

Performance Measurement and Reporting

Chapter 3

Intermediate Financial Accounting I **AcFn 302 I**

Learning Objectives

1. Understand the uses and limitations of an income statement.
2. Understand the content and format of the income statement.
3. Explain the five-step revenue recognition process
4. Prepare an income statement.
5. Explain how to report items in the income statement.
6. Identify where to report discontinued operations & measurement of assets held for sale.
7. Explain income tax allocation.
8. Explain how to report other comprehensive income.
9. Prepare a retained earnings statement and statement of changes in equity.
10. Understand the reporting of accounting policies, changes and errors.

Statement of profit or loss and other comprehensive income

Format

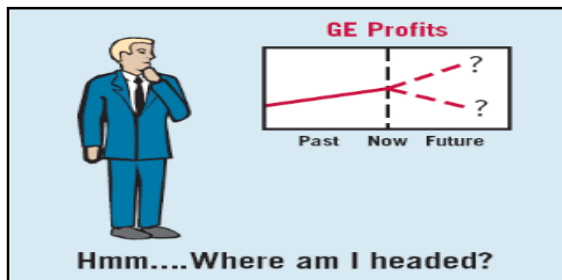
IFRS allows income and expense items (information on financial performance) to be presented either:

- (a) In a single statement of profit or loss and other comprehensive income; or
- (b) In two statements: a separate statement of profit or loss (Income statement) and statement of other comprehensive income.

Income Statement

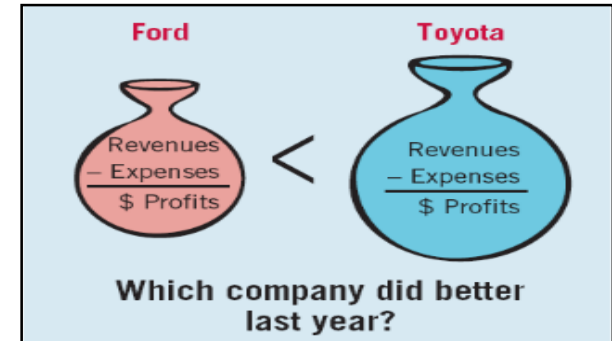
Usefulness

- Evaluate past performance.



- Predicting future performance.

- Help assess the risk or uncertainty of achieving future cash flows.



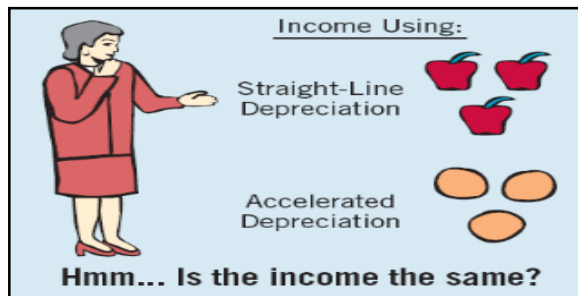
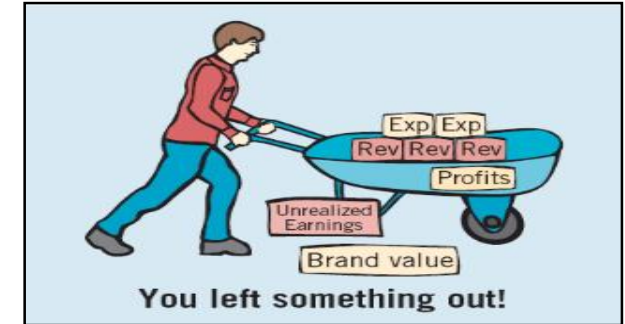
Siemens'	Recurring?
Income for Year Ended 12/31/11	
Revenues	
– Operating expenses	
Operating income	Yes
Discontinued operations	No
\$ Net Income	?

Recurring items are more certain in the future.

Income Statement

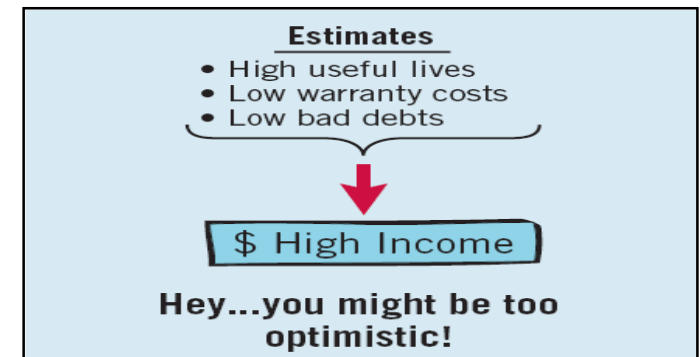
Limitations

- Companies omit items that cannot be measured reliably.



- Income is affected by the accounting methods employed.

- Income measurement involves judgment.



Information presented in the income statement

The standard lists the following as the **minimum** to be disclosed on the face of the statement of profit or loss.

- (a) Revenue
- (b) Finance costs
- (c) Share of profits and losses of associates and joint ventures accounted for using the equity method
- (d) a single amount comprising the total of
 - The post-tax profit or loss of discontinued operations and
 - The post-tax gain or loss recognized on the measurement to fair value less cost to sell or on the disposal of assets or disposal group constituting the discontinued operation.
- (e) Tax expense
- (f) Profit or loss (net income or loss)

The following items must be disclosed as allocations of profit or loss for the period.

- (a) Profit or loss attributable to non-controlling interest
- (b) Profit or loss attributable to owners of the parent

The allocated amounts must not be presented as items of income or expense. (These relate to group accounts, covered in advanced financial accounting.)

Elements of the Income Statement

Income includes both revenues and gains.

- Revenues - ordinary activities of a company
- Gains - may or may not arise from ordinary activities.

Revenue Accounts

- Sales
- Fee revenue
- Interest revenue
- Dividend revenue
- Rent revenue

Gain Accounts

- Gains on the sale of long-term assets
- gains on remeasurement of investment property

Elements of the Income Statement

Expenses include both expenses and losses.

- Expenses - ordinary activities of a company
- Losses - may or may not arise from ordinary activities.

Expense Accounts

- Cost of goods sold
- Depreciation expense
- Interest expense
- Rent expense
- Salary expense

Loss Accounts

- Losses on restructuring charges
- Losses on sale of long-term assets
- Unrealized losses on available-for-sale securities.

Information presented in the income statement

Income and expense items can only be **offset** when, and only when:

- (a) It is permitted or required by an IFRS, or
- (b) Gains, losses and related expenses arising from the same or similar transactions and events are immaterial, in which case they can be aggregated.

Format of the Income Statement

Intermediate Components

Common for companies to present some or all of these sections and totals within the income statement.

1. **Sales or Revenue Section.** Presents sales, discounts, allowances, returns, and other related information. Its purpose is to arrive at the net amount of sales revenue.
2. **Cost of Goods Sold Section.** Shows the cost of goods sold to produce the sales.

Gross Profit. Revenue less cost of goods sold.

3. **Selling Expenses.** Reports expenses resulting from the company's efforts to make sales.
4. **Administrative or General Expenses.** Reports expenses of general administration.
5. **Other Income and Expense.** Includes most other transactions that do not fit into the revenues and expenses categories provided above. Items such as gains and losses on sales of long-lived assets, impairments of assets, and restructuring charges are reported in this section. In addition, revenues such as rent revenue, dividend revenue, and interest revenue are often reported.

Income from Operations. Company's results from normal operations.

6. **Financing Costs.** A separate item that identifies the financing cost of the company, hereafter referred to as *interest expense*.

Income before Income Tax. The total income before income tax.

7. **Income Tax.** A short section reporting taxes levied on income before income taxes.

Income from Continuing Operations. A company's results before any gain or loss on discontinued operations. If the company does not have any gain or loss on discontinued operations, this section is not reported and this amount is reported as net income.

8. **Discontinued Operations.** Gains or losses resulting from the disposition of a component of a company.

Net Income. The net results of the company's performance over a period of time.

9. **Non-Controlling Interest.** Presents an allocation of net income to the primary shareholders and to the non-controlling interest (also referred to as *minority interest*).
10. **Earnings per Share.** Per share amounts that are reported.

Format

Illustration

Includes all of the major items in the list above, except for discontinued operations.

