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DEPARTMENT OF COMMERCE (ACCOUNTING & FINANCE)

SUBJECT NAME: FINANCIAL REPORTING

SEMESTER: III

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FINANCIAL REPORTING

SYLLABUS

UNIT I: Financial Statements (per US GAAP and IFRS) Balance sheet - income statement - Statement of Comprehensive Income - Statement of changes in equity - Statement of cash flows - Integrated reporting

UNIT II: Revenue Recognition (per US GAAP and IFRS) 5-Step approach to Revenue Recognition - Certain Customer's Rights & Obligations - Specific Arrangements - Matching principle, Accruals & Deferrals, Adjusting Journal Entries

UNIT III: Current Assets and Current Liabilities (per US GAAP and IFRS) Cash & Cash Equivalents - Accounts Receivable - Notes Receivable - Transfers & Servicing of Financial Assets - Accounts Payable - Employee-related Expenses Payable - Determining Inventory & Cost of Goods Sold - Inventory Valuation - Inventory Estimation Methods

UNIT IV: Asset Valuation and Valuation of Liabilities (per US GAAP and IFRS) Acquisition of Fixed Assets - Capitalization of Interest - Costs Incurred After Acquisition - Depreciation - Impairment - Asset Retirement Obligation - Disposal & Involuntary Conversions - Knowledge-based intangibles (R&D, software) - Legal rights based intangibles (patent, copyright, trademark, franchise, license, leasehold improvements) - G oodwill - Leasehold Assets & Liabilities - Deferred Taxes

UNIT V: Equity transactions (per US GAAP and IFRS) Paid-in capital - Retained earnings - Accumulated other comprehensive income - Stock dividends and stock splits - Stock options - Business Combinations & Consolidations - Differences between US GAAP and IFRS

UNIT- 1Financial Statement (per US GAAP and IFRS)

GAAP Financial Statements

Generally Accepted Accounting Principles or GAAP are basically the set of ten accounting standards set by the United States Financial Accounting Standards Board (FASB). First established by FASB in 1973, the GAAP principles are now accepted by the Securities Exchange Commission (SEC) and the American Institute of Certified Public Accountants as the official

standards for financial accounting. In this article, we will talk about GAAP financial statements, which every company following GAAP should prepare.

Reporting Requirements Under GAAP

As per the GAAP, organizations should provide reports on their cash flows, profit-making operations, and overall financial conditions. To report these things, the most important GAAP financial statements are – Balance Sheet, Income Statement, Shareholder's Equity, and Cash Flow Statement.

Balance Sheet talks about assets and liabilities of the company, while the Shareholder's Equity detail the available equity in the company. The income statement details the revenue earned by the company and the corresponding expenses. The Cash Flow statement, as the name suggests, is simply the cash record of the company. Cash flow becomes important because both the income statement and balance sheet reveal the financial health of the company on the accrual basis, and therefore, do not talk about the real financial position.

GAAP Financial Statements

Balance Sheet

The balance sheet primarily consists of Assets and Liabilities. Assets include both current and non-current assets and so are the liabilities. All the assets that a company can easily convert into cash are known as current assets. On the other hand, the assets that can't be converted into cash easily are non-current assets. Current Assets include items such as cash, account receivables, inventory, prepaid expenses and so on. Non-current assets (or mainly fixed assets) include land and building, equipment, prepaid insurance and so on.

Liabilities, on the other hand, are the portion of the firm's asset that a company owes to the creditors. One can categorize liabilities into both long and short term depending on the duration. Some examples of current liabilities are accounts payable, taxes payable, wages payable and so on. The long-term liabilities are bonds payable mortgages payable and more.

Statement of Owner's Equity

This statement shows the changes in the equity (in the balance sheet) during an accounting period. Or, we can say, it reports the events that lead to an increase or decrease in the owner's equity over a given period. Stockholders' Equity statement in a corporation consists of:

Common Stock (recorded at par value)
Add Preferred Stock (recorded at par value)
Add Premium on Common Stock (issue price – par value)
Add Premium on Preferred Stock (issue price – par value)
Add Retained Earnings
The ending result is Stockholder's Equity

Income Statement

The income statement is the representation of the company's operation during the period of time. A simple equation to describe the Net Income would be Revenue Less Expenses. Here revenue represents the funds received from the sale of end product or the service offered to the customers.

Cash Flow Statement

The underlying premise of accrual basis of accounting is that the company might be earning profit, but may be short of cash. Cash is essential to keep the business running and meet the day-to-day expenses of the company. Therefore, understanding the sources of cash in a company

becomes very crucial. For a given period, the cash flow statement should include the following information:
Source of Cash
Uses of Cash
Change in Cash Balance
Further, the cash flow statement does not only include cash transactions from operations, but from other activities as well. For instance, businesses makes investments, buy assets, sell assets, raises cash and more. All these activities can be categorized into three heads;
Operating activities
Investing activities
Financing activities

Guidelines for GAAP Financial Statements

All financial statements under GAAP are affected by three basic assumptions. These are the monetary unit for financial reporting, "going concern" assumption and reporting period options.

All the financial statements must display data in a common currency, such as the US dollar. If for any reason, a transaction does not have a monetary unit, an accountant must not include it in the financial statements.

Reporting period for a business could be from a few months to one year. Also, businesses can choose to report the financial statements either quarterly or semi-annually or both. For a given reporting period, the financial statement should include a heading describing the time period, such as "the three months ended September 30, 2013"

The going concern assumption implies that the business is not in the process or considering liquidation. This assumption makes it possible for the business to defer certain expenses to a future date.

Benefits of Using GAAP Financial Statements

GAAP is helpful in creating consistency because all the financial statements follow the same set of principles. Businesses that follow and maintain their financial statements as per GAAP have an upper hand as they offer the best information to run business.

Also, since all the organizations, financial institutions, banks and authorities accept GAAP principles; it becomes easier for the companies to apply for loans and other financial aid. Banks and other financial institutions trust companies that maintain their financial statements as per the GAAP rules.

All stakeholders know that the GAAP financial statements are based on the facts and not speculation. Be it a loan provider, investor, promoters or anyone else, they trust the financial statements made as per GAAP, and base their decisions on the same.

Moreover, it is important for companies to have ethical standards and follow it religiously. GAAP financial statements are such that they help the organizations in following the ethical standards and establish trust among all the parties.[1–3]

Income statement, also referred to as profit and loss statement (P&L), revenue statement, statement of financial performance, earnings statement, operating statement or statement of operations, is a company's financial statement that indicates how the revenue (cash or credit sales of products and services before expenses are taken out) is transformed into the net income (the result after all revenues and expenses have been accounted for, also known as Net Profit or "bottom line"). It displays the revenues recognized for a specific period, and the cost and

expenses charged against these revenues, including write-offs (e.g., depreciation and amortization of various assets) and taxes.

The income statement can be prepared in one of two methods. The Single Step income statement takes a simpler approach, totaling revenues and subtracting expenses to find the bottom line. The more complex Multi-Step income statement (as the name implies) takes several steps to find the bottom line, starting with the gross profit. It then calculates operating expenses and, when deducted from the gross profit, yields income from operations. Adding to income from operations is the difference of other revenues and other expenses. When combined with income from operations, this yields income before taxes. The final step is to deduct taxes, which finally produces the net income for the period measured.

In addition to the Single and Multi-step methods, the income statement can be reported on a cash or accrual basis. An income statement reported on a cash basis is typically used by smaller businesses that record transactions based on the exchange of cash; the revenues and expenses reported reflects cash received on sales and cash paid for expenses for the accounting period. Larger entities use the accrual basis, which is also the recommended method by the FASB. An income statement under accrual accounting reflects revenues "earned", where an exchange in value among the parties has taken place, regardless of whether cash was received. Expenses on the statement have been "incurred", where the business has received a benefit and has paid for it or has recorded a liability to pay it at a future date. As with revenues, the exchange of cash does not dictate the amount reported for the expense.

Income statements should help investors and creditors determine the past financial performance of the enterprise, predict future performance, and assess the capability of the business to generate future revenue streams through the reporting of income and expenses.
However, information of an income statement has several limitations: items that might be relevant but cannot be reliably measured are not reported (e.g. brand recognition and loyalty). Some numbers vary based on the accounting methods used (e.g. using FIFO or LIFO accounting to measure inventory level). Some numbers depend on judgments and estimates (e.g. depreciation expense depends on estimated useful life and salvage value).

Guidelines for statements of comprehensive income and income statements of business entities are formulated by the International Accounting Standards Board and numerous country-specific organizations, for example the FASB in the U.S.

Elements of the Income Statement

The income statement, or profit and loss statement (P&L), reports a company's revenue, expenses, and net income over a period of time.

Elements of the Income Statement

The income statement is a financial statement that is used to help determine the past financial performance of the enterprise, predict future performance, and assess the capability of generating future cash flows. It is also known as the profit and loss statement (P&L), statement of operations, or statement of earnings.

XYZ Retailers

Income Statement

For the year ended 30 June 2011

	$	$
REVENUE		
Sales		250,000
Cost of Goods Sold		
Opening inventories (as at 1 July 2010)	40,000	
Add purchases	100,000	
Add freight-in and customs duty	10,000	
Less closing inventory (as at 30 June 2011)	60,000	
Less Cost of Goods Sold		90,000
Gross Profit		160,000
Add other operating revenue		
Rent received	3,000	
Commission received	2,000	
Total Revenue		165,000
LESS OTHER OPERATING EXPENSES		
Selling & Distribution expense		
Advertising	5,000	
Public Relations	2,000	
Website marketing	7,500	
General and Administrative expenses		
Depreciation	10,000	
Electricity	1,500	
Insurance	1,000	
Rent expense	30,000	
Wages & salaries	46,500	
Financial expenses		
Bad debts	1,500	
Total expenses		105,000
NET PROFIT (EBIT)		60,000

A Sample Income Statement: Expenses are listed on a company's income statement.

The income statement consists of revenues (money received from the sale of products and services, before expenses are taken out, also known as the "top line") and expenses, along with the resulting net income or loss over a period of time due to earning activities. Net income (the "bottom line") is the result after all revenues and expenses have been accounted for. The income statement reflects a company's performance over a period of time. This is in contrast to the balance sheet, which represents a single moment in time.

Methods for Constructing the Income Statement

The income statement can be prepared in one of two methods: single or multi-step.

The *Single Step* income statement totals revenues, then subtracts all expenses to find the bottom line.

The more complex *Multi-Step* income statement (as the name implies) takes several steps to find the bottom line. First, operating expenses are subtracted from gross profit. This yields income from operations. Then other revenues are added and other expenses are subtracted. This yields income before taxes. The final step is to deduct taxes, which finally produces the net income for the period measured.

Operating Revenues and Expenses

The operating section includes revenue and expenses. Revenue consists of cash inflows or other enhancements of the assets of an entity. It is often referred to as gross revenue or sales revenue. Expenses consist of cash outflows or other using-up of assets or incurrence of liabilities.

Elements of expenses include:

Cost of Goods Sold (COGS): the direct costs attributable to goods produced and sold by a business. It includes items such as material costs and direct labor.

Selling, General and Administrative Expenses (SG&A): combined payroll costs, except for what has been included as direct labor.

Depreciation and amortization: charges with respect to fixed assets (depreciation) and intangible assets (amortization) that have been capitalized on the balance sheet for a specific accounting period.

Research & Development (R&D): expenses included in research and development of products.

Non-operating Revenues and Expenses

The non-operating section includes revenues and gains from non- primary business activities (such as rent or patent income); expenses or losses not related to primary business operations (such as foreign exchange losses); gains that are either unusual or infrequent, but not both; finance costs (costs of borrowing, such as interest expense); and income tax expense.

In essence, if an activity is not a part of making or selling the products or services, but still affects the income of the business, it is a non-operating revenue or expense.

Reading the Income Statement

Certain items must be disclosed separately in the notes if it is material (significant). This could include items such as restructurings, discontinued operations, and disposals of investments or of property, plant and equipment. Irregular items are reported separately so that users can better predict future cash flows.

The “bottom line” of an income statement—often, literally the last line of the statement—is the net income that is calculated after subtracting the expenses from revenue. It is important to investors as it represents the profit for the year attributable to the shareholders. For companies with shareholders, earnings per share (EPS) are also an important metric and are required to be disclosed on the income statement.

Noncash Items

Noncash items, such as depreciation and amortization, will affect differences between the income statement and cash flow statement.

Noncash Items

Noncash items that are reported on an income statement will cause differences between the income statement and cash flow statement. Common noncash items are related to the investing and financing of assets and liabilities, and depreciation and amortization. When analyzing income statements to determine the true cash flow of a business, these items should be added back in because they do not contribute to inflow or outflow of cash like other gains and expenses.

Fixed assets, also known as a non- current asset or as property, plant, and equipment (PP&E), is an accounting term for assets and property. Unlike current assets such as cash accounts receivable, PP&E are not very liquid. PP&E are often considered fixed assets: they are expected to have relatively long life, and are not easily changed into another asset. These often receive a more favorable tax treatment than short-term assets in the form of depreciation allowances.

Machinery: Machinery is an example of a noncash asset.
Broadly speaking, depreciation is a way of accounting for the decreasing value of long-term assets over time. A machine bought in 2012, for example, will not be worth the same amount in 2022 because of things like wear-and-tear and obsolescence.

On a more detailed level, depreciation refers to two very different but related concepts: the decrease in the value of tangible assets (fair value depreciation) and the allocation of the cost of tangible assets to periods in which they are used (depreciation with the matching principle). The former affects values of businesses and entities. The latter affects net income.

In each period, long-term noncash assets accrue a depreciation expense that appears on the income statement. Depreciation expense does not require a current outlay of cash, but the cost of acquiring assets does. For example, an asset worth $100,000 in year 1 may have a depreciation expense of $10,000, so it appears as an asset worth $90,000 in year 2.
Amortization is a similar process to deprecation but is the term used when applied to intangible assets. Examples of intangible assets include copyrights, patents, and trademarks.

Uses of the Income Statement

The primary purpose of the income statement is to assess efficiency as revenues transform into profits/losses. The income statement is to demonstrate the profitability of an organization's operations over a fixed period of time by illustrating how proceeds from operations (i.e. revenues) are transformed into net income (profits and losses).

Compared to the balance sheet and the cash flow statement, the income statement is primarily focused on the actual operational efficiency of the organization. The balance sheet discusses leverage, assets, funding, and other aspects of the organization's existing infrastructure. The cash flow statement is primarily a description of liquidity. The income statement, however, is ultimately about how a given revenue input can be converted to profitability through assessing what is required to attain that revenue.

Assessing Efficiency

The income statement is relatively straight-forward. As an investor or a manager, the simplest way to view each section is by focusing on efficiency. An optimally efficient organization will have higher margins in the following areas:

Profit margin: A higher net profit as a proportion of sales indicates an overall higher capacity to capture returns on revenue. Profit margin is one of the first aspects of an organization a prospective investor will look at when considering the overall validity of a company as an investment. This is calculated as:

Operating Margin: Another useful indicator of profitability is operating income over net sales. Operating income subtracts the cost of goods sold (COGS) alongside selling, general, and administrative expenses (SG&A), leaving the overall profit before taxes and interest on financial debt. Comparing this to the overall profit margin can give useful indications of reliance on debt.

Another useful indicator is the gross margin. This essentially demonstrates the added value of each unit of sales, as it focuses exclusively on the impact of the cost of goods sold (COGS). COGS represents the costs incurred (directly) from materials, labor, and production of each individual unit. This can be a great indicator of how scalable an operation is, and the relative return an organization will see as they achieve growth.

Income Statement Examples

Income statement provides a summary of all the revenues and the expenses over the time period in order to ascertain the profit or loss of the company and the example of which includes income statement prepared by a company XYZ Ltd. Every half-yearly in order to present the different revenues and the expenses of the company during the period of half-year to present financial picture of the company.

An income statement (also known as profit and loss account) is one of the **financial statement** that shows the income and expenses of a company for a specified time. Investors and business managers use the income statement to determine the financial health of the company.

Major parameters included in Income Statement –

Revenue: The revenue of the company is the income from all sources.

Expenses: Cost incurred by a company like the **cost of goods sold**, **operating expenses** come under this head.

Gains/Losses: These are non-op

Income Statement Example (GAAP)

Generally Accepted Accounting Principle has two classifications.

Example #1 – Single-Step Income Statement

In this, the classification of all expenses are mentioned under this head. Then they are deducted from the total income to get net income before tax. Both small and large companies use such a format.

There is no implication that one type of revenue or expense item has priority over another. All are treated equally.

Revenues: All income and revenues are totaled.

Expenses: All expenses are totaled.

Net Income: Net income is derived from subtracting Expenses from Income. It is also referred to as "the bottom line."

ABC Ltd.Income StatementAs on March 2018		
Particulars	**Amount**	**Amount**
Revenues		
Net Sales	300000	
Dividend Revenue	30000	
Rent Revenue	70000	
Total Revenue	400000	400000
Expenses		
Cost of goods sold	100000	
Selling Expenses	10000	
Administrative Expenses	10000	
Interest Expenses	10000	
Income Tax Expense	10000	
Total Expense		140000
Net Income		260000
Earning per share		1.3

Revenue – Expenses = Net Income

Assuming 200000 **outstanding shares**;

Explanation #1

Suppose ABC is a USA based company. In the above example, the single-step income statement is followed where all the incomes from various sources are totaled, and all the expenses to different requirements are totaled. Net income is derived from the difference between the two. None of the entities is given priority. All are treated equally.

Example #2 – Multi-Step Income Statement

The **multi-step income statement format** comprises a **gross profit** section where the cost of sales is deducted from sales, followed by income and expenses to reach an income before tax. As compared to a single-step income statement, a multi-step income statement examples are more complex.

It also provides a more detailed overview of the company's financial position.

The sections of a multi-step income statement include:

Sales: This section includes total sales, the cost of goods sold, and the difference between the two, which is gross profit.

Operating Expenses: These are the expenses that are directly related to Operations of the company like selling, general, and administrative expenses.

Operating Income: It is the **income earned from operating activities** of the income. It is derived from the difference between gross profit and total operating expenses.

Non-Operating Income or Expenses: Non-operating activities like investments involve expenses, revenue, gain, or loss. Such an entity comes under this category.

Net Income: Any resulting profit or loss calculated as the difference between total income and total expenses is called net income.

XYZ Ltd.Income StatementAs on March 2018		
Particulars	**Amount**	**Amount**
Sales		1000000
Cost of goods sold		100000
Gross Profit		900000
Operating Expenses	50000	
Selling	50000	
Administrative	10000	
Total Operating expenses		110000
Income from Operations		790000
Non operating Income		
Interest Revenue	50000	
Dividend Revenue	50000	100000
Non operating Expenses		
Interest on Loans	50000	50000
Pre Tax Income		840000
Income Tax(25%)		210000
Net Income for the year		630000

Assuming the number of outstanding shares to be 6 lakhs;

Explanation #2

Suppose XYZ is a US-based company, and here multiple-step income statement is followed. We can see that here all entities are assembled in a different category based on their characteristic.
Gross profit is derived from subtracting COGS from Sales.
Selling and administration are operating expenses and are shown separately.
The difference between gross profit and **operating expenses gives operating income**.
The same follows for non-operating expenses and income.
Income Statement Examples (IFRS)
Most companies follow IFRS in the world for **financial reporting**.
The IFRS requires the following items in the income statement :
revenue
finance cost
The share of post-tax results of associates and joint ventures
after-tax gain or loss.
profit or loss for the period
Under IFRS, a company that shows operating results should include all the items of irregular or unusual nature.
Example #3 – IFRS based Income Statement

PQR Ltd.Income StatementAs on March 2018		
Particulars	**Amount**	**Amount**
Continuing Operations		
Revenue from contracts with customers		2000000
Cost of sales of goods	100000	
Cost of providing services	100000	200000
Gross Profit		1800000
Distribution Costs	100000	
Administrative Expenses	100000	
Net impairment losses on financial and contract assets	100000	-300000
Other Income	200000	
Other gains/losses	200000	
Operating Profit		400000
Finance Income	100000	
Finance Costs	50000	
Finance Costs(Net)		50000
Share of net profit of associates and joint ventures		50000
Profit before Income Tax		2000000
Income tax expense		500000
Profit from continuing Operations		1500000

Explanation #3

Suppose PQR is a UK based company that follows IFRS for reporting. In the above example, we can see that apart from normal entities, all the activities that are unusual and continuous are also taken into count.
Also, profit from **joint ventures** and associates are also considered.
So, IFRS is a more comprehensive and informative type of reporting income statement.
Example #3 – IFRS based Income Statement

STU Ltd.Income StatementAs on March 2018		
Particulars	**Amount**	**Amount**
Sales Revenue		500000
Less: Sales Return	50000	
Net Sales Revenue		450000
Cost of goods sold		100000
Gross Profit		350000
Operating Expenses		
Selling Expenses		
Sales Salaries and commissions		
Freight and transportation		
Telephone and internet expenses	10000	
Administrative expenses		
Stationery, posting & stamps		
Utility Expenses		
Insurance expenses		
Officers expenses	10000	20000
Income from other Operations		330000
Other: Revenue & Gains		
Dividend Revenue	9000	
Rent Revenue	1000	10000
Other: Expenses & Losses		
Interest on bonds	10000	10000
Income before Income Tax		330000
Income Tax		82500
Net Income for the year		247500
Earning per common share		2.475

The income statement is one of the three fundamental financial statements that aims at the calculation of net income from the operations of the organization. GAAP and IFRS are the two major financial reporting methods. Income statement states the financial health of the organization.

Statement of Comprehensive Income

The statement of comprehensive income is a financial statement that summarizes both standard net income and other comprehensive income (OCI). The net income is the result obtained by preparing an income statement. Whereas, other comprehensive income consists of all unrealized gains and losses on assets that are not reflected in the income statement. It is a more robust document that often is used by large corporations with investments in multiple countries.

Definition:

Comprehensive Income or Statement of Comprehensive Income is a financial performance statement that listed down all profit and loss and other comprehensive income of entity for the period of time.

It usually prepares and presents monthly, quarterly, and annually.

There are two main importance types of income that contain in this statement which differentiate it from the income statement.

First, is realize profit or loss which is the actual profit or loss for the period. And second is unrealized gain or loss which is the profit or loss as the result of accounting mater.

Statement of Comprehensive Income is the same as Statement of Profit or Loss and Other Comprehensive Income. The name was changed by IASB.

Noted: *IASB had changed the name of Statement of Comprehensive Income to Statement of Profit and Loss and Other Comprehensive Income in June 2011.*

Types of Comprehensive Income Statement:

Statement of Comprehensive Income (Statement of Profit and Loss and Others Comprehensive Income) could be prepared and presented into two different formats that allowed by IASB (ias 1 presentation of financial statements.

As the Statement of Comprehensive Income is another word of Statement of Profit and Loss and Others Comprehensive Income, the formats also the same.

The following is the list of two types of the comprehensive income statement:

The single-step income statement

The first format that allows by IASB is single-step income statements. This kind of format required to report and present revenue and expenses into different sections regardless of realize or unrealized.

That means all kinds of revenues are recorded in the revenue sections no mater those revenues are realized or not.

For example, sales revenues, gain on interest income, and gain on revaluation are records in the revenue sections.

In the expenses section, the cost of goods sold, operating expenses, and loss of the exchange rate are recorded in the same sections.

Multiple-step income statement

The second format of Statement of Comprehensive Income is the multiple-step of the income statement. This format divided the statement into two different types. One is operation profit and the second one is non-operation profit.

The operating profit results from operation revenue fewer operating expenses. As an operation profit, non-operation profit results in non-operation revenue less non-operation expenses.

Statement of Comprehensive Income records both operating profit and loss and other comprehensive income which is not from normal operating activities.

It can call this term in your daily works; however, the official term to called and used in official financial statements is Statement of Profit and Loss and Other Comprehensive Income.

