value. Therefore, impairment has occurred. Loss on impairment 15,000,000 and Goodwill 15,000,000

- b) At December 31, 2008, it is estimated that the division's fair value increased to \$345 million. Prepare the journal entry (if any) to record this increase in fair value.

- No entry necessary.
- Adjusted carrying amount of the goodwill is its new accounting basis.
- Subsequent reversal of recognized impairment losses is not permitted under

Summary of Impairment Tests

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

Example:

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

December 20, 2003:

Dividends Declared.....	24,000
Intercompany Dividends Payable	24,000

Intercompany dividends payable will be eliminated when preparing consolidated statement.

Palm corporation will record the following entry:

December 20, 2003:

Intercompany Dividend Receivable.....	24,000
Inv't in Starr Co. Common Stock	24,000

December 31, 2003:

Investment in Starr Co. Common Stock	60,000
Intercompany Investment Income	60,000

2. Adjustment of purchased subsidiary's net income:

- Palm must prepare a third equity method journal entry on December 31,2003 to adjust

Starr's net income for depreciation and amortization attributable to the difference between CFV and carrying values of Starr's Co. net assets on Dec. 31,2002, the date of combination.

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

	<u>Dec 31, 2002</u>	<u>Dec 31, 2003</u>	
Inventories (FIFO)	Br 25,000		
Plant assets (net):			
Land	15,000		15,000
Building (15 Years)	30,000	28,000	61,000
Machinery (10 Years).....	<u>20,000</u>	65,000	18,000
Patent (5 Years)		5,000	4,000
Goodwill (life 30 Years)		<u>15,000</u>	<u>14,500</u>
Total		<u>110,000</u>	<u>79,500</u>

Palm Corporation prepares the following additional equity method journal entry to reflect the effects of depreciation and amortization of the differences between the CFV and carrying amounts of Starr Company's net assets on Starr's net income for the year ended Dec.31.2003. *The amount of amortization, which the difference between CFVs and carrying amounts of Starr Company's net assets on December 31, 2003 is determined as follows:*

Inventories - to CGS.....	Br.25,000
Building - depreciation (30,000 /15)	2,000
Machinery – depreciation (20,000/ 15)	2,000
Patent- amortization (5,000/ 5)	1,000
Goodwill-amortization (15,000/ 30).....	<u>500</u>
Total	<u>30,500</u>

December 31, 2003:

Intercompany Investment Income	30,500
Investment in Starr Co. Common Stocks	30,500

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

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

Developing the Elimination:

The working paper elimination are as follows:

A. Removing Subsidiary' equity account and increase in assets

Common stock- Starr	200,000	
Add paid in capital-Starr	58,000	
Retained Earnings- Starr	132,000	
Inter-company Investment Income.....	29,500	
Plant asset (net) –Starr.....	61,000	
Patent (net) –Starr.....	4,000	
Goodwill (net) –Starr	14,500	
COGS-Starr	25,000	
Operating expenses – Starr Company	5,500	
Investment in Starr Co. Common stock.....		505,500
Dividends declared – Starr.....		24,000

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

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

	COGS	Expenses
Inventories sold	Br 25,000	
Building depreciation		2,000
Machinery depreciation.....		2,000
Patent amortization.....		1,000
Goodwill amortization		<u>500</u>
Total	<u>25,000</u>	<u>5,500</u>

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

Working Paper Eliminations for Equity Method

- Three components of the subsidiary's stock holders' equity are reciprocal to the parent company's Investment Ledger Account.
- The subsidiary's beginning-of-year retained earnings amount is eliminated.
- Subsidiary's dividends are an offset to the subsidiary's retained earnings.

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

Palm Corporation and Subsidiary
Working Paper for Consolidated Financial Statements For Year
Ended Dec.31,2003

Types of financial statements:	Palm Corp.	Starr Co.	Elimination	Consolidated
Income statement				
Revenue:				
Net Sales	1,100,000	680,000		1,780,000
Intercompany Investment Income	29,500		(a)(29,500)	
Total Revenue	1,129,500	680,000	(29,500)	1,780,000
Cost of goods sold.....	700,000	450,000	(a)25,000	1,175,000
Operating expenses	217,667	130,000	(a)5,500	353,167
Interest expense.....	49,000			49,000
Income tax expenses	53,333	40,000		93,333
Total Costs and Expenses.....	1,020,000	620,000	30,500*	1,670,500
Net income	109,500	60,000	(60,000)	109,500
Statement of Retained Earnings				
Retained Earnings Jan.1, 2000.....	134,000	132,000	(a)(132,000)	134,000
Net income for the year.	<u>109,500</u>	<u>60,000</u>	<u>(60,000)</u>	<u>109,500</u>
Subtotal	243,500	192,000	(192,000)	243,500
Dividend Declared	<u>30,000</u>	<u>24,000</u>	<u>(a)(24,000)</u>	<u>30,000</u>
Retained Earnings end of year	213,500	168,000	(168,000)	213,500
Balance sheet				
Cash.....	15,900	72,100		88,000
Intercompany Receivables (payable)....	24,000	(24,000)		—

Inventories.....	136,000	115,000		251,000
Other current assets.....	88,000	131,000		219,000
Investment in Starr Co	505,500	–	(a)(505,500)	–
Plant asset (net)	440,000	340,000	(a) 61,000	841,000
Patent (net)	–	16,000	(a) 4,000	20,000
Goodwill (net).....	–	–	(a)14,500	14,500
Total asset	1,209,400	650,100	(426,000)	1,433,500
Liabilities and SHE				
Income tax payable	40,000	20,000		60,000
Other liabilities.....	190,900	204,100		395,000
Common stock Br 10 par	400,000	–		400,000
Common stock Br 5 par	–	200,000	(200,000)	–
Additional paid-in capital	365,000	58,000	(58,000)	365,000
Retained Earnings	213,500	168,000	(168,000)	213,500
Total Liab. & SHE	1,209,400	650,100	(426,000)	1,433,500

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

Note: Use the working paper and prepare consolidated financial statements (Consolidated income

statement, statement of retained Earning and balance sheet)

Income Statement

PALM CORPORATION AND SUBSIDIARY

Consolidated Income Statement

For Year Ended December 31, 2003

Net sales	Br 1,780,000
Cost and expenses:	
Cost of goods sold	Br 1,175,000
Operating expenses	353,167
Interest Expense	49,000
Income Taxes Expense	<u>93,333</u>
Total costs and expenses	(1,670,500)
Net Income.....	<u>Br 109,500</u>

Basic earnings per share of common stock (40,000 shares outstanding) Br 2.74

Statement of Retained Earnings

PALM CORPORATION AND SUBSIDIARY

Consolidated Statement of Retained Earnings

For year ended December 31, 2003

Retained earnings, beginning of year	134,000
Add: Net Income	<u>109,500</u>
Subtotal.....	243,500
Less: Dividends (Br 0.75 a share)	<u>30,000</u>
Retained earnings, end of year.....	<u><u>213,500</u></u>

Balance Sheet

PALM CORPORATION AND SUBSIDIARY

Consolidated Balance Sheet

December 31, 2003

Assets:

Cash	88,000
Inventories	251,000
Other	219,000
Total current assets	558,000
Plant assets (net).....	841,000
Intangible assets:	
Patent (net)	20,000
Goodwill (net).....	<u>14,500</u>
	<u>34,500</u>

Total Assets

1,433,500

Liabilities and Stockholders' Equity:

Liabilities:

Income taxes payable.....	60,000
Other.....	<u>395,000</u>
Total liabilities	455,000

Stockholders' Equity:

Common stock, Br 10 par	400,000	
Additional paid-in capital.....	365,000	
Retained earnings.....	<u>213,500</u>	<u>978,500</u>
Total liabilities and stockholders' equity		<u>1,433,500</u>

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

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

- *Parent Company Net Income = Consolidated Net Income*
 - *Parent Company Retained Earnings = Consolidated Retained Earnings*
- Despite the equalities, *consolidated financial statements are superior to parent company financial statements* for the presentation of financial position and operating results of parent and subsidiary companies.

Closing Entries:

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

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

To close revenue accounts:

Net Sales	1,100,000	
Intercompany Investment Income.....		29,500
Income Summary	1,129,500	

To close expense accounts:

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

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

Income Summary	109,500	
Retained Earnings of Subsidiary (29,500 – 24,000)		5,500
Retained Earnings (109,500- 5,500)		104,000

To close dividends declared accounts:

Retained Earnings	30,000
Dividend Declared	30,000

Accounting For Operating Results Of Partially Owned Purchased Subsidiaries

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

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

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

Sage records the following journal entries.