BOC HONG COMPANY INCOME STATEMENT FOR THE YEAR ENDED DECEMBER 31, 2011			
Sales revenue			
Sales			\$3,053,081
Less: Sales discounts	\$ 24,241		
Sales returns and allowances	56,427		80,668
Net sales revenue			2,972,413
Cost of goods sold			1,982,541
Gross profit			989,872
Selling expenses			
Sales salaries and commissions	202,644		
Sales office salaries	59,200		
Travel and entertainment	48,940		
Advertising expense	38,315		
Freight and transportation-out	41,209		
Shipping supplies and expense	24,712		
Postage and stationery	16,788		
Telephone and Internet expense	12,215		
Depreciation of sales equipment	9,005	453,028	
Administrative expenses			
Officers' salaries	186,000		
Office salaries	61,200		
Legal and professional services	23,721		
Utilities expense	23,275		
Insurance expense	17,029		
Depreciation of building	18,059		
Depreciation of office equipment	16,000		
Stationery, supplies, and postage	2,875		
Miscellaneous office expenses	2,612	350,771	803,799
Other income and expense			
Dividend revenue	98,500		
Rental revenue	42,910		
Gain on sale of plant assets	30,000		171,410
Income from operations			357,483
Interest on bonds and notes			126,060
Income before income tax			231,423
Income tax			66,934
Net income for the year			\$ 164,489
Attributable to:			
Shareholders of Boc Hong			\$ 120,000
Non-controlling interest			44,489
Earnings per share			\$1.74

Format of the Income Statement

Condensed

More
representative of
the type found in
practice.

BOC HONG COMPANY INCOME STATEMENT FOR THE YEAR ENDED DECEMBER 31, 2011		
Net sales		\$2,972,413
Cost of goods sold		<u>1,982,541</u>
Gross profit		989,872
Selling expenses (see Note D)	\$453,028	
Administrative expenses	<u>350,771</u>	803,799
Other income and expense		<u>171,410</u>
Income from operations		357,483
Interest expense		<u>126,060</u>
Income before income tax		231,423
Income tax		<u>66,934</u>
Net income for the year		<u><u>\$ 164,489</u></u>
Attributable to:		
Shareholders of Boc Hong		\$ 120,000
Non-controlling interest		44,489
Earnings per share		<u><u>\$1.74</u></u>

Reporting Within the Income Statement

Gross Profit

- Computed by deducting cost of goods sold from net sales revenue.
- Disclosure of net sales revenue is useful.
- Unusual or incidental revenue is disclosed in other income and expense.
- Analysts can more easily understand and assess trends in revenue from continuing operations.

Income from Operations

- Determined by deducting selling and administrative expenses as well as other income and expense from gross profit.
- Highlights items that affect regular business activities.
- Used to predict the amount, timing, and uncertainty of future cash flows.

Presentation of expenses

IFRS offers two possible formats for the statement of profit or loss or separate profit or loss section – by function or by nature. Classification by function is more common.

Note. *The usual method of presentation is expenses by function and this is the format likely to appear in most presentations in practice*

1. Nature of expense method

- Expenses are not reallocated amongst various functions within the entity, but are aggregated in the Income statement **according to their nature** (eg purchase of materials, depreciation, wages and salaries, transport costs).
- This is by far the easiest method, especially for smaller entities.

2 Function of expense/cost of sales method

Expenses are classified according to their function as part of cost of sales, distribution or administrative activities.

- This method often gives **more relevant information** for users, but the allocation of expenses by function requires the use of judgement and can be arbitrary.
- Consequently, perhaps, when this method is used, entities should disclose **additional information** on the nature of expenses, including staff costs, and depreciation and amortisation expense.

Reporting Within the Income Statement

Illustration: Assume that the accounting firm of Telaris Co. provides audit, tax, and consulting services. It has the following revenues and expenses.

Service revenues	\$400,000
Cost of services	
Staff salaries (related to various services performed)	145,000
Supplies expense (related to various services performed)	10,000
Selling expenses	
Advertising costs	20,000
Entertainment expense	3,000
Administrative expenses	
Utilities expense	5,000
Depreciation on building	12,000

Expense Classification (Nature-of-Expense Approach)

TELARIS CO. INCOME STATEMENT FOR THE MONTH OF JANUARY 2011	
Service revenues	\$400,000
Staff salaries	145,000
Supplies expense	10,000
Advertising costs	20,000
Utilities expense	5,000
Depreciation on building	12,000
Entertainment expense	3,000
Net income	<u>\$205,000</u>

Expense Classification (Function-of-Expense Approach)

TELARIS CO. INCOME STATEMENT FOR THE MONTH OF JANUARY 2011	
Service revenues	\$400,000
Cost of services	155,000
Selling expenses	23,000
Administrative expenses	17,000
Net income	<u>\$205,000</u>

Reporting Within the Income Statement

Gains and Losses

IASB takes the position that both

- revenues and expenses and
- other income and expense

should be reported as part of income from operations.

Companies can provide additional line items, headings, and subtotals when such presentation is relevant to an understanding of the entity's financial performance.

Reporting Within the Income Statement

Income before Income Tax

Financing costs must be reported on the income statement.



Network Rail

On its income statement:
(000)

Finance costs

Note 10

£1,014

10 Finance costs

Interest on bank loans and overdrafts	£	71
Interest on bonds issued under the debt issuance programme		672
Interest on debt issued under the medium term note programme		253
Interest on commercial paper		12
Interest on obligations under finance leases		16
Other interest		82
Total borrowing costs		1,106
Less: Amounts included in the cost of qualifying assets		92
Total finance costs		£1,014

Borrowing costs are included in the costs of qualifying assets to the extent that the asset is financed by the Group. The average rate used during the year was 5.0% (2007: 5.0%).

Reporting Within the Income Statement

Net Income

Represents the income after **all**

- ✓ revenues and

- ✓ expenses

for the period are considered.

Viewed by many as the most important measure of a company's success or failure for a given period of time.

Reporting Within the Income Statement

Allocation to Non-Controlling Interest

If a company prepares a consolidated income statement that includes a partially own subsidiary. IFRS requires that net income of the subsidiary be allocated to the controlling and non-controlling interest. This allocation is reported at the bottom of the income statement after net income.

Net income	\$164,489
Attributable to:	
Shareholders of Boc Hong	\$120,000
Non-controlling interest	44,489

Reporting Within the Income Statement

Exercise: Presented below is some financial information related to Volaire Group. Compute the following:

Other Income
and Expense

Revenues	€800,000
Income from continuing operations	100,000
Comprehensive income	120,000
Net income	90,000
Income from operations	220,000
Selling and administrative expenses	500,000
Income before income tax	200,000

Reporting Within the Income Statement

Exercise: Presented below is some financial information related to Volaire Group. Compute the following:

Financing Costs

Revenues	€800,000
Income from continuing operations	100,000
Comprehensive income	120,000
Net income	90,000
Income from operations	220,000
Selling and administrative expenses	500,000
Income before income tax	200,000

Reporting Within the Income Statement

Exercise: Presented below is some financial information related to Volaire Group. Compute the following:

		<u>Income Tax</u>
Revenues	€800,000	
Income from continuing operations	100,000	
Comprehensive income	120,000	
Net income	90,000	
Income from operations	220,000	
Selling and administrative expenses	500,000	
Income before income tax	200,000	

Reporting Within the Income Statement

Exercise: Presented below is some financial information related to Volaire Group. Compute the following:

		<u>Discontinued Operations</u>
Revenues	€800,000	
Income from continuing operations	100,000	
Comprehensive income	120,000	
Net income	90,000	
Income from operations	220,000	
Selling and administrative expenses	500,000	
Income before income tax	200,000	

Reporting Within the Income Statement

Earnings Per Share

Net income - Preference dividends

Weighted average of ordinary shares outstanding

- Important business indicator.
- Measures the dollars earned by each ordinary share.
- Must be disclosed on the income statement.

Earnings Per Share: In 2010, Hollis Corporation reported net income of \$1,000,000. It declared and paid preference share dividends of \$250,000. During 2010, Hollis had a weighted average of 190,000 ordinary shares outstanding. Compute Hollis's 2010 earnings per share.

Net income - Preference dividends

Weighted average number of ordinary shares

\$1,000,000 - \$250,000 = **\$3.95** per share

190,000

Reporting Within the Income Statement

Discontinued Operations

A component of an entity that either has been disposed of, or is classified as held-for-sale, and:

1. Represents a major line of business or geographical area of operations, or
2. Is part of a single, co-coordinated plan to dispose of a major line of business or geographical area of operations, or
3. Is a subsidiary acquired exclusively with a view to resell.