RECAP CORPORATION Statement of Comprehensive Income For the Year Ending December 31, 20X7		
Sales		$6,500,000
Cost of goods sold		4,000,000
Gross profit		$2,500,000
Operating expenses		
Salaries	$750,000	
Rent	250,000	
Other operating expenses	300,000	1,300,000
Income from continuing operations before income taxes		$1,200,000
Income taxes		500,000
Income from continuing operations		$ 700,000
Discontinued operations		
Profit on operations of food processing unit, including gain on disposal	$800,000	
Less: Income tax on disposal of business unit	200,000	
Gain on discontinued operations		600,000
Extraordinary item		
Gain on sale of diamonds found in landfill	$900,000	
Less: Income tax on diamonds	250,000	
Extraordinary gain		650,000
Net income/earnings		$1,950,000
Other comprehensive income adjustments from certain investments		100,000
Comprehensive income		$2,050,000

Source

Breaking Down Comprehensive Income

One of the most important components of the statement of comprehensive income is the income statement. It summarizes all the sources of revenue and expenses, including taxes and interest charges.Unfortunately, net income only accounts for the earned income and incurred expenses. There are times when companies have accrued gains or losses resulting from the fluctuations in the value of their assets, that are not recognized in net income. Some examples of these unrealized gains or losses are:

Gains or losses from pension and other retirement programs
Adjustments made to foreign currency transactions
Gains or losses from derivative instruments
Unrealized gains or losses from debt securities
Unrealized gains or losses from available-for-sale securities

One thing to note is that these items rarely occur in small and medium-sized businesses. OCI items occur more frequently in larger corporations that encounter such financial events.
That said, the statement of comprehensive income is computed by adding the net income – which is found by summing up the recognized revenues minus the recognized expenses – to other

comprehensive income, which captures any unrealized balance sheet gains or losses that are excluded from the income statement.

Uses of a Statement of Comprehensive Income

As explained earlier, the statement of comprehensive income encompasses the income statement and other comprehensive income. Preparing the income statement sheds light on a company's financial events. Here are some of the uses of an income statement:

1. Detailed revenue information

The primary purpose of an income statement is to provide information on how a company is raising its revenue and the costs incurred in doing so. The income statement is very thorough in highlighting these details. Not only does it explain the cost of goods sold, which relate to the operating activities, but it also includes other unrelated costs such as taxes. Similarly, the income statement captures other sources of revenue which are not associated with the main operations of a company. This entails items such as the accrued interest from business investments.

2. Analysis tool for investors

The SCI, as well as the income statement, are financial reports that investors are interested in evaluating before they decide to invest in a company. The statements show the earnings per share or the net profit and how it's distributed across the outstanding shares. The higher the earnings for each share, the more profitable it is to invest in that business.

Limitations of a Statement of Comprehensive Income

1. Misrepresentation

Although the income statement is a go-to document for assessing the financial health of a company, it falls short in a few aspects. The income statement encompasses both the current revenues resulting from sales and the accounts receivables, which the firm is yet to be paid.

Similarly, it highlights both the present and accrued expenses – expenses that the company is yet to pay. But if there's a large unrealized gain or loss embedded in the assets or liabilities of a company, it could affect the future viability of the company drastically. Therefore, an income statement on its own can be misleading.

2. Difficulties in making predictions

Another area where the income statement falls short is the fact that it cannot predict a firm's future success. The income statement will show year over year operational trends, however, it will not indicate the potential or the timing of when large OCI items will be recognized in the income statement.

Final Word

The statement of comprehensive income reports the change in net equity of a business enterprise over a given period. The statement of retained earnings includes two key parts: net income, and other comprehensive income, which incorporates the items excluded from the income statement.

What is Statement of Changes in Equity?

The statement of changes in equity is also called the statement of retained earnings in U.S. GAAP. This statement explains the change in owner's equity during a specific accounting period

by detailing the movement of reserves that make up the shareholder's equity. This statement offers vital information about equity reserves not found anywhere else in the financial statements.

The following elements make up the movement of shareholder's equity during the accounting period:

Net profit and/or loss attributed to shareholders
Increase or decrease in share capital reserves
Shareholder dividend payments
Changes in accounting policy
Corrections of prior period errors

The following components are the main elements in the statement of changes in equity:

Opening Balance

This is taken from the prior period's statement of financial position, and is unadjusted. Any adjustments that should be made will be presented separately in the statement of changes in equity; changes in accounting policy and correction of prior period errors.

Changes in Accounting Policies

The effects of any changes in accounting policies are reported in the classification. This allows for restatement of the opening equity as if the new accounting policy had always been used.

Correction of Prior Period Error(s)

The effects of any prior period errors must be recorded as an adjustment to the opening reserves, not the opening balance so that the current period amounts can be reconciled, and traced to prior period financial statements.

Restated Balance

This is the stockholder's equity after adjustments made due to above changes and corrections.

Changes in Share Capital

If there is any further issuance of share capital during the accounting period it must be added to the statement of changes in equity, and redemption of shares must be deducted. These must be recorded separately for share capital reserve and share premium reserve.

Dividends

Current period dividend payments or announcements must be deducted from shareholder equity as a distribution of wealth of stockholders.

Income or Loss

Stockholder's profit or loss is reported as taken from the income statement.

Revaluation Reserve

Revaluation gains and/or losses during the period are recorded in the statement of changes in equity to the extent that they are recognized outside the income statement. Gains included in the income statement due to reversal of pervious losses are not recorded separately because they would be in the profit and loss for the accounting period.

Other Gains and/or Losses

All other gains and losses not in the income statement would be recorded as actuarial gains and losses.

Closing Balance

This is the balance of shareholder's equity reserves at the end of the accounting period.

The purpose and importance of the statement of changes in equity allows analysts and reviewers of the financial statements to see the factors of change in owner's equity during the accounting

period. Movements of shareholder reserves can be found on the balance sheet but information detailing equity reserves is not recorded separately in the other financial statements. Examples of this information would include: share capital issue and redemption, effects of changes in accounting policy, correction of prior period errors, gains and losses not reported on the income statement, dividends declared and bonus shares issued within the accounting period.

Purpose & Importance

This primary purpose of Statement of Changes in Equity is to provide details about all the movements in the **equity** account during an **accounting period**, which is otherwise not available anywhere else in the **financial statements**. As such, it helps the **shareholders** and investors in making more informed decisions about their investments. Further, it also allows the analysts and other readers of the financial statements to understand what factors resulted in the change in the equity capital.

Statement of changes in equity helps users of financial statement to identify the factors that cause a change in the owners' equity over the accounting periods. Whereas movement in shareholder reserves can be observed from the balance sheet, statement of changes in equity discloses significant information about equity reserves that is not presented separately elsewhere in the financial statements which may be useful in understanding the nature of change in equity reserves. Examples of such information include share capital issue and redemption during the period, the effects of changes in accounting policies and correction of prior period errors, gains and losses recognized outside income statement, dividends declared and bonus shares issued during the period.

Statement of Changes in Equity refers to the reconciliation of the opening and closing balances of equity in a company during a particular reporting period. It explains the connection between a company's income statement and balance sheet and also includes all those transactions not captured in these two financial statements, such as dividend payment, equity withdrawal, accounting policies changes, and corrections of prior period errors, etc.

In the US, the Statement of Changes in Equity is also known as the ***Statement of Retained Earnings*** and is required under the US GAAP.

Formula

The formula for a statement of changes in equity includes the opening and closing value of the equity, net income for the year, dividends paid, along with other changes.

Opening Balance of Equity + Net Income – Dividends +/- Other Changes = Closing Balance of Equity

Opening Balance: It represents the value of equity capital at the beginning of the reporting period, which is the same as the prior period's closing balance of equity.

Net Income: It represents the net profit or loss reported in the **income statement** during the period.

Dividends: Dividends declared during the reporting period should be subtracted from the equity balance as it represents the distribution of wealth among shareholders.

Other Changes include the following –

Effects of Changes in Accounting Policies: Usually, changes in **accounting policies** have to apply retrospectively, which results in adjustments in the preceding period and then restated financial position.
Effects of Prior Period Correction: The effects of other **prior period adjustments** should be captured separately in the statement of changes in equity.
Changes in Share Capital: Issuance (increase) and withdrawal/ redemption (decrease) of **share capital** during the period should be captured to show movement in equity funding.
Changes in Reserve Capital: It captures all gains and losses recognized in the **revaluation reserve** during the period.
Closing Balance: It represents the value of equity capital at the end of the **reporting period**.
Steps to Prepare Statement of Changes in Equity
Step #1 Firstly, determine the value of the equity at the beginning of the reporting period, which is the same as the value at the end of the last reporting period. It is the opening balance of equity.
Step #2 Next, determine the **net income** or loss booked by the firm.
Step #3 Next, determine the value of the dividend declared by the management for the reporting period.
Step #4 Next, determine all the adjustments for the reporting period, which may include effects of changes in accounting policies, correction of prior period errors, changes in reserve capital as well as share capital.
Step #5 Finally, the closing balance of equity can be derived by adding net income (step 2) to the opening balance of equity (step 1), deducting dividends (step 3), and other adjustments (step 4), as shown below.
Opening Balance of Equity + Net Income – Dividends +/- Other Changes = Closing Balance of Equity
The statement of cash flows, or the cash flow statement, is a financial statement that summarizes the amount of cash and cash equivalents entering and leaving a company.
The cash flow statement (CFS) measures how well a company manages its cash position, meaning how well the company generates cash to pay its debt obligations and fund its operating expenses. The cash flow statement complements the balance sheet and income statement and is a mandatory part of a company's financial reports since 1987.[1]
In this article, we'll show you how the CFS is structured, and how you can use it when analyzing a company.
A cash flow statement is a financial statement that summarizes the amount of cash and cash equivalents entering and leaving a company.
The cash flow statement measures how well a company manages its cash position, meaning how well the company generates cash to pay its debt obligations and fund its operating expenses.
The cash flow statement complements the balance sheet and income statement and is a mandatory part of a company's financial reports since 1987.[1]
The main components of the cash flow statement are cash from operating activities, cash from investing activities, and cash from financing activities.
The two methods of calculating cash flow are the direct method and the indirect method.

Cash Flow Statement
The CFS allows investors to understand how a company's operations are running, where its money is coming from, and how money is being spent. The CFS is important since it helps investors determine whether a company is on a solid financial footing.

Creditors, on the other hand, can use the CFS to determine how much cash is available (referred to as liquidity) for the company to fund its operating expenses and pay its debts.

The Structure of the Cash Flow Statement

The main components of the cash flow statement are:

Cash from operating activities

Cash from investing activities

Cash from financing activities

Disclosure of noncash activities is sometimes included when prepared under the generally accepted accounting principles (GAAP).[2]

It's important to note that the CFS is distinct from the income statement and balance sheet because it does not include the amount of future incoming and outgoing cash that has been recorded on credit. Therefore, cash is not the same as net income, which on the income statement and balance sheet includes cash sales and sales made on credit.

Cash From Operating Activities

The operating activities on the CFS include any sources and uses of cash from business activities. In other words, it reflects how much cash is generated from a company's products or services.

Generally, changes made in cash, accounts receivable, depreciation, inventory, and accounts payable are reflected in cash from operations.

These operating activities might include:

Receipts from sales of goods and services

Interest payments

Income tax payments

Payments made to suppliers of goods and services used in production

Salary and wage payments to employees

Rent payments

Any other type of operating expenses[3]

In the case of a trading portfolio or an investment company, receipts from the sale of loans, debt, or equity instruments are also included. When preparing a cash flow statement under the indirect method, depreciation, amortization, deferred tax, gains or losses associated with a noncurrent asset, and dividends or revenue received from certain investing activities are also included. However, purchases or sales of long-term assets are not included in operating activities.

Volume 75%

How Cash Flow Is Calculated

Cash flow is calculated by making certain adjustments to net income by adding or subtracting differences in revenue, expenses, and credit transactions (appearing on the balance sheet and income statement) resulting from transactions that occur from one period to the next. These adjustments are made because non-cash items are calculated into net income (income statement) and total assets and liabilities (balance sheet). So because not all transactions involve actual cash items, many items have to be re-evaluated when calculating cash flow from operations.

As a result, there are two methods of calculating cash flow: the direct method and the indirect method.

Direct Cash Flow Method

The direct method adds up all the various types of cash payments and receipts, including cash paid to suppliers, cash receipts from customers, and cash paid out in salaries. These figures are calculated by using the beginning and ending balances of a variety of business accounts and examining the net decrease or increase in the accounts.

Indirect Cash Flow Method

With the indirect method, cash flow from operating activities is calculated by first taking the net income off of a company's income statement. Because a company's income statement is prepared on an accrual basis, revenue is only recognized when it is earned and not when it is received.

Net income is not an accurate representation of net cash flow from operating activities, so it becomes necessary to adjust earnings before interest and taxes (EBIT) for items that affect net income, even though no actual cash has yet been received or paid against them. The indirect method also makes adjustments to add back non-operating activities that do not affect a company's operating cash flow.

For example, depreciation is not really a cash expense; it is an amount that is deducted from the total value of an asset that has previously been accounted for. That is why it is added back into net earnings for calculating cash flow.

The only time income from an asset is accounted for in CFS calculations is when the asset is sold.

Accounts Receivable and Cash Flow

Changes in accounts receivable (AR) on the balance sheet from one accounting period to the next must also be reflected in cash flow. If accounts receivable decreases, this implies that more cash has entered the company from customers paying off their credit accounts—the amount by which AR has decreased is then added to net earnings. If accounts receivable increases from one accounting period to the next, the amount of the increase must be deducted from net earnings because, although the amounts represented in AR are revenue, they are not cash.

Inventory Value and Cash Flow

An increase in inventory, on the other hand, signals that a company has spent more money to purchase more raw materials. If the inventory was paid with cash, the increase in the value of inventory is deducted from net earnings. A decrease in inventory would be added to net earnings. If inventory was purchased on credit, an increase in accounts payable would occur on the balance sheet, and the amount of the increase from one year to the other would be added to net earnings.

The same logic holds true for taxes payable, salaries payable, and prepaid insurance. If something has been paid off, then the difference in the value owed from one year to the next has to be subtracted from net income. If there is an amount that is still owed, then any differences will have to be added to net earnings.

Cash from Investing Activities

Investing activities include any sources and uses of cash from a company's investments. A purchase or sale of an asset, loans made to vendors or received from customers, or any payments related to a merger or acquisition is included in this category. In short, changes in equipment, assets, or investments relate to cash from investing.[3]

Usually, cash changes from investing are a "cash out" item, because cash is used to buy new equipment, buildings, or short-term assets such as marketable securities. However, when a

company divests an asset, the transaction is considered "cash in" for calculating cash from investing.

Cash from Financing Activities

Cash from financing activities includes the sources of cash from investors or banks, as well as the uses of cash paid to shareholders. Payment of dividends, payments for stock repurchases, and the repayment of debt principal (loans) are included in this category.

Changes in cash from financing are "cash in" when capital is raised, and they're "cash out" when dividends are paid. Thus, if a company issues a bond to the public, the company receives cash financing; however, when interest is paid to bondholders, the company is reducing its cash.

Negative Cash Flow Statement

Cash flow statements look this healthy or exhibit a positive cash flow, but negative cash flow should not automatically raise a red flag without further analysis. Sometimes, negative cash flow is the result of a company's decision to expand its business at a certain point in time, which would be a good thing for the future. This is why analyzing changes in cash flow from one period to the next gives the investor a better idea of how the company is performing, and whether or not a company may be on the brink of bankruptcy or success.

Balance Sheet and Income Statement

As we have already discussed, the cash flow statement is derived from the income statement and the balance sheet. Net earnings from the income statement are the figure from which the information on the CFS is deduced.

As for the balance sheet, the net cash flow in the CFS from one year to the next should equal the increase or decrease of cash between the two consecutive balance sheets that apply to the period that the cash flow statement covers. For example, if you are calculating cash flow for the year 2019, the balance sheets from the years 2018 and 2019 should be used.

The Bottom Line

A cash flow statement is a valuable measure of strength, profitability, and the long-term future outlook for a company. The CFS can help determine whether a company has enough liquidity or cash to pay its expenses. A company can use a cash flow statement to predict future cash flow, which helps with matters of budgeting.

For investors, the cash flow statement reflects a company's financial health since typically the more cash that's available for business operations, the better. However, this is not a hard and fast rule. Sometimes, a negative cash flow results from a company's growth strategy in the form of expanding its operations.

By studying the cash flow statement, an investor can get a clear picture of how much cash a company generates and gain a solid understanding of the financial well-being of a company.

The Cash Flow Statement ” also referred to as a statement of cash flows or funds flow statement ” is one of the three financial statements commonly used to gauge a company’s performance and overall health. The other two financial statements — **Balance Sheet** and **Income Statement** — have been addressed in previous articles.

As the name implies, the Cash Flow Statement provides information about an organization’s cash inflows and outflows over a specified time period. Simply put, it reveals how a company spends its money (cash outflows) and where that money comes from (cash inflows).

The Cash Flow Statement is the best resource for testing a company's liquidity because it shows changes over time, rather than absolute dollar amounts at a specific point in time. It's also useful in determining the short-term viability of a company.
It's important to note that the Cash Flow Statement reflects a firm's *liquidity*. It does not show *profitability* " the Income Statement does that.

Components of the Cash Flow Statement
The Cash Flow Statement organizes and reports cash in three categories: operating, investing and financing.
Operating Activities
This represents the key source of an organization's cash generation. It's considered by many to be the most important information on the Cash Flow Statement.
This section of the Cash Flow Statement shows how much cash is generated from a company's core products or services. A strong, positive cash flow from operations (especially over time) is a good sign of a healthy company.
Operating Activities starts with the **Net Income** number from the Income Statement.

If all of a company's operating revenues and expenses were in cash, then **Net Cash Provided by Operating Activities** (Cash Flow Statement) would equal **Net Income** (Income Statement). However, this is rarely the case. Typically, the Net Income must be adjusted on the Cash Flow Statement based on an increase or decrease in cash calculated from changes on the Balance Sheet from one period to the next.

Most of these adjustment items can either result in an increase or decrease in cash from operating activities. Exceptions would be adjustments for depreciation and amortization, which are always an increase to **Net Income** on the Cash Flow Statement.

Look for consistent levels of cash flow from Operating Activities over time, indicating the company will probably continue to be able to fund its operations.
Investing Activities
This section records changes in equipment, assets or investments.
Cash changes from investing are generally considered "cash outflows" because cash is used to purchase equipment, buildings, or short-term assets. When a company divests an asset, the transaction is considered a "cash inflow". A healthy company generally invests continually in plant, equipment, land and other fixed assets.

Financing Activities
Changes in debt, loans or stock options, long-term borrowings, etc. are accounted for under Financing Activities.
When capital is raised, it is considered "cash in"; when dividends are paid or debt is reduced, "cash out". The Financing Activities section shows how borrowing affects the company's cash flow.

The bottom line on the Cash Flow Statement is the **Net Increase (Decrease) in Cash and Cash Equivalents.** It's determined by calculating the total cash inflows and outflows for each of the three sections in the Cash Flow Statement.

The 2018 **Net Increase (Decrease) in Cash and Cash Equivalents** on the Cash Flow Statement should equal the difference between the 2018 and 2017 **Cash and Cash Equivalents** figures on the Balance Sheet.

The Cash Flow Statement shows how a company raised money (cash) and how it spent those funds during a given period. It's a tool that measures a company's ability to cover its expenses in the near term.

Cash flow reflects a company's financial health, and its ability to pay its bills and other liabilities.

In most cases, the more cash available for business operations, the better. However, a low or negative cash flow in one year could result from a company's growth strategy " and, therefore, not be a real issue. As with all financial analysis, it's important to determine the company's cash flow *trend*.

"High Quality" Net Income

To determine if a company's net income is of "high quality", compare the **Net Cash Provided by Operating Activities** to the **Net Income**. Both of these figures are found on the Cash Flow Statement. The **Net Cash Provided by Operating Activities** should be consistently (over time) greater than the **Net Income**.

The problem with using the Balance Sheet for liquidity analysis is that it only presents data that measures where the organization stands at a particular point in time.

The problem with the Income Statement is that it includes many non-cash allocations, accounting conventions, accruals and reserves that have nothing to do with cash.

Utilizing the Cash Flow Statement for liquidity analysis results in a more dynamic picture of the resources a company has to meet its current financial obligations.

Ratio #1: Cash Flow to Sales = Operating Cash Flow ÷ Net Sales

This ratio determines how much cash is being generated for each dollar of sales. Obviously, the higher the number, the better.

Is this good or bad? At first glance, just one or two cents cash generated by each one dollar of sales doesn't look good. To make a more accurate assessment, however, you should compare this performance to industry benchmarks. In addition, you'll want to determine why the cash generated is so low.

Ratio #2: Operation Index = Net Cash from Operations ÷ Net Income after income tax

This measures the relationship between operating cash flows and profit. The higher the percentage, the better.

Ratio #3: Operating Cash Flow Ratio = Cash Flow from Operations Ã· Current Liabilities

This ratio is used to assess whether an operation is generating enough cash to cover current liabilities.

If the ratio falls below 1.00, the company isn't bringing in enough cash and will have to find other sources to finance its operations.

Looking at the **Balance Sheet** and **Income Statement** in previous articles, LLH Inc. seemed to be in pretty good shape. However, the overall impression from the Cash Flow Statement raises concern regarding LLH's ability to pay its short-term liabilities (including payments due creditors).

The Income Statement and Balance Sheet are important tools for evaluating a company's health. However, the Cash Flow Statement is an important complement to these, and should not be overlooked.

There are several differences which exist with respect to the manner in which the cash flow statement is prepared under IFRS versus US GAAP.The most significant difference lies in the fact that IFRS gives companies more flexibility with respect to how interest paid/received and dividend paid/received is reported and how income tax expense is classified. Despite the additional flexibility provided by IFRS, companies must use a consistent classification each year and separately disclose the amounts of interest and dividends received and paid and where the amounts are reported.

IFRS vs. US GAAP Cash Flow Statements

The elements below summarize the major differences between how the cash flow statement is prepared under IFRS and US GAAP.

IFRS Requirements

Interest received may be classified as either an operating activity or investing activity.
Interest paid may be classified as either an operating activity or financing activity.
Dividends received may be classified as either an operating activity or investing activity.
Dividends paid may be classified as either an operating activity or financing activity.
Income tax expense is generally classified as an operating activity, but a portion may be allocated to investing or financing activities if it is specifically identifiable with those activities.
Bank overdrafts are classified as part of 'cash and cash equivalents.'
Either the direct or indirect method may be used for reporting cash flow from operating activities, although the direct method is encouraged.

US GAAP Requirements

Interest received must be classified as an operating activity.
Interest paid must be classified as an operating activity.
Dividends received must be classified as an operating activity.
Dividends paid must be classified as a financing activity.
Income tax expense must be classified as an operating activity.
Bank overdrafts are not considered to be a part of 'cash and cash equivalents' but are instead classified as a financing activity.
Either the direct or indirect method may be used for reporting cash flow from operating activities, although the direct method is encouraged. Unlike under IFRS however, a reconciliation of net income to cash flow from operating activities must be provided regardless of the method used.

Integrated Reporting

The concept of integrated reporting as proposed by the International Integrated Reporting Council (IIRC) offers a sea change opportunity for corporate accountability—but will it make a difference? Will it significantly impact and change the way organizational risk is managed and assessed and decisions are made or will it add costs with few benefits?

The concept of integrated reporting is certainly timely; depending upon traditional financial reporting no longer provides investors with a clear representation of the value of their

investment. While an earnings and cash flow statement give some indication of an organization's net worth, the balance sheet often represents less than 20% of the assets employed to earn income and create an organizations value (See "The Intangible Corporation" and surveys by Interbrand and Brand Finance).