December 5, 2004: To record declaration of dividend payable

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

December 19, 2004: To record payment of dividend declared

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

Post record the following journal entries for 2004, under the equity method in relation with subsidiary

December 5, 2004: to record dividend declared by Sage Company for proportionate Share of Dividend

Intercompany Dividend Receivable.....	38,000
Investment in Sage Co.....	38,000

December 19, 2004: To record receipt of dividend from Sage Co

Cash	38,000
Intercompany Dividend Receivable.	38,000

(Proportionate Share of Dividend)

December 31, 2004:

Investment in Sage Co	85,500
Intercompany Investment Income (95% @ 90,000 =85,500)....	85,500

To record 95% of net income of sage company for the year ended dec.31, 2000 Adjustment of purchased Subsidiary's net income. Assume the following CFV and carrying values:

	<u>Excess Cost</u>	<u>Expense</u>	<u>Balance</u>
Inventories (FIFO)	26,000	(26,000)	
Plant Assets (net):			-
Land.....	60,000	-	60,000
Building (20 Years)	80,000	(4,000)	76,000
Machinery (5Years).....	50,000	(10,000)	40,000
Leasehold (6Years)	<u>30,000</u>	<u>(5,000)</u>	<u>25,000</u>
Total	<u>246,000</u>	<u>(45,000)</u>	<u>201,000</u>
			176,000

In addition, **Post** acquired **goodwill** in the amount of Br 38,000 to be amortized over 40 years. **Post** Corporation prepares the following additional entry to consider the above items.

Intercompany Investment Income (95% @ 45, 000) 42,750
 Investment in Sage Co. Common Stock42,750

The amortization of goodwill will be recorded as:

Amortization Expense (38,000/ 40) 950
 Investment in Sage Co. Common Stock950

The Investment in Sage Company

	Investment in Sage Co	
Dividend	1,192,250	38,000
Amortization of Excess		42,750
Cost	85,500	950
Impairment of Goodwill		
	1,196,050	

Note: Goodwill in a business combination involving a partially owned subsidiary is attributable to the parent company in a partially owned subsidiary rather than the subsidiary. Consequently, amortization of goodwill is debited to the amortization Expense ledger account of the parent company.

Developing the Elimination Entries

Post Corporation uses the equity method of accounting for its investment in **Sage Company** results in balance the Investment ledger account that is a mixture of three components.

- i.** The carrying amount of Sage's identifiable net assets
- ii.** the "current fair value excess or Excess Cost over CFV: which is attributable to Sage's **identifiable** assets: and
- iii.** the goodwill acquired by post in the business combination with Sage

The Eliminations column of the working paper is presented below:

Common Stock –Sage Co.....	400,000
Add paid in capital – Sage.....	235,000
RES-Sage.....	334,000
Intercompany Investment Income-Post.....	42,750
Plant Assets (net) –Sage	176,000
Leasehold-Sage	25,000
Goodwill (net)-Sage	37,050
CGS – Sage	26,000
Operating Expenses- Sage.....	19,000
Investment in Sage co. CS-Post	1,196,050
Dividends-Sage	40,000
Minority interest in subsidiary (60,750-2000*)	58,750

* *Minority interest in dividend declared* $Br\ 40,000 \times 0.05 = Br\ 2000$

** *For year 2004 depreciation and amortization on differences between CFVs and carrying amounts of Sage's net assets are as follows:*

	<u>COGS</u>	<u>Operating Expenses</u>
Inventories Sold.....	26,000	
Building Depreciation		4,000
Machinery Depreciation		10,000
Leasehold Amortization		<u>5,000</u>
Total.....	<u>26,000</u>	<u>19,000</u>

Minority Interest

Minority Interest in Net Income of Subsidiary	2,250
Minority Interest in Net Assets of Subsidiary	2,250

Minority interest in subsidiary's adjusted net income for year 2000 is computed as follows:

Net Income of Subsidiary	Br 90,000
Net reduction of elimination (A) (43,000 + 2000)	<u>(45,000)</u>
Adjusted Net Income of subsidiary.....	45,000
Minority Interest in Adjusted Income (45,000 x 0.05)	<u>(2,250)</u>

Post Corporation and Subsidiary
Working Paper for Consolidated Financial Statements
For Year Ended Dec.31,2004

	Post Corp.	Sage Co.	Elimination	Consolidated
Income statement				
Revenue:				
Net Sales	5,611,000	1,089,000		6,700,000
Intercompany Investment income.....	42,750		(a)(42,750)	
Total Revenue.....	5,653,750	1,089,000	(42,750)	6,700,000
Cost of goods sold.....	3,925,000	700,000	(a) 26,000	4,651,000
Operating expenses	*556,950	129,000	(a)19,000	704,950
Interest and income tax expense	710,000	170,000		880,000
Minority interest in net income of Sub			(b) 2,250	2,250
Total costs and Expenses	5,191,950	999,000	** 47,250	6,238,200
Net income.....	461,800	90,000	(90,000)	461,800
Statement of Retained Earnings				
Retained Earnings Jan.1.2004.....	1,050,000	334,000	(a)(334,000)	1,050,000
Net income for the year.....	461,800	90,000	(90,000)	461,800
Subtotal	1,511,800	424,000	(424,000)	1,511,800
Dividend Declared	1,58,550	40,000	*** (a)(40,000)	158,550
Retained Earnings end of year	1,353,250	384,000	(384,000)	1,353,250
Balance sheet				
Inventories.....	861,000	439,000		1,300,000
Other Current Assets.....	639,000	371,000		1,010,000
Investment in Sage Co. CS	1,196,050		(a)(1,196,050)	
Plant asset(net)	3,600,000	1,150,000	(a) 176,000	4,926,000
Leasehold(net).....			(a) 25,000	25,000
Goodwill (net)	95,000		(a)37,050	132,050
Total asset	6,391,050	1,960,000	(958,000)	7,393,050

Liabilities and SHE				
Liabilities	2,420,550	941,000		3,361,550
Minority interest in net asset Subsidiary			(a) 58,750 (b) 2,250	61,000
Common stock Br 1 par	1,057,000			1,057,000
Common stock Br 10 par		400,000	(400,000)	
Additional paid-in capital.....	1,560,250	235,000	(235,000)	1,560,250
Retained Earnings	1,353,250	384,000	(384,000)	1,353,250
Total Liab & SHE	6,391,050	1,960,000	(958,000)	7,393,050

* includes Br. 950 amortization of goodwill

** An increase in total costs and expenses, and a decrease in net income *** A decrease in dividends and an increase in retained earnings.

Consolidated Financial statements

The consolidated income statement, statement of retained earnings and balance sheet of Post Corporation and subsidiary for the year ended Dec.31, 2004 are shown below:

Income Statement

Post Corporation and Subsidiary	
Consolidated Income statement	
For the year ended December 31, 2004	
<hr/>	
Net Sales	Br 6,700,000
Costs and expenses:	
Cost of goods sold	4,651,000
Operating expense	704,950
Interest and Income tax expense.....	880,000
Minority Interest in net income of subsidiary	<u>2,250</u>
Total costs and expenses.....	<u>(6,238,200)</u>
Net Income	<u>461,800</u>
Earning per share of common stock (461,800 / 1,057,000 shares)	<u>Br 0.44</u>

Retained Earnings Statement

Post Corporation and Subsidiary
Consolidated Retained Earning
Statement For year ended Dec.31 2004

Retained earnings, beginning of the year	Br 1,050,000
Add: Net income	<u>461,800</u>
Subtotal	1,511,800
Less: Dividends (Br 0.15 a share)	<u>(158,550)</u>
Retained Earnings, Ending of the Year	<u>1,353,250</u>

Balance Sheet

Post Corporation and Subsidiary
Consolidated Balance Sheet Dec.31, 2004

Assets:	
Current assets:	
Inventories	1,300,000
Other	<u>1,010,000</u>
Total current assets	2,310,000
Plant assets (net)	4,926,000
Intangible assets:	
Leasehold (net)	25,000
Goodwill (net).....	<u>132,050</u> <u>157,050</u>
Total assets	<u>7,393,050</u>
Liabilities and Stockholders' equity:	
Liabilities:	
Liabilities other than Minority Interest	3,361,550
Minority interest in net assets of subsidiary	<u>61,000</u>
Total liabilities.....	3,422,550
Stockholders' Equity:	
Common stock, Br.1par.....	1,057,000
Additional paid in capital	1,560,250
Retained earnings	<u>1,353,250</u>
Total liabilities and stockholders' equity	7,393,050

Closing Entries:

Parent's Dec.31 2004 closing entries under the Equity method of accounting for purchased subsidiary are as follows:

To close revenue accounts

Net Sales.....	5,611,000	
Intercompany investment income		42,750
Income summary	5,653,750	

To close expense accounts:

Income Summary	5,191,950	
Cost of Goods Sold		3,925,000
Operating Expenses		556,950
Interest and Income tax expense	710,000	

To close income summary accounts; to transfer net income legally available for dividends to retained earnings; and to segregate 95% share of adjusted net income of subsidiary not distributed as dividends:

Income Summary	461,800	
Retained Earnings of Subsidiary (42,750 – 38,000)		4,750
Retained Earnings (461,800- 4,750)	457,050	

To close dividends declared accounts:

Retained Earnings.....	158,550	
Dividend Declared.....		158,550

Quick Check

- ✚ What differs consolidation of partially owned subsidiary on date of business combination under purchase method of accounting?
- ✚ What is minority interest
- ✚ Explain parent company concept
- ✚ What are the advantages and shortcomings of consolidated financial statement?
- ✚ What differs Accounting for operating results of wholly owned company subsequent to date of acquisition from on the date of acquisition?