Companies report as discontinued operations

1. (in a separate income statement category) the gain or loss from disposal of a component of a business.
2. The results of operations of a component that has been or will be disposed of separately from continuing operations.
3. The effects of discontinued operations net of tax, as a separate category after continuing operations.

Reporting Within the Income Statement

Illustration: Multiplex Products, a highly diversified company, decides to discontinue its electronics division. During the current year, the electronics division lost \$300,000 (net of tax). Multiplex sold the division at the end of the year at a loss of \$500,000 (net of tax).

Income from continuing operations	\$20,000,000
Discontinued operations:	
Loss from operations, net of tax	300,000
Loss on disposal, net of tax	<u>500,000</u>
Total loss on discontinued operations	<u>800,000</u>
Net income	<u><u>\$19,200,000</u></u>

Reporting Within the Income Statement

A company that reports a discontinued operation must report per share amounts for the line item either on the face of the income statement or in the notes to the financial statements.

POQUITO INDUSTRIES INC. INCOME STATEMENT FOR THE YEAR ENDED DECEMBER 31, 2011			
Sales revenue			\$1,420,000
Cost of goods sold			<u>600,000</u>
Gross profit			820,000
Selling and administrative expenses			<u>320,000</u>
Other income and expense			
Interest revenue	10,000		
Loss on disposal of part of Textile Division	(5,000)		
Loss on sale of investments	<u>(30,000)</u>		<u>(25,000)</u>
Income from operations			475,000
Interest expense			<u>15,000</u>
Income before income tax			460,000
Income tax			<u>184,000</u>
Income from continuing operations			276,000
Discontinued operations			
Income from operations of Pizza Division, less applicable income tax of \$24,800		54,000	
Loss on disposal of Pizza Division, less applicable income tax of \$41,000		<u>(90,000)</u>	<u>(36,000)</u>
Net income			<u>\$240,000</u>
Per share			
Income from continuing operations			\$2.76
Income from operations of discontinued division, net of tax			0.54
Loss on disposal of discontinued operation, net of tax			<u>(0.90)</u>
Net income			<u>\$2.40</u>

Non-current Assets Held For Sale

- The term refers to an *individual asset* or *group of assets*
- An *individual non-current asset* is regarded as 'held for sale' if its carrying amount will be recovered principally through a sale transaction rather than through continuing use
- A *disposal group* is a group of assets to be disposed of together as a single transaction together with liabilities directly associated with those assets that will be transferred in the transaction

non-current assets / group as held for sale

- Classify as held for sale if carrying amount will be recovered principally through a sale transaction rather than through continuing use.
- Asset is available for immediate sale in its present condition.
- Sale is highly probable
 - ✓ Management is committed to a plan to sell the asset
 - ✓ Programme to locate a buyer is initiated
 - ✓ Asset is actively marketed at a price that is reasonable in relation to its fair value
 - ✓ Disposal plan should be completed within one year from date of classification (subject to events outside entity's control)
 - ✓ Significant change in plan or withdrawal unlikely
- Lower of the carrying amount and FVLCS
- No depreciation or amortisation charges (even if asset is still used)

ACCOUNTING FOR INCOME TAXES

Companies must file income tax returns following the guidelines developed by the appropriate tax authority.

Because IFRS and tax regulations differ in a number of ways, frequently the amounts reported for the following will differ:

- ◆ **Income tax expense** (IFRS)
- ◆ **Income taxes payable** (Tax Authority)

Illustration: Bantu SC reported revenues of \$130,000 and expenses of \$60,000 in each of its first three years of operations. For tax purposes, it reported the same expenses to the taxing authority in each of the years. It reported taxable revenues of \$100,000 in 2015, \$150,000 in 2016, and \$140,000 in 2017. What is the effect on the accounts of reporting different amounts of revenue for IFRS versus tax?

Book vs. Tax Differences

IFRS Reporting

	2015	2016	2017	Total
Revenues	\$130,000	\$130,000	\$130,000	\$390,000
Expenses	60,000	60,000	60,000	180,000
Pretax financial income	\$70,000	\$70,000	\$70,000	\$210,000

Tax Reporting

	2015	2016	2017	Total
Revenues	\$100,000	\$150,000	\$140,000	\$390,000
Expenses	60,000	60,000	60,000	180,000
Taxable income	\$40,000	\$90,000	\$80,000	\$210,000
Income taxes payable (30%)	\$12,000	\$27,000	\$24,000	\$63,000

Book vs. Tax Differences

Comparison	2015	2016	2017	Total
Income tax expense (IFRS)	\$21,000	\$21,000	\$21,000	\$63,000
Income tax payable (TA)	12,000	27,000	24,000	63,000
Difference	\$9,000	\$(6,000)	\$(3,000)	\$0
Income tax expense (30%)	\$21,000	\$21,000	\$21,000	\$63,000

Are the differences accounted for in the financial statements?

Yes

Year

Reporting Requirement

2015

Deferred tax liability account **increased** to \$9,000

2016

Deferred tax liability account **reduced** by \$6,000

2017

Deferred tax liability account **reduced** by \$3,000

Temporary Differences-Examples

- Depreciation of an asset in the income statement is greater than the depreciation allowed for tax purposes up to the end of the reporting period.
- Sale of goods revenue is included in accounting profit when the goods are delivered, but only included in taxable profit when cash is received.
- Bad debt expense is estimated and deducted from accounting profit but is deducted from taxable profit only when the receivable is written off.
- Fair value Adjustments

Comprehensive Income

All changes in equity during a period except those resulting from investments by owners and distributions to owners.

Includes:

- ✓ all revenues and gains, expenses and losses reported in net income, and
- ✓ all gains and losses that bypass net income but affect equity.

Income Statement

+

Other Comprehensive Income

- Unrealized gains in PPE.
- Translation gains and losses on foreign currency.
- Plus others

Reported in Equity

Other Reporting Issues

Two approaches to reporting Comprehensive Income:

1. A second income statement.
2. A combined statement of comprehensive income.

Comprehensive Income

Two-statement format:
Comprehensive
Income

V. GILL INC. INCOME STATEMENT FOR THE YEAR ENDED DECEMBER 31, 2011	
Sales revenue	\$800,000
Cost of goods sold	<u>600,000</u>
Gross profit	200,000
Operating expenses	<u>90,000</u>
Net income	<u><u>\$110,000</u></u>

V. GILL INC. STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED DECEMBER 31, 2011	
Net income	\$110,000
Other comprehensive income	
Unrealized holding gain, net of tax	<u>30,000</u>
Comprehensive income	<u><u>\$140,000</u></u>

Comprehensive Income

Combined statement
format: Comprehensive
Income

V. GILL INC. STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED DECEMBER 31, 2011	
Sales revenue	\$800,000
Cost of goods sold	<u>600,000</u>
Gross profit	200,000
Operating expenses	<u>90,000</u>
Net income	110,000
Other comprehensive income	
Unrealized holding gain, net of tax	<u>30,000</u>
Comprehensive income	<u><u>\$140,000</u></u>

Revenue Recognition

Revenue Recognition Standard

Revenue from Contracts with Customers, adopts an **asset-liability approach**.

- ◆ Companies account for revenue based on the asset or liability arising from contracts with customers.
- ◆ Companies analyze contracts with customers because contracts initiate revenue transactions.
- ❖ Contracts indicate terms of the transaction,
- ❖ provide the measurement of the consideration, and
- ❖ specify the promises that must be met.

Revenue Recognition Standard

Key Concepts of Revenue Recognition

KEY OBJECTIVE

Recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration that the company receives, or expects to receive, in exchange for these goods or services.

FIVE-STEP PROCESS FOR REVENUE RECOGNITION

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

REVENUE RECOGNITION PRINCIPLE

Recognize revenue in the accounting period when the performance obligation is satisfied.



Performance Obligation is Satisfied

The Five-Step Process Revisited

Identifying the Contract with Customers—Step 1

Contract:

- ◆ Agreement between two or more parties that creates enforceable rights or obligations.
- ◆ Can be: written, oral, or implied from customary business practice.