Investors and other interested stakeholders have traditionally depended on a growing patchwork of supplementary reporting to understand areas of risk and sustainability and to provide the additional information they require. This ranges from mandatory environmental reporting in some jurisdictions to triple bottom line reports, corporate social responsibility reports, carbon disclosure reporting, and other approaches. Recent additions, such as the UK Strategic Report required by the Financial Reporting Council, also aim to increase insight. In addition, efforts by the accounting profession have resulted in broadened management commentary in the management discussion and analysis. Each of these brings added administrative work to the organization and also raises the question of the integrity of the information provided.

This is not a new problem; since the Savings and Loan scandal in the late 1980s, the media has asked whether those responsible were asleep at the wheel and if they should have known better. To some degree, management also had a problem in the past trying to make decisions based on purely financial information. The publication of the Balanced Scorecard in 1996 highlighted this. It argued that a broader range of strategic and operational metrics are required to make effective management decisions and understand the relationship between financial performance and process performance, customer performance and relationships, and the development of human skills (learning and growth).

However, many implementations of the scorecard approach failed to make a difference, and there may be some lessons here for adoption of integrated reporting (as an example, see "A Critique of the Balanced Scorecard as a Performance Measurement Tool"). For the scorecard approach, little value was gained if the measures adopted were not linked to strategy and, thus, decision making and alternative choices. If governance and culture weren't impacted then management failed to gain support for strategic shifts. If financial measures remained dominant, trade-off decisions would be biased toward continued short term benefits. In my 2005 book, *Governance, Accountability, and Sustainable Development,* I highlight the governance issue and suggested the need to expand the management lessons learned through broader reporting to the level of broad-based governance.

For integrated reporting to make real change it must result in a different set of decisions. If, like many scorecards, the integrated report is either only populated with "available" metrics and/or becomes an end in itself, then it will probably fail in its goal of changing outcomes. Worse still, if the focus becomes one of compliance and audit then it can easily become another costly burden for business that adds little value and fails to impact decision making and corporate behavior. So what is the *actual* desired outcome of integrated reporting? Certainly not the report itself. The need for an integrated approach comes from a pedigree that includes recognition that:financial accountability no longer fully represents corporate accountability;

an effective organization manages a portfolio of resources in order to operate—one of which is financial capital but also includes human, intellectual, relationship, natural, and manufactured capitals;for an investor, there may be unknown risks associated with the maximization of financial returns while other capitals required for sustainability are depleted;

continuing to treat "externalities" as costs for society to bear is no longer socially acceptable nor feasible for global survival; and

ignoring intangibles can in fact result in destruction of organizational value, shareholder wealth and sustainable capacity (in this case, intangibles is used in the broader sense than those recognized under GAAP, IFRS, and the US Financial Accounting Standards Board).

So for integrated reporting to be effectively implemented, the metrics developed must be strategic in nature and directly linked to the drivers of organizational value and sustainability. This requires adoption and complete understanding from investors so that as an interested party, they start asking the right questions. In many situations, being asleep at the wheel can be caused by not knowing what you don't know. If investors don't understand the interaction of the organizational resources used to create and sustain value, it is going to be hard to support the required strategies for sustainability.

A key challenge for leadership—both managers and investors—will be making the right decisions. Business attempts to operate on a level playing field and, within this, to make decisions that gain a competitive advantage. This in itself is a challenge in a global business environment with a wide range of differing legislative frameworks. Survival is about making the right decisions and balancing financial returns, which drive access to capital with sustainable decisions both for the business and for society. Successful organizations will be those whose decision makers are closest to the societies and communities within which they operate, know the drivers of organizational value and sustainability, and can make fast and informed decisions.

It could be argued that organizations that already have this integrated thinking have no need for a structured approach to integrated reporting as it already forms the foundation of their business model? However recent studies appear to indicate that few companies have yet integrated this approach to explain sustainable thinking.

UNIT- 2

What is Revenue Recognition?

Revenue recognition is an accounting principle that outlines the specific conditions under which revenue is recognized. In theory, there is a wide range of potential points at which revenue can be recognized. This guide addresses recognition principles for both IFRS and U.S. GAAP.

Conditions for Revenue Recognition

According to the IFRS criteria, for revenue to be recognized, the following conditions must be satisfied:

1. Risks and rewards of ownership have been transferred from the seller to the buyer.
2. The seller loses control over the goods sold.
3. The collection of payment from goods or services is reasonably assured.
4. The amount of revenue can be reasonably measured.
5. Costs of revenue can be reasonably measured.

Conditions (1) and (2) are referred to as **Performance**. Regarding performance, it occurs when the seller has done what is to be expected to be entitled to payment.

Condition (3) is referred to as **Collectability**. The seller must have a reasonable expectation that he or she will be paid for the performance.

Conditions (4) and (5) are referred to as **Measurability.** Due to the accounting guideline of the matching principle, the seller must be able to match the revenues to the expenses. Hence, both revenues and expenses should be able to be reasonably measured.

Revenue Recognition from Contracts

IFRS 15, revenue from contracts with customers, establishes the specific steps for revenue recognition. It is important to note that there are some exclusions from IFRS 15 such as:

- Lease contracts (IAS 17)
- Insurance contracts (IFRS 4)
- Financial instruments (IFRS 9)

Steps in Revenue Recognition from Contracts

The five-step model applies to revenue earned from a contract with a customer with limited exceptions, regardless of the type of revenue transaction or the industry.

Studying this technical article and answering the related questions can count towards your verifiable CPD if you are following the unit route to CPD and the content is relevant to your

learning and development needs. One hour of learning equates to one unit of CPD. We'd suggest that you use this as a guide when allocating yourself CPD units.

Step one: Identification of contract

Step one in the five-step model requires the identification of the contract with the customer. Contracts may be in different forms (written, verbal or implied), but must be enforceable, have commercial substance and be approved by the parties to the contract.

The model applies once the payment terms for the goods or services are identified and it is probable that the entity will collect the consideration. Each party's rights in relation to the goods or services have to be capable of identification. If a contract with a customer does not meet these criteria, the entity can continually reassess the contract to determine whether it subsequently meets the criteria.

"Contracts... must be enforceable, have commercial substance and be approved by the parties to the contract."
Two or more contracts that are entered into around the same time with the same customer may be combined and accounted for as a single contract, if they meet the specified criteria. The standard provides detailed requirements for contract modifications. A modification may be accounted for as a separate contract or a modification of the original contract, depending upon the circumstances of the case.

Step two: Performance obligations

Step two requires the identification of the separate performance obligations in the contract. This is often referred to as 'unbundling', and is done at the beginning of a contract. The key factor in identifying a separate performance obligation is the distinctiveness of the good or service, or a bundle of goods or services. A good or service is distinct if the customer can benefit from the good or service on its own or together with other readily available resources and is separately identifiable from other elements of the contract.

IFRS 15 requires a series of distinct goods or services that are substantially the same with the same pattern of transfer, to be regarded as a single performance obligation. A good or service which has been delivered may not be distinct if it cannot be used without another good or service that has not yet been delivered. Similarly, goods or services that are not distinct should be combined with other goods or services until the entity identifies a bundle of goods or services that is distinct.

IFRS 15 provides indicators rather than criteria to determine when a good or service is distinct within the context of the contract. This allows management to apply judgment to determine the separate performance obligations that best reflect the economic substance of a transaction.

Step three: Transaction price

Step three requires the entity to determine the transaction price, which is the amount of consideration that an entity expects to be entitled to in exchange for the promised goods or services. This amount excludes amounts collected on behalf of a third party - for example, government taxes. An entity must determine the amount of consideration to which it expects to be entitled in order to recognise revenue.

The transaction price might include variable or contingent consideration.

Variable consideration should be estimated as either the expected value or the most likely amount. The expected value approach represents the sum of probability-weighted amounts for various possible outcomes. The most likely amount represents the most likely amount in a range of possible amounts.

Management should use the approach that it expects will best predict the amount of consideration and it should be applied consistently throughout the contract. An entity can only include variable consideration in the transaction price to the extent that it is highly probable that a subsequent change in the estimated variable consideration will not result in a significant revenue reversal. If it is not appropriate to include all of the variable consideration in the transaction price, the entity should assess whether it should include part of the variable consideration. However, this latter amount still has to pass the ‘revenue reversal’ test.

Variable consideration is wider than simply contingent consideration as it includes any amount that is variable under a contract, such as performance bonuses or penalties.

"Variable consideration is wider than simply contingent consideration as it includes any amount that is variable under a contract, such as performance bonuses or penalties."
Additionally, an entity should estimate the transaction price, taking into account:

- non-cash consideration
- consideration payable to the customer
- time value of money if a significant financing component is present.

The latter is not required if the time period between the transfer of goods or services and payment is less than one year. In some cases, it will be clear that a significant financing component exists due to the terms of the arrangement.

In other cases, it could be difficult to determine whether a significant financing component exists. This is likely to be the case where there are long-term arrangements with multiple performance obligations such that goods or services are delivered and cash payments received throughout the arrangement. For example, if an advance payment is required for business purposes to obtain a longer-term contract, then the entity may conclude that a significant financing obligation does not exist.

If an entity anticipates that it may ultimately accept an amount lower than that initially promised in the contract due to, for example, past experience of discounts given, then revenue would be estimated at the lower amount with the collectability of that lower amount being assessed.

Subsequently, if revenue already recognised is not collectable, impairment losses should be taken to profit or loss.

Step four: Allocation of price to performance obligations

Step four requires the allocation of the transaction price to the separate performance obligations. The allocation is based on the relative standalone selling prices of the goods or services promised and is made at inception of the contract. It is not adjusted to reflect subsequent changes in the standalone selling prices of those goods or services.

The best evidence of standalone selling price is the observable price of a good or service when the entity sells that good or service separately. If that is not available, an estimate is made by using an approach that maximises the use of observable inputs - for example, expected cost plus an appropriate margin or the assessment of market prices for similar goods or services adjusted for entity-specific costs and margins or in limited circumstances a residual approach. The residual approach is different from the residual method that is used currently by some entities, such as software companies.

When a contract contains more than one distinct performance obligation, an entity allocates the transaction price to each distinct performance obligation on the basis of the standalone selling price.

Where the transaction price includes a variable amount and discounts, consideration needs to be given as to whether these amounts relate to all or only some of the performance obligations in the contract. Discounts and variable consideration will typically be allocated proportionately to all of the performance obligations in the contract. However, if certain conditions are met, they can be allocated to one or more separate performance obligations.

This will be a major practical issue as it may require a separate calculation and allocation exercise to be performed for each contract. A mobile telephone contract typically bundles together the handset and network connection. IFRS 15 will require their separation.

"A mobile telephone contract typically bundles together the handset and network connection. IFRS 15 will require their separation."

Step five: Recognition of revenue

Step five requires revenue to be recognised as each performance obligation is satisfied. This differs from IAS 18 where, for example, revenue in respect of goods is recognised when the significant risks and rewards of ownership of the goods are transferred to the customer. An entity satisfies a performance obligation by transferring control of a promised good or service to the customer, which could occur over time or at a point in time. The definition of control includes the ability to prevent others from directing the use of and obtaining the benefits from the asset. A performance obligation is satisfied at a point in time unless it meets one of the following criteria, in which case, it is deemed to be satisfied 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.

Revenue is recognised in line with the pattern of transfer. Whether an entity recognises revenue over the period during which it manufactures a product or on delivery to the customer will depend on the specific terms of the contract.

If an entity does not satisfy its performance obligation over time, it satisfies it at a point in time and revenue will be recognised when control is passed at that point in time. Factors that may indicate the passing of control include the present right to payment for the asset or the customer has legal title to the asset or the entity has transferred physical possession of the asset.

As a consequence of the above, the timing of revenue recognition may change for some point-in-time transactions when the new standard is adopted.

In addition to the five-step model, IFRS 15 sets out how to account for the incremental costs of obtaining a contract and the costs directly related to fulfilling a contract and provides guidance to assist entities in applying the model to:

- licences
- warranties
- rights of return
- principal-versus-agent considerations
- options for additional goods or services
- breakage

IFRS 15 is a significant change from IAS 18, Revenue, and even though it provides more detailed application guidance, judgment will be required in applying it because the use of estimates is more prevalent.

GAAP Revenue Recognition Principles

The Financial Accounting Standards Board (FASB) which sets the standards for U.S. GAAP has the following 5 principles for recognizing revenue:

1. Identify the customer contract
2. Identify the obligations in the customer contract
3. Determine the transaction price
4. Allocate the transaction price according to the performance obligations in the contract
5. Recognize revenue when the performance obligations are met

Two accounting boards are working toward a common set of procedures for recognizing revenue. The international financial reporting standards, or IFRS, are the International Accounting Standards Board's counterpart to the generally accepted accounting principles, or GAAP, set forth by the U.S. Financial Accounting Standards Board. Revenue recognition is concerned with how and when to book income as a result of completing an earnings process.

General Differences

GAAP rules for revenue recognition are detailed regarding specific industries, such as real estate and software. IFRS guidance is universal; Standard 18 sets forth general principles and examples applicable to all industries. GAAP also features exceptions for specific types of transactions and requires public companies to follow additional rules set down by the Securities and Exchange Commission. IFRS lacks these features. A joint project between the two boards sees a common approach taking effect for public entities by Dec. 15, 2016. Several differences will have to be resolved by then.

Sale of Goods

Under GAAP, you can recognize revenue from the sale of goods if you've made delivery according to a definitive agreement for a fixed or determinable fee that you are reasonably sure you'll collect. IFRS allows recognition when the risks and rewards of ownership have been transferred, you've given the buyer control of the goods, the amount of revenue is reliably understood and the economic benefits of the sale will flow to your company -- meaning, you'll get paid.

Rendering of Service

GAAP has special rules for rendering software services. Otherwise, it calls for stretching out revenue recognition throughout the service period; you can't book all your revenues upfront for an extended service agreement, for example. If the service involves a multiple-element contract, you must wait to book revenue if you could trigger a refund of previous payments because you fail to deliver later elements, unless each element has its own stand-alone value. IFRS allows for the possibility of recognizing revenue upfront when some amount of performances has occurred. It allows you to book the delivered elements of a multiple-element contract even if a refund could be triggered, as long as each element has "commercial substance."

Construction Contracts

The "completed contract method" is standard under GAAP; you must wait to finish construction before recognizing revenue. However, large construction projects can use the "percentage of completion method" in which your revenue matches the percentage of work completed. If you meet certain criteria, you can combine or segment construction contracts under GAAP. IFRS bans the completed contract method. It allows the percentage of completion method under certain conditions. Otherwise, you only recognize revenue on any

recoverable costs you incur. IFRS also allows contracts to be combined or segmented but applies different criteria than does GAAP for this purpose.

Consumer Rights

Right to safety

Means right to be protected against the marketing of goods and services, which are hazardous to life and property. The purchased goods and services availed of should not only meet their immediate needs, but also fulfil long term interests. Before purchasing, consumers should insist on the quality of the products as well as on the guarantee of the products and services. They should preferably purchase quality marked products such as ISI,AGMARK, etc

Right to choose

Means right to be assured, wherever possible of access to variety of goods and services at competitive price. In case of monopolies, it means right to be assured of satisfactory quality and service at a fair price. It also includes right to basic goods and services. This is because unrestricted right of the minority to choose can mean a denial for the majority of its fair share. This right can be better exercised in a competitive market where a variety of goods are available at competitive prices

Right to be informed

Means right to be informed about the quality, quantity, potency, purity, standard and price of goods so as to protect the consumer against unfair trade practices. Consumer should insist on getting all the information about the product or service before making a choice or a decision. This will enable him to act wisely and responsibly and also enable him to desist from falling prey to high pressure selling techniques.

Right to consumer education

Means the right to acquire the knowledge and skill to be an informed consumer throughout life. Ignorance of consumers, particularly of rural consumers, is mainly responsible for their exploitation. They should know their rights and must exercise them. Only then real consumer protection can be achieved with success.

Right to be heard

Means that consumer's interests will receive due consideration at appropriate forums. It also includes right to be represented in various forums formed to consider the consumer's welfare. The Consumers should form non-political and non-commercial consumer organizations which can be given representation in various committees formed by the Government and other bodies in matters relating to consumers.

Right to Seek redressal

Means right to seek redressal against unfair trade practices or unscrupulous exploitation of consumers. It also includes right to fair settlement of the genuine grievances of the consumer. Consumers must make complaint for their genuine grievances.Many a times their complaint may be of small value but its impact on the society as a whole may be very large. They can also take the help of consumer organisations in seeking redressal of their grievances.

As the markets are globalizing, the direct link between the manufacturer and the final user getting distant, post purchase grievances have to be heard through a strong redressal system. For this, **Consumer disputes redressal agencies (popularly known as Consumer Forums or Consumer Courts)** are set up under the Act at District, State and National level to provide simple and inexpensive quick redressal against consumer complaints. The District forum deals

with complaints where the compensation sought is less than 23 lakhs. This limit is commonly known as the 'pecuniary jurisdiction' of the Consumer Redressal Forum. The State Forum deals with the complaints where the value of the goods and services and compensation claimed does not exceed rupees one crore and the National Forum entertains the complaints where the value of the goods or services and compensation claimed exceeds rupees one crore.
The Consumer Forum can order the company to take the following actions once it hears the complaint and decides that the company is at fault:

- Correct deficiencies in the product to what they claim.
- Repair defect free of charges
- Replace product with similar or superior product
- Issue a full refund of the price
- Pay compensation for damages / costs / inconveniences
- Withdraw the sale of the product altogether
- Discontinue or not repeat any unfair trade practice or the restrictive trade practice
- Issue corrective advertisement for any earlier misrepresentation

Consumer Protection Act
An Act to provide for protection of the interests of consumers and for the said purpose, to establish authorities for timely and effective administration and settlement of consumers' disputes and for matters connected connected therewith." (According to Consumer Protection Act, 2019).
"An Act to provide for better protection of the interests of consumers and for that purpose to make provision for the establishment of consumer councils and other authorities for the settlement of consumers' disputes and for matters connected therewith."(According to Consumer Protection Act, 1986).
Consumer Protection Act, 1986 seeks to promote and protect the interest of consumers against deficiencies and defects in goods or services. It also seeks to secure the rights of a consumer against unfair or restrictive trade practices. This act was passed in Lok Sabha on 9th December,1986 and Rajya Sabha on 10th December, 1986 and assented by the President of India on 24th December, 1986 and was published in the Gazette of India on 26th December, 1986.
Consumer Responsibilities

Be Critically Aware

- The responsibility to be more alert and to question more – about prices, about quantity and quality of goods bought and services used.

Be Involved

- The responsibility to be assertive – to ensure that you get a fair deal as a consumer. Remember, if you are passive, you are likely to be exploited.

Be Organized

- The responsibility to join hands and raise voices as consumers; to fight in a collective and to develop the strength and influence to promote and protect consumer interest.

Practice Sustainable Consumption

- The responsibility to be aware of the impact of your consumption on other citizens, especially the disadvantaged or powerless groups; and to consume based on needs – not wants.

Be Responsible to the Environment

- The responsibility to be aware and to understand the environmental consequences of our consumption. We should recognize our individual and social responsibility to conserve natural resources and protect the earth for future generations.

Consumer Rights Vs Responsibilities

Sl.No	Rights	Responsibility
1	Right to be heard	1. Ensure that the company has provided you the contact details of the consumer grievance handling system and are easily accessible. 2. Avoid purchase of products/services from a company which do not provide details of the consumer grievance officers to handle consumer grievances
2	Right to Redress	1. Ignoring the loss suffered on purchase of defective goods and services and not filing complaint encourages the corrupt business man to supply low standards or defective goods and services. Therefor file a complaint even for a small loss. File only a genuine complaint. 2. Consumer must file a complaint if not satisfied with the quality of product/services. 3. Claim the penalties/compensation as provided under rules and regulations to ensure that the quality delivery system improves. 4. Study carefully all terms and conditions related to return/replacement of defective goods, refund and warranty policies.
3	Right to Safety	1. While purchasing the goods or services, Consumer must look for standard quality mark such as ISI, Hallmark, Agmark, ISO, FSSAI , etc. 2. Do not buy any spurious/ fake/duplicate/ hazardous products

4	Right to Consumer Education/ Right to be Informed	1. Do not get carried away by advertisements only or believe on the words of the seller. Consumer must look market reviews/feedback. Similarly inform offers if product and services of companies are of substandard. 2. Consumer must insist on getting complete information on the quality, quantity, utility, price etc. of the product or services. 3. Ask for complete contact details of the consumer grievance mechanism of the company the consumer wish to buy from
5	Right to Choose	1. Access the information available on various alternatives available for the product and services under purchase consideration. 2. Compare specifications, competition and fair prices of the goods and services before finalizing on the purchase 3. Study various feedbacks/reviews of the products/services

Accruals and Deferrals

The use of accruals and deferrals in accounting ensures that revenue and expenditure is allocated to the correct accounting period. Adjusting the accounting records for accruals and deferrals ensures that financial statements are prepared on an accruals and not cash basis and comply with the matching concept of accounting.

The term accruals and deferrals applies equally to both revenue and expenses as explained below.

Revenue Accruals and Deferrals

1. **Accrual:** Accrue if the revenue has been earned but the cash has not yet been received. Accrued revenue is an asset of the business. The adjusting journal entry will be between a revenue and an asset account.
2. **Deferral:** Defer if the cash has been received but the revenue has not yet been earned (unearned). Deferred revenue is a liability of the business, and is sometimes referred to as unearned revenue. The adjusting journal entry will be between a revenue and a liability account.

Expense Accruals and Deferrals

The difference between expense accruals and deferrals are summarized in the table below.

1. **Accrual:** Accrue if the expense has been incurred but the cash has not yet been paid. Accrued expenses are a liability of the business. The adjusting journal entry will be between an expense and a liability account.
2. **Deferral:** Defer if the cash has been paid but the expense has not yet been incurred. Deferred expenses are an asset of the business. The adjusting journal entry will be between an expense and an asset account.

Accruals and Deferrals Journal Entries

The adjusting journal entries for accruals and deferrals will always be between an income statement account (revenue or expense) and a balance sheet account (asset or liability). This is summarized in the table below.

The examples below set out typical bookkeeping journal entries in relation to accruals and deferrals of revenue and expenditure.

Revenue Accrual Journal Entry

The adjusting entry is between a revenue and an asset account.

Account	**Debit**	**Credit**
Revenue accrual	XXX	
Revenue		XXX

Revenue accrual journal

This accrued revenue journal entry example establishes an asset account in the balance sheet.

Revenue Deferral Journal Entry

The original cash entry is posted to the revenue account. The adjusting entry is between a revenue and a liability account.

Account	**Debit**	**Credit**
Revenue	XXX	
Deferred revenue		XXX

Revenue deferral journal

The deferred revenue journal entry example establishes a liability account in the balance sheet, the liability is sometimes referred to as the unearned revenue account.

Expenses Accrual Journal Entry

The adjusting entry is between an expense and a liability account.

Account	**Debit**	**Credit**
Expense	XXX	
Expense accrual		XXX

Expense accrual journal

The journal entry for accrued expenses establishes a balance sheet liability account.

Expenses Deferral Journal Entry

The original cash entry is to an expense account. The adjusting entry is between an expense and a liability account.

Account	**Debit**	**Credit**
Expense deferred	XXX	
Expense		XXX

Expense deferral journal

The deferred expenditure journal entry establishes an asset account in the balance sheet.

Deferred or Prepaid Expenses

It should be noted that in relation to expenses the term deferral is often used interchangeably with the term prepayment. Generally, a deferred expense is one which has been paid more than a one year in advance and is shown as a long term asset in the balance sheet, whereas a prepaid expense or prepayment is an expense which has been paid less than one year in advance and is therefore shown as a current asset in the balance sheet.

UNIT- 3Current Assets and Current Liabilities (per US GAAP and IFRS)

What are Cash and Cash Equivalents?