Cost Method for Partially Owned Purchased Subsidiary

To illustrate the cost method of accounting for the operating results of a purchased Subsidiary, the Post Corporation-Sage Company business combination, which involves a partially owned subsidiary, is used. Post acquired 95% of Sage's outstanding common stock at a total cost (including out-of-pocket costs) of Br1, 192.250 on December 31, 2003 Sage's operations for the first two years following the business combination included the following:

Year Ended Dec. 31	Net Income	Dividends Declared
2004	Br 90, 000	Br 40, 000
2005	105,000	50,000

Illustration of Cost Method for partially Owned Purchased Subsidiary for First Year after Business Combination

If Post Corporation used the cost method, rather than the equity method, of accounting for Sage company's operating results for the year ended December 31, 2004, Post Corporation would not prepare journal entries to record Sage's net income for the year. Post would record Sage's dividend declaration as follows on November 24, 2004:

Intercompany Dividends Receivable 38,000
 Intercompany Dividends Revenue38,000
(To record dividend declared by Sage Company)

Post's journal entry for receipt of the dividend from Sage would be the same under the cost method as under the equity method of accounting.

Working Paper for Consolidated Financial Statements

The working paper for consolidated financial statements and the related working paper for consolidated financial statements and the related working paper eliminations (in journal entry format) for Post corporation and subsidiary for the year ended December 31,2004 follow:

Post Corporation and Subsidiary
Working paper for consolidated Financial Statements for Year Ended
Dec.31,2004

	Post Corp.	Sage Co.	Elimination	Consolidated
Income statement				
Revenue:				
Net Sales	5,611,000	1,089,000		6,700,000
Intercompany Investment income	38,000		(c)(38,000)	
Total Revenue.....	5,649,000	1,089,000	(38,000)	6,700,000
Cost of goods sold.....	3,925,000	700,000	(a) 26,000	4,651,000
Operating expenses	*556,000	129,000	(a)19,950	704,950
Interest and income tax expense	710,000	170,000		880,000
Minority interest in net income of Sub...			(b) 2,250	2,250
Total costs and Expenses	5,191,000	999,000	* 48,200	6,238,200
Net income.....	458,000	90,000	(86,200)	461,800
Statement of Retained Earnings				
Retained Earnings Jan.1.2004.....	1,050,000	334,000	(a)(334,000)	1,050,000
Net income for the year.....	458,800	90,000	(86,200)	461,800
Subtotal	1,508,000	424,000	(420,200)	1,511,800
Dividend Declared	158,550	40,000	** (a)(40,000)	158,550
Retained Earnings end of year	1,349,450	384,000	(380,200)	1,353,250
Balance sheet				
			(a) 26,000	
Inventories	861,000	439,000	(b) (26,000)	1,300,000
Other Current Assets.....	639,000	371,000		1,010,000
Investment in Sage Co. CS	1,192,250		(a)(1,192,250)	
			(a) 190,000	
Plant asset (net)	3,600,000	1,150,000	(b) (14,000)	4,926,000
			(a) 30,000 (b)	
Leasehold (net)			(5,000)	25,000
			(a)38,000 (b)	
Goodwill (net).....	95,000		(950)	132,050
Total asset	6,387,250	1,960,000	(954,200)	7,393,050
Liabilities and SHE				
Liabilities	2,420,550	941,000		3,361,550
Minority interest in net asset Subsidiary			(a) 60,750 (c)	
.....			(2000)	
			(d) 2,250	61,000
Common stock Br 1 par	1,057,000			1,057,000
Common stock Br 10 par		400,000	(400,000)	
Additional paid-in capital	1,560,250	235,000	(235,000)	1,560,250
Retained Earnings	1,353,250	384,000	(384,000)	1,353,250
Total Liab & SHE	6,387,250	1,960,000	(954,200)	7,393,050

** An increase in total costs and expenses, and a decrease in net income*

*** A decrease in dividends and an increase in retained earnings.*

**Post Corporation and Subsidiary
Working Paper Eliminations (Cost method)
December 31, 2004**

A. To eliminate intercompany investment and equity accounts of Subsidiary on date of business combination (Dec.31,2004); to Allocate excess of cost over carrying amounts of identifiable Assets acquired, with remainder to goodwill; and to establish Minority Interest in net assets of subsidiary on date of business combination (Br1,215,000 @ 0.05 = Br.60.750).

Common Stock – Sage	400,000
Additional Paid-in Capital-Sage.....	235,000
Retained Earnings –Sage.....	334,000
Inventories – Sage	26,000
Plant Assets (net)-Sage.....	190,000
Leasehold (net) – Sage	30,000
Goodwill (net) – Post	38,000
Investment in Sage Company Common Stock-post	1,192,250
Minority Interest in Net Assets of Subsidiary.....	60,750

B. To provide for year 2004 depreciation and amortization on differences between business combination date current fair Values and carrying amounts of Sage’s identifiable assets and to amortize goodwill acquired in business combination

Cost of Goods Sold – Sage	26,000
Operating Expenses – Sage.....	19,000
Operating Expenses – Post.....	950
Inventories – Sage	26,000
Plant Assets (net) Sage.....	14,000
Leasehold (net)-Sage.....	5,000
Goodwill (net)-Post	950

The Allocation as Follows:

COGS Operating Exp.

Inventories Sold.....	26,000	
Building Depreciation	4,000	
Machinery Depreciation	10,000	
Leasehold Amortization	<u>5,000</u>	
Total.....	<u>26,000</u>	<u>19,000</u>

□ Amortization of Goodwill:

Br 38, 000 ÷ 40 = Br 950 (Income tax effects are disregarded.)

C. To eliminate intercompany dividends and minority interest share thereof (40,000 @ 0.05 = 2000) Intercompany Dividends revenue-Post 38,000

Minority interest in net assets of subsidiary

2,000

Dividend declared-Sage.....

40,000

D. To Record Minority Interest in Net Income of Subsidiary

Minority interest in net income of subsidiary

2,250

Minority interest in net assets of subsidiary.....

2,250

To establish minority interest in subsidiaries adjusted net income for year 2000 as follows:

Net income of subsidiary.....

Br 90,000

Net reduction in elimination (b)

(45,000)

Adjusted net income of subsidiary

45,000 Minority

interest share (45,000 @ 0.05)

2,250

The points that follow

relative to the cost-method working papers for Post Corporation and Subsidiary

should be noted:

1. The consolidated amounts in the cost-method working paper for consolidated financial statements are identical to the consolidated amounts in the equity method working paper (page 20). This outcome results from the use of different eliminations in the two methods.

2. Three cost-method elimination, (a), (b), and (c), are required to accomplish what single equity method elimination, (a) on page 19, does. The reason is that the parent company's accounting records are used in the equity method to reflect the parent's share of the subsidiary's adjusted net income or net loss.

3. Elimination (a) deals with the intercompany investment and subsidiary equity accounts on the date of the business combination. This account technique is necessary because the parent's investment in Sage company common stock method.