To be a contract for revenue recognition:

1. The contract has commercial substance
2. The parties have approved the contract
3. Identification of the rights of the parties is established
4. Payment terms are identified
5. It is probable that the consideration will be collected

Contract with Customers—Step 1

Accounting

- ◆ Revenue cannot be recognized until a contract exists.
- ◆ Company obtains rights to receive consideration and assumes obligations to transfer goods or services.
- ◆ Rights and performance obligations gives rise to an (net) asset or (net) liability.
- ◆ Company does not recognize contract assets or liabilities until one or both parties perform under the contract.

Separate Performance Obligations—Step 2

A **performance obligation** is a promise to provide a **distinct** product or service to a customer.

A product or service is distinct when a customer is able to

- ◆ benefit from a good or service on its own or
- ◆ together with other readily available resources.

The objective is to determine whether the nature of a company's promise is to transfer individual goods and services to the customer or to transfer a combined item (or items) for which individual goods or services are inputs.

Example

ABC PLC imports and sells electrical equipments. It has entered into a contract with **XYZ Company** to supply the following:

- a. Deliver the equipments
- b. Installation service.
- c. Maintenance service for three years

ABC PLC is not the only company able to install this equipments, and the maintenance service can also be provided by other companies.

Explain whether the goods or services provided to XYZ company are distinct in accordance with *Revenue Model*

Determining Transaction Price—Step 3

Transaction price

- ◆ Amount of consideration that company expects to receive from a customer.
- ◆ In a contract, it is often easily determined because customer agrees to pay a fixed amount.
- ◆ Other contracts, Companies must consider:
 - ▶ Variable consideration
 - ▶ Time value of money
 - ▶ Non-cash consideration
 - ▶ Consideration paid or payable to customers

Determining Transaction Price—Step 3

Variable Consideration

- ◆ Price dependent on future events.
 - ▶ May include price increases, volume discounts, rebates, credits, performance bonuses, or royalties.
- ◆ Companies estimate amount of revenue to recognize.
 - ▶ Expected value
 - ▶ Most likely amount

ILLUSTRATION: Estimating Variable Consideration

Expected Value: Probability-weighted amount in a range of possible consideration amounts.

- May be appropriate if a company has a large number of contracts with similar characteristics.
- Can be based on a limited number of discrete outcomes and probabilities.

Most Likely Amount: The single most likely amount in a range of possible consideration outcomes.

- May be appropriate if the contract has only two possible outcomes.

Variable Consideration

ESTIMATING VARIABLE CONSIDERATION

Peabody Construction Company enters into a contract with a customer to build a warehouse for \$100,000, with a performance bonus of \$50,000 that will be paid based on the timing of completion. The amount of the performance bonus decreases by 10% per week for every week beyond the agreed-upon completion date. The contract requirements are similar to contracts that Peabody has performed previously, and management believes that such experience is predictive for this contract. Management estimates that there is a 60% probability that the contract will be completed by the agreed-upon completion date, a 30% probability that it will be completed 1 week late, and only a 10% probability that it will be completed 2 weeks late.

Question: How should Peabody account for this revenue arrangement?

Variable Consideration

Question: How should Peabody account for this revenue arrangement?

Management has concluded that the **probability-weighted method** is the most predictive approach:

On time:	60% chance of \$150,000	=	\$ 90,000
1 week late:	30% chance of \$145,000	=	43,500
2 weeks late:	10% chance of \$140,000	=	<u>14,000</u>
			<u>\$147,500</u>

Most likely outcome, if management believes they will meet the deadline and receive the \$50,000 bonus, the total transaction price would be?

\$150,000 (the outcome with 60% probability)

Determining Transaction Price—Step 3

Time Value of Money

- ◆ When contract (sales transaction) involves a significant financing component.
 - ▶ Interest accrued on consideration to be paid over time.
 - ▶ Fair value determined either by measuring the consideration received (using cash equivalent price) or by discounting the payment using an imputed interest rate.
 - ▶ Company reports as interest expense or interest revenue.
 - ▶ Companies are not required to reflect the time value of money if the time period for payment is less than a year.

Time Value of Money

EXTENDED PAYMENT TERMS

Facts: On July 1, 2023, SEK Company sold goods to Grant Company for \$900,000 in exchange for a 4-year, zero-interest-bearing note with a face amount of \$1,416,163. The goods have a cost on SEK's books of \$590,000.

Questions: (a) How much revenue should SEK Company record on July 1, 2023?

(b) How much revenue should it report related to this transaction on December 31, 2023?

Entry to record SEK's sale to Grant Company on July 1, 2023, is as follows.

Notes Receivable	900,000	
Sales Revenue		900,000
Cost of Goods Sold	590,000	
Inventory		590,000

Entry to record interest revenue at the end of the year, December 31, 2023.

Notes Receivable	54,000	
Interest Revenue (12% x $\frac{1}{2}$ x \$900,000)		54,000

Determining Transaction Price—Step 3

Non-Cash Consideration

Goods, services, or other non-cash consideration.

- ◆ Companies sometimes receive contributions (e.g., donations and gifts).
- ◆ Customers sometimes contribute goods or services, such as equipment or labor, as consideration for goods provided or services performed.
- ◆ **Companies generally recognize revenue on the basis of the fair value of what is received.**

Consideration Paid or Payable to Customers

- ◆ May include discounts, volume rebates, coupons, free products, or services.
 - ◆ In general, these elements reduce the consideration received and the revenue to be recognized.
- 

Consideration Paid or Payable

VOLUME DISCOUNT

Facts: Sansung Company offers its customers a 3% volume discount if they purchase at least \$2 million of its product during the calendar year. On March 31, 2023, Sansung has made sales of \$700,000 to Artic Co. In the previous 2 years, Sansung sold over \$3,000,000 to Artic in the period April 1 to December 31.

Questions: How much revenue should Sansung recognize for the first 3 months of 2023?

Sansung makes the following entry on March 31, 2023.

Accounts Receivable	679,000	
Sales Revenue		679,000

Sansung should reduce its revenue by **\$21,000** ($\$700,000 \times 3\%$) because it is probable that it will provide this rebate.

Assuming Sansung's customer meets the discount threshold, Sansung makes the following entry.

Cash	679,000	
Accounts Receivable		679,000

If Sansung's customer fails to meet the discount threshold, Sansung makes the following entry upon payment.

Cash	700,000		
Accounts Receivable		Sales	679,000
Discounts Forfeited			21,000

Allocating Transaction Price to Separate Performance Obligations— Step 4

- ◆ Based on their relative fair values.
- ◆ Best measure of fair value is what the company could sell the good or service for on a standalone basis.
- ◆ If not available, companies should use their best estimate of what the good or service might sell for as a standalone unit.

Allocating Transaction Price

MULTIPLE PERFORMANCE OBLIGATIONS

Facts: Handler Company is an established manufacturer of equipment used in the construction industry. Handler's products range from small to large individual pieces of automated machinery to complex systems containing numerous components. Unit selling prices range from \$600,000 to \$4,000,000 and are quoted inclusive of installation and training. The installation process does not involve changes to the features of the equipment and does not require proprietary information about the equipment in order for the installed equipment to perform to specifications.

Handler has the following arrangement with Chai Company.

- Chai purchases equipment from Handler for a price of \$2,000,000 and chooses Handler to do the installation. Handler charges the same price for the equipment irrespective of whether it does the installation or not. (Some companies do the installation themselves because they either prefer their own employees to do the work or because of relationships with other customers.) The installation service included in the arrangement is estimated to have a standalone selling price of \$20,000.
- The standalone selling price of the training sessions is estimated at \$50,000. Other companies can also perform these training services.
- Chai is obligated to pay Handler the \$2,000,000 upon the delivery and installation of the equipment.
- Handler delivers the equipment on September 1, 2022, and completes the installation of the equipment on November 1, 2022 (transfer of control is complete). Training related to the equipment starts once the installation is completed and lasts for 1 year. The equipment has a useful life of 10 years.

Allocating Transaction Price

Question: (a) What are the performance obligations for purposes of accounting for the sale of the equipment?

Handler's primary objective is to sell equipment. The other services (installation and training) can be performed by other parties if necessary. As a result, the equipment, installation, and training are three separate products or services. Each of these items has a standalone selling price and is not interdependent.

Question: (b) If there is more than one performance obligation, how should the payment of \$2,000,000 be allocated to various components?