Cash and cash equivalents is a line item on the balance sheet, stating the amount of all cash or other assets that are readily convertible into cash. Any items falling within this definition are classified within the current assets category in the balance sheet. The two primary criteria for classification as a cash equivalent are that an asset be readily convertible into a known amount of cash, and that it be so near its maturity date that there is an insignificant risk of changes in value due to changes in interest rates by the time the maturity date arrives. If there is any question about whether a financial instrument can be classified as a cash equivalent, consult with the company's auditors.

Cash and cash equivalents information is sometimes used by analysts in comparison to a company's current liabilities to estimate its ability to pay its bills in the short term. However, such an analysis may be excessively conservative if there are receivables that can be readily converted into cash within a few days; in this case, receivables should also be included in the analysis.

Types of Cash and Cash Equivalents

Examples of cash are as follows:

- Coins
- Currency
- Cash in checking accounts
- Cash in savings accounts
- Bank drafts
- Money orders
- Petty cash

Examples of cash equivalents are as follows:

- Commercial paper
- Marketable securities
- Money market funds
- Short-term government bonds
- Treasury bills

Definition of Cash and Cash Equivalents

Cash and cash equivalents are those items which are recorded in the balance sheet of the company and refers to the value of the assets of the company which are held in cash or can be easily convertible to cash i.e. bank accounts and marketable securities like debt securities where the maturity date is less than 90 days, treasury bills, commercial papers and short term government bond.

Explanation of Cash and Cash Equivalent

Cash and cash equivalent offer a high level of liquidity to the company. They are generally a part of the balance sheet of a company and refers to the value of the asset of the company which is either held in cash or near to cash equivalent like short term bonds, treasury bills, commercial papers, etc. which have maturity date for a small period of time which is generally less than three months or 90 days' time. Marketable securities and money market holdings are equivalent of cash because they are highly liquid and are not exposed to material deviations in value. A company with a healthy sum of cash and cash equivalent in its balance sheet is generally considered efficient enough or capable enough to meet its short-term obligations. Cash equivalents are generally denoted for those assets whose maturity time is less than three months or 90 days.

Types of Cash and Cash Equivalents

The different types of cash and cash equivalents are as follows:

- **Bank Account:** Cash stored in the bank account is the best example for this discussion because it is one of the most liquid assets for the company and can be a lot of help for the company to repay back its short-term obligations. It is defined as money in the form of currency, coins, and notes. A demand deposit plays a rile here which is defined as a kind of account from where fund can be withdrawn at any point in time without informing the business.
- **Foreign Currency:** Companies which have a lot of forex transaction may face certain exchange risk and thus it is better to convert the currency to the reporting currency for the purpose of financial reporting. The gains made in the mode of conversion can also be considered as cash or cash equivalent but any kind of loses made in the mode of conversion are reported as "accumulated other comprehensive income".
- **Cash Equivalents:** These are an investment made that can be easily converted to cash and must be of the short term usually with a maturity period of not more than three months or 90 days. They must be of the highest liquidity in nature and should be easily sold in the market. The buyers of such an asset class must be easy to access. Certificate of deposit can be considered as cash equivalent provided the maturity date is less than 90 days. Preferred shares of equity can also be considered as an example of a cash equivalent. Treasury bill, commercial papers, and short-term bonds are also an example of a cash equivalent.

Example of Cash and Cash Equivalents

Example of cash and cash equivalents are given below:

- **Cash:** Cash in the form of currency notes, coins and bills are considered the highest level of liquid asset
- **Certificate of Deposit**: Certificate of deposits with a maturity period less than 90 days are also an example of cash and cash equivalent.
- **Commercial Papers:** Commercial papers issued by corporates are also considered as a cash equivalent.
- **Treasury Bills:** Treasury bill which is a government back up security can be also considered to have a high level of liquidity.
- **Short Term Bonds**: Bonds having a maturity period of less than 90 days are an example of a cash equivalent.

Cash and Cash Equivalents Note to Financial Statement

Cash and cash equivalent are generally recorded in the balance sheet of a company under the current asset section with the same name as cash and cash equivalent and only the overall value is shown. The break up of the overall sum is provided by a note at the end of the financial statement. The cash and cash equivalent will generally bear a number beside its total, which generally describes the serial number in the notes section to understand the break up of the cash and cash equivalent.

As we see serial number 18 means in the balance sheet the cash and cash equivalent total was mentioned with serial number 18 against it which act as a reference to the user to refer to the notes section serial number 18 to understand the breakup.

Advantages

Some of the advantages are as follows:

- It offers the highest level of liquidity available to the management of the company
- It can be used to repay the short-term obligations and other minor operating expenses as and when it is needed.
- A company with a healthy balance of cash and cash equivalent is perceived to perform well and manage its resources.
- During mergers and acquisitions, this component plays a major role in the valuation of the company.
- It helps in borrowing as the lender will look at the cash and cash equivalent portion of the company to take it as a sort of commitment by the company.
- The extra cash be used as a form of a dividend to be issued to the shareholders.

Disadvantages

Some of the disadvantages are as follows:

- The company may tend to misuse this excess balance in the wrong way and end up utilizing the entire balance.
- Too much of cash may also resemble that company is not paying dividends to its shareholders and instead of retaining back the money.

- Retaining cash and cash equivalents doesn't fetch a good interest rate so ideally it means that the investment there is reaping a kind of loss which if invested in some other instrument may have given more returns.
- In business handling, a lot of cash in foreign exchange may eventually lead to an exchange loss while converting it to the reporting currency.

Conclusion

Cash and cash equivalent are an important component of a balance sheet and resembles the financial health of a company. It can be used to pay off short term obligation very easily without any kind of borrowing needed. It is also an important component for the shareholders because this can also be used to pay back dividends to the shareholders.

Definition of accounts receivables

Accounts receivable refers to the amount that a company is entitled to receive from its customers for goods or services sold on credit. In other words, it is the amount that your customer owes you in respect of contractual obligations.

Accounts receivables are also known as debtor, trade debtors, bills receivable or trade receivables.

Accounts receivables examples

On 1st June, 2020, Max Enterprises sold goods worth 75,000 to National Traders with a credit period of 15 days. From 1st June to the date the bill is paid, 75,000 will be treated as accounts receivables against National Traders account.

Let's say, on 10th National Traders paid 50,000 to Max Enterprises. This will be reduced from National trader's account. Post adjustment, the overall accounts receivable will be 25,000.

Likewise, when you sell on credit to different customers, it will be added to the overall accounts receivable and when you receive from the customers, it will be reduced.

How to record accounts receivables in the books of account?

The following are journal entry to account and adjust the accounts receivables in the books of account

When a sale is made on credit

Dr National Traders a/c (Customer)	75,000	
Cr Sales a/c		75,000

When a sale bill is paid

Dr Bank/Cash a/c 75,000

Cr National Traders a/c 75,000

Treatment of accounts receivables in financial statement

As you know, accounts receivable is the amount that is yet to be received from your customers within a defined period, usually a short period, thus it is treated as current assets. As on the date of creating financial statements, the total accounts receivables are shown under the current asset section of the balance sheet as bills receivables, sundry debtors, trade receivables etc.

The sample format of accounts receivables in the balance sheet is shown below:

Max Electronics
A 204,Shivaji Nagar, Bengaluru
Contact : 9810123456
www.maxelectronics.com

Balance Sheet
1-Apr-2019 to 17-Mar-2020

Liabilities	as at 17-Mar-2020		Assets	as at 17-Mar-2020	
Capital Account		**20,00,000.00**	**Fixed Assets**		**3,50,000.00**
Capital	*20,00,000.00*		*Office Computers*	*1,50,000.00*	
			Office Furnitures	*2,00,000.00*	
Loans (Liability)					
			Current Assets		**65,61,747.72**
Current Liabilities		**34,73,864.00**	*Closing Stock*	*12,42,976.72*	
Duties & Taxes	*3,16,560.00*		Sundry Debtors	*45,67,140.00*	
Sundry Creditors	*31,57,304.00*		Cash-in-Hand	*28,880.00*	
			Bank Accounts	*7,22,751.00*	
Profit & Loss A/c		**14,37,883.72**			
Opening Balance	*1,97,000.00*				
Current Period	*12,40,883.72*				
Total		**69,11,747.72**	**Total**		**69,11,747.72**

Accounts receivables process

While the process of accounts receivables differs from business to business, we have listed common things that you will get to see in accounts' receivables process followed by most businesses.

- Invoicing the customer on credit as per the credit policy
- Capturing or recording the credit days or due date
- Follow-up and collection schedule
- Generating the overdue bills and the ones that are pending from the longer time
- Sending reminder letter with the details of bills that are pending
- On receiving payment, account the receipt and adjust the receivables accordingly.
- If there are any cash discount for early payment, the relevant adjustment to receivables account needs to be made.

Costs of accounts receivables

- The company requires additional funds as cash is blocked in receivables which involves a cost in the form of interest (loan funds) or opportunity cost (own funds)
- Administrative costs such as record keeping, sending reminder letters etc.
- Collection costs
- Defaulting costs as a result of bad debts

Importance of accounts receivables

Management of receivables refers to planning and controlling of debt owed to the customer on account of credit sales. In simple words, the successful closure of your order to sales is determined only when you convert your sales into cash. Till your sales are converted into cash, you need to manage 'how much you need to receive? from whom? And when?

To do this, you need accounts receivables management, popularly known as a credit management system in place.

Another reason, accounts receivables are one of the key sources of cash inflow and given the volume of credit sales, a large amount of money gets tied-up in accounts receivables. This simply implies that so much of money is not available till it is paid. If these are not managed efficiently, it has a direct impact on the working capital of the business and potentially hampers the growth of the business.

Take a look at 6 tips to manage accounts receivables efficiently

On the other side, managing accounts receivables efficiently will benefit the business in several ways. The most important being the increased cash inflow by faster realization of sales to cash. It also helps you to build a better relationship with your customer by not having the discrepancies in pending bills and mitigates the risk of bad debts. All these require you to be top of your account's receivables and you can easily achieve this by using accounting software. It helps you track, monitor and on-time action on overdue/long-pending bills resulting in increased inflow of cash that is essential for business growth.

When you own a business, you would like to think that every customer who owes you money will pay in full. In reality, though, a certain percentage of customers will likely default on their obligations. Recognizing this, the financial accounting standards known as GAAP — generally accepted accounting principles — include procedures for estimating, reporting and eventually writing off bad debts.

Accounts Receivable

When customers owe your business money, that debt is listed on your balance sheet as an asset, called accounts receivable, or "A/R." Under GAAP, you must evaluate your outstanding

accounts receivable from time to time — say, once a year or once a quarter — and come up with an estimate of how much of the total you think you probably won't be able to collect. Companies make their estimate based on past experience.

Bad Debt Expense

Under GAAP, when you make sales to customers, you immediately recognize the revenue on your income statement — even when the customers don't pay immediately. When you are unable to collect on customers' accounts, you have to report an expense to offset the revenue you reported at the time of the sale. This is known as a "bad debt expense." But here's where it gets tricky: You don't wait for accounts to go bad before reporting an expense. Rather, you report an expense based on the estimate you arrived at when you analyzed your accounts receivable. Say you have $50,000 in A/R, and your analysis suggests that $1,500 will not be collectible. GAAP requires you to report that $1,500 bad debt expense immediately. You don't know which particular accounts will go bad — but you know that some will, and GAAP insists that your financial statements reflect that.

Allowance for Doubtful Accounts

Paired with the accounts receivable in a typical company's books is a special account called the "allowance for doubtful accounts" or "allowance for uncollectible accounts." This is a "contra asset," meaning it offsets the balance in another asset account -- in this case A/R. The amount you report as a bad debt expense goes into this allowance. Continuing with the example, you would have an accounts receivable balance of $50,000 with an allowance of $1,500. Under GAAP, your balance sheet should report A/R "net of allowance." So your balance sheet would show net accounts receivable of $48,500.

Write-Offs

At some point, you will actually deem an account uncollectible. When that happens, you "write off" the account. Say you decide that a specific $100 debt is uncollectible. First, you decrease your accounts receivable by $100. You also decrease the allowance for doubtful accounts by $100. So in the example, your accounts receivable balance would fall to $49,900, while the allowance would drop to $1,400. Note, however, that your net accounts receivable remains the same: $49,900 - $1,400 = $48,500. This write-off takes place only on the balance sheet. You've already reported the bad debt expense, so there's no impact on the income statement.

Adjustments

If there's still money "left over" in the doubtful-accounts allowance the next time you review A/R, you may be able to report a smaller bad debt expense. For example, say the allowance has $500 left in it when you conduct your regular review. If you determine that $1,300 of your accounts are uncollectible, you only need to report an $800 bad debt expense, which gets the allowance back up to the necessary $1,300. On the other hand, if your allowance runs out faster than expected between reviews and you need to write off more bad debt, you'll need to replenish the allowance by taking an additional bad debt expense immediately.

Most businesses sell to their customers on credit. That is, they deliver the goods and services immediately, send an invoice, then get paid a few weeks later. Businesses keep track of all the money their customers owe them using an account in their books called **accounts receivable**.

Here we'll go over how accounts receivable works, how it's different from accounts payable, and how managing your accounts receivable correctly can get you paid faster.

What is accounts receivable?

Accounts receivable is any money your customers owe you for goods or services they purchased from you in the past. This money is typically collected after a few weeks, and is recorded as an asset on your company's balance sheet. You use accounts receivable as part of accrual basis accounting.

Where do I find accounts receivable?

You can find accounts receivable under the 'current assets' section on your balance sheet or chart of accounts. Accounts receivable are classified as an asset because they provide value to your company. (In this case, in the form of a future cash payment.)

What's the difference between accounts receivable and accounts payable?

Accounts receivable are an asset account, representing money that your customers owe you.

Accounts payable on the other hand are a **liability** account, representing money that you owe another business.

Let's say you send your friend Keith's business, Keith's Furniture Inc., an invoice for $500 in exchange for a logo you designed for them.

When Keith gets your invoice, he'll record it as an **accounts payable** in his books, because it's money he has to pay someone else.

You'll record it as an **account receivable** on your end, because it represents money you will *receive* from someone else.

Does accounts receivable count as revenue?

Accounts receivable is an asset account, not a revenue account. However, under accrual accounting, you record revenue at the same time that you record an account receivable.

For the example above, you'd make the following entry in your books the moment you invoice Keith's Furniture:

Account	Debit	Credit
Accounts Receivable—Keith's Furniture Inc.	$500	-
Revenue	-	$500

(If you want to understand why we're making *two* entries to record one transaction here, check out our guide to double-entry accounting.)

But remember: under cash basis accounting, there are no accounts receivable. Under that system, a transaction doesn't count as a sale until the money hits your bank account.Learn More

What is the "allowance for uncollectible accounts" account?

If you do business long enough, you'll eventually come across clients who pay late, or not at all. When a client doesn't pay and we can't collect their receivables, we call that a **bad debt**.

Businesses that have been around for a while will often estimate their total bad debts ahead of time to make sure the accounts receivable shown on their financial statements aren't unrealistically high. They'll do this by setting up something called an "allowance for uncollectible accounts."

Let's say your total sales for the year are expected to be $120,000, and you've found that in a typical year, you won't collect 5% of accounts receivable.

To estimate your bad debts for the year, you could multiply total sales by 5% ($120,000 * 0.05). You'd then credit the resulting amount ($6,000) to "allowance for uncollectible accounts," and debit "bad debt expense" by the same amount:

Account	Debit	Credit
Bad debt expense	$6,000	-
Allowance for uncollectible accounts	-	$6,000

What happens if my clients don't pay?

When it's clear that an account receivable won't get paid, we have to write it off as a **bad debt expense.**

For example, let's say that after a few months of waiting, calling him on his cellphone and talking to his family members, it becomes clear that Keith has disappeared and isn't going to pay that $500 invoice you sent him.

In this case, you'd debit "allowance for uncollectible accounts" for $500, to decrease it by $500.

Why?

Remember that the allowance for uncollectible accounts account is just an estimate of how much you won't collect from your customers. Once it becomes clear that a specific customer won't pay, there's no longer any ambiguity about who won't pay.

Once you're done adjusting uncollectible accounts, you'd then credit "accounts receivable—Keith's Furniture Inc." by $500, also decreasing it by $500. Because we've decided that the invoice you sent Keith is uncollectible, he no longer owes you that $500.

So the resulting journal entry would be:

Account	Debit	Credit
Allowance for uncollectible accounts	$500	-
Accounts Receivable—Keith's Furniture Inc.	-	$500

What if they end up paying me after all?

Let's say a few more months pass and a mysterious envelope with no return address appears in your mailbox. It's a cheque from Keith's Furniture Inc. for $500—he ended up paying you after all!

To record this transaction, you'd first debit "accounts receivable—Keith's Furniture Inc." by $500 again to get the receivable back on your books, and credit revenue by $500.

Account	Debit	Credit
Accounts Receivable—Keith's Furniture Inc.	$500	-
Revenue	-	$500

Finally, to record the cash payment, you'd debit your "cash" account by $500, and credit "accounts receivable—Keith's Furniture Inc." by $500 again to close it out once and for all.

Account	Debit	Credit

Account	Debit	Credit
Cash	$500	-
Accounts Receivable—Keith's Furniture Inc.	-	$500

Why is accounts receivable important?

Having lots of customers is great. But if some of them are paying you late, or aren't paying at all, selling to them could be hurting your business. Late payments from customers are one of the top reasons why companies get into cash flow problems.

One of the best ways to keep track of late payments and make sure they aren't getting out of hand is to calculate the **accounts receivable turnover ratio** for your business.

What is the accounts receivable turnover ratio?

The accounts receivable turnover ratio is a simple financial calculation that shows you how fast your customers are at paying their bills.

We calculate it by dividing total **net sales** by **average accounts receivable**.

Let's use a fictional company XYZ Inc.'s financials for the year 2018 as an example.

Let's say that at the beginning of 2018 (Jan 1), XYZ Inc. had total accounts receivable of $2,500. Let's also say that at the end of 2018 (Dec 31) its total accounts receivable was $1,500. It also had total net sales of exactly $60,000 for 2018.

To get the **average accounts receivable** for XYZ Inc. for that year, we add the beginning and ending accounts receivable amounts and divide them by two:

$2,500 + $1,500 / 2 = **$2,000**

To calculate the accounts receivable turnover ratio, we then divide net sales ($60,000) by average accounts receivable ($2,000):

$60,000 / $2,000 = **30**

This means XYZ Inc. has an accounts receivable turnover ratio of 30. The higher this ratio is, the faster your customers are paying you.

Thirty is a *really* good accounts receivable turnover ratio. For comparison, in the fourth quarter of 2018 Apple Inc. had a turnover ratio of 15.02.

To calculate the **average sales credit period**—the average time that it takes for your customers to pay you—we divide 52 (the number of weeks in one year) by the accounts receivable turnover ratio (30):

52 weeks / 30 = **1.73 weeks**

This means that in 2018, it tooks XYZ Inc.'s customers an average of 1.73 weeks to pay their bills. Pretty good!

What is an accounts receivable aging schedule?

If you have many different customers, keeping track of exactly who's behind on which payments can get tricky. Some businesses will create an **accounts receivable aging schedule** to solve this problem.

Here's an example accounts receivable aging schedule for the fictional company XYZ Inc.

Accounts Receivable Aging Schedule

XYZ Inc., as of July 22, 2019

Customer Name	1-30 days	30-60 days	60+ days	Total
Keith's Furniture Inc.	$500	$1,000	$500	$2,000
Joe's Fencing	$500	$100	$100	$700
ABC Paint Supply	$1,000	$200	$0	$1,200
Learner Farms	$1,000	$0	$100	$1,100
Nina's Pizza	$2,000	$50	$0	$2,050
Total	$5,000	$1,350	$700	$7,050

A quick glance at this schedule can tell us who's on track to pay within 30 days, who's behind schedule, and who's *really* behind.

For example, you can immediately see that Keith's Furniture Inc. is having problems paying its bills on time. You might want to give them a call and talk to them about getting their payments back on track.

What can I do to make people pay faster?

Following up with late-paying customers can be stressful and time-consuming, but tackling the problem early can save you loads of trouble down the road. Here's what you can do to encourage customers to pay you on time.

Develop a crystal-clear credit policy

When you're starved for sales, it can be tempting to loosen up the rules you have in place for extending credit to your customers (also known as your **credit policy**). Don't. This is a short-term fix, usually causes more problems than it solves, and can take your company down a slippery slope.

Instead, develop crystal-clear guidelines for when you can and cannot extend credit to your customers, and don't hesitate to enforce them, even if it means turning down a few people in the short-term.

Vet new customers, ask for up front deposits on large orders, and institute interest payments for late payments. When a new customer signs up and sees these terms, they'll understand from the get-go you're serious about getting paid.

Give them a financial incentive

One way to get people to pay you sooner is to make it worth their while. Offering them a discount for paying their invoices early—2% off if you pay within 15 days, for example—can get you paid faster and decrease your customer's costs.

Call them and schedule regular reminders

Often times, simply getting on the phone with a client and reminding them about a late payment can be enough to get them to pay. Sending email reminders at regular intervals—say, after 15, 30, 45 and 60 days—can also help jog your customers' memory.

What if they don't pay?

Let's say you've done all of the above and you still haven't received your money. What now?

Cut late-paying customers off

Many companies will stop delivering services or goods to a customer if they have bills that are more than 120, 90, or even 60 days due. Cutting a customer off in this way can send a signal that you're serious about getting paid, and that you won't do business with people who break the rules.

Convert their account receivable into a long-term note

If you have a good relationship with the late-paying customer, you might consider converting their account receivable into a long-term note. In this situation, you replace the account

receivable on your books with a loan that is due in more than 12 months, and which you charge the customer interest for.

Hire a collection agency

If you can't contact your customer and are convinced you've done everything you can to collect, you can hire someone else to do it for you.

Before deciding whether or not to hire a collector, contact the customer and give them one last chance to make their payment. Collection agencies often take a huge cut of the collectable amount—sometimes as much as 50 percent—and are usually only worth hiring to recover large unpaid bills. Coming to some kind of agreement with the customer is almost always the less time-consuming, less expensive option.

Learn More

When to call something 'bad debt'

If the costs of collecting the debt start approaching the total value of the debt itself, it might be time to start thinking about writing the debt off as bad debt—that is, debt that is no longer of value to you. Bad debt can also result from a customer going bankrupt and being financially incapable of paying back their debts.

The IRS says that bad debts include "loans to clients and suppliers," "credit sales to customers," and "business loan guarantees," and that a business "deducts its bad debts, in full or in part, from gross income when figuring its taxable income."

The IRS's Business Expenses guide provides detailed information about which kinds of bad debt you can write off on your taxes.

Notes Receivable

Notes Receivable Definition

A note receivable is a written promise to receive a specific amount of cash from another party on one or more future dates. This is treated as an asset by the holder of the note. Overdue accounts receivable are sometimes converted into notes receivable, thereby giving the debtor more time to pay, while also sometimes including a personal guarantee by the owner of the debtor.

Notes Receivable Terms

The payee is the party who receives payment under the terms of the note, and the maker is the party obligated to send funds to the payee. The amount of payment to be made, as listed

in the terms of the note, is the principal. The principal is to be paid on the maturity date of the note.

A note receivable usually includes a specific interest rate, or a rate which is tied to another interest rate, such as a bank's prime rate. The calculation of the interest earned on a note receivable is:

Principal x Interest rate x Time period = Interest earned

If an entity has a large number of notes receivable outstanding, it should consider setting up an allowance for doubtful notes receivable, in which it can accrue a bad debt balance that it can use to write off any notes receivable that later become uncollectible. An uncollectible note receivable is said to be a dishonored note.