4. The parent company's cost-method net income and retained earnings are not the same as the consolidated amounts. Thus, the consolidated amounts on December 31, 2000, may be proved as follows, to assure their accuracy:

Consolidated Net Income:

Net income of Post Corporation.....	Br 458,000
Less: amortization of business combination goodwill	(950)
Add: Post's share of Sage Company's adjusted net income not	
Distributed as dividends [(Br 45,000- 40,000) x 0.95]	<u>4,750</u>
<i>Consolidated net income</i>	<u>461,800</u>

Consolidated Retained Earning:

Retained earnings of Post Corporation.....	Br 1,349,540
Less: amortization of business combination goodwill	(950)
Add: Post's share of adjusted net increase in Sage Company's	
Retained earnings [(Br 50,000-45,000) x0.95]	<u>4,750</u>
Consolidated Retained Earnings	<u>1,353,250</u>

Closing Entries

There are no unusual features of closing entries for a parent company that uses the cost method of accounting of a subsidiary's operating results. The Intercompany dividends revenue ledger account is closed with other revenue accounts to the Income Summary account. Because the parent company does not record the undistributed earnings of subsidiaries under the cost method, Retained earnings Subsidiary ledger account is unnecessary.

Consolidated Statement of Cash Flows

Peculiarities:

1. If the statement of cash flows starts with consolidated net income, then the noncontrolling interest is already included and need not be added back.

2. Subsidiary dividends paid to the noncontrolling stockholders must be included with dividends paid by the parent company when calculating cash outflow from financing activities.

3. Subsidiary stock acquired directly from the subsidiary represents an intercompany cash transfer that does not affect the total cash balance of the consolidated group.

CHAPTER SUMMARY

The Parent prepares Parent Financial Statements while the Subsidiary prepares Subsidiary Financial Statements. However, Consolidated Financial Statements is prepared by the Parent by combining separate financial statements of the parent and the subsidiary as the Parent Company is the Reporting Entity. They are similar to the combined financial statements for a Home Office and its branches. Assets, liabilities, revenue, and expenses of the parent company and its subsidiaries are totaled; inter- company transactions and balances are eliminated; and the final consolidated amounts are reported in the balance sheet, income statements, statement of stockholders' equity, and statement of cash flows. However, the separate legal entity status of the parent and subsidiary corporations necessitates eliminations that are generally more complex.

Traditionally, an investor's direct or indirect ownership of more than 50% of an investee's outstanding common stock has been required to evidence the controlling interest underlying a parent-subsidiary relationship. However, even though such a common stock ownership exists, other circumstances may negate the parent company's *actual* control of the subsidiary. Accountants generally use a **working paper for consolidated balance sheet** and **working paper eliminations** to facilitate the preparation of a consolidated balance sheet on the date of a business combination. A consolidated income statement, a consolidated statement of stockholders' equity, and a consolidated statement of cash flows are not appropriate for the accounting period ended on the date of a business combination, because the combining companies were separate **economic** as well as **legal** entities prior to the combination. Consolidation of a parent company and its partially owned subsidiary differs from the consolidation of a wholly owned subsidiary in one major respect - the recognition of **minority interest (non-controlling interest)**.

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

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

REVIEW QUESTIONS:

Example: Bronzewing Company has the following information collected in order to do make a cash flow statement and uses the indirect format for Cash Flow from Operations. The annual report year end is December 31, 2005.

Noncontrolling Interest Dividends	\$17,000
Undistributed Income of Equity Investees	7,500
Depreciation Expense	65,000
Consolidated Net Income	175,000
Increase in Accounts Payable	15,000
Amortization of Patent	13,000
Decrease in Accounts Receivable	48,000
Increase in Inventories	27,500
Gain on sale of equipment	45,000
Noncontrolling Interest Expense	17,000

Required: Prepare the Cash Flow for Operations part of the cash flow statement for Bronzewing.

CHAPTER SIX

ACCOUNTING FOR FOREIGN CURRENCY TRANSACTIONS

6.1 FOREIGN EXCHANGE CONCEPTS

Exchange rate: It is the ratio between a unit of one currency and the amount of another currency for which that unit can be exchanged at a particular time. The difference between the rates at which a bank is willing to buy and sell currency is known as the “*spread*.” The exchange rate can be computed directly or indirectly. Assume that 17 ETB can be exchanged for 1 USD.

Direct quotation (ETB per one foreign currency unit): $ETB\ 17/1 = 17ETB$

Indirect quotation (the number of foreign currency units per ETB): $USD1/ 17 = \$0.0589$

The first approach is a *direct quotation* (from an Ethiopian viewpoint) because the rate is expressed in ETB: 17 is equivalent to one USD (one unit of the foreign currency). The second approach is an *indirect quotation* (from Ethiopian viewpoint) because the rate is expressed in USD (the foreign currency); 0.0589 is equivalent to one ETB.

6.1.1 Currency arrangements

- a. **Floating exchange rates:** These exchange rates are those that reflect fluctuating market prices for a currency based on supply and demand and other factors in the world currency markets.
- b. **Fixed/Pegged/Official exchange rates:** are set by a government and do not change as a result of changes in world currency markets.
- c. **European Monetary System (euro)**

6.1.2 Spot and Forward Rates

Foreign currency trades can be executed on a spot or forward basis.

Spot rate: It is the price at which a foreign currency can be purchased or sold today. In contrast,

Forward rate: is the price today at which foreign currency can be purchased or sold sometime in the future. Because many international business transactions take some time to be completed, the ability to lock in a price today at which foreign currency can be purchased or sold at some future date has definite advantages. *The actual spot rate at the future date may differ from today's forward rate.*

6.2 FOREIGN CURRENCY TRANSACTIONS

Export sales and import purchases are international transactions; they are components of what is called *trade*. When two parties from different countries enter into a transaction, they must decide which of the two countries' currencies to use to settle the transaction. When the purchase or sales is made on credit base, the buyer or the seller will be *exposed to foreign exchange risk*. In short, export sale and import purchase have associated risks.

A. Import purchase: A transaction exposure exists when the importer is *required to pay in foreign currency* and is *allowed to pay sometime after the purchase has been made*. The importer is exposed to the risk that the foreign currency might appreciate (increase in price) between the date of purchase and the date of payment, thereby increasing the U.S. dollars that have to be paid for the imported goods.

Illustration

Assume that an Ethiopian corporation imports inventory from a US firm when the spot rate for US dollars is Br 17. The invoice calls for payment of 5,000 US dollars in 30 days.

Inventory	Br 85,000
Accounts payable	85,000

(Translation: 5,000 US dollars * Br17 spot rate.)

If the account payable is paid when the spot rate is Br 16, the payment is recorded as follows:

Accounts payable	85,000
Exchange gain	5000
Cash	80,000

(Cash required equals 5000 US dollars * Br 16 spot rate.)

a. Export sale: A transaction exposure exists when the exporter allows the buyer to **pay in a foreign currency and allows the buyer to pay sometime after the sale has been made**. The exporter is exposed to the risk that the foreign currency might depreciate (decrease in value) between the date of sale and the date payment is received, thereby decreasing the Ethiopian birr ultimately collected.

Illustration

Assume Ethiopian corporation sells merchandise to US Corporation for \$6000, when the exchange rate is Br 17, and receives payment when the exchange rate is Br 16.

Accounts receivable	102,000
Sales	102,000

(To record sales to US Corporation when spot rate is Birr 17)

Cash	96,000
Foreign exchange loss	6000
Accounts receivables	102,000

(To record collection in full from US corporation)

The one-transaction perspective; assumes that an export sale is not complete until the foreign currency receivable has been collected and converted into Ethiopian birr. Any change in the Ethiopian birr value of the foreign currency is accounted for as an adjustment to Accounts Receivable and to Sales.

Instead, U.S. GAAP requires companies to use *a two-transaction perspective* in accounting for foreign currency transactions. *This perspective treats the export sale and the subsequent collection of cash as two separate transactions*. Because management has made two decisions (1) to make the export sale and (2) to extend credit in foreign currency to the customer—the company should report the income effect from each of these decisions separately. The Ethiopian birr value of the sale is recorded at the date the sale occurs. At that point, the sale has been completed; there are no subsequent adjustments to the Sales account. Any difference between the number of Ethiopian birr that could have been received at the date of sale and the number of Ethiopian birr actually received at the date of collection due to fluctuations in the exchange rate is a result of the decision to extend foreign currency credit to the customer. This difference is treated as a *foreign exchange gain or loss that is reported separately from Sales in the income statement*.