The total revenue of \$2,000,000 should be allocated to the three components based on their relative standalone selling prices. In this case, the standalone selling price of the equipment is \$2,000,000, the installation fee is \$20,000, and the training is \$50,000. The total standalone selling price therefore is \$2,070,000 (\$2,000,000 + \$20,000 + \$50,000). The allocation is as follows.

Equipment	\$1,932,367 $[(\$2,000,000 \div \$2,070,000) \times \$2,000,000]$
Installation	\$19,324 $[(\$20,000 \div \$2,070,000) \times \$2,000,000]$
Training	\$48,309 $[(\$50,000 \div \$2,070,000) \times \$2,000,000]$

Handler makes the following entry on November 1, 2022, to record both sales revenue and service revenue on the installation, as well as unearned service revenue.

November 1, 2022

Cash	2,000,000	
Service Revenue (installation)		19,324
Unearned Service Revenue		48,309
Sales Revenue		1,932,367

Allocating Transaction Price

Question: (b) If there is more than one performance obligation, how should the payment of \$2,000,000 be allocated to various components?

Assuming the cost of the equipment is \$1,500,000, the entry to record cost of goods sold is as follows.

November 1, 2022

Cost of Goods Sold	1,500,000	Inventory	1,500,000
--------------------	-----------	-----------	-----------

Handler recognizes revenue from the sale of the equipment once the installation is completed on November 1, 2022. In addition, it recognizes revenue for the installation fee because these services have been performed.

Handler recognizes the training revenues on a straight-line basis starting on November 1, 2022, or \$4,026 ($\$48,309 \div 12$) per month for 1 year (unless a more appropriate method such as the percentage-of-completion method—discussed in the next section—is warranted). The journal entry to recognize the training revenue for 2 months in 2022 is as follows.

December 31, 2022

Unearned Service Revenue	8,052	
Service Revenue (training) ($\$4,026 \times 2$)		8,052

Therefore, Handler recognizes revenue at December 31, 2022, in the amount of \$1,959,743 ($\$1,932,367 + \$19,324 + \$8,052$). Handler makes the following journal entry to recognize the remaining training revenue in 2020, assuming adjusting entries are made at year-end.

December 31, 2023

Unearned Service Revenue	40,257	
Service Revenue (training) ($\$48,309 - \$8,052$)		40,257

Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied—Step 5

I. Recognition of revenue (point in time)

Recognise revenue when control transfers

Change in Control Indicators

1. Company has a right to payment for asset.
2. Company has transferred legal title to asset.
3. Company has transferred physical possession of asset.
4. Customer has significant risks and rewards of ownership.
5. Customer has accepted the asset.

II. Recognition of revenue (over time)

The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs

The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced

The entity's performance does not create an asset with an alternative use to the entity, **and** the entity has an enforceable right to payment for performance completed to date.

Recognition of revenue over time: methods of measuring progress

Method	Description	Example	Advantage	Disadvantage
Output	Based on the value of the goods delivered relative to those undelivered	• Surveys of performance to date • Appraisals of results achieved • Milestones reached • Units produced or delivered	Probably most faithful depiction of entity's performance	• May not be directly observable • Information may be expensive to obtain
Input	Based on the entity's efforts or inputs towards satisfying the performance obligation relative to the total expected inputs	• Resources consumed • Costs incurred • Labour hours • Machine hours	Can recognise revenue on straight-line basis if inputs expended evenly	May not be a direct relationship between inputs and transfer of control

Recognition of Revenue Over Time: Methods of Measuring Progress

Most notable example is long-term construction contract accounting.

Two Methods:

- Percentage-of-Completion Method.
- Cost-recovery (zero-profit) method

Long-Term Contracts (Construction)

Must use Percentage-of-Completion method when estimates of progress toward completion, revenues, and costs are reasonably dependable and all of the following conditions exist:

1. Contract clearly specifies the enforceable rights regarding goods or services by the parties, the consideration to be exchanged, and the manner and terms of settlement.
2. Buyer can be expected to satisfy all obligations.
3. Contractor can be expected to perform under the contract.

Companies should use the **cost-recovery method** when one of the following conditions applies:

1. When a company cannot meet the conditions for using the percentage-of-completion method, or
2. When there are inherent hazards in the contract beyond the normal, recurring business risks.

Long-Term Contracts (Construction)

Percentage-of-Completion Method

Calculation for Revenue to Be Recognized

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


$$\text{Percent complete} \times \text{Estimated total revenue (or gross profit)} = \text{Revenue (or gross profit) to be recognized to date}$$


$$\text{Revenue (or gross profit) to be recognized to date} - \text{Revenue (or gross profit) recognized in prior periods} = \text{Current-period revenue (or gross profit)}$$

Long-Term Contracts (Construction)

Illustration: KC Construction Company has a contract to construct a €4,500,000 bridge at an estimated cost of €4,000,000. The contract is to start in July 2010, and the bridge is to be completed in October 2012. The following data pertain to the construction period.

	2010	2011	2012
Costs to date	€1,000,000	€2,916,000	€4,050,000
Estimated costs to complete	3,000,000	1,134,000	—
Progress billings during the year	900,000	2,400,000	1,200,000
Cash collected during the year	750,000	1,750,000	2,000,000

Illustration: Compute percentage complete.

	2010	2011	2012
Contract price	€4,500,000	€4,500,000	€4,500,000
Less estimated cost:			
Costs to date	1,000,000		
Estimated costs to complete	3,000,000		
Estimated total costs	4,000,000		
Estimated total gross profit	€ 500,000		
Percent complete	25%		
	(€1,000,000)		
	(€4,000,000)		

Long-Term Contracts (Construction)

Illustration: KC would make the following entries to record (1) the costs of construction, (2) progress billings, and (3) collections.

	2010	2011	2012
To record cost of construction:			
Construction in Process	1,000,000		
Materials, Cash, Payables, etc.	1,000,000		
To record progress billings:			
Accounts Receivable	900,000		
Billings on Construction in Process	900,000		
To record collections:			
Cash	750,000		
Accounts Receivable	750,000		

Percentage-of-Completion, Revenue and Gross Profit, by Year

	To Date	Recognized in Prior Years	Recognized in Current Year
2010			
Revenues ($€4,500,000 \times 25\%$)	€1,125,000		€1,125,000
Costs	1,000,000		1,000,000
Gross profit	€ 125,000		€ 125,000
2011			
Revenues ($€4,500,000 \times 72\%$)	€3,240,000	€1,125,000	€2,115,000
Costs	2,916,000	1,000,000	1,916,000
Gross profit	€ 324,000	€ 125,000	€ 199,000
2012			
Revenues ($€4,500,000 \times 100\%$)	€4,500,000	€3,240,000	€1,260,000
Costs	4,050,000	2,916,000	1,134,000
Gross profit	€ 450,000	€ 324,000	€ 126,000

Long-Term Contracts (Construction)

Illustration: KC's entries to recognize revenue and gross profit each year and to record completion and final approval of the contract.

	2010	2011	2012
To recognize revenue and gross profit:			
Construction in Process (gross profit)	125,000		
Construction Expenses	1,000,000		
Revenue from Long-Term Contracts	1,125,000		
To record completion of the contract:			
Billings on Construction in Process			
Construction in Process			

Illustration: Content of Construction in Process Account—Percentage-of-Completion Method

Construction in Process			
2010 construction costs	€1,000,000	12/31/12	to close
2010 recognized gross profit	125,000		completed
2011 construction costs	1,916,000		project
2011 recognized gross profit	199,000		
2012 construction costs	1,134,000		
2012 recognized gross profit	126,000		
Total	€4,500,000	Total	€4,500,000

Long-Term Contracts (Construction)

Financial Statement Presentation—Percentage-of-Completion

Computation of Unbilled Contract Price at 12/31/10

Contract revenue recognized to date: €4,500,000 × $\frac{€1,000,000}{€4,000,000}$	€1,125,000
Billings to date	900,000
Unbilled revenue	€ 225,000

HARDHAT CONSTRUCTION COMPANY

<u>Income Statement</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
Revenue from long-term contracts	€1,125,000	€2,115,000	€1,260,000
Costs of construction	1,000,000	1,916,000	1,134,000
Gross profit	€ 125,000	€ 199,000	€ 126,000

<u>Statement of Financial Position (12/31)</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
Current assets			
Inventories			
Construction in process	€1,125,000		
Less: Billings	900,000		
Costs and recognized profit			
in excess of billings	€ 225,000		€ -0-
Accounts receivable	150,000	€ 800,000	-0-
Current liabilities			
Billings	€3,300,000		
Less: Construction in process	3,240,000		
Billings in excess of costs			
and recognized profits		€ 60,000	€ -0-

Long-Term Contracts (Construction)

Cost-Recovery Method

Companies recognize revenue only to the extent of costs incurred that are expected to be recoverable.