Example of Notes Receivable Accounting

For example, Aruba Bungee Cords (ABC) sells a number of bungee cords to Arizona Highfliers for $15,000, with payment due in 30 days. After 60 days of nonpayment, the two parties agree that Arizona will issue a note payable to ABC for $15,000, at an interest rate of 10%, and with payment of $5,000 due at the end of each of the next three months. The initial entry to convert the account receivable to a note receivable is:

	Debit	Credit
Notes receivable	15,000	
Accounts receivable		15,000

At the end of the month, Arizona pays $5,000 under the terms of the note, as well as interest, which is calculated as $15,000 x 10% x 30 days/365 days = $123. The entry is:

	Debit	Credit
Cash	5,123	
Notes receivable		5,000
Interest income		123

At the end of the second month, Arizona pays another $5,000 under the terms of the note, as well as interest, which is calculated as $10,000 x 10% x 30 days/365 days = $82. The amount of interest has declined, since it is based on the remaining amount of principal outstanding, which was only $10,000 during the month. The entry is:

	Debit	Credit
Cash	5,082	
Notes receivable		5,000
Interest income		82

At the end of the third and final month, Arizona pays the last $5,000 increment under the terms of the note, as well as interest, which is calculated as $5,000 x 10% x 30 days/365 days = $41. The entry is:

	Debit	Credit
Cash	5,041	
Notes receivable		5,000
Interest income		41

The note has now been completely paid off, and ABC has recorded a total of $246 in interest income over a three-month period.

What if Arizona had instead agreed to pay all of the interest income on the maturity date of the note, which in the example is in 90 days? Then ABC accrues the interest in each of the three months of the note. For example, it would have made this entry at the end of the first month:

	Debit	Credit

Interest receivable	123	
Interest income		123

By the maturity date of the note, ABC would have accrued a total of $246 in interest income. When Arizona pays the interest on the maturity date, ABC's entry to record the transaction would be:

	Debit	Credit
Cash	246	
Interest receivable		246

If Arizona had been unable to pay the final installment of $5,000 and the related interest payment of $41, and ABC had been accruing the interest income, then ABC would have to write off the remaining note balance, as well as the related interest income. It could do so with the following entry:

	Debit	Credit
Allowance for doubtful accounts	5,041	
Notes receivable		5,000
Interest receivable		41

Classification of Notes Receivable

You should classify a note receivable in the balance sheet as a current asset if it is due within 12 months or as non-current (i.e., long-term) if it is due in more than 12 months. If a note has a duration of longer than one year, and the maker does not pay interest on the note during the first year, it is customary to add the unpaid interest to the beginning principal balance in the second year, and use that as the basis upon which to calculate interest in the second year.

For example, the maker owes $200,000 to the payee at a 10% interest rate, and pays no interest during the first year. The interest earned by the payee in the first year is $20,000, which is rolled into the $200,000 principal balance at the beginning of the second year; consequently, the interest earned in the second year of $22,000 is higher than in the first year, because the calculation is based on an increased principal balance of $220,000.

A company's auditors will examine the classification of notes receivable from the most conservative perspective, and so will insist on their classification as short-term if there are reasonable grounds for doing so.

Terms Similar to Notes Receivable

Notes receivable are also known as promissory notes receivable.

Both U.S. GAAP and IFRS have complex rules on whether a transfer of a financial asset is actually a sale or whether it in essence is a secured borrowing. This issue arises because often the transferrer of a financial asset will transfer only a portion of a financial asset or will continue to remain involved even after transferring a financial asset in its entirety. There are strict rules on when a transferor can treat the partial transfer of a financial asset as a sale. There are also numerous rules on what type of continuing involvement a transferor may have with a transferred financial asset and still have the transfer qualify as a sale. This Portfolio explains the rules for characterizing transfers as either sales or secured borrowings.
If a transaction is a sale, the transferor derecognizes the asset and reports any resulting gain or loss. Special rules exist on computing the gain or loss when the transferor transfers only a portion of a financial asset. There also are special rules for recognizing a transfer that is characterized as a secured borrowing. This Portfolio explains the rules on accounting for both sale and secured borrowing transactions.
Lastly, this Portfolio explains how to account for servicing rights. Often, when selling a financial asset that is a debt obligation, the transferor will retain the rights to service the asset and will receive servicing fees in return. The transferor must determine whether the servicing rights constitute a servicing asset (because the fees will more than adequately compensate it for servicing the financial asset) or a servicing liability (because the fees will not adequately compensate it).
This Portfolio may be cited as Bloomberg BNA Tax and Accounting Portfolio No. 5184, Rood, *Transfers and Servicing of Financial Assets* (Accounting Policy and Practice Series).

Accounting for transfers in which the transferor has no continuing involvement with the transferred financial assets or with the transferee has not been controversial. However, transfers of financial assets often occur in which the transferor has some continuing involvement either with the assets transferred or with the transferee. Examples of continuing involvement with the transferred financial assets include, but are not limited to, any of the following:
a. Servicing arrangements

aa. Recourse arrangements

aaa. Guarantee arrangements

b. [Subparagraph superseded]

c. Agreements to purchase or redeem transferred financial assets

d. Options written or held

dd. Derivative financial instruments that are entered into contemporaneously with, or in contemplation of, the transfer

ddd. Arrangements to provide financial support

e. Pledges of collateral

f. The transferor's beneficial interests in the transferred financial assets.

Transfers of financial assets with continuing involvement raise issues about the circumstances under which the transfers should be considered as sales of all or part of the assets or as secured borrowings and about how transferors and transferees should account for sales and secured borrowings. This Topic establishes standards for resolving those issues.

Sales and other transfers may result in a disaggregation of financial assets and liabilities into components, which become separate assets and liabilities. This Subtopic provides guidance on accounting for such transfers and provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

Transfers of financial assets take many forms. This guidance provides an overview of the following types of transfers discussed in this Topic:

a. Securitizations
b. Factoring
c. Transfers of receivables with recourse
d. Securities lending transactions
e. Repurchase agreements
f. Loan participations
g. Banker's acceptances.

860-20 Sales of Financial Assets

ASC 860-20 notes that it "provides guidance on the accounting for a transfer of financial assets that satisfies the conditions for sale accounting in paragraph 860-10-40-5 and the accounting if a transferor regains control of assets previously sold."

860-30 Secured Borrowing and Collateral

ASC 860-30 notes the following:
This Subtopic provides guidance on transactions that are accounted for as secured borrowings with a transfer of collateral.

A debtor (obligor) may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the obligor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party.

If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings.

860-40 Transfers to Qualifying Special Purpose Entities

ASC 860-40 was superseded by ASU 2009-16, *Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets* (originally issued as FASB Statement No. 166), which removed the concept of a qualifying special-purpose entity.

860-50 Servicing Assets and Liabilities

ASC 860-50 notes the following:
This Subtopic provides accounting guidance for servicing assets and servicing liabilities.

Servicing of mortgage loans, credit card receivables, or other financial assets commonly includes, but is not limited to, the following activities:

a. Collecting principal, interest, and escrow payments from borrowers
b. Paying taxes and insurance from escrowed funds
c. Monitoring delinquencies
d. Executing foreclosure if necessary
e. Temporarily investing funds pending distribution
f. Remitting fees to guarantors, trustees, and others providing services
g. Accounting for and remitting principal and interest payments to the holders of beneficial interests or participating interests in the financial assets.

A servicer of financial assets commonly receives the following benefits of servicing:

a. Revenues from contractually specified servicing fees
b. A portion of the interest from the financial assets
c. Late charges
d. Other ancillary sources, including float.

A servicer is entitled to receive all of those benefits of servicing only if it performs the servicing and incurs the costs of servicing the financial assets.

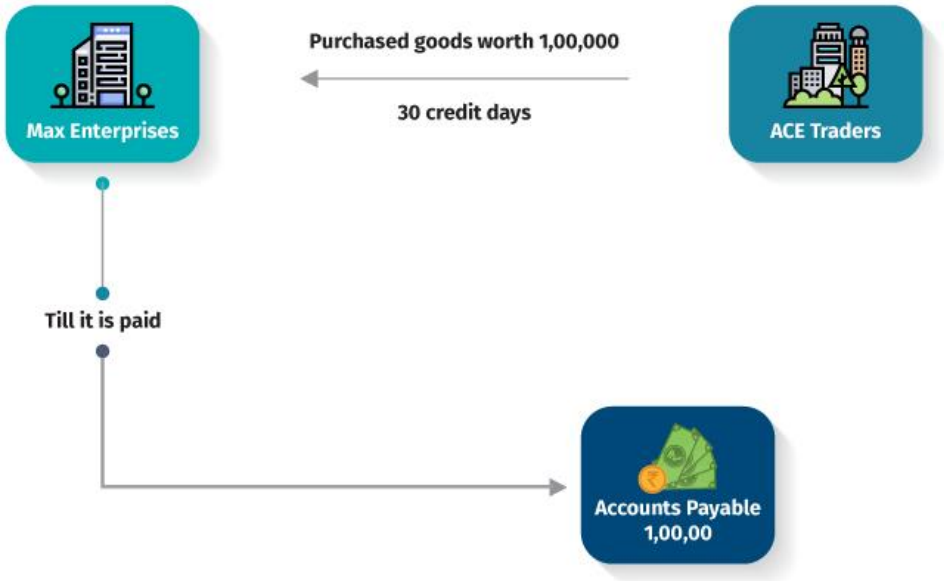
Accounts payable is any sum of money owed by a business to its suppliers shown as a liability on a company's balance sheet. In simple words, when you buy goods or services with an arrangement to pay at a later date, such amount till it is paid is referred to as accounts payable.

Accounts payable is also called as bills payable and the total amount that a company is liable to pay is shown as liability under the head ‘sundry creditor’ in the balance sheet.

Accounting solutions to help you manage your business just the way you want.

Example of accounts payable

Max Enterprises purchased goods worth 1,00,000 from Ace Traders. Ace Traders offered a credit period of 30 days within which the bill should be paid by Max Enterprises**.**



Here, till the date Max Enterprises pays Ace Traders, the amount of 1,00,000 will be called as accounts payables and shown as liability towards creditors in the balance sheet.

Importance of accounts payable

Any business, whether manufacturing or trading, need to procure the goods or services from their suppliers and most times, you will be offered to pay on a later date. This results in a major source of cash outflows towards the trade payable and therefore businesses must manage it efficiently.

While accounts payable are short-term liabilities that need to be honoured within a specific date, any delayed payment will attract additional charges in the form of interest and later payment charges. Also, delayed payment may create ill-feeling and impacts the credibility of the business which in turn leads to disruption of the supplies.

Accounts payables involve a carrying cost, not just the additional charges for delayed payments but also the other form of cost. Find out by reading ‘Cost of Accounts Payables’

Accounts payable process

An accounts payable process has many moving parts, potentially manual process steps, and multiple people across the organization involved.

The accounts payable process starts right after you have decided to procure the goods or services on a credit basis. The following is the accounts payable process that you get to see in most of the business

- Evaluating the credit policy of the supplier in terms of credit days allowed, delayed payment charges, cash discount on early payment etc.
- Finalize the supplier and procure the goods in accordance with the procurement process followed by your business
- Once the goods are received, account the invoice in the books
- Need to pay special attention to record the due date within which the bills need to be paid
- Track the bills that are nearing the due date and plan to clear. Accounts payables and the ageing report will be of great help here.
- Account the payments made in the books and it will good practice to keep a track the invoices against which the payments are honoured
- Send the acknowledgements such as payment advice or any other statement to inform the supplier about the payment that is made.

Taking full advantage of the credit days will help you to manage the cash flow efficiently. While it is easy but not tracking and knowing when to honour bills will prove to be a disadvantage to the business.

6 Tips for Efficient Cash Flow Management

Employee-related expenses means, with respect to employees of Sellers or their Affiliates performing the projects currently anticipated to occur in 2017 as reflected on the Facilities Capital Expenditures Plan, the actual cost (salary or wage, plus portion of budgeted bonus accrued) of such employees, and the costs of incentives for such employees (other than cash bonuses), benefits and allowances, vacation and holiday pay, sick leave, employer's portion of such employees' insurance, social security retirement and medical benefits, withholding (including social security), employment and unemployment Taxes, worker's compensation and employer's liability insurance, any other insurance premiums measured by such costs, and other employee contributions and benefits from time to time imposed by applicable Law.
What are the main types of benefits and expenses?
Employee benefits range from gym memberships to bonuses. Some of the most common types of benefits and expenses include:

- pension and retirement benefits schemes
- company cars and fuel
- medical insurance
- travel expenses

- food and entertainment expenses
- childcare costs

For a full list of benefits, see the government website.

What are the tax implications of employee benefits?
The amount of tax which must be paid depends on the expense or benefit; some are tax free (eg mobile phones and meals in a staff canteen). In general, employers are responsible for reporting and paying taxes on employee benefits as part of PAYE (see below).

Read the government's guidance to find out what has to be paid on the different types of expenses and benefits.

How should these be reported and paid?
Businesses which have registered with HMRC before the start of the tax year can pay taxes on benefits and expenses through the payroll.

A P11D form must be submitted to HMRC at the end of the tax year for each employee who has received expenses or benefits - unless this is being dealt with entirely through the payroll.

Additionally, a P11D(b) form may be required if:

- a P11D form has already been submitted
- the employees' expenses or benefits have been paid through payroll
- HMRC have requested this.

P11D(b) forms deal with any Class 1A National Insurance which is required in relation to expenses and benefits. If no Class 1A National Insurance is owed (eg HMRC has asked you to provide form P11D(b)), a declaration needs to be completed stating that you do not owe Class 1A National insurance.

A penalty of £100 per 50 employees will be charged for each month of part month that a P11D(b) form is late. Penalties and interest will also be charged on late payments to HMRC.

What are the deadlines?
PAYE tax and Class 1 National Insurance owed on expenses or benefits must be paid through the payroll every month. Other deadlines are:

- **6 July** - submission of P11D and P11D(b) forms (as well as providing employees with a copy of this information)
- **22 July** - payment of any Class 1A National Insurance owed on expenses or benefits
- **22 October** - payment of tax and Class 1B National Insurance in respect of PAYE Settlement Agreements

What records must be kept?
HMRC may ask to see evidence of all accounting in respect of employee benefits and expenses, so meticulous records should be kept, including:

- dates and details of all expenses and benefits provided
- full information required to calculate amounts
- any payments contributed by employees to expenses and benefits
- any correspondence with HMRC

Records should be kept for at least three years from the end of the tax year to which they relate.

Are there any exemptions?
There are certain routine employee expenses which do not need to be reported to HMRC. These exemptions include:

- business travel
- phone bills
- business entertainment expenses
- uniforms and tools for work

In order to qualify for these exemptions, employers must either be:

- paying a flat rate to their employees as part of their earnings (see the government's guidance for details of this flat rate)
- paying back the employees' actual costs

Determining Inventory & Cost of Goods Sold

Generally Accepted Accounting Principles (GAAP) recognize three different types of inventory: raw materials, work-in-process and finished goods. Not every type of business carries all three types of inventory; retailers, for example, generally deal solely with finished-goods inventory, while manufacturers most often carry all three. The process of determining the value of inventory on hand depends on the types of inventory you carry and the inventory-costing method you have chosen.

1. Choose an inventory costing method in the start-up stage of your business, and stick to this method as long as it is feasible. Costing methods influence the way in which accounts recognize cost-of-goods-sold expenses, which in turn affects the value of inventory remaining on hand. Choose among the first-in-first-out, last-in-last-out, weighted average or specific identification methods and recognize costs in a consistent manner to maintain reliable records.

2. Determine the balance of raw-materials inventory if you are in the manufacturing industry. Raw-materials inventory consists of things like steel, wood, silicon and plastic, which will become component parts of finished products. Find the ending balance of raw-materials inventory from the previous period. Add the value of any raw-materials purchases made during the period. Then subtract the value of raw materials used during the period to determine the

value of raw materials on hand. Perform a physical audit of your raw materials, if possible, to check your numbers.

3. Calculate the balance of work-in-process inventory. Work-in-process inventory consists of raw materials on which work has begun but has not yet been completed at the time of your calculation. Calculating work-in-process inventory can be a bit more tricky than the other two types.

First, perform a physical count of units on which work has begun but has not been completed. Consult production managers to determine the completion percentage of each unfinished inventory item. Multiply each unfinished unit by its completion percentage; then add up all of the results to arrive at a number of equivalent units in process. Multiply the number of equivalent units on hand by the value you would assign to finished-goods inventory -- including direct costs and any allocated overhead -- to determine the balance of work-in-process inventory.

4. Determine the amount of finished-goods inventory on hand. As with raw materials, begin with the previous period's ending balance of finished goods. Add the value of finished-goods inventory produced during the period, which should be available in your production-output records. Then subtract the cost of goods sold during the period to determine the value of finished goods remaining.

5. Add the balances of all three inventory types to determine a total inventory value for the period. When presenting inventory data, list each subtotal under this total inventory value.

Determining Cost of Goods Sold

Cost of goods sold (COGS) may be one of the most important accounting terms for business leaders to know. COGS includes all of the direct costs involved in manufacturing products. Understanding COGS, and managing its components, can mean the difference between running a business profitably and spinning on the proverbial hamster wheel to nowhere.

What is Cost of Goods Sold (COGS)?

If revenue represents the total sales of a company’s products and services, then COGS is the accumulated cost of creating or acquiring those products.

COGS is an accounting term with a specific definition under U.S. Generally Accepted Accounting Principles (GAAP) that requires product companies to apply inventory costing principles. That definition provides guidelines for which costs to include and an associated formula for calculating COGS. Most importantly, COGS is a key component of determining two critical business metrics: a company’s gross profit and its gross margin.

Gross profit is obtained by subtracting COGS from revenue, while gross margin is gross profit divided by revenue. The higher a company's COGS, the lower its gross profit. So, COGS is an important concept to grasp.

COGS, sometimes called "cost of sales," is reported on a company's income statement, right beneath the revenue line.

What Is Included in Cost of Goods Sold?

COGS includes all direct costs incurred to create the products a company offers. Most of these are the variable costs of making the product—for example, materials and labor—while others can be fixed costs, such as factory overhead.

A good litmus test to determine whether something should be included in COGS is to ask: Would the cost exist if no products were produced? If the answer is no, then the cost is likely included in COGS.

Examples of costs generally considered COGS include:

- Raw materials
- Items purchased for resale
- Freight-in costs
- Purchase returns and allowances
- Trade or cash discounts
- Factory labor
- Parts used in production
- Storage costs
- Factory overhead

Exclusions From COGS

On the flip side, items that are *excluded* from COGS include selling, general and administrative expenses such as distribution costs to customers, office rents, advertising, accounting and legal fees, and management salaries. Logically, all nonoperating costs, such as interest and capital expenditures, are excluded from COGS, too.

Also excluded from COGS are the costs for products that remain unsold at the end of a given period. Instead, these are reflected in the inventory on hand at the end of the period.

How to Calculate the Cost of Goods Sold (COGS)

Every accountant worth her spreadsheet should be able to rattle off the basic COGS formula in her sleep. On the surface, it's simple, comprising just three variables: beginning inventory,

purchases and ending inventory. However, layers of complexity underlie each component, requiring several steps to determine their value.

Basic COGS Formula
Here's the general formula for calculating cost of goods sold:

(Beginning Inventory + Purchases) – Ending Inventory **= COGS**

4 Steps to Calculate COGS
Diving a level deeper into the COGS formula requires five steps. Typically, these are tackled by accounting and tax experts, often with the help of powerful software. But these four steps are something all managers should have an appreciation for:

1. Identify the beginning inventory of raw materials, then work in process and finished goods, based on the prior year's ending inventory amounts.
2. Determine the cost of purchases of raw materials that were made during the period, taking into account freight in, trade and cash discounts.
3. Determine the ending inventory balance. Typically, it's based on physical cycle counts and is done in accordance with the company's inventory-valuation method of choice.
4. Ensure that any other direct costs of production are included in the valuation of inventory.

COGS and Inventory

As evidenced by the COGS formula, COGS and inventory go hand-in-hand. For this reason, the different methods for identifying and valuing the beginning and ending inventory can have a significant impact on COGS. Most companies do periodic physical counts of inventory to true up inventory quantity on hand at the end of a period. This physical count is a double check on "book" inventory records. It also helps companies identify damaged, obsolete and missing ("shrinkage") inventory.

Once a company knows what inventory it has, leaders determine its value to calculate the final inventory account balance using an accounting method that complies with GAAP.

Companies' beginning inventory for the current period equals their ending inventory for the prior period, and under GAAP, purchases during each year must be recorded using accrual basis accounting.

Periodic physical inventory and valuation are performed to calculate ending inventory.

Choosing an Accounting Method for COGS

There are many different methods for valuing inventory under GAAP. Different accounting methods will yield different inventory values, and these can have a significant impact on COGS and profitability.

Here are three of the most commonly used methods for valuing inventory under GAAP:

First-in-First-Out (FIFO)
The FIFO method assumes that the oldest inventory units are sold first. It's an order-of-production approach. This means that the inventory remaining at the end of an accounting period would be the units that were most recently produced. During periods where costs for raw materials or labor are increasing, the FIFO method would yield a higher per-unit valuation of inventory for those items still on hand, compared with those that were sold earlier in the period. In this case, FIFO would cause COGS to be lower.

Last-in-First-Out (LIFO)
LIFO inventory valuation is a reverse-production-order approach. It assumes that the ending inventory on hand are the oldest units produced, and that the newest units produced have already been sold. During periods when costs for raw materials or labor are increasing, LIFO yields a lower per-unit valuation of inventory for those items still on hand, because they were produced earlier in the period. In this case, LIFO would cause COGS to be higher.

Average Cost Method
ACM values inventory using an average cost for the period. It blends costs from throughout the period and smooths out price fluctuations. Total costs to create products are divided by total units created over the entire perio

Examples of COGS
Consider this simplified example of COGS:
Décor.com sells high-end kitchen tables to consumers. On Jan. 1, 2019, it held five tables in inventory, each valued at $1,000. Then, during the year, Décor purchased 10 additional tables from its supplier. On Dec. 31, 2019, Décor counted three unsold tables in its warehouse.

Here's how the company would calculate its costs:

(Beginning Inventory + Purchases) – Ending Inventory **= COGS**

So, in Décor's case:

Beginning Inventory	$5,000

+ Purchases	10,000
- Ending Inventory	3,000
= Cost of Goods Sold	$12,000

How Is COGS Different From Cost of Revenue and Operating Expenses

Several other accounting concepts are similar to COGS, but each is different in its own way. Two of the most commonly confused terms are "cost of revenue" and "operating expenses."

Here's how they differ:

Cost of revenue vs. COGS:
Cost of revenue is most often used by service businesses, although some manufacturers and retailers use it as well. Cost of revenue is more expansive than COGS; it includes not only all the COGS components, but also direct costs in the sales function, such as sales commissions, sales discounts, distribution and marketing. Similar to COGS, cost of revenue excludes any indirect costs, such as manager salaries, that are not attributed to a sale.

Operating expenses vs. COGS:
"Operating expenses" is a catchall term that can be thought of as the opposite of COGS. It deals with the costs of running a business, but not necessarily the costs of producing a product. Operating expenses include selling, general and administrative (SG&A) expenses such as insurance, legal and accounting fees, travel, taxes and office supplies. Excluded from operating expenses are COGS items as well as nonoperating expenses, such as interest and currency exchange costs.

What Does Cost of Goods Sold Tell You, and Why is it Important?

Subtracting COGS from revenue gives gross profit, which reveals the core essence of business viability: What are my costs to make a product, and how much do I sell it for?

How to Use Cost of Goods Sold for Your Business

Properly calculating COGS shows a business manager the true cost of the products sold. This is critical when setting customer pricing to ensure an adequate profit margin.

In addition, COGS is used to calculate several other important business management metrics. For example, inventory turnover—a sales productivity metrics indicating how frequently a company

replaces its inventory—relies on COGS. This metric is useful to managers looking to optimize inventory levels and/or increase salesforce sell-through of their products.