Balance Sheet Date Before Date of Payment

Assume Ethiopian corporation sells merchandise to US Corporation for \$6,000 on December 20, 2011 with payment to be received on January 30, 2012. Assume that on December 20 the spot

rate of dollar was Br 17, but by December 31 dollar has appreciated to Birr 17.5. Further assume that the spot rate on January 30 was Birr 16.2

12/20/11

Accounts receivable	102,000	
Sales		102,000

12/31/11

Accounts receivable	3000	
Foreign exchange gain		3000

1/30/12

Cash	97,200	
Foreign exchange loss	7,800	
Accounts receivable		105,000

6.3 TRANSLATION OF FOREIGN CURRENCY FINANCIAL STATEMENTS

Exchange Rates used in translation

- Historical Exchange Rates – those which existed at the time a transaction occurred
- Current Exchange Rate – the exchange rate which exists at the balance sheet date

Translation Adjustments

- The use of different exchange rates during translation means the resulting financial statements will not balance!
- To force the statements to balance, an account called “Translation Adjustment” is debited or credited.
- Exposure to translation adjustments is called “balance sheet,” “translation,” or “accounting” exposure.
- Assets translated at the current exchange rate when the foreign currency is appreciating (increasing in value relative to the Birr) generate positive translation adjustments (a credit entry)
- Liabilities translated at the current exchange rate when the foreign currency is appreciating generate negative translation adjustments (a debit entry)

Quick Check

- ✎ Explain the concept of foreign exchange concepts
- ✎ What are currency arrangements
- ✎ What is the difference between spot and forward rates?
- ✎ What is translation of foreign currency financial statements?

Balance Sheet Exposure

Balance sheet items translated at *current* exchange rates change in value from one balance sheet to the next and are exposed to translation adjustments. Balance sheet items translated at *historical* exchange rates do not change in value from one balance sheet to the next and are NOT subject to balance sheet exposure.

Balance Sheet

Foreign Currency (FC)

Exposure

Appreciates

Depreciates

Net asset	Positive translation adjustment	Negative translation adjustment
Net liability	Negative translation adjustment	Positive translation adjustment

Translation Methods

There are two translation methods of foreign currency financial statement;

1. Current rate and
2. Temporal methods.

1. Current rate method

The basic assumption underlying the *current rate method* is that a company's *net investment* in a foreign operation is *exposed* to foreign exchange risk. *The balance sheet exposure under the current rate method is equal to the foreign operation's net asset (total assets minus total liabilities) position.* A positive translation adjustment arises when the foreign currency appreciates, and a negative translation adjustment arises when the foreign currency depreciates. The major difference between the translation adjustment and a foreign exchange gain or loss is that the translation

adjustment is not necessarily realized through inflows and outflows of cash. The translation adjustment that arises when using the current rate method is unrealized

- Use current exchange rates to translate all assets and liabilities.
- Use historical (or average) exchange rates to translate equity accounts.
- Use historical (or average) exchange rates to translate income statement accounts.
- *when an income account, such as a gain or loss, occurs at a specific point in time, the exchange rate at that date should be used for translation*

2. Temporal method

The basic objective underlying the *temporal method* of translation is to produce a set of Ethiopian Birr –translated financial statements as if the foreign subsidiary had actually used Ethiopian birr in conducting its operations.

- Use historical exchange rates to translate assets and liabilities carried at historical cost.
- Use current exchange rates to translate those carried at current cost or future value.
- Use historical (or average) exchange rates to translate equity, revenue, and expense accounts.
- Objective is to produce a set of financial statements as if the foreign subsidiary had actually used U.S. dollars

The following table shows summary of current rate and temporal methods to translate balance sheet and income statement accounts.

	Temporal Method Exchange Rate	Current Rate Method Exchange Rate
Balance Sheet		
Assets		
Cash and receivables	Current	Current
Marketable securities	Current*	Current
Inventory at market	Current	Current
Inventory at cost	Historical	Current
Prepaid expenses	Historical	Current
Property, plant, and equipment	Historical	Current
Intangible assets	Historical	Current
Liabilities		
Current liabilities	Current	Current
Deferred income	Historical	Current
Long-term debt	Current	Current
Stockholders' equity		
Capital stock	Historical	Historical
Additional paid-in capital	Historical	Historical
Retained earnings	Composite	Composite
Dividends	Historical	Historical
Income Statement		
Revenues	Average	Average
Most expenses	Average	Average
Cost of goods sold	Historical	Average
Depreciation of property, plant, and equipment	Historical	Average
Amortization of intangibles	Historical	Average

CHAPTER SUMMARY

Exchange rate is the ratio between a unit of one currency and the amount of another currency for which that unit can be exchanged at a particular time. The difference between the rates at which a bank is willing to buy and sell currency is known as the “*spread*.” The exchange rate can be computed directly or indirectly. Assume that 17 ETB can be exchanged for 1 USD. *Direct quotation* (ETB per one foreign currency unit): $ETB\ 17/1 = 17ETB$. *Indirect quotation* (the number of foreign currency units per ETB): $USD1/17 = \$0.0589$

Foreign currency trades can be executed on a spot or forward basis. *Spot rate*: It is the price at which a foreign currency can be purchased or sold today. In contrast, *Forward rate*: is the price today at which foreign currency can be purchased or sold sometime in the future. Because many international business transactions take some time to be completed, the ability to lock in a price today at which foreign currency can be purchased or sold at some future date has definite advantages. *The actual spot rate at the future date may differ from today's forward rate.*

Export sales and import purchases are international transactions; they are components of what is called *trade*. When two parties from different countries enter into a transaction, they must decide which of the two countries' currencies to use to settle the transaction. When the purchase or sales is made on credit base, the buyer or the seller will be *exposed to foreign exchange risk*. In short, export sale and import purchase have associated risks.

Exchange rates used in translation can be historical exchange rates – those which existed at the time a transaction occurred and current exchange rate – the exchange rate which exists at the balance sheet date

The use of different exchange rates during translation means the resulting financial statements will not balance. to force the statements to balance, an account called “translation adjustment” is debited or credited. exposure to translation adjustments is called “balance sheet,” “translation,” or “accounting” exposure. There are two translation methods of foreign currency financial statement. these are current rate and temporal methods.

REVIEW QUESTIONS

Based on Data C: below, answer Qn. 1 to 4.

Data C: Assume that **Tekeze Commercial** is an exporter of Ethiopian Coffee to American market. Tekeze Commercial sold Ethiopian Coffee to **NY company** in US for \$16,000 on December 25, 2016. The payment will be received on January 15, 2016. On December 25, 2016 the spot rate of US dollar indicates Br. 28, but on the balance sheet date the US dollar has appreciated to Br. 29. Further assume that the spot rate on the date of collection depreciated to Br. 27.

23. Which of the following alternative is **true** regarding the above transaction on the date of sale on the book of Tekeze Commercial?
- A. Cash is debited and sales credited for Br. 448,000.
 - B. Receivable credited and cash debited for Br. 464,000
 - C. Receivable debited and sales credited for Br. 464,000
 - D. Receivable debited and sales credited for Br. 432,000.
 - E. None
24. What happened related to the transaction on December 31, 2016?
- A. Cash will decrease by Br. 16,000
 - B. Receivable will decrease by Br. 28,000
 - C. Loss recoded as Br. 16,000
 - D. Receivable will be presented by Br. 480,000.
 - E. None
25. What the amount of actual cash collection on January 2016?
- A. Br. 480,000 B. Br. 435,000 C. Br. 464,000 D. Br. 16,000 E. None
26. Which rate is considered as historical exchange rate and current exchange rate respectively from **Data C** above?
- A. Br. 27 and 29
 - B. Br. 29 and 28
 - C. Br. 28 and 27
 - D. Br. 28 and 29
 - E. None

CHAPTER SEVEN

SEGMENT REPORTING AND INTERIM REPORTING

7.1 Meaning of Segment Reporting

The AICPA has defined a segment of business as “Component of an entity whose activities represent a separate major line of business or class of customer. A segment may be in the form of a subsidiary or division or a department, and in some cases a joint venture or other non-subsidiary investee, provided that its assets, results of operations and activities can be clearly distinguished, physically and operationally and for financial reporting purposes from the other assets, results of operations and activities of the entity.”

7.2 Business Segment

Business Segment is a distinguishable part of an enterprise that is involved in providing an individual product or service or a group of related products, or services and that is subject to risks and returns that are different from those of other business segments.

7.2.1 Geographical Segment

Geographical Segment is a distinguishable part of an enterprise that is involved in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments.

7.2.2 Reportable Segment

Reportable Segment is a business segment or a geographical segment identified based on the foregoing definition for which segment information is required to be disclosed.

7.3 Terminology of Segment Reporting

- 1. Segment Revenue:** Segment Revenue reported in the statement of profit and loss of an enterprise that is directly attributable to a segment and the relevant portion of enterprise revenue that can be allocated on a reasonable basis to a segment, whether from sales external customers or from transactions with other segments of the same enterprise.