Only after all costs are incurred is gross profit recognized.

Cost-Recovery (Zero-Profit) Method

Illustration: For the bridge project illustrated on the preceding pages, Hardhat Construction would report the following revenues and costs.

	<u>To Date</u>	<u>Recognized in Prior Years</u>	<u>Recognized in Current Year</u>
<u>2010</u>			
Revenues (costs incurred)	€1,000,000		€1,000,000
Costs	<u>1,000,000</u>		<u>1,000,000</u>
Gross profit	<u>€ 0</u>		<u>€ 0</u>
<u>2011</u>			
Revenues (costs incurred)	€2,916,000	€ 1,000,000	€1,916,000
Costs	<u>2,916,000</u>	<u>1,000,000</u>	<u>1,916,000</u>
Gross profit	<u>€ 0</u>	<u>€ 0</u>	<u>€ 0</u>
<u>2012</u>			
Revenues (€4,500,000 × 100%)	€4,500,000	€ 2,916,000	€1,584,000
Costs	<u>4,050,000</u>	<u>2,916,000</u>	<u>1,134,000</u>
Gross profit	<u>€ 450,000</u>	<u>€ 0</u>	<u>€ 450,000</u>

Illustration: Hardhat's entries to recognize revenue and gross profit each year and to record completion and final approval of the contract.

	<u>2010</u>	<u>2011</u>	<u>2012</u>
Construction Expense	1,000,000	1,916,000	
Revenue from Long-Term Contract		1,916,000	
(To recognize costs and related expenses)	1,000,000		
Construction in Process (Gross Profit)			450,000
Construction Expense			1,134,000
Revenue from Long-Term Contract			1,584,000
(To recognize costs and related expenses)			
Billings on Construction in Process			4,500,000
Construction in Process			4,500,000
(To record completion of the contract)			

Cost-Recovery (Zero-Profit) Method

Illustration: Comparison of gross profit recognized under different methods.

	<u>Percentage-of-Completion</u>	<u>Cost-Recovery</u>
2010	€125,000	€ 0
2011	199,000	0
2012	126,000	450,000

Long-Term Contracts (Construction)

Financial Statement—Cost-Recovery Method

HARDHAT CONSTRUCTION COMPANY				
<u>Income Statement</u>		<u>2010</u>	<u>2011</u>	<u>2012</u>
Revenue from long-term contracts		€1,000,000	€1,916,000	€1,584,000
Costs of construction		<u>1,000,000</u>	<u>1,916,000</u>	<u>1,134,000</u>
Gross profit		<u>€ 0</u>	<u>€ 0</u>	<u>€ 450,000</u>

<u>Statement of Financial Position (12/31)</u>		<u>2010</u>	<u>2011</u>	<u>2012</u>
Current assets				
Inventories				
Construction in process	€1,000,000			
Less: Billings	<u>900,000</u>			
Costs in excess of billings		€ 100,000		€ -0-
Accounts receivable		150,000	€ 800,000	-0-
Current liabilities				
Billings	€3,300,000			
Less: Construction in process	<u>2,916,000</u>			
Billings in excess of costs and recognized profits			€ 384,000	€ -0-

Long-Term Contracts (Construction)

Homework

Casper Construction Co.

	2010	2011	2012
Contract price	€675,000	€675,000	€675,000
Cost incurred current year	150,000	287,400	170,100
Estimated cost to complete in future years	450,000	170,100	0
Billings to customer current year	135,000	360,000	180,000
Cash receipts from customer Current year	112,500	262,500	300,000

a) Prepare the journal entries and show the financial statement presentations for 2010, 2011, and 2012 under both percentage of completion and cost recovery methods

Long-Term Contracts (Construction)

Long-Term Contract Losses

- ◆ Loss in the Current Period on a Profitable Contract
 - ▶ Percentage-of-completion method only, the estimated cost increase requires a current-period adjustment of gross profit recognized in prior periods.
- ◆ Loss on an Unprofitable Contract
 - ▶ Under both percentage-of-completion and **cost recovery** methods, the company must recognize in the current period the entire expected contract loss.

Long-Term Contract Losses

Illustration: Loss in Current Period

Casper Construction Co.

	2010	2011	2012
Contract price	€675,000	€675,000	€675,000
Cost incurred current year	150,000	287,400	215,436
Estimated cost to complete in future years	450,000	215,436	0
Billings to customer current year	135,000	360,000	180,000
Cash receipts from customer Current year	112,500	262,500	300,000

b) Prepare the journal entries for 2010, 2011, and 2012 assuming the estimated cost to complete at the end of 2011 was €215,436 instead of €170,100.

Long-Term Contract Losses

Illustration: Loss in Current Period

	2010	2011	2012
Contract price	€675,000	€675,000	€675,000
Cost incurred current year	150,000	287,400	215,436
Estimated cost to complete in future years	450,000	215,436	0
Billings to customer current year	135,000	360,000	180,000
Cash receipts from customer Current year	112,500	262,500	300,000

	2010	2011	2012
Costs incurred to date	€ 150,000		
Estimated cost to complete	450,000		
Est. total contract costs	600,000		
Est. percentage complete	25.0%		
Contract price	675,000		
Revenue recognizable	168,750		
Rev. recognized prior year			
Rev. recognized currently	168,750		
Costs incurred currently	(150,000)		
Gross profit recognized	€ 18,750		

Long-Term Contract Losses

Illustration: Loss in Current Period

	2010	2011	2012
Construction in progress	18,750		7,314
Construction expense	150,000		215,436
Construction revenue	168,750		222,750
Construction in progress		3,900	
Construction expense		287,400	
Construction revenue		283,500	

Long-Term Contract Losses

Illustration: Loss on Unprofitable Contract

Casper Construction Co.

	2010	2011	2012
Contract price	€675,000	€675,000	€675,000
Cost incurred current year	150,000	287,400	246,038
Estimated cost to complete in future years	450,000	246,038	0
Billings to customer current year	135,000	360,000	180,000
Cash receipts from customer Current year	112,500	262,500	300,000

c) Prepare the journal entries for 2010, 2011, and 2012 assuming the estimated cost to complete at the end of 2011 was € 246,038 instead of € 170,100.

Long-Term Contract Losses

Illustration: Loss on Unprofitable Contract

	2010	2011	2012
Costs incurred to date	€ 150,000	€ 437,400	€ 683,438
Estimated cost to complete	450,000		
Est. total contract costs	600,000		
Est. percentage complete	25.0%		
Contract price	675,000		
Revenue recognizable	168,750		
Rev. recognized prior year			
Rev. recognized currently	168,750		
Costs incurred currently	(150,000)		
Gross profit recognized	€ 18,750		

Plug

	2010	2011	2012
Contract price	€675,000	€675,000	€675,000
Cost incurred current year	150,000	287,400	246,038
Estimated cost to complete in future years	450,000	246,038	0
Billings to customer current year	135,000	360,000	180,000
Cash receipts from customer Current year	112,500	262,500	300,000

Long-Term Contract Losses

Illustration: Loss on Unprofitable Contract

	2010	2011	2012
Construction in progress	18,750		-
Construction expense	150,000		243,000
Construction revenue	168,750		243,000
Construction in progress		27,188	
Construction expense		290,438	
Construction revenue		263,250	

Long-Term Contract Losses

Illustration: Loss on Unprofitable Contract

For the **Cost-Recovery** method, companies would recognize the following loss:

	<u>2010</u>	<u>2011</u>
Loss on construction contract		8,438
Construction in progress		8,438
Construction expense		287,400
Construction revenue		287,400

Retained Earnings Statement

Increase

- Net income
- Change in accounting principle
- Prior period adjustment

Decrease

- Net loss
- Dividends
- Change in accounting principle
- Prior period adjustment

STRICKEN INC.
RETAINED EARNINGS STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2011

Retained earnings, January 1, as reported		\$1,050,000
Correction for understatement of net income in prior period (inventory error)		<u>50,000</u>
Retained earnings, January 1, as adjusted		1,100,000
Add: Net income		<u>360,000</u>
		1,460,000
Less: Cash dividends	\$100,000	
Share dividends	<u>200,000</u>	<u>300,000</u>
Retained earnings, December 31		<u><u>\$1,160,000</u></u>

Statement of Changes in Equity

IFRS requires a statement of changes in equity. This shows the movement in the equity section of the statement of financial position. A full set of financial statements includes a statement of changes in equity.