COGS is also used to determine gross profit, which is another metric that managers, investors and lenders may use to gauge the efficiency of a company's production processes.

Drawbacks and Limitations of COGS

Because a COGS calculation has so many moving parts, it can be prone to errors and subject to manipulation. An incorrect COGS calculation can obscure the true results of a business' operations. It can also result in misstated net income and tax liability.

At the very least, this can lead to wasted time and lost opportunities. At worst, there can be ethical and legal implications.

Cost of Goods Sold and Tax Returns

So far, this discussion of COGS has focused on GAAP requirements, but COGS also plays a role in tax accounting. Businesses that hold physical inventory—such as manufacturers, retailers and distributors—are required to calculate COGS when determining their taxable income.

This tax calculation of COGS includes both direct costs and parts of the indirect costs for certain production or resale activities as defined by the uniform capitalization rules. Indirect costs to be included for tax purposes include rent, interest, taxes, storage, purchasing, processing, repackaging, handling and administration. For detailed worksheets, see IRS Publication 334; for most managers, however, it's sufficient to understand that this expanded calculation of COGS typically decreases the total tax bill.

For businesses with under $25 million in gross receipts ($26 million for 2020), there are some exceptions to the rules for inventory, accrual accounting and, by extension, COGS.

Cost of Goods Sold and Accounting Software

Calculating COGS can be challenging. It requires a company to keep complete and accurate records for the GAAP calculations reported on financial statements and, separately, to support a tax return. A company's inventory management, from both the physical and valuation perspectives, must be precise. Purchases and production costs must be tracked during the year.

And regardless of which inventory-valuation method a company uses—FIFO, LIFO or average cost—much detail is involved.

All of the above can become exponentially more complicated when volumes and product lines increase. For companies with many SKUs, the best approach to calculating COGS will be a robust accounting system that's tied to inventory management.

However you manage it, knowing your COGS is critical to achieving and sustaining profitability, so it's important to understand its components and calculate it correctly. COGS also reveals the

true cost of a company's products, which is important when setting pricing to yield strong unit margins.

Calculating COGS can be challenging, especially as the business becomes more complex; an accounting system integrated with inventory management software can reduce the effort required and ensure accuracy.

What is inventory valuation

Inventory valuation is an accounting practice that is followed by companies to find out the value of unsold inventory stock at the time they are preparing their financial statements. Inventory stock is an asset for an organization, and to record it in the balance sheet, it needs to have a financial value. This value can help you determine your inventory turnover ratio, which in turn will help you to plan your purchasing decisions.

To give you an example, if you run a shoe business and you're left with 50 pairs of shoes at the end of the year, then you need to calculate their financial value and record it in your balance sheet. Let's look at how and why you'll calculate the value.

Why inventory valuation is important?

Identifying the unsold items is just one step in inventory valuation. You also need a rate that you can multiply by the quantity to arrive at a final value. You may have paid different prices for these items throughout the year, so you need to choose a technique to calculate a common rate.

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What are the different types of Inventory Valuation Methods

There are three methods for inventory valuation: FIFO (First In, First Out), LIFO (Last In, First Out), and WAC (Weighted Average Cost).

In FIFO, you assume that the first items purchased are the first to leave the warehouse. In other words, whenever you make a sale, under FIFO, the items will be subtracted from the first list of products which entered your store or warehouse.

In LIFO, you make the opposite assumption: that the last items that enter your store are the first ones to leave.

The WAC method uses the item's average cost throughout the year. The average cost per unit is calculated by dividing the total cost by the total number of units purchased during the year.

How to value inventory with different inventory valuation methods

Let's continue our above example and find out how each of these techniques calculates the value of your unsold stock.

- In the above example, the FIFO value is more than the LIFO value because you paid more per unit at the end of the year. However, this is not always the case. If your purchase price drops throughout the year, the FIFO value will be less than the LIFO value and the WAC value will change accordingly.

- If the quantity of items unsold at the end of the year is greater than the first or last order, then the calculation will be slightly different. For example, if you have **150 unsold items at the end of the year**, then the calculations will look like this:

FIFO: Items bought first will be sold first
Use the newest purchase rate for the number of items included in the newest order, then use the previous rate for the remaining items.

LIFO: Items bought last will be sold first
Use the oldest purchase rate for the number of items included in the oldest order, then use the next rate for the remaining items.

Which inventory valuation method is the best for your business?
Actually, there is no straight answer to this question. Your inventory valuation technique depends on the market conditions, and your financial goals for your organization. Here are a few scenarios which can help you to pin down the best inventory valuation technique for your business.

1. Applying for a loan for business expansion

If you're planning to apply for a loan, then you will need to keep your stock as collateral. In such cases, it is preferable if the value of your stock is high, because higher valuation will give more assurance to the lender. If prices are increasing throughout the year, a FIFO inventory valuation technique will give you a higher value for closing inventory. If prices are decreasing, a LIFO technique will give you a higher value. The value of the closing inventory in your balance sheet is one of the factors used by financial institutions before approving a loan to a company, so the technique that gives you the highest inventory value will be the best for your company.

2. Attracting investors and keeping shareholders happy

A company with a high profit margin can get a lot of attention from potential investors and keep its existing shareholders happy. So if you're looking for a new funding opportunity or if you want to please your shareholders with good earnings, then FIFO valuation will be beneficial under inflationary market conditions. Similarly, the LIFO valuation will be a better choice when prices are falling.

Because the FIFO method results in a **higher gross profit**, it will make the company more attractive to investors.

3. Saving taxes

If you're looking for ways to cut down on your tax liability, then your inventory valuation technique can help. Assuming an inflationary situation again, a LIFO valuation technique will save you some money. We can see that the tax liability is the highest when you follow the FIFO valuation technique, because the profit is also highest. Under LIFO, the liability is lower because the **profit margin is lower**. However, keep in mind that we're assuming the prices will go up during the year. During a depression, this scenario might play out differently.

Summing it up

The concept of inventory valuation can seem a little heavy at first. However, once we break it down and demonstrate each technique, it gets a lot simpler. That's exactly what we tried to achieve in this article. If you got slightly overwhelmed, though, here's a quick recap of what you need to know:

– Inventory valuation is the monetary value of your unsold stock.

– You need to choose an inventory valuation technique because the price you pay for items from your vendor might change throughout the year.

– There are three techniques of inventory valuation: FIFO (First In, First Out), LIFO (Last In, First Out), and WAC (Weighted Average Cost).

– Choosing an inventory valuation technique depends a lot on your financial goals and market conditions. Just don't change valuation techniques too often, because it can complicate your bookkeeping and raise suspicions.

Whether you're an established business owner or a newbie entrepreneur, you need to know about inventory valuation because inventory plays a big part in the asset category of your balance sheet. An understanding of inventory valuation and its importance can help you meet your business growth goals and make the best of current market conditions.

Unit – 4
Asset Valuation and Valuation of Liabilities (per US GAAP and IFRS)

What Is a Fixed Asset?

A *fixed* asset is a tangible piece of property, plant or equipment (PP&E); a fixed asset is also known as a *non-current asset*. An asset is *fixed* because it is an item that a business will not consume, sell or convert to cash within an accounting calendar year.

The term *fixed*, however, does not refer to the physicality of an asset. Some companies move fixed assets regularly for business purposes. Recording fixed-asset transactions helps create valuations and aids in financial reporting, which can be crucial to capital-intensive projects. Most businesses own at least some fixed assets.

What Is an Asset?

An *asset* is any resource that you own or manage with the expectation that it will yield continuing benefits or cash flows. An asset is also a resource the value of which you can dependably measure. Individuals, companies and governments can hold assets. Entities record their purchase of a fixed asset on the balance sheet, Asset purchases used to be noted on a sources and uses of funds statement, which is now called a cash flow statement.

Fixed assets differ from *inventory* in that inventory exists for the purpose of consumption. Inventory includes items such as raw materials and supplies for manufacturing, finished goods for sale and supplies for maintenance, repair and operations.

List of Fixed Assets in Accounting

In accounting records, each fixed asset receives an account. The following list includes examples of fixed assets.

Examples of Fixed Assets

- **Buildings and Facilities:**
  Fixed assets include existing buildings and facilities that are under construction. Anything under construction exists in an accumulation account (for example, Construction-in-Process) until the work is complete. Upon completion, an accountant will move the asset to the appropriate fixed-asset account.
- **Computer Equipment:**
  These assets include servers, laptops, desktops, iPads and so on.
- **Computer Software:**
  Software fixed assets focus on enterprise packages and platforms. Cloud-based applications are treated like software fixed assets for internal use, described later in this article.
- **Furniture, Fixtures and Fittings:**
  Furniture includes office equipment, desks, cupboards and conference tables. Fixtures include

built-in items that you can't easily remove, such as fireplaces. Fittings (known as chattels in the UK and movables in Scotland) include removable items such as mirrors, lights and art.

Land

- **Leasehold Improvements:**
  These fixed assets are any additions and upgrades you make to leased assets or rental property. Such assets include built-in cabinets, interior walls, ceilings and any electrical and plumbing upgrades.

Heavy Machinery and Equipment

- **Tools:**
  Tools used in the business may be fixed assets depending on their financial basis and the value threshold of the company. For example, you would expense a $12 hammer, but a $1,500 insulated tool set or high-end drill bit set may be a fixed asset.
- **Vehicles:**
  These assets include cars, trucks, forklifts and more.

Classification of Fixed Assets in Accounting

Companies classify their assets into recognizable types, which are essential to understanding the net working capital and solvency of an organization. Accountants categorize assets using the following guidelines:

- **Properties:**
  Assets are a resource and represent ownership and economic value. An owner can exchange an asset for its commercial value or use it as a resource to create more wealth or benefits.
- **Classifications:**
  You can also distinguish assets by their physicality (physical existence), convertibility (level of ease with which you can convert them to cash) and their business usage.

What's the Difference Between Total Assets and Net Assets?

Net worth or *net assets* describe the value of an entity. The calculation for net assets is assets minus liabilities. Determine total assets by adding total liabilities to owner's equity.

Net Assets Formula

Net Assets = Total Assets – Total Liabilities

Total Assets Formula

Total Assets = Total Liabilities + Owner's Equity

Determining Service Life of an Asset

For accounting purposes, an asset's service life may not match its item life. The service life of an asset is an accounting and management estimate of the useful life of an object. Base the service life estimate on the following:

- General knowledge of how long similar items last
- Whether the asset is new or used
- Whether you use the asset frequently or seldom
- History of obsolescence for such items
- Service patterns for an industry or an individual business

Some assets return value after their service life, such as with car trade-ins, while some companies use other assets until they are worthless.

What Is Fixed-Asset Accounting?

Fixed-asset accounting records all financial activities related to fixed assets. The practice details the lifecycle of an asset, such as purchase, depreciation, audits, revaluation, impairment and disposal. In a company's books, each asset has an account, where all the financial activities related to fixed asset are recorded.

"Fixed-asset accounting is about understanding how to properly account for the investments you make as a business and about understanding what would count as a capitalized cost,"

explains Riley Adams, a licensed CPA in the state of Louisiana working as a senior financial analyst for Google in the San Francisco Bay Area. He writes the personal finance blog Young and the Invested, which is dedicated to helping young professionals find financial independence and explore entrepreneurship.

"The capitalized cost of an asset is depreciated over time with its use. Fixed-asset accounting is about distinguishing between what costs can be capitalized and what should be immediately expensed in the year the asset goes into service," Adams adds.

Accounting regulations and standards are followed to ensure the uniformity of an organization's financial statements. These procedures include documenting financial records, calculating revenue, estimating fixed-asset valuations and complying with tax laws. Generally Accepted Accounting Procedures (GAAP) form the standard used by the United States Securities and Exchange Commission (SEC). The International Financial Reporting Standards (IFRS),

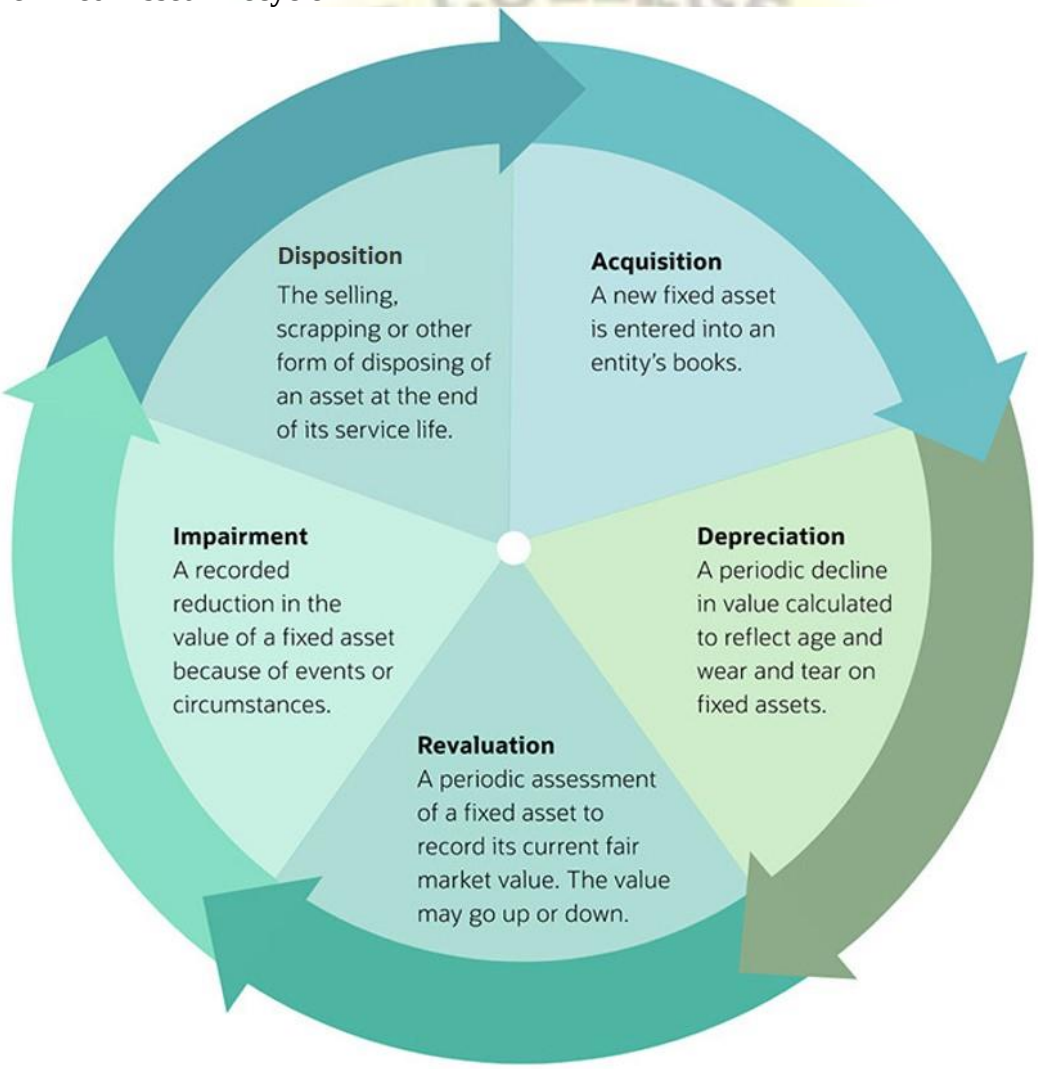
headquartered in London, with the International Accounting Standards Board (IASB) as its standards-forming board, provides common accounting practices for businesses worldwide.

"Most businesses in the U.S. use GAAP. Public companies that file quarterly and annual reports to the SEC must present their financial statements in accordance with GAAP," Adams says.

The Fixed-Asset Accounting Cycle

Each fixed asset has a lifecycle that includes at least three of these stages: purchase, depreciation, revaluation, impairment and disposal.

The Fixed-Asset Lifecycle



These journal entries (see examples below) cover the transactions associated with the fixed-asset lifecycle:

- **Acquisition:**
  Enter the total purchase cost, including any costs to ship, install or costs that ensure the safe and

serviceable function of an asset. The journal entry documents whether you purchase the asset outright, through installments or via an exchange.

- **Depreciation:**
  In this entry, you record periodic depreciation or a decline in net book value for tangible assets and amortization for intangible assets.
- **Revaluation:**
  These types of entries reflect the current fair market value of a fixed asset. You'll need to make a series of accounting changes to determine if there is a gain or loss from revaluation.
- **Impairment:**
  Also called *writing down*, represents the period during which the market value of an asset is less than the valuation entered on an organization's balance sheet.
- **Disposition:**
  At the end of an asset's useful life, a company may dispose of an asset by selling, trading or scrapping it. In this phase, you eliminate the assets from the accounting records. You may end up recording a gain or loss on the asset disposal transaction during that financial period.

Acquisition: Accounting for Purchase of Fixed Assets

To record the purchase of a fixed asset, debit the asset account for the purchase price, and credit the cash account for the same amount. For example, a temporary staffing agency purchased $3,000 worth of furniture. When the furniture arrives, the accountant debits the fixed assets account and credits the cash account to pay for the furniture.

Non-Monetary Transfer of a Fixed Asset

Non-monetary transactions usually involve real estate swaps or asset transfers, as when someone donates an asset to a nonprofit. Suppose a consulting firm is moving to a new office and decides to donate its old desks to a charity. The original cost was $25,000. The accumulated depreciation is $15,000. The book value, therefore, is $10,000. The fair market value is calculated at $17,000.

Accounting for Depreciation of Fixed Assets

Enter depreciation on the books for the total sum of assets or by asset type. The amount of accumulated depreciation plays a role in calculating any loss or gain at the disposal of the asset.

There are four types of depreciation:

- **Straight Line:**
  This option spreads the depreciation evenly over the useful life of an asset.
- **Accelerated or Sum of Remaining Years:**
  This method writes off more of the cost in the early years and less in the later years.
- **Units of Production:**
  Depreciation by units of production writes off an asset according to how much that asset produces.

- **Double Declining Balance:** This method accounts for the expense of a longer-lived asset that quickly loses its value or becomes obsolete. Examples of assets that should use the double declining methods are computer equipment, expensive cell phones and other technology that has more value at the beginning of its life than at the end.

Journal Entries for Fixed-Asset Depreciation

Depreciation is a significant cost-saving function. Depreciation provides an approximate current value and allows you to spread the cost of an asset over its useful life

Salvage Value in Depreciation Calculations

When an organization anticipates that it can sell an asset or that an asset will otherwise provide value at disposal, that amount represents the salvage value. You deduct the salvage value from the initial cost to determine the amount that will be depreciated through the service life of the asset.

Here is the formula to calculate salvage value:

Cost – Expected Sales Value **= Salvage Value**

Value estimates may not be consistent, and they can and should be adjusted throughout the life of an asset.

Below are the formulas for each type of depreciation.

Straight-Line Depreciation

To record straight-line depreciation, debit the asset depreciation expense account and credit the accumulated depreciation account. Here is the formula:

Depreciation Expense = (Cost – Salvage Value) / Useful Life

Accelerated or Sum of Remaining Years Depreciation

This method of calculating depreciation assumes that the asset productivity decreases over time. Here is the formula:

Depreciation Expense =
(Remaining Life / Sum of the Years' Digits) * (Cost – Salvage Value)

For example, a manufacturing company purchases a machine on Dec. 1, 2019 for $56,000. The company expects that machine to be useful for three years. The salvage value is $3,000.

The schedule for this depreciation looks like this:

.

Units of Production Depreciation

This method evaluates depreciation based on how much an asset is used. In a period during which the asset has more usage, a company may charge more depreciation. When the asset doesn't have as much usage, a company will charge less usage. Here is the formula:

Depreciation Expense = (Number of Units Produced / Life in Number of
*
(Cost – Salvage Value)

For example, a company that specializes in tailoring garments purchases a new sewing machine. The company will charge depreciation based on how much it uses the new machine. The information for this calculation is in the table below:

From this formula above, calculate the depreciation expense. This is the practical use for the rate of depreciation that companies use on taxes. Accountants can apply the rate and number of units produced to every successive year the company uses the machine in order to calculate the tax write-off amount. For the first year, this is

Depreciation Expense = (Number of Units P
*
(Units of Production Rate)

Depreciation Expense = 5,000 * 0.05
= $250

Double Declining Balance Depreciation

Companies use an accelerated depreciation method to account for the expense of long-lived assets. Companies recognize most of the depreciation for these assets in the first few years of their useful life, with smaller amounts of depreciation in later years. Note that the basis for

depreciation changes each year. According to Adams: "The balance will asymptotically approach $0 but never get there. Since the balance adjusts each year, the asset will never be fully depreciated under the DDB system. Most companies opt to switch from DDB to SL depreciation when it becomes more advantageous to do so." Here is the formula:

Periodic Depreciation Expense = Annual Book Value * Rate of Depreciation

In example 1, a $100,000 asset with a four-year life and $10,000 salvage value, the following year-by-year breakdown shows the depreciation.

Assume the straight-line depreciation is $22,500.

In example 2, the company shows the depreciation of a $200,000 asset with a useful life of four years with a salvage value of $20,000. The company does not subtract the salvage value from the base. The assumptions for this:

- The total depreciable amount for the life of the asset is $180,000 ($200,000 - $20,000).
- The annual SL depreciation rate is 25% (100%/4 years). The DDB rate is 50%.
- The beginning period book value is $100,000 ($200,000 x 50%).
- The chart below shows the calculation of the ending period value.

Depreciation stops when the accumulated depreciation reaches the amount of the depreciable base.

Depreciation and Tax Deductions

Depreciation spreads the cost of an asset over its service life. By reducing the taxable earnings, depreciation reduces the amount of taxes owed. For the purpose of tax deductions, an asset's service life may be different than its depreciation life.

Depreciation for tax purposes focuses on offering a faster tax write-off, whereas depreciation for accounting purposes helps to match revenue with expense.

What Is the Accounting Treatment for the Revaluation of Fixed Assets?

The revaluation of fixed assets helps to reflect the fair market value of volatile assets or changes to the usefulness of an asset. Revaluation analysis describes the carrying value, or book value, of the asset, or its value through its life. Although carrying value usually decreases over time, under International Accounting Standard (IAS) 16, you can revalue some assets so that the carrying value increases.

Since values for some assets change frequently, revaluation can happen as often as once a year. More commonly, revaluations occur every 3-5 years. However, you cannot revalue a fully depreciated asset.

Revaluation Accounting Entry
Carrying amount of non-current assets on revaluation date.
Valuation of non-current assets (revalued assets price)

Difference = Gain or Loss From Revaluation

Revaluation: Valuation Models for Fixed Assets
After the purchase of an asset, measure valuation when you need to understand the value of your asset before you sell it, solicit investments, anticipate a merger or acquisition, require a loan, prepare a financial report or conduct an audit. Here are two models:

- **Cost:** In this model, subtract the accumulated depreciation and any impairment costs from the original cost price.
- **Revaluation:** Under IAS 16, subtract the accumulated depreciation and impairment costs from the current fair market value.

Performing Impairment Testing

Asset impairment is akin to an advanced depreciation, which is when you reduce the potential benefit from an asset. When fixed assets undergo a significant change in circumstance that may reduce their gross future cash flow to an amount below their carrying value, apply an impairment test. The impairment may apply to one asset or a group of assets. Below is an impairment journal entry when the loss is $50,000.

Changes to the status of an individual asset do not signal impairment, and, frequently, only the estimated service life needs adjusting. These scenarios and similar circumstances may prompt impairment testing. Significant deterioration in an asset's condition, a history of operating losses that suggest a future pattern or a significant drop in the asset's market price are all scenarios that might require impairment testing. For example, a 30-year-old, coal-fired power plant is nearing retirement age and a new regulation appears, requiring millions of dollars in updates. A cost-benefit analysis may show that the investment in an aging plant that's soon to be taken offline is not worthwhile. If you cannot continue to operate the plant, you would write off the remaining value of the asset, impair the asset value and write it off on your books. If the useful life of the asset or its value changes, it is classified as an impaired asset.