Segments revenue does not include:

- a) Extraordinary' items.

- b) Interest or dividend income, including interest earned on advances or loans to other segments, unless the operations of the segment are primarily of a financial nature
- c) Gain on sales of investments or gains on extinguishment of debt. Unless the operations of the segment are primarily of a financial nature.

2. Segment Expense: Segment Expense is an Expense resulting from the operating activities of a Segment that is directly attributable to the segment and the relevant portion of an expense that can be allocated on a reasonable basis to a segment, including expenses relating to sales to external customers and expenses relating to transactions with other segments of the same enterprise. Segment expense does not include. (As per AS—17)

- a) Extraordinary items.
- b) Interest; including interest incurred on advances or Loans from other segments unless the operations of the segment are primarily of a financial nature
- c) Losses on Sale of Investments or losses on extinguishment of debt unless the operations of the segment are primarily of a financial nature.
- d) Income tax expense.
- e) General administrative expenses, head office expenses, and other expenses that arise at the enterprise level and relate to the enterprise as a whole. However, costs are sometimes incurred at the enterprise level on behalf of a segment such costs are segment expenses if they relate to the segment's operating expenses and if they can be directly attributed or allocated to the segment on a reasonable basis.

3. Segment Result: Segment result is Segment revenue less segment expenses.

4. Segment Assets: Segment Assets are those operating assets that are used by a segment in its operating activities and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

5. Segment Liabilities: Segment Liabilities are those operating liabilities which result from the operating activities of a division and either are directly attributable to the division or can be allocated to the division on a reasonable basis.

6. Segment Accounting Policies: Segment accounting policies are accounting policies framed for preparing and presenting the financial statement of the enterprise as well as those accounting policies that relate specifically to segment reporting.

7.4 Need for Segment Reporting

Diversified companies present a unique type of problem for investment decision making. The performance of a diversified company can be judged from the performance of all several segments. The success of diversified company depends on success of all segments that is why segmental disclosures in company's annual reports are more useful to investors and other user groups.

Use of Segment Financial Reporting

- i) Users of financial statements can better understand the performance of an enterprise.
- ii) Users can better assess the risks and return of an enterprise.
- iii) Users can make more informed judgment about the enterprise judgment about the enterprise as a whole.
- iv) Users can benefit from an enhanced degree of comparability with other enterprises.

7.5 Disclosures and User Groups of Segment Reporting:

1. Investors:

Segment reporting provides investor's information about profitability risk and growth of various segments of enterprises operations. Investors will be in better position to assess accurately a firm's future earnings. Investor's uncertainty about company's prospects will thus be reduced with the help of segment reporting.

2. Employees:

Employees and trade unions are also interested in the performance and prospects of the enterprise from the stand point of wage negotiations and job security. Segment reporting helps them as it helps investors.

3. Management:

Segment reporting is also helpful to the management while taking various important managerial decisions. Management while taking policy decisions may need for information on segmental performance. Lack of information on segmental performance may lead to misunderstanding between Management and workers.

4. Government Agencies:

Government agencies at national and international level in the case of multinational companies, are becoming more concerned by the activities of large companies and the balance; of payments.

Segment disclosures by the geographical location seem likely to promote a better understanding of corporate strategy and its impact.

5. Consumers:

The Interests of consumers and the General public may also be promoted by segmental disclosures in the sense that social responsibility in terms of the removal of price discrimination could be encouraged by segment disclosures regarding profits.

What are interim financial reports?

Interim financial statements are financial statements that cover a period of less than one year. The concept is most commonly applied to publicly-held companies, which must issue these statements at quarterly intervals. These entities issue three sets of interim statements per year, which are for the first, second, and third quarters. The final reporting period of the year is encompassed by the year-end financial statements, and so is not considered to be associated with interim financial statements.

The interim statement concept can apply to any period, such as the last five months. Technically, the "interim" concept does not apply to the balance sheet, since this financial statement only refers to assets, liabilities, and equity as of a specific point in time, rather than over a period of time.

Interim financial statements contain the same documents as will be found in annual financial statements - that is, the income statement, balance sheet, and statement of cash flows. The line items appearing in these documents will also match the ones found in annual financial statements. The main differences between interim and annual statements can be found in the following areas:

- **Disclosures.** Some accompanying disclosures are not required in interim financial statements, or can be presented in a more summarized format.
- **Accrual basis.** The basis upon which accrued expenses are made can vary within interim reporting periods. For example, an expense could be recorded entirely within one reporting period, or its recognition may be spread across multiple periods. These issues can make the results and financial positions contained within interim periods appear to be somewhat inconsistent, when reviewed on a comparative basis.
- **Seasonality.** The revenues generated by a business may be significantly impacted by seasonality. If so, interim statements may reveal periods of major losses and profits, which are not apparent in the annual financial statements.

Interim financial statements are not usually audited. Given the cost and time required for an audit, only the year-end financial statements are audited. If a company is publicly-held, its quarterly financial statements are instead reviewed. A review is conducted by outside auditors, but the activities encompassed by a review are much reduced from those employed in an audit.

Objective of IAS 34

The objective of IAS 34 is to prescribe the minimum content of an interim financial report and to prescribe the principles for recognition and measurement in financial statements presented for an interim period.

Key definitions

Interim period: a financial reporting period shorter than a full financial year (most typically a quarter or half-year). [IAS 34.4]

Interim financial report: a financial report that contains either a complete or condensed set of financial statements for an interim period. [IAS 34.4]

Matters left to local regulators

IAS 34 specifies the content of an interim financial report that is described as conforming to International Financial Reporting Standards. However, IAS 34 does not mandate: which entities should publish interim financial reports, how frequently, or how soon after the end of an interim period. Such matters will be decided by national governments, securities regulators, stock exchanges, and accountancy bodies. [IAS 34.1] However, the Standard encourages publicly traded entities to provide interim financial reports that conform to the recognition, measurement, and disclosure principles set out in IAS 34, at least as of the end of the first half of their financial year, such reports to be made available not later than 60 days after the end of the interim period. [IAS 34.1]

Minimum content of an interim financial report

The minimum components specified for an interim financial report are: [IAS 34.8]

- a condensed balance sheet (statement of financial position) either
- a condensed statement of comprehensive income or
- a condensed statement of comprehensive income and a condensed income statement
- a condensed statement of changes in equity

- a condensed statement of cash flows selected explanatory notes.

If a complete set of financial statements is published in the interim report, those financial statements should be in full compliance with IFRSs. [IAS 34.9]

If the financial statements are condensed, they should include, at a minimum, each of the headings and sub-totals included in the most recent annual financial statements and the explanatory notes required by IAS 34. Additional line-items or notes should be included if their omission would make the interim financial information misleading. [IAS 34.10]

If the annual financial statements were consolidated (group) statements, the interim statements should be group statements as well. [IAS 34.14]

The periods to be covered by the interim financial statements are as follows: [IAS 34.20]

- balance sheet (statement of financial position) as of the end of the current interim period and a comparative balance sheet as of the end of the immediately preceding financial year
- statement of comprehensive income (and income statement, if presented) for the current interim period and cumulatively for the current financial year to date, with comparative statements for the comparable interim periods (current and year-to-date) of the immediately preceding financial year.
- statement of changes in equity cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.
- statement of cash flows cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

If the company's business is highly seasonal, IAS 34 encourages disclosure of financial information for the latest 12 months, and comparative information for the prior 12-month period, in addition to the interim period financial statements [IAS 34.21].

Note: Disclosures

The explanatory notes required are designed to provide an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the last annual reporting date. IAS 34 states a presumption that anyone who reads an

entity's interim report will also have access to its most recent annual report. Consequently, IAS 34 avoids repeating annual disclosures in interim condensed reports. [IAS 34.15].

Examples of specific disclosure requirements of IAS 34

Examples of events and transactions for which disclosures are required if they are significant [IAS 34.15A-15B]

- ✓ write-down of inventories
- ✓ recognition or reversal of an impairment loss
- ✓ reversal of provision for the costs of restructuring
- ✓ acquisitions and disposals of property, plant and equipment
- ✓ commitments for the purchase of property, plant and equipment
- ✓ litigation settlements
- ✓ corrections of prior period errors
- ✓ changes in business or economic circumstances affecting the fair value of financial assets and liabilities
- ✓ unremedied loan defaults and breaches of loan agreements
- ✓ transfers between levels of the 'fair value hierarchy' or changes in the classification of financial assets
- ✓ Changes in contingent liabilities and contingent assets.