- Generally comprised of
 - ✓ share capital—ordinary,
 - ✓ share premium—ordinary,
 - ✓ retained earnings, and the
 - ✓ accumulated balances in other comprehensive items.
 - ✓ Non-controlling interest

Reports the change in each equity account and in total equity for the period.

1. Comprehensive income for the period.
2. Contributions (issuances of shares) and distributions (dividends) to owners.
3. Reconciliation of the carrying amount of each component of equity from the beginning to the end of the period.

Format

This is the format of the statement of changes in equity as per IFRS.

XYZ GROUP – STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20X7

	<i>Share capital</i>	<i>Retained earnings</i>	<i>Investments in equity instruments</i>	<i>Revaluation surplus</i>	<i>Total</i>	<i>Non- controlling interest</i>	<i>Total equity</i>
	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000
Balance at 1							
January 20X6	600,000	118,100	1,600	–	719,700	29,800	749,500
Changes in accounting policy	–	400	–	–	400	100	500
Restated balance	600,000	118,500	1,600	–	720,100	29,900	750,000
Changes in equity							
Dividends	–	(10,000)	–	–	(10,000)	–	(10,000)
Total comprehensive income for the year	–	53,200	16,000	1,600	70,800	18,700	89,500
Balance at 31	600,000	161,700	17,600	1,600	780,900	48,600	829,500
December 20X6							
Changes in equity for 20X7							
Issue of share capital	50,000	–	–	–	50,000	–	50,000
Dividends	–	(15,000)	–	–	(15,000)	–	(15,000)
Total comprehensive income for the year	–	96,600	(14,400)	800	83,000	21,450	104,450
Transfer to retained earnings	–	200	–	(200)	–	–	–
Balance at 31	650,000	243,500	3,200	2,200	898,900	70,050	968,950
December 20X7							

Accounting Policies, Changes in Accounting Estimates, and Errors

SELECTION OF ACCOUNTING POLICIES

Accounting policies: Specific principles, bases, conventions, rules, and practices adopted by an entity in preparing and presenting financial statements.

For a specific transaction or event –

1. 1st look to the IFRS that deals specifically with that situation
2. 2nd If no specific IFRS that applies:
 - Develop a policy that results in relevant & reliable information using judgment
 - Other IFRS with similar situations & issues
 - Conceptual framework basics
 - Use other sources not in conflict the above



ACCOUNTING CHANGES

Types of Accounting Changes:

1. Change in Accounting Policy.
 2. Changes in Accounting Estimate.
- **Errors** are not considered an accounting change but necessitate changes in accounting.

CHANGES IN ACCOUNTING POLICY

Change from one accepted accounting policy to another.

Examples include:

- ◆ Average-cost to FIFO.
- ◆ Cost model to Revaluation model.

If change due to:

- different economic conditions
- new events or conditions
- previously **immaterial effects**

Then, NOT a change in Acct policy

CHANGES IN ACCOUNTING POLICY

Three approaches for acct policy changes:

- 1) Currently: the effect of the change on prior years' income appears only in the current-year income statement
- 2) Retrospectively: refers to the application of a different accounting policy to recast previously issued financial statements
- 3) Prospectively (in the future): adjust only the current & future financial statements

IASB requires use of the **retrospective** approach.

Rationale - Users can then better compare results from one period to the next.

CHANGES IN ACCOUNTING POLICY

Retrospective Accounting Change Approach

Company reporting the change

- 1) Adjusts its financial statements for each prior period presented to the same basis as the new accounting policy.
- 2) Adjusts the carrying amounts of assets and liabilities as of the beginning of the first year presented. Also makes an offsetting adjustment to the opening balance of retained earnings or other appropriate component of equity or net assets as of the beginning of the first year presented.

CHANGES IN ACCOUNTING POLICY

Retrospective Accounting Change: Inventories

Illustration: Denson Company has accounted for its inventories using the weighted average method. In 2022, the company changed to the First-in, First-out (FIFO) method. Management believes this approach provides a more appropriate measure of the inventory cost. For tax purposes, the company uses the weighted average method and plans to continue doing so in the future. (Assume a 30 percent enacted tax rate.)

CHANGES IN ACCOUNTING POLICY

AVERAGE COST METHOD
DENSON COMPANY
INCOME STATEMENT (PARTIAL)
FOR THE YEAR ENDED DECEMBER 31

	2020	2021	2022
Income before income tax	\$400,000	\$160,000	\$190,000
Income tax (30%)	120,000	48,000	57,000
Net Income	\$280,000	\$112,000	\$133,000

FIFO METHOD
DENSON COMPANY
INCOME STATEMENT (PARTIAL)
FOR THE YEAR ENDED DECEMBER 31

	2020	2021	2022
Income before income tax	\$600,000	\$180,000	\$200,000
Income tax (30%)	180,000	54,000	60,000
Net Income	\$420,000	\$126,000	\$140,000

Data for Retrospective Change Example

	Pretax Income from		Difference in Income		
Year	FIFO	WA	Difference	Tax Effect 30%	Income Effect (net of tax)
Prior to 2021	\$600,000	\$400,000	\$200,000	\$60,000	\$140,000
In 2021	<u>180,000</u>	<u>160,000</u>	<u>20,000</u>	<u>6,000</u>	<u>14,000</u>
Total at begin. of 2022	\$780,000	\$560,000	\$220,000	\$66,000	\$154,000
Total in 2022	\$200,000	\$190,000	\$10,000	\$3,000	\$7,000

Journal entry
beginning of 2022

Inventory 220,000
Deferred Tax Liability 66,000
Retained Earnings 154,000

CHANGES IN ACCOUNTING POLICY

Comparative Statements: (Assume beginning retained earnings for 2021 to be \$100,000.)

Income Statement

	2022	Restated 2021	Previous 2021
Pre-tax income	100,000	100,000	\$ 160,000
Income tax (30%)	30,000	30,000	48,000
Net income	70,000	70,000	\$ 112,000

Statement of Retained Earnings

Beg. Retained earnings	100,000	100,000	\$ 100,000
Accounting change	0	0	
Beg. R/Es restated	0	0	100,000
Net income	70,000	70,000	112,000
End. Retained earnings	170,000	170,000	\$ 212,000

CHANGES IN ACCOUNTING POLICY

Impracticability

Companies should not use retrospective application if one of the following conditions exists:

1. Company cannot determine the effects of the retrospective application.
2. Retrospective application requires assumptions about management's intent in a prior period.
3. Retrospective application requires significant estimates that the company cannot develop.

If any of the above conditions exists, the company **prospectively applies** the new accounting principle.

CHANGES IN ACCOUNTING ESTIMATE

An adjustment of the carrying amt of an Asset/Liability, or related expense, resulting from reassessing the present status of, & expected future benefits & obligations associated with, that asset or liability.

Examples of Estimates

1. Bad debts.
2. Inventory obsolescence.
3. Depreciation methods, useful lives and residual values of assets.
4. Liabilities for warranty costs.

CHANGES IN ACCOUNTING ESTIMATE

Prospective Reporting

Changes in accounting estimates are reported **prospectively**.

Account for changes in estimates in

1. the period of change if the change affects that period only, or
2. the period of change and future periods if the change affects both.

IASB views changes in estimates **as normal recurring corrections and adjustments** and prohibits retrospective treatment.



CHANGES IN ACCOUNTING ESTIMATE

Illustration: Arcadia HS purchased equipment for \$510,000 which was estimated to have a useful life of 10 years with a salvage value of \$10,000 at the end of that time. Depreciation has been recorded for 7 years on a straight-line basis. In 2015 (year 8), it is determined that the total estimated life should be 15 years with a salvage value of \$5,000 at the end of that time.

Required:

What is the journal entry to correct prior years' depreciation expense?

No Entry
Required

Calculate depreciation expense for 2015.