Accounting for Disposal of Fixed Assets

Asset disposal requires that the asset be removed from the balance sheet. Disposal indicates that the asset will yield no further benefits. Depending on the value of the asset, a company may need to record gain or loss for the reporting period during which the asset is disposed.

Journal Entry for Gain on Disposal
Gain on disposal is calculated by subtracting the accumulated depreciation from the original cost of an asset and then adding the sales amount. In this example, the asset was purchased for $100,000, and accumulated depreciation is $80,000. A buyer paid $54,000 cash for the asset, which results in a gain on disposal of $34,000.

Journal Entry for Loss on Disposal
To calculate the loss on disposal of an asset, subtract the accumulated depreciation from the original cost, and then subtract the sales price. In the example below, accumulated depreciation is $45,000; the original cost of the asset is $75,000; and the sales price is $10,000. After depreciation, a loss of $20,000 is recognized on the disposal of the asset.

Journal Entry for Loss on Disposal

Account	Debit	Credit
Cash	$ 10,000.00	—
Accumulated Depreciation	$ 45,000.00	—
Gain/Loss on Asset Disposal	$ 20,000.00	—
Asset	—	$ 75,000.00
Total	**$ 75,000.00**	**$ 75,000.00**

Fixed-Asset Accounting Best Practices

"For your business, the key is understanding the distinction between the capitalizable costs and those that should be immediately expensed. These costs vary business by business. But broadly, if the cost you're incurring is material and it is necessary to extend an asset's useful life beyond one year, then that is a cost that should be capitalized," advises Adams.

Consider these useful tips when recording and tracking fixed assets:

Always:

- Consider asset impairment when significant events or changes in circumstances occur.
- Tag assets for easy tracking. Asset tags allow organizations to track equipment and other assets through their lifecycle to ensure maintenance and prevent loss. Basic tags can include QR, barcodes or serial numbers and organization contact information. On computer equipment, organizations frequently use the manufacturer's serial number or universally unique identifier (UUID) for asset tracking. Tracking with traditional labels requires staff to physically contact the label with a scanning device or record the numbers on paper. Today, companies often monitor critical and high-cost assets with radio frequency identification (RFID) tags. Tag materials range from vinyl for minimum endurance, through polyester, to surface printed aluminum and subsurface printed aluminum for high endurance scenarios.
- Review estimates of useful lives regularly.
- Make sure your key assets are covered by insurance, and keep detailed records in case an insurance claim needs to be filed.
- If an asset can return some gain at the end of its service life, determine the depreciation on cost minus the estimated salvage value.
- Capitalize assets where the cost is material and the useful life is greater than 12 months.
- When recording a fixed asset, include all expenditures to acquire, ship and install the asset. These costs become part of the capitalized cost of the asset.
- If your organization builds an asset and you borrowed money to pay for the work, the cost comprises all components, including materials, labor, overhead and any interest expense. Capitalize any additions you made to extend the service life or capability of the asset.
- The board of directors or senior managers of an organization should create a capitalization policy with a dollar amount threshold. Expense any assets that cost less than the threshold.

Never:

- Expense the costs associated with purchasing a fixed asset.
- Confuse tax-based depreciation with GAAP-based depreciation.
- Disregard significant changes in circumstances for an asset, as it may be subject to impairment.
- Depreciate a leased asset over its service life without considering the asset's proper life.
- Forget insurance recordkeeping requirements when recording and tracking fixed assets.

Special Cases in Fixed-Asset Accounting and How to Handle Them

Every accounting specialty has unique considerations. Fixed assets usually form a substantial investment for an organization, and each asset can include many components requiring special attention.

When to Record Software and Associated Costs as Fixed Assets
In accounting, software for internal use is treated differently from software purchased or developed to sell to others.

Internal Use Software: When you purchase software or commission software development for your company's internal use, GAAP specifies that you capitalize some components and expense others. FASB Accounting Standard Update ASU 2018-15 introduces specific guidance to cover cloud licensing and implementation. Examples of internal-use software that you may capitalize include customer resource management systems, accounting systems, production management systems, and service contracts for cloud-based systems. Learn more about these guidelines by reading, "ASU 2018-15 Simplifies the Process for Accounting for Cloud Computing Expenses."

In general, capitalize the following:

- Amounts paid to a third party for purchase or development
- Fees for installation and testing of hardware
- Internal or external travel, payroll and contracting expenses that are related to development or installation
- Interest costs related to financing a software purchase
- For cloud-based implementations, costs are amortized over the life of the service contract on a straight-line basis

Expense the following:

- Costs to research and shop for the purchase of software
- Fees for software training and maintenance
- Costs for upgrades and additions. If upgrades and enhancements increase functionality, capitalize the costs.
- Charges for the process of converting old data

Software for External Sales:
The developer creating a software product to sell has limited capitalization opportunities. No asset exists in the initial planning and R&D stages, so you must expense costs. During product development, expense costs spent directly towards creating product. Capitalize only the cost of development and test team salaries and other costs spent directly on the product. After the product launch, expense maintenance costs.

Handling Leasing Fixed Assets
Not all fixed assets are purchased directly. Sometimes, companies lease large machinery that has a minimal chance of becoming obsolete. In a capital lease, the lessee assumes all the

responsibilities of an owner and treats payments on a long-term lease as fixed-asset payments. The asset can depreciate and be treated as a debt. By keeping the liability off the balance sheet, a company can present a false impression of financial robustness. For this reason, the new ASC 842 and IFRS 16 standards require public and private companies to update their leased fixed asset recording practices to ensure that records reflect true asset turnover rates and profits and earnings. The new standards present far reaching implications for reporting and financial and contractual obligations. Learn more about preparing for these changes by reading

How to Deal with Fixed-Asset Accounting for an Insurance Claim

When you place an insurance claim on fixed assets, you must take certain accounting steps. Remove the asset from your books, but record the payout as a proceed. You can record the transaction when payment is possible or when you receive it. The best practice is to record the payout when you receive it. Proceeds may cover only the fair market value of the asset. If the insurance policy carries a coinsurance clause, you are required to carry insurance to cover at least 60% of the asset's fair market value.

"When you are expecting an insurance payout, or, conversely, when you are liable, you must account for the liability or accrue the revenue on your balance sheet if an insurance action is probable or likely," Adams says.

Full Reimbursement on an Insurance Claim

If you receive a full payout, record the proceeds and the full value of the loss. However, you still must zero out the total of the loss on your books. For example, if you own an art store and your $6,000 classroom is totaled in a fire and the payout covers the full amount, then the entry would be:

No Payout from Insurance Company
If your insurance does not reimburse the loss, enter the dollar amount of the damage, and reduce or write off the asset.

Gain or Loss
You may record a loss on your insurance payout. For example, if insurance pays $4,000, record a loss (debit) of $2,000.

You may also record a gain. For example, if a fire destroyed the same $6,000 classroom but the payout was $7,000, you have a gain in proceeds of $1,000.

Fixed-Asset Accounting FAQ

Below are the most frequently asked questions concerning fixed asset accounting, as well as the concise, clear answers you're seeking.

What Is a Fixed-Asset Accountant?
A fixed-asset accountant is usually a certified public accountant (CPA) who specializes in the correct accounting of a company's fixed assets. Fixed-asset accountants often work with other accounting roles to calculate asset depreciation. They also ensure that accounting departments record and track assets correctly as well as handle tax accounting requirements for fixed assets.

What Is Component Accounting for Fixed Assets?
Component accounting or component depreciation assigns different costs to different parts of a large property, plant or equipment asset. Since these components wear out at varying rates and have different salvage values, each component depreciates separately.

How Do You Handle Accounting for Deposits on Fixed Assets?
Suppose you are buying an asset through installments or loan payments and you make a deposit. If a fixed-asset account does not already exist, you need to create one. Then, post any payments to the account on the dates you made them. You'll also want to create a liability record for the loan and record the loan as a debt. If the organization has not yet received the asset, it is still a current asset, not a fixed asset. In this case, only the deposit is an asset.

How Do You Handle Accounting for Replacing Assets?
Calculate replacement cost by subtracting the accumulated depreciation from the asset value listed on the balance sheet. When reviewing a company's balance sheet, you can detect which assets may soon require replacement by looking for assets with a high accumulated depreciation. For journal entries, use a substitution approach. For example, a manufacturing company replaces some machinery for $120,000. The net book value of these assets is $15,000, which is the net value minus the accumulated depreciation of the old assets ($120,000 - $105,000). The journal entry would look like the following:

What Are Fixed-Asset Clearing Accounts?
Clearing accounts provide temporary holding places for cash totals. Rather than requiring an accounts payable clerk to know each specific destination account, this method allows them to work from the clearing account. The balance is usually 0.00 because the clearing account gets credited and the fixed-asset account is debited the same amount.

Use clearing accounts when you cannot immediately post payments to a permanent account. For example, if you are furnishing a new building for a client, you may place costs and payments in a clearing account until the work is complete. If checks must clear and you have the cash to deposit in the bank , you may add the amounts to a clearing account.

NetSuite's Fixed-Asset Accounting System for Improved Asset Visibility

Dedicated fixed-asset accounting software can calculate depreciation and record other relevant details. Online platforms remove the burden of multiple manual entries, improve reporting and facilitate audit trails. Additionally, fixed-asset accounting systems can track assets to guard against theft.

Business owners know that maintaining complete and up-to-date fixed-asset records isn't easy. What's more, if you are preparing for any audit, fixed-asset management accounting can be quite daunting. That's why it's essential to have the right tools to help you monitor fixed assets throughout their useful lives. NetSuite's financial management solution provides real-time visibility into all of your company's fixed assets and expedites financial transactions.

Tips for fixed asset capitalization rules and policy

For most businesses, fixed assets represent a significant capital investment, so it is critical that the accounting be applied correctly. Here are some key facts to understand and insights to keep in mind:

- Fixed assets are capitalized. That's because the benefit of the asset extends beyond the year of purchase, unlike other costs, which are period costs benefitting only the period incurred.
- Fixed assets should be recorded at cost of acquisition. Cost includes all expenditures directly related to the acquisition or construction of and the preparations for its intended use. Such costs as freight, sales tax, transportation, and installation should be capitalized.
- Businesses should adopt a capitalization policy establishing a dollar amount threshold. Fixed assets that cost less than the threshold amount should be expensed.
- Assets constructed by the entity should include all components of cost, including materials, labor, overhead, and interest expense, if applicable.
- Additions that increase the service potential of the asset should be capitalized. Additions that are better categorized as repairs should be expensed when incurred.

Capitalizing software costs

GAAP includes specific guidance for accounting for costs of computer software that is purchased for internal use.

Capitalized costs consist of the fees that are paid to third parties to purchase and/or develop software. Capitalized costs also include fees for the installation of hardware and testing, including any parallel processing phase. Costs to develop or purchase software that allows for the conversion of old data are also capitalized. However, the data conversion costs themselves are expensed as incurred.

Training and maintenance costs, which are often a significant portion of the total expenditure, are expensed as period costs.

Upgrade and enhancement costs should be expensed unless it is probable that they will result in additional functionality.

When an organization purchases software from a third party, the purchase price may include multiple elements such as software training costs, fees for routine maintenance, data conversion costs, reengineering costs, and costs for rights to future upgrades and enhancements. Such costs should be allocated among all individual elements, with allocations based on objective evidence of fair value of the contract elements, not necessarily the separate prices for each element stated in the contract, and then capitalized and expensed accordingly.

The ins and outs of depreciation

Depreciation is the process of allocating the cost of the asset to operations over the estimated useful life of the asset. For financial reporting purposes, the useful life is an asset's service life, which may differ from its physical life. An asset's estimated useful life for financial reporting purposes may also be different than its depreciable life for tax reporting purposes.

Furthermore, the objectives of financial reporting and tax depreciation are different; generally, tax methods and lives take advantage of rules that encourage investments in productive assets by permitting a faster write-off, whereas depreciation for financial reporting purposes is intended to match costs with revenue.

The service life for financial reporting is an estimate made by management, considering some of the following factors:

- Type of asset
- Condition when purchased: New or used
- Past experience
- Expected usage: Normal or excessive
- Expected obsolescence

The service life may be based on industry standards or specific to a business based on how long the business expects to use the asset in its operations. Certain assets may be used until they are worthless and are disposed of without remuneration, while others may still have value to the business at the end of their service life.

If an asset will have a residual value at the end of its service life that can be realized through sale or trade-in, depreciation should be calculated on cost less the estimated salvage value. Remember, the depreciable life is the term that the asset is used by the owner, but if the asset is not worthless at the end of that life, estimated salvage value should be considered.

For example, most businesses use five years as the useful life for automobiles. In practice, a particular business may have a policy of purchasing and trading in automobiles every three years. In this case, three years, not five, should be the estimated useful life for depreciation, but the trade-in value must be estimated and used in the calculation of depreciation (the cost, less the estimated salvage value, should be depreciated over the three-year service life to the business). As with all accounting rules, materiality should be considered in determining whether the recognition of residual values is needed.

While straight-line depreciation is the method most commonly used, other methods such as units of production, sum of the year's digits, and declining balance exist.

As estimates, useful lives should be evaluated during an asset's life, and changes should be made when appropriate. Changes in estimates are accounted for prospectively.

Impairment testing

Fixed assets should be tested for impairment individually, or as part of a group, when events or changes in circumstances indicate that an asset's carrying value may exceed its gross future cash flows. Such circumstances include the following:

- A significant decrease in the market price of the asset
- A significant adverse change in the degree or manner in which the asset is being used
- Significant deterioration in the asset's physical condition
- An accumulation of costs significantly exceeding the amount originally expected for the acquisition or construction of the asset
- An operating loss in the current period and a history of losses, indicating that future ongoing losses associated with the use of the asset will occur

Keep in mind that impairment accounting applies to a situation when a significant asset, or collection of assets, is not as economically viable as originally thought. Isolated incidents when a particular asset may be impaired are usually not material enough to warrant recognition. In those cases, a change in an asset's estimated life for depreciation may be all that is needed. Impairment is typically a material adjustment to the value of an asset or collection of assets. It is, in essence, an acceleration of depreciation to account for the lower future benefits to be received from the asset; the charge for impairment is recorded as part of income from operations in the same section of the statements as depreciation.

Leasing fixed assets

Keep in mind that not all fixed assets are purchased by a business. Most businesses utilize both purchasing and leasing to acquire fixed assets. Under current accounting rules, assets under capital leases are capitalized by the lessee. Depreciable lives of assets under capital leases are generally the asset's useful life (for leases with a transfer of ownership to the lessee at the end of the lease) or the term of the related lease (for all other capital leases).

Leases of real estate are generally classified as operating leases by the lessee; consequently, the leased facility is not capitalized by the lessee. However, improvements made to the property—termed leasehold improvements—should be capitalized when purchased by the lessee. The depreciation period for leasehold improvements is the shorter of the useful life of the leasehold improvement or the lease term (including renewal periods that are reasonably certain to occur).

In February 2016, the Financial Accounting Standards Board issued a new accounting standard for lease accounting. The new standard will replace existing classifications of capital and operating leases. Under the new standard, all long-term leases will require capitalization of a right-of-use asset. The effect of the new standard will result in an increased number of assets being capitalized by lessees.

Fixed asset accounting takeaways

Given all the various principles, rules and policies surrounding fixed assets, here is a recap of the most important dos and don'ts to remember:

Do:

- Consider all costs at time of acquisition or construction.
- Adopt a capitalization policy.
- Estimate useful life for depreciation based on an asset's estimated service life.
- Consider whether the asset will have value at the end of its service life, then base depreciation on cost, less estimated salvage value.
- Reevaluate estimates of useful lives on an ongoing basis.
- Keep your depreciation records in sufficient detail so assets can be accurately tracked when physically moved and/or disposed.
- Consider asset impairment when significant events or changes in circumstances occur.
- Be aware of changes forthcoming with new lease accounting standards.

Don't:

- Expense costs such as sales tax or freight incurred on a fixed asset purchase.
- Use depreciable lives based on Internal Revenue Service rules for financial reporting purposes.
- Ignore changes in an asset's use or service; you may need to consider asset impairment.
- Automatically depreciate a leased asset over its useful life; consider lease accounting to determine proper life.
- Forget to consider insurance recordkeeping requirements when recording and tracking fixed assets.

Account for an Impaired Fixed Asset

An asset impairment arises when there is a sudden drop in the fair value of an asset below its recorded cost. The accounting for asset impairment is to write off the difference between the fair value and the recorded cost. Some impairments can be so large that they cause a significant decline in the reported asset base and profitability of a business.

Impairment only occurs when the amount is not recoverable. This happens when the carrying amount exceeds the sum of the undiscounted cash flows expected to result from the use of the asset over its remaining useful life and the final disposition of the asset. The bulk of these cash flows are usually derived from subsequent use of the asset, since the disposition price may be low.

The amount of an impairment loss is the difference between an asset's carrying amount and its fair value. Once you recognize an impairment loss, this reduces the carrying amount of the asset, so you may need to alter the amount of periodic depreciation being charged against the asset to adjust for this lower carrying amount.

It is necessary to test assets for impairment at the lowest level at which there are identifiable cash flows that are largely independent of the cash flows of other assets. In cases where there are no identifiable cash flows at all (as is common with corporate-level assets), place these assets in an asset group that encompasses the entire entity, and test for impairment at the entity level.

Also, test for the recoverability of an asset whenever the circumstances indicate that its carrying amount may not be recoverable. Examples of such situations are:

- *Cash flow*. There are historical and projected operating or cash flow losses associated with the asset.
- *Costs*. There are excessive costs incurred to acquire or construct the asset.
- *Disposal*. The asset is more than 50% likely to be sold or otherwise disposed of significantly before the end of its previously estimated useful life.
- *Legal*. There is a significant adverse change in legal factors or the business climate that could affect the asset's value.
- *Market price*. There is a significant decrease in the asset's market price.
- *Usage*. There is a significant adverse change in the asset's manner of use, or in its physical condition.

If there is an impairment at the level of an asset group, allocate the impairment among the assets in the group on a pro rata basis, based on the carrying amounts of the assets in the group. However, the impairment loss cannot reduce the carrying amount of an asset below its fair value.

Under no circumstances is it allowable to reverse an impairment loss under GAAP.

Asset Retirement Obligation -

In accounting, an asset retirement obligation (ARO) describes a legal obligation associated with the retirement of a tangible, long-lived asset, where a company will be responsible for removing equipment or cleaning up hazardous materials at some future date. AROs should be included in a company's financial statement to present a more accurate and holistic snapshot of the enterprise's overall value.

Understanding Asset Retirement Obligations

Asset retirement obligation accounting often applies to companies that create physical infrastructure which must be dismantled before a land lease expires, such as underground fuel storage tanks at gas stations. AROs also apply to the removal of hazardous elements and/or waste materials from the land, such as nuclear power plant decontamination. The asset is considered to be retired once the clean up/removal activity is complete, and the property is restored back to its original condition.

An Example of an Asset Retirement Obligation

Consider an oil-drilling company that acquires a 40-year lease on a parcel of land. Five years into the lease, the company finishes constructing a drilling rig. This item must be removed, and the land must be cleaned up once the lease expires in 35 years. Although the current cost for doing so is $15,000, an estimate for inflation for the removal and remediation work over the next 35 years is 2.5% per year. Consequently, for this ARO, the assumed future cost after inflation would be calculated as follows: 15,000 * (1 + 0.025) ^ 35 = 35,598.08.

Asset Retirement Obligations Oversight

Because calculating asset retirement obligations can be complex, businesses should seek guidance from Certified Public Accountants to ensure compliance with the Financial Accounting Standards Board's Rule No. 143: Accounting for Asset Retirement Obligations. Under this mandate, public companies must recognize the fair value of their AROs on their balance sheets in an effort to render them more accurate. This represents somewhat of a departure from the income-statement approach many businesses previously used.

Asset Retirement Obligation: Calculating Expected Present Value

To calculate the expected present value of an ARO, companies should observe the following iterative steps:

1. Estimate the timing and cash flows of retirement activities.
2. Calculate the credit-adjusted risk-free rate.
3. Note any increase in the carrying amount of the ARO liability as an accretion expense by multiplying the beginning liability by the credit-adjusted risk-free rate for when the liability was first measured.
4. Note whether liability revisions are trending upward, then discount them at the current credit-adjusted risk-free rate.
5. Note whether liability revisions are trending downward, then discount the reduction at the rate used for the initial recognition of the related liability year.

Asset Retirement Obligations do not apply to unplanned cleanup costs resulting from unplanned events, such as chemical spills and other accidents.

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An asset retirement obligation (ARO) is a legal obligation that is associated with the retirement of a tangible, long-term asset. It is generally applicable when a company is responsible for removing equipment or cleaning up hazardous materials at some agreed-upon future date.

A company must realize the ARO for a long-term asset at the point an obligating event takes place, so their financial statements accurately reflect the company's value.

Purpose of Asset Retirement Obligations

The purpose of asset retirement obligations is to act as a fair value of a legal obligation that a company undertook when it installed infrastructure assets that must be dismantled in the future (along with remediation efforts to restore their original state). The fair value of the ARO must be recognized immediately, so the present financial position of the company is not distorted; however, it must be done reliably.

AROs ensure that known future problems are planned for and resolved. In the real world, they are utilized mainly by companies that typically use infrastructure in their operations. A good example is oil and gas companies.

Governing Rules for AROs

ARO calculations are governed by the Financial Accounting Standards Board's Rule 143. The rule essentially states that a company has a legal obligation to remove the asset, and there are certain calculation rules for an accountant to follow.

Calculating AROs

When a company installs a long-term asset with future intentions of removing it, it incurs an ARO. To recognize the obligation's fair value, CPAs use a variety of methods; however, the most common is to use the expected present value technique. To use the expected present value technique, you will need the following:

1. Discount Rate

Acquire a credit-adjusted, risk-free rate to discount the cash flows to their present value. The credit rating of a business may affect the discount rate.

2. Probability Distribution

When calculating the expected values, we need to know the probability of certain events occurring. For example, if there are only two possible outcomes, then you can assume that each outcome comes with a 50% probability of happening. It is recommended you use the probability distribution method unless other information must be considered.

Then, you can follow the steps to calculate the expected present value of the ARO:

1. Estimate the timing of the future retirement costs (cash flows), along with their respective amounts.

2. Determine an appropriate discount rate based on the businesses' credit rating and an underlying risk-free rate. You can use the Capital Asset Pricing Model (CAPM) to find the appropriate discount rate.

3. Recognize any period-to-period increases in the ARO carrying amount (it is like an accretion expense). You can do it by multiplying the beginning balance of the liability by the original credit adjusted, risk-free rate.

4. Recognize upward liability revisions – discount any costs that may be incurred in the future that you did not originally account for.

5. Recognize downward liability revisions – remove the discounted effect of any costs that might have been overstated in your original estimate.

If you are seeking a rough estimate, you can usually acquire it by accounting only for inflation.

Subsequent ARO Measurement

A company should periodically review its AROs to account for upward or downward liability revisions. During the review, the company should use an updated discount rate that reflects current market conditions. Follow the steps below to assist in the recognition of any additional costs an ARO's undertaken since original recognition:

1. Recognize the future costs (the liability) at fair value.

2. Allocate the ARO liability over the lifetime of the long-term asset.

3. Measure changes to the ARO (the liability) with the passage of time, using the original discount rate when each liability layer was recognized. It will be reflected in the differing balance on the balance sheet.

4. As time passes, the probabilities and amount that are associated with the ARO will improve in predictive accuracy. As such, you should continuously look at whether to adjust the liability upwards or downwards.

If you adjust upwards, use the current credit adjusted, risk-free rate to discount it. If you adjust downwards, use the original credit adjusted, risk-free rate.