Examples of other disclosures required [IAS 34.16A]

- changes in accounting policies
- explanation of any seasonality or cyclicity of interim operations
- unusual items affecting assets, liabilities, equity, net income or cash flows
- changes in estimates
- issues, repurchases and repayment of debt and equity securities
- dividends paid
- particular segment information (where IFRS 8 Operating Segments applies to the entity)
- events after the end of the reporting period
- changes in the composition of the entity, such as business combinations, obtaining or losing control of subsidiaries, restructurings and discontinued operations
- disclosures about the fair value of financial instruments

Quick Check

- ★ Define Segment Reporting
- ★ What is the difference between geographical and reportable segment?
- ★ What is the importance of for segment reporting?
- ★ List the minimum content of an interim financial report

7.6 Accounting Policies

The same accounting policies should be applied for interim reporting as are applied in the entity's annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. [IAS 34.28]

A key provision of IAS 34 is that an entity should use the same accounting policy throughout a single financial year. If a decision is made to change a policy mid-year, the change is implemented retrospectively, and previously reported interim data is restated [IAS 34.43].

Measurement: Measurements for interim reporting purposes should be made on a year-to-date basis, so that the frequency of the entity's reporting does not affect the measurement of its annual results. [IAS 34.28]

Several Important Measurement Points:

Revenues that are received seasonally, cyclically or occasionally within a financial year should not be anticipated or deferred as of the interim date, if anticipation or deferral would not be appropriate at the end of the financial year. [IAS 34.37]. Costs that are incurred unevenly during a financial year should be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year [IAS 34.39].

Income tax expense should be recognized based on the best estimate of the weighted average annual effective income tax rate expected for the full financial year [IAS 34 Appendix B12]. An appendix to IAS 34 provides guidance for applying the basic recognition and measurement principles at interim dates to various types of asset, liability, income, and expense.

Materiality: In deciding how to recognize measure, classify, or disclose an item for interim financial reporting purposes, materiality is to be assessed in relation to the interim period financial data, not forecast annual data. [IAS 34.23]

Disclosure in Annual Financial Statements

If an estimate of an amount reported in an interim period is changed significantly during the financial interim period in the financial year but a separate financial report is not published for that period, the nature and amount of that change must be disclosed in the notes to the annual financial statements. [IAS 34.26]. The objective of IAS 34 is to prescribe the minimum content of an interim financial report and to prescribe the principles for recognition and measurement in financial statements presented for an interim period. The objective of IAS 34 is to prescribe the minimum content of an interim financial report and to prescribe the principles for recognition and measurement in financial statements presented for an interim period.

CHAPTER SUMMARY

The AICPA has defined a segment of business as “Component of an entity whose activities represent a separate major line of business or class of customer. A segment may be in the form of a subsidiary or division or a department, and in some cases a joint venture or other non-subsidiary investee, provided that its assets, results of operations and activities can be clearly distinguished, physically and operationally and for financial reporting purposes from the other assets, results of operations and activities of the entity.”

Business Segment is a distinguishable part of an enterprise that is involved in providing an individual product or service or a group of related products, or services and that is subject to risks and returns that are different from those of other business segments. These segments include Geographical Segment is a distinguishable part of an enterprise that is involved in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments and Reportable Segment is a business segment or a geographical segment identified based on the foregoing definition for which segment information is required to be disclosed.

Diversified companies present a unique type of problem for investment decision making. The performance of a diversified company can be judged from the performance of all several segments. The success of diversified company depends on success of all segments that is why segmental disclosures in company's annual reports are more useful to investors and other user groups.

Interim financial statements are financial statements that cover a period of less than one year. The concept is most commonly applied to publicly-held companies, which must issue these statements at quarterly intervals. These entities issue three sets of interim statements per year, which are for the first, second, and third quarters. The final reporting period of the year is encompassed by the year-end financial statements, and so is not considered to be associated with interim financial statements.

Answer Key for all chapters' Review Questions

CHAPTER 1

Multiple Choices:

1. B 2. F 3. E 4. B 5. B 6. C 7. F 8. F

CHAPTER 2

Multiple Choices:

- | | | |
|------|-------|-------|
| 1. C | 6. D | 11. C |
| 2. C | 7. B | 12. C |
| 3. D | 8. F | 13. B |
| 4. F | 9. B | |
| 5. F | 10. D | |

CHAPTER 3

Multiple Choices:

- | | |
|------|-------|
| 1. D | 6. B |
| 2. C | 7. C |
| 3. D | 8. A |
| 4. D | 9. C |
| 5. B | 10. E |

CHAPTER 4

Multiple Choices:

- | | | |
|------|------|-------|
| 1. F | 5. C | 9. C |
| 2. C | 6. C | 10. D |
| 3. E | 7. C | 11. C |
| 4. E | 8. E | 12. F |

CHAPTER 5

Solution for the Case:

Bronzewing Company and Subsidiary Consolidated

Statement of Cash Flows for the Year

Ended December 31,2005

Cash Flows from Operating Activities

Consolidated Net Income		\$175,000
Adjustments to reconcile net income to cash		
Noncontrolling Interest Expense	\$17,000	
Undistributed Income of Equity Investees	(7,500)	
Depreciation Expense	65,000	
Increase in Accounts Payable	15,000	
Amortization of Patent	13,000	
Decrease in Accounts Receivable	48,000	
Increase in Inventories	(27,500)	
Gain on sale of equipment	<u>(45,000)</u>	<u>78,000</u>
Net cash flows from operating activities		253,000

CHAPTER 6:

Multiple Choices:

1. C
2. D
3. E
4. D

ASSIGNMENT FOR ADVANCED FINANCIAL ACCOUNTING

ARBA MINCH UNIVERSITY



Name.....
ID No......
Program.....
Center.....
Phone No......
Date

This assignment is to be completed and send to the institute for evaluation. Its maximum load is **30%**.

Do not try to complete the assignment until you have covered all the lessons and have reviewed the study guide and yourself test exercises.

In addition to this, your tutor will clarify the assignment for you.

After successfully completing this assignment, be certain that to write your **Name, ID No., and Address** on the cover page of your assignment and also your **Name and ID No.** on the other pages.

ARBA MINCH UNIVERSITY
COLLEGE OF BUSINESS AND ECONOMICS
DEPARTMENT OF ACCOUNTING AND FINANCE
ASSIGNMENT FOR ADVANCED FINANCIAL ACCOUNTING (ACFN 3151)
DISTANCE EDUCATION

1. Perycal Co. merges with Inter Buy, Inc., and acquires several different categories of intangible assets including trademarks, a customer list, copyrights on artistic materials, agreements to receive royalties on leased intellectual property, and unpatented technology.
 - A. Describe the criteria for determining whether an intangible asset acquired in a business combination should be separately recognized apart from goodwill.
 - B. For each of the acquired intangibles listed, identify which recognition criteria (separability and legal/contractual) may or may not apply in recognizing the intangible on the acquiring firm's financial statements.
2. The home office shipped merchandise costing \$8,000 to Dila Branch and paid freight costs of \$500. A week later, the home office instructed Dila Branch to transfer this merchandise to Arba Minch Branch. Dila paid \$400 for the transfer. If the merchandise had been shipped directly from the home office to Arba Minch, the freight costs would have been \$600.

Required: Make the necessary journal entry for each company which have been affected?

3. Assume that **Chamo** Company, which prepares financial reports at the end of the calendar year, established a branch in **Abaya** on July 1, 2011. The following transactions occurred during the formation of the branch and its first six months of operations, ending December 31, 2011
 - a. The home office sent \$ 28,000 cash to the branch to begin operations.
 - b. The home office shipped inventory to the branch. Intra company billings totaled \$80,000, which is the home office cost plus 33 1/3 % initial cost. (Both the home office and the branch use a periodic inventory system.)