CHANGES IN ESTIMATE

After 7 years

Equipment cost	\$510,000
Residual value	- 10,000
Depreciable base	<u>500,000</u>
Useful life (original)	10 years
Annual depreciation	<u>\$ 50,000</u>

First, establish book value at date of change in estimate.

$$\times 7 \text{ years} = \text{\$350,000}$$

Statement of financial position (Dec. 31, 2014)

Property, Plant, and Equipment:

Equipment	\$510,000
Accumulated depreciation	<u>350,000</u>
Book value (BV)	<u>\$160,000</u>

Book value	
Residual value (if any)	
Depreciable base	
Useful life	
Annual depreciation	

Second, calculate depreciation expense for 2015.

Journal entry for 2015

Depreciation expense	19,375	
Accumulated depreciation		19,375

ACCOUNTING ERRORS

Types of Accounting Errors:

1. Incorrect application of accounting policy.
2. Mathematical mistakes.
3. Changes in estimates that occur because a company did not prepare the estimates in good faith.
4. Failure to accrue or defer certain expenses or revenues.
5. Misuse of facts.
6. Incorrect classification of a cost as an expense instead of an asset, and vice versa.

ACCOUNTING ERRORS

- ◆ All material errors must be corrected.
- ◆ Record **corrections of errors** from prior periods as an adjustment to the beginning balance of equity in the current period.
- ◆ Such corrections are called **prior period adjustments**.
- ◆ For comparative statements, a company should restate the prior statements affected, to correct for the error.



Example of Error Correction

Illustration: In 2016 the bookkeeper for Selectro Company discovered an error. In 2015 the company failed to record £20,000 of depreciation expense on a newly constructed building. This building is the only depreciable asset Selectro owns. The company correctly included the depreciation expense in its tax return and correctly reported its income taxes payable.

Selectro's income statement for 2015 with and without the error.

SELECTRO COMPANY INCOME STATEMENT FOR THE YEAR ENDED, DECEMBER 31, 2015				
		Without Error		With Error
Income before depreciation expense		£100,000		£100,000
Depreciation expense		20,000		0
Income before income tax		80,000		100,000
Current	£32,000		£32,000	
Deferred	-0-	32,000	8,000	40,000
Net income		<u>£ 48,000</u>		<u>£ 60,000</u>

What are the entries that Selectro should have made and did make for recording depreciation expense and income taxes?

Entries Company Should Have Made (Without Error)			Entries Company Did Make (With Error)		
Depreciation Expense	20,000		No entry made for depreciation		
Accumulated Depreciation—Buildings		20,000			
Income Tax Expense	32,000		Income Tax Expense	40,000	
Income Taxes Payable		32,000	Deferred Tax Liability		8,000
			Income Taxes Payable		32,000

Income Statement Effects

Depreciation expense (2015) is understated £20,000.

Income tax expense (2015) is overstated £8,000 ($£20,000 \times 40\%$).

Net income (2015) is overstated £12,000 ($£20,000 - £8,000$).

Statement of Financial Position Effects

Accumulated depreciation—buildings is understated £20,000.

Deferred tax liability is overstated £8,000 ($£20,000 \times 40\%$).

Example of Error Correction

Prepare the proper correcting entry in 2016, that should be made by Selectro.

Entries Company Should Have Made (Without Error)		Entries Company Did Make (With Error)	
Depreciation Expense	20,000	No entry made for depreciation	
Accumulated Depreciation—Buildings	20,000		
Income Tax Expense	32,000	Income Tax Expense	40,000
Income Taxes Payable	32,000	Deferred Tax Liability	8,000
		Income Taxes Payable	32,000

Correcting
Entry in 2016

Retained Earnings

12,000

Example of Error Correction

Prepare the proper correcting entry in 2016, that should be made by Selectro.

Entries Company Should Have Made (Without Error)		Entries Company Did Make (With Error)	
Depreciation Expense	20,000	No entry made for depreciation	
Accumulated Depreciation—Buildings	20,000		
Income Tax Expense	32,000	Income Tax Expense	40,000
Income Taxes Payable	32,000	Deferred Tax Liability	8,000
		Income Taxes Payable	32,000

Correcting
Entry in 2016

Retained Earnings
Deferred Tax Liability

12,000

8,000

Reversal



Example of Error Correction

Prepare the proper correcting entry in 2016, that should be made by Selectro.

Entries Company Should Have Made (Without Error)			Entries Company Did Make (With Error)		
Depreciation Expense	20,000		No entry made for depreciation		
Accumulated Depreciation—Buildings		20,000			
Income Tax Expense	32,000		Income Tax Expense	40,000	
Income Taxes Payable		32,000	Deferred Tax Liability		8,000
			Income Taxes Payable		32,000

Correcting
Entry in 2016

Retained Earnings 12,000
 Deferred Tax Liability 8,000
 Accumulated Depreciation—Buildings 20,000

Example of Error Correction

Single-Period Statements

Illustration: Selectro Company has a beginning retained earnings balance at January 1, 2016, of £350,000. The company reports net income of £400,000 in 2016.

SELECTRO COMPANY		
RETAINED EARNINGS STATEMENT		
FOR THE YEAR ENDED DECEMBER 31, 2016		
Retained earnings, January 1, as reported		£350,000
Correction of an error (depreciation)	£20,000	
Less: Applicable income tax reduction	<u>8,000</u>	<u>(12,000)</u>
Retained earnings, January 1, as adjusted		338,000
Add: Net income		<u>400,000</u>
Retained earnings, December 31		<u><u>£738,000</u></u>

Example of Error Correction

Comparative Statements

Company should

1. make adjustments to correct the amounts for all affected accounts reported in the statements for **all periods** reported.
2. restate the data to the correct basis for each year presented.
3. show any **catch-up adjustment** as a prior period adjustment to retained earnings for the earliest period it reported.

Summary of Accounting Changes and Correction of Errors

Changes in accounting policy

Employ the retrospective approach by:

- a. Changing the financial statements of all prior periods presented.
- b. Disclosing in the year of the change the effect on net income and earnings per share for all prior periods presented.
- c. Reporting an adjustment to the beginning retained earnings balance in the statement of retained earnings in the earliest year presented.

If impracticable to determine the prior period effect:

- a. Do not change prior years' income.
- b. Use opening asset balance in the year the method is adopted as the base-year balance for all subsequent computations.
- c. Disclose the effect of the change on the current year, and the reasons for omitting the computation of the cumulative effect and amounts for prior years.

Changes in accounting estimate

Employ the current and prospective approach by:

- a. Reporting current and future financial statements on the new basis.
- b. Presenting prior period financial statements as previously reported.
- c. Making no adjustments to current-period opening balances for the effects in prior periods.

Changes due to error

Employ the restatement approach by:

- a. Correcting all prior period statements presented.
- b. Restating the beginning balance of retained earnings for the first period presented when the error effects occur in a period prior to the first period presented.

Exercises: Identify the type of accounting change & how to account it.

#1 The **B Division** of HW PLC has **consistently shown an increasing profit over each of the past four years.**

On closer examination of the division's operating reports, the PLC's controller noticed that **the bad debt expense and inventory obsolescence charges are not in line with the level of activity or with other divisions.** In discussing this with the divisional accountant, the controller learned that the accountant used estimates related to **the write-off of receivables and inventory to manage the division's bottom line** and the amount of profit reported.

#2 An entity has measured its investment property at cost less accumulated depreciation and impairment. During the current business year the administration decided to change the method of valuation of all its investment properties at fair value model.

Exercises...

#3 At a recent conference on financial accounting and reporting, three **participants provided examples of similar accounting changes** they had just encountered. They all relate to changes involving the accounting for **development costs**.

The **1st** participant explained that it had recently come to her attention that **capitalized product development costs incurred three years ago had not been adjusted or amortized** since they were incurred. These costs should have been amortized **over three years, but had been incorrectly coded** and were missed in the annual adjustment process.

The **2nd** participant explained that his company was switching to a policy of expensing development costs as incurred because **changing technologies were making the product life cycles so short**. Previously, the Co. had **amortized these costs over a 24- month period**.

Exercises...

#3 (continued) The 3rd participant also reported a change in accounting for development costs. In this case, instead of amortizing development costs on a straight-line basis over the estimated product life as in the past, her company was changing to an activity-based method. The new method charges an equal amount of development cost amortization to each inventory item produced. The change was made because the new approach better represents the benefits received from the development cost assets (which the accountant was not aware of previously.)

END

CHAPTER 3