An individual will usually carry out a subsequent measure of an ARO when a portion of the liability must be paid before the asset retires. If there is no expense associated with retiring the asset, then they can write down the ARO to 0.

Disposal of Assets

Sale

The disposal sale of an asset is similar to a regular asset sale, where cash proceeds are received and a loss or gain may be realized.

Disposal of an Asset via Sale

The sale of an asset for disposal purposes is similar to a regular asset sale. Unlike a regular disposal of an asset, where the asset is abandoned and written off the accounting records, an asset disposal sale involves a receipt of cash or other proceeds. When the sale takes places, a journal entry is recorded that (1) updates depreciation expense, (2) removes the asset and its accumulated depreciation account off the balance sheet, (3) increases cash or other asset with the amount of proceeds received, and (4) records a gain or loss on the sale.

Depreciation Expense at Disposal

At the time of disposal, depreciation expense should be recorded to update the asset's book value. A journal entry is recorded to increase (debit) depreciation expense and increase (credit) accumulated depreciation. Depreciation expense is reported on the income statement as a reduction to income. The increase in the accumulated depreciation account reduces the asset to its current book value.

An Asset for Sale — one way of disposing an asset is by selling it.: A business disposing of a building through a sale receives cash proceeds and may realize a gain or loss.

Proceeds Received and Loss/Gain at Disposal

The proceeds received on the asset sale are compared to the asset's book value to determine if a gain or loss on disposal has been realized. If the proceeds are less than book value, a loss on disposal has been realized. If the proceeds are more than book value, the result is a gain. The proceeds from the sale will increase (debit) cash or other asset account. Depending on whether a loss or gain on disposal was realized, a loss on disposal is debited or a gain on disposal is credited. The loss or gain is reported on the income statement. The loss reduces income, while the gain increases it.

Asset Disposal and the Balance Sheet

The entry to remove the asset and its contra account off the balance sheet involves decreasing (crediting) the asset's account by its cost and decreasing (crediting) the accumulated depreciation account by its account balance. Prior to zeroing out their account balances, these accounts should reflect the updated depreciation expense computed up to the disposal sale date.

Involuntary Conversion

Involuntary conversion of assets occurs when disposal is due to unforeseen circumstances, such as theft or casualty.

Definition of Involuntary Conversion

The involuntary conversion of an asset occurs when an asset must be disposed of due to unforeseen circumstances, such as theft, casualty, or condemnation. The forced disposal of the asset may result in cash proceeds from the filing and payment of an insurance claim on the asset or the receipt of a casualty award. If the monetary exchange is more than the asset's book value, updated for depreciation up to the disposal date, a gain on disposal results; if the proceeds are less, the disposal realizes a loss. Unlike a voluntary sale, involuntary conversion of assets can involve an asset exchange for monetary or non-monetary assets.

An involuntary conversion is the forced disposal of an asset.: An airplane manufacturer's involuntary conversion of a plane can result in a loss or gain on the income statement.

Exchange for Monetary Assets

Monetary assets consist of cash or cash-equivalent assets. An involuntary conversion involving an exchange for monetary assets is accounted for the same way as a typical sales transaction, with a gain or loss reported in the income statement in the period the conversion took place. The gain or loss is the difference between the proceeds received and the book value of the asset disposed of, updated for current depreciation expense.

Exchange for Non-Monetary Assets

Non-monetary assets are not easily converted to cash, such as equipment. An exchange between non-monetary assets should be analyzed to determine if the exchange has commercial substance. An asset exchange with commercial substance will cause future cash flows to materially change. If the exchange has commercial substance, the asset received is recorded on the balance sheet at either (1) the market value (purchase price) of the asset received or (2) the market value of the asset given up plus any cash paid. If the value of the new asset exceeds the book value of the old asset, a gain is recognized. If the new asset's value is less, a loss is recognized.

For non-monetary asset exchanges without commercial substance, the expectation is that the exchange will not materially alter future cash flows. This type of exchange usually involves like-kind property, such as exchanging a truck for another truck. The asset received is recorded on the balance sheet at the book value of the asset given up plus any cash paid. Gains or losses on these transactions are not recognized.

Accounting Treatment for Involuntary Conversions

By definition, an involuntary conversion is a mandatory liquidation of assets, such as a loss due to destruction (i.e., fire, hail, flooding, hurricane, tornado, etc.), theft, condemnation, or repossession, and the lost property is replaced by another asset such as cash or insurance proceeds.

Under generally accepted accounting principles (GAAP), the difference between the asset lost (building) and the asset received (cash) is then recognized as a gain or a loss. If the loss occurs in one year and the proceeds from the insurance company are received in the following year, then the assets lost should be recorded as a disposition from the books. The assets to be received, however, should not be recorded unless the assets to be received are determinable (i.e., the insurance company has already provided you with the amount of insurance proceeds you will receive). Moreover, if the total insurance recoveries amount to more than your total loss, you cannot recognize the incremental benefit until the cash is received.

Valuation of Brands, Intangible Assets & Intellectual Property

Over the years, Businesses have witnessed paradigm shift from providing physical goods & services towards companies that provide information, digital goods and data services. Outside of this digital realm also, corporates, in general, are now investing more and more into intangible assets like technology, software, customers and brands, in addition to physical assets and property, plant and equipment. With lenders giving out loan funds against Intangible assets as a collateral, the importance of Valuation of Intangible Assets has further increased.

Investors, lenders, analysts and other stakeholders are getting increasingly alert to the importance and valuation of Intangible Assets. The importance of valuing intangible assets arises from the fact that the reported net worth of businesses may not represent its true value, which more often is in the form of intangibles. This is evident from the gap between company's book value and market value on stock exchanges/ transaction value in M&A transaction. Also, Ind AS 38 require impairment assessment of intangibles asset on an annual basis and whenever there is an indication that the intangible asset is impaired.

RBSA has the expertise to help clients estimate and assign the value to their Intangible assets using valuation approaches and methodologies which are globally recognised.

Categories of Intangible Assets

- Marketing related: Trademarks (Brands), trade names, service marks, newspaper, mastheads, internet domain names, non-competition agreements.
- Contract-based intangible assets: Licensing and royalty agreements, advertising, construction, service or supply agreements, lease agreements, franchise agreements, employment contracts.
- Technology-based intangible assets: Patented technology, computer software, unpatented technology (know-how), databases, trade secrets such as secret formulas, processes and recipes.
- Customer-related intangible assets: Customer lists, order or production backlogs, customer contracts and customer relationships including non-contractual relationships.
- Artistic-related intangible assets: Plays, operas, ballets, books, magazines, newspapers, pictures, photographs.

Trademarks

A trademark is an intangible asset legally preventing others from using a business's logo, name, or other branding.

Trademarks

Trademark Symbol: The following symbol is attached to images or text that have been trademarked with the federal government.

A trademark is an image, word, phrase, logo or combination of those elements used to identify a specific type of business or service. A trademark allows a customer to instantly identify a product and associate the item with a response regarding its quality and price. If developed properly, a trademark will allow customers to make a positive connection with the product to which it is attached. In short, a trademark is a visual representation of a business's brand or logo.

To protect the work that it puts into developing its brand, a company will obtain a trademark. The legal protection of a trademark prevents other businesses from using the specific image and text associated with the brand. In some circumstances, a business may obtain a "common law" trademark. This offers the business some legal protection. Generally, American businesses will register their logo with the U.S. Patent and Trademark Office. This offers them more legal protection, but can also be more expensive to obtain.

A trademark is an intangible asset, as it's a nonphysical item granting a business the legal right to exclusively use a logo or other item. This means it is reported on a business's balance sheet.

Valuing Trademarks

Trademarks have enormous value to businesses, although that may not translate to a business's financial report. A business can only value any intangible asset, including a trademark, based on what it cost to acquire. For example, if a business purchased a product line from another company, the trademark associated with that product could have a high value on the acquiring company's books.

The value of a trademark can also be quite low. All costs associated with creating the logo or promoting its public awareness are not included in the trademark's value if the business did all these tasks internally. As a result, some trademarks could have no value on a company's books despite a significant investment by the business.

Annual Review of Trademarks

Some intangible assets are amortized over time. This means that the value decreases every year as an expense for using the item. The amount the value of the asset decreases also decreases the business's income for that year. Trademarks are not amortized since each is considered to have an indefinite life, meaning a perception exists that a trademark can retain its value forever.

However, a business must reassess the value of its trademarks annually. If a business determines that one of its trademarks is worth less than it was a year ago, the value of the intangible asset must be impaired. When an impairment occurs, the value of the asset must be decreased to its current market value. The difference between the current value of the trademark and its former value must be recorded as a financial loss.

Copyrights

A copyright is an amortizable, intangible asset that is used to secure the legal right to publish a work of authorship.

Copyrights

Copyright: This is the emblem attached to something that is copyrighted.

A copyright is a legal protection preventing others from publishing or reproducing works of authorship. A work of authorship can include poetry, novels, plays, computer software and architectural drawings. A person who creates a work of authorship has a copyright the moment the work is created and is fixed in a form that either a person or machine can read. As a result, an author does not have to register their work with the U.S. Copyright Office. Formally registering a work is generally recommend because it provides additional legal protection against those who would copy the work.

A copyright only lasts so long, but how long it lasts depends on several factors. Generally, most copyrights last for the duration of an author's life plus 70 years. If it is an anonymous work or something done for hire, the copyright lasts for 95 years after it was published or 120 years from the year it was created.

While a copyright is associated with a tangible work, since it is a legal right it is also classified as an intangible asset and can be included on a business's balance sheet.

Valuing a Copyright

The value a business attaches to a copyright depends on how it was acquired. If the business developed the work in question, the value of the copyright is equal to the cost the business incurred securing the copyright. This would include any legal or application fees it might have incurred to obtain the copyright.

If the business purchased the copyright from another company, the business will record the acquired asset at it acquisition cost.

Amortizing a Copyright

Since a copyright eventually terminates, it is amortized. This means that every year the value of the copyright on the company's books will decrease. The business will record an amortization

expense to reflect the decrease in the asset's value. Generally, an intangible asset like a copyright is amortized via the straight-line method. This means that the book value of the copyright is divided by the useful life of the copyright to determine the amortization amount. The useful life determines how long the business expects the copyright to provide it revenue, and therefore may not equal the full term of the copyright.

Every year, the amortization amount is subtracted from the value of the copyright and is listed as an expense. This continues until the value of the copyright equals zero.

Patents

A patent is an amortizable, intangible asset that grants a business the sole right to manufacture and sell an invention.

Patents

A patent is a legal license granting its holder the exclusive right to make, use, or sell a specific invention. There are three types of patents. A utility patent is for processes, machines, and articles of manufacture. The light bulb and the Model T would have been utility patents. A design patent is used for any new, original ornamental design that can be affixed to an item of manufacture, such as a hood ornament for a Model T. A plant patent is granted to anyone that has invented or created a new plant, such as a unique strain of corn.

A patent is an example of an intangible asset with a limited life: A patent is an example of an intangible asset with a limited life.

A U.S. patent currently lasts 20 years. Despite the fact that a patent is connected to a specific type of item, a patent represents a legal right and not a tangible item. A patent is classified as an intangible asset and is listed on a company's balance sheet.

Valuing a Patent

The value of a patent that a company would record on its books depends on how it acquired the patent. If the business developed the invention internally, all the research and development costs associated with that item would have been listed as an expense as those fees were incurred. Therefore, the initial value of an internally developed patent could be quite low.

If the business purchased the patent from the original holder, the value of the patent equals the acquisition cost.

The value of the patent may be increased if a patent holding company defends its rights to the invention in a lawsuit. If the company uses an outside law firm, all fees the business pays to the firm to defend the patent will be included as part of the patent's book value.

Amortizing a Patent

Since a patent is only valid for a limited number of years, a business is required to amortize it. The process of amortization requires decreasing the value of the asset annually by an amount equal to the value of the asset divided by the number of years of the patent's useful life. The useful life of the patent can be no longer than how much time is left on the patent's term, but should reflect the period that the underlying invention can generate revenue for the business that owns it. Every year the business records a decrease in the patent's value, it must also record a corresponding amortization expense equal to the decrease.

For example, assume a business acquires a patent that has 15 years left on its term for 1 million dollars. However, the invention the patent secures will only generate revenue for ten years. For the next ten years, the company must decrease the value of the asset by 100,000. To ensure the books are balanced, the business must also record a $100,000 amortization expense for the next ten years.

Goodwill

Goodwill is an intangible asset that equals an acquired company's purchase price minus the value of its net assets when it

Goodwill

The value of a business is not always defined by what assets it owns and what it owes. A successful business will develop customer loyalty and an overall positive reputation in its community, which will cause its market value to be greater than its book value. A company may also generate a higher value if it proves over time that it can generate superior revenues than its competition through managerial expertise, its reputation within its business sector, and other company attributes.

The difference between the value of a company as reflected in its balance sheet and its market value is known as its goodwill. Accounting goodwill is the excess value of a firm's net assets and is recorded at time of business acquisition or combination. Goodwill is not associated with a physical object that the business owns, so it is an intangible asset and is listed on a company's balance sheet. In comparison, economic goodwill refers to company attributes that are hard to quantify, such as brand loyalty, brand recognition, company innovation, and executive talent.

Apple is a successful company with considerable goodwill.: Apple is a successful company with considerable goodwill.

Valuing Goodwill

A company can list goodwill on its balance sheet when it acquires another business at a higher cost than what the assets and liabilities on the acquired company's balance sheet dictate. In short, goodwill equals the acquisition price minus net assets.

Say a business was purchased for 100 million. Its assets were worth 80 million but it had 30 million in liabilities. The acquired business' assets would be equal to 50 million, and the acquiring business would record 50 million worth of goodwill on its balance sheet.

However a business may not record goodwill that it generates for itself. Using the same example, assume the business was not acquired, but it was worth 100 million and still had 80 million of assets with 30 million in liabilities. The business would not be able to record the 50 million of goodwill on its own balance sheet. Goodwill can only be recorded when an entire business or an entire section of a business is purchased at a price greater than the value of its assets.

Annual Review of Goodwill

It used to be that goodwill was amortized. This meant that the value of goodwill was decreased annually, with the business recording a loss equal to the amount of the decrease in value. As of 2001, goodwill is no longer amortized.

Every year the value of goodwill must be evaluated by the business that owns it. The company must determine the present value of all of the future revenues of the business segment associated with the goodwill. If the present value of those revenues equal or exceed the value of the business segment's carrying value, or its total assets (including goodwill) minus assets, the business does not have to make any changes.

If the present value of the future revenues is less than the business segment's carrying value, the business must impair, or decrease the value, of the goodwill account. Goodwill must be decreased so that the segment's carrying value equals the present value of its revenues. If the the total value of goodwill is not enough to make up the difference, the goodwill balance must be set to zero. A business cannot have a negative goodwill balance.

Any impairment of goodwill is recognized as a loss for year of the decrease and reported on the income statement.

Franchises and Licenses

Franchises and licenses are intangible assets that legally entitle a business to sell a product or service developed by another entity.

McDonald's, Oldham Road, Manchester.: McDonald's is one well known organization that operates using franchises.

A franchise is a contract that grants a business the right to operate using the name and products of an established brand. A franchisor will develop the brand, produce goods and develop marketing campaigns for its products. A franchisee will then purchase the rights to sell the franchisor's products in a given area and benefit from the franchisor's marketing efforts. The franchisor makes money by selling rights to franchisees, while the franchisee profits by selling directly to customers. A common industry that uses franchising is fast food.

A license is similar to a franchise, in that it grants someone the right to legally use someone else's intellectual property or gooda. This license will contain terms that will define how the purchaser can use the product and whether she can share it. A common example of a license a business might purchase is for software.

Valuing Franchises and Licenses

How a franchise is recorded on a balance sheet depends on the conditions of the contract. If a franchisee makes periodic payments to the franchisor over the contract's term, the franchisee does not record a franchise asset. Instead, the franchisee records a franchise expense when she pays the franchise fee.

If the contract requires that a lump sum be paid up front to secure the franchise rights for several years, the franchisee would record a franchise asset on its balance sheet. Therefore, the value of the franchise asset equals what it cost to acquire.

The same rules apply to a license. If a business must pay licensing fees on a monthly or on an annual basis that coincides with the end of the business's fiscal year, the business does not record a license asset. The fees that the business paid for those licenses are included as an expense. If the license is for multiple years or accounting periods and is acquired by paying an initial fee, the license is recorded as an asset on the balance sheet and its value equals what it cost to acquire the license.

Amortizing Franchises and Licenses

Amortizing is a term that only applies if there is a franchise or license asset. Amortization is the process of writing off the cost of an asset over its useful life. Useful life is the amount of time that a business can generate revenues from the asset. For a franchise, the useful life is generally the length of the franchise contract. The useful life of a license is how long it grants the holder the exclusive right to use the underlying product.

The amortization rate is calculated by dividing the initial value of the asset by its useful life. Depending on when the balance sheet is issued, the useful life is presented as a number of months, quarters, or years. Every accounting period, the value of the asset is decreased by the amortization rate. The business also records an expense equal to the amortization rate every accounting period.

Research and Development

Research is a planned and detailed investigation into a product or service for gaining scientific or technical know-how. Development is the application of such researches to develop new and better products and service than the current portfolio a company has.

R&D is a part of internally generated intangible assets of a company. Companies spend millions of dollars on R&D and hence, it is a valuable intangible asset capable of taking a company to new heights.

Definition: A leasehold is an intangible asset to a lessee that gives the him or her certain rights to use leased property. These rights are often referred to as leasehold rights or simply leasehold. The the lessor grants these rights to the lessee when he or she signs a lease contract.
What Does Leasehold Mean?
Many companies can't afford to buy buildings or large pieces of equipment, so they rent them. When a company signs a rental contract for a period of time, the contract is considered to be a lease contract and the rent payments are considered lease payments.
Example
Take a car for example. When a company leases a vehicle, it is given the rights to possess the vehicle, use it, and sometimes even customize it to the lessee. Unless lease contract is broken or an exception is stated in the lease contract, the leaser cannot confiscate the leased property from the lessee prematurely. The car remains in the lessee's possession and use until the lease contract is over.

Some leases allow the lessee to customize or alter the leased property. This is called a leasehold improvement. In this case, the leasehold gives the lessee the right to improve the leased property according to the contract. Usually some specific improvements are agreed upon between the lessor and lessee before the improvements are made. Most of the time leasehold improvements are made on leased buildings. Retailers usually want to customize the look of their rented space, so it matches their branding. Depending on the lease contract, the lessor or the lessee will pay for the building improvements.

Lease liability – recap

Before we begin, let's summarize a few concepts. In order to record the lease liability on the balance sheet, we need to determine the **lease term**. Determining the lease term sometimes requires judgment, particularly when we have renewal and termination options as part of the lease agreement (see **December 2019's blog** for additional insight on the lease term).

We also need to determine the **lease payment**. Determining the lease payment also requires judgment in some cases, for example, when there are payments related to renewal or termination options (see **February 2020's blog** for additional insight on the lease payment).

In addition to the lease term and lease payment, we also need to know the rate that will be used to discount the lease liability. If we are using the incremental borrowing rate, we have to make sure the inputs that go into calculating the rate are reliable (see **September 2019's blog** for additional insight on the discount rate). We need all three of these inputs to record the lease liability. In this blog, we will figure out how to put it all together.

Lease liability – recording it

The lease liability represents the obligation to make lease payments and is measured at the present value of future lease payments. Once we have gathered our information, i.e., we know the lease term, the lease payment and the discount rate, we simply discount the liability over the lease term, using the discount rate. We then record the lease liability, or the resulting amount, on

the balance sheet. Next, we'll have to record the lease asset. Let's continue reading to determine what steps we need to take.

Right-of-use asset

To begin, the asset that we are going to be recording is known as a "right-of-use" asset. The right-to-use asset is an intangible asset and if you are familiar with the old lease standard, you'll notice this as a difference right away. Using the old lease standard, we would record the asset (for example, a truck) directly on the balance sheet; now we are recording the right to use the asset (for example, the right to use a truck) instead of the actual asset itself. The right-of-use asset is an intangible asset.

There are three items that we need to consider before we can arrive at the correct amount for the right-to-use asset:

- Initial direct costs (incurred by the lessee)
- Lease incentives (received by the lessee)
- Lease prepayments (made by the lessee)

Initial direct costs

Initial direct costs are defined as follows:

Incremental costs of a lease that would not have been incurred if the lease had not been obtained

It may help to look at some examples here. Payments made to a lawyer to obtain tax or legal advice would most likely not be an initial direct cost. On the other hand, a payment made to a broker as commission would most likely be an initial direct cost as that payment would only be made if the lease had been obtained. Likewise, a payment made to an existing tenant as an incentive to terminate the lease would likely be an initial direct cost (again, this cost would be incurred only if the lease had been obtained).

Lease incentives and prepayments

A lessor may provide an incentive to a prospective tenant to induce them to sign a lease. This is known as a lease incentive and may be provided in the form of an up-front cash payment, a payment of the lessee's costs (for example, moving expenses) or the assumption of the lessee's preexisting lease, to provide a few examples.

Lease prepayments are simply payments made in advance.

What Is a Deferred Tax Asset?
Items on a company's balance sheet that may be used to reduce taxable income in the future are called deferred tax assets. The situation can happen when a business overpaid taxes or paid taxes in advance on its balance sheet. These taxes are eventually returned to the business in the form of tax relief. Therefore, overpayment is considered an asset to the company. A deferred tax asset is

the opposite of a deferred tax liability, which can increase the amount of income tax owed by a company.

Deferred Tax Assets

Deferred tax assets are often created due to taxes paid or carried forward but not yet recognized on the income statement. For example, deferred tax assets can be created due to the tax authorities recognizing revenue or expenses at different times than that of an accounting standard. This asset helps in reducing the company's future tax liability. It is important to note that a deferred tax asset is recognized only when the difference between the loss-value or depreciation of the asset is expected to offset future profit.[1]

A deferred tax asset can conceptually be compared to rent paid in advance or refundable insurance premiums; while the business no longer has cash on hand, it does have comparable value, and this must be reflected in its financial statements.

How Deferred Tax Assets Arise

The simplest example of a deferred tax asset is the carryover of losses. If a business incurs a loss in a financial year, it usually is entitled to use that loss in order to lower its taxable income in the following years.[2] In that sense, the loss is an asset.

Another scenario where deferred tax assets arise is when there is a difference between accounting rules and tax rules. For example, deferred taxes exist when expenses are recognized in the income statement before they are required to be recognized by the tax authorities or when revenue is subject to taxes before it is taxable in the income statement.[1] Essentially, whenever the tax base or tax rules for assets and/or liabilities are different, there is an opportunity for the creation of a deferred tax asset.

Practical Example of Deferred Tax Asset Calculation

A computer manufacturing company estimates, based on previous experience, that the probability a computer may be sent back for warranty repairs in the next year is 2% of the total production. If the company's total revenue in year one is $3,000 and the warranty expense in its books is $60 (2% x $3,000), then the company's taxable income is $2,940. However, most tax authorities do not allow companies to deduct expenses based on expected warranties; thus the company is required to pay taxes on the full $3,000.

If the tax rate for the company is 30%, the difference of $18 ($60 x 30%) between the taxes payable in the income statement and the actual taxes paid to the tax authorities is a deferred tax asset.

Important Considerations for Deferred Tax Assets

There are some key characteristics of deferred tax assets to consider. First, starting in the 2018 tax year, they can be carried forward indefinitely for most companies, but are no longer able to be carried back.

The second thing to consider is how tax rates affect the value of deferred tax assets. If the tax rate goes up, it works in the company's favor because the assets' values also go up, therefore providing a bigger cushion for a larger income. But if the tax rate drops, the tax asset value also

declines. This means that the company may not be able to use the whole benefit before the expiration date.

How is a Deferred Tax Liability or Asset Created?

A deferred tax liability or asset is created when there are temporary differences between book tax and actual income tax. There are