- c. The branch acquired merchandise display equipment, which cost \$ 12,000 on July 1, 2011. (Assume that branch fixed assets are not carried on the home office books.).
- d. The branch purchased inventory costing \$ 43,000 from outside vendors on account.
- e. The branch had credit sales of \$ 85,000 and cash sales of \$ 35,000.
- f. The branch collected \$ 44,000 on accounts receivable.
- g. The branch paid outside vendors \$ 28,000.
- h. The branch incurred selling expenses of \$ 15,000 and general and administrative expenses of \$ 12,000. These expenses were paid in cash when they were incurred and include the expense of leasing the branch's facilities.
- i. The home office charged the branch \$ 2,000 for its share of insurance.
- j. Depreciation expense on the merchandise display equipment acquired by the branch is \$ 1,000 for the six month period. (Depreciation expense is classified as a selling expense.).
- k. The branch remitted \$ 10,000 cash to the home office.
- l. The branch's physical inventory on December 31, 2011, is \$ 33,000, of which \$ 25,000 was acquired from the home at billed price (there was no beginning inventory). The home office's physical inventory on December 31, 2011, is \$ 150,000 (the beginning inventory was \$ 135,000). (Home office purchases were \$ 285,000.). Cost of goods sold is determined and recorded in a separate account for each accounting entity. (Note that the year-end inventory accounts are adjusted in this entry to the year-end physical inventory balances).
- m. The branch closes its income statement accounts.
- n. The home office prepares its adjusting entry to reflect the increase in the branch's net assets resulting from the branch's operations.
- o. Determine the realized gross profit inventory overvaluation and make the necessary journal entry?

Required:

Based on the above given data make the necessary journal entry for Chamo Company's home office and its Abaya branch?

4. **Bahirdar Textile Company (BTC)** ships 20 Motorbikes on consignment to **Arba Minch Textile Company (ATC)** to be sold at ETB 50,000 each. **ATC** is incurred ETB 1,000 for freight cost to be reimbursed and is to receive a commission of 10% of the selling price. Out of 20 motorbikes **ATC** could sale only 10 bikes and returned the remaining bikes to the consigner. You are required to pass the necessary journal entries in the books of the consigner.
5. On December 31st 2011 **MJ** company sold a land for ETB, 900,000 with the cost of ETB 600,000. Commission and other costs to the sale were ETB, 10,000 and were charged to **MJ** co. **MJ** company received a down payment of 10% of selling price and the remaining balance is to be received in equal semiannual instalments starting from 30th June 2012. In addition the buyer agreed to pay semiannual interest 10% on the unpaid balance. **MJ** co. used instalment method of accounting to recognize the gross profit.
Required: prepare the necessary journal entries in the books of MJ co. for the 3 years.
6. **ABC co.** sales merchandise on instalment basis and the company deals with many buyers. On the 1st January 2010 **ABC** co. sold merchandise worth ETB 60,000 at 100,000 ETB on instalment basis to **XYZ** co. The companies follows perpetual inventory system. The Carrying cost and other expenses amounted to ETB 10,000 were covered by the seller. The **ABC co.** received a down payment 30% of selling price and the rest of amount was agreed to be paid in 7 equal annual instalments. For the remaining amount the promissory notes were issued. The buyer is also expected to pay an interest of 10% per annum on the remaining amount.
7. On the 1st April 2013 an another buyer **PQR co.** failed to pay the instalment and the goods ETB, 11,000 which consisted of ETB, 10,000 selling price and ETB 1,000 carrying charges. The selling price is also inclusive of differed gross profit @ 30 % on the selling price. The goods worth **ETB 4,000** could only be recovered from the buyer. The **ABC co.** reconditioned the goods for which they spend ETB, 1,000 and sold the repossessed goods for ETB, **7,000**. **Required:** Record the necessary transactions in the books of **ABC CO** for the economic event with **XYZ CO** from Jan, 2010 up to December 2013 and with **PQR** for April 2013

8. The following book and fair values were available for Westmont Company as of March 1.

	<u>Book Value</u>	<u>Fair Value</u>
Inventory	\$ 630,000	\$ 600,000
Land	750,000	990,000
Buildings	1,700,000	2,000,000
Customer relationships	–0–	800,000
Accounts payable	(80,000)	(80,000)
Common stock	(2,000,000)	
Additional paid-in capital	(500,000)	
Retained earnings 1/1	(360,000)	
Revenues	(420,000)	
Expenses	280,000	

Arturo Company pays \$4,000,000 cash and issues 20,000 shares of its \$2 par value common stock (fair value of \$50 per share) for all of Westmont’s common stock in a merger, after which Westmont will cease to exist as a separate entity. Stock issue costs amount to \$25,000 and Arturo pays \$42,000 for legal fees to complete the transaction. Prepare Arturo’s journal entry to record its acquisition of Westmont.

9. The balance sheet of Mel Company on January 31, 2005, showed current assets, \$100,000; other assets, \$800,000; current liabilities, \$80,000; long-term debt, \$240,000; common stock (10,000 shares, \$10 par), \$100,000; and retained earnings, \$480,000. On that date, Mel merged with Sal Corporation in a business combination in which Sal issued 35,000 shares of its \$1 par (current fair value \$20 a share) common stock to stockholders of Mel in exchange for all their outstanding common stock. The current fair values of Mel’s liabilities were equal to their carrying amounts; the current fair values of Mel’s current assets and other assets (none intangible) were \$120,000 and \$850,000, respectively, on January 31, 2005. Also, on that date, Sal paid direct out-of-pocket costs of the business combination, \$40,000, and costs of registering and issuing its common stock, \$70,000.

Required: Prepare journal entries (omit explanations) for Sal Corporation to record its merger with Mel Company on January 31, 2005. (Disregard income taxes.) (**Check figure Debit Good will \$90,000**)

10. On March 31, 2005, Combinor Company issued 100,000 shares of its \$1 par common stock (current fair value \$5 a share) for the net assets of Combine Company. Also on that date, Combinor paid the following out-of-pocket costs in connection with the combination:

Finder's, accounting, and legal fees relating to business combination.....	\$ 70,000
Costs associated with SEC registration statement.....	<u>50,000</u>
Total out-of-pocket costs of business combination.....	\$120,000

The balance sheet of Combinee on March 31, 2005, with related current fair values, was as follows:

COMBINEE COMPANY
Balance Sheet (prior to business combination)
March 31, 2005

	<u>Carrying</u> <u>Amounts</u>	<u>Current</u> <u>Fair Values</u>
<u>Assets</u>		
Current assets	\$200,000	\$260,000
Plant assets (net)	400,000	480,000
Other assets (none intangible)	140,000	150,000
Total assets	\$740,000	
Liabilities and Stockholders' Equity		
Current liabilities.....	\$80,000	\$80,000
Long-term debt	260,000	260,000
Common stock, no par or stated value.....	150,000	
Retained earnings	250,000	
Total liabilities and stockholders' equity	\$740,000	

Required: Prepare journal entries (omit explanations) for Combinor Company on March 31, 2005, to record the business combination with Combinee Company. (Disregard income taxes.) (**Check Figure- Amount of goodwill \$20,000**).

11. Emu Corporation paid \$77,000 for a 60% interest in Chick Inc. on January 1, 2005, when Chick's Capital Stock was \$80,000 and its Retained Earnings \$20,000. The fair values of Chick's identifiable assets and liabilities were the same as the recorded book values on the acquisition date. Trial balances at the end of the year on December 31, 2005 are given below:

	Emu Inc.	Chick Inc.
Cash	\$ 4,500	\$ 20,000
Accounts Receivable	25,000	30,000
Inventory	100,000	70,000
Investment in Cave	77,000	
Cost of Goods Sold	71,500	50,000
Operating Expenses	22,000	37,000
Dividends	15,000	10,000
	<u>\$ 315,000</u>	<u>217,000</u>
Liabilities	\$ 47,000	\$ 27,000
Capital stock, \$10 par value	100,000	80,000
Additional Paid-in Capital	11,000	
Retained Earnings	31,000	20,000
Sales Revenue	120,000	90,000
Dividend Income	6,000	
	<u>\$ 315,000</u>	<u>217,000</u>

During 2005, Emu made only two journal entries with respect to its investment in Chick. On January 1, 2005, it debited the Investment in Chick account for \$77,000 and on November 1, 2005, it credited Dividend Income for \$6,000.

Required:

1. Prepare a consolidated income statement and a statement of retained earnings for Emu and Subsidiary for the year ended December 31, 2005.

2. Prepare a consolidated balance sheet for Emu and Subsidiary as of December 31, 2005.

12. **Girum Company** which uses lower of cost or market value principle for inventory pricing. The company practices FIFO method for managing its inventory. The company had single merchandise item of 30,000 units with FIFO cost at Br.10 per unit on January 1, 2018. Quarterly sales and end quarter replacement cost (Market value) for inventory were as follows for the year.

Quarter ended	Quarterly Sales (units)	End quarter Market Value Per unit
March 31	4000	11
June 30	2000	7
Sept. 30	10,000	12
Dec, 31	4000	9
Total	20,000	

Required:

- a. Find Cost of goods sold for each quarter
- b. Quarterly cost of goods sold with total year value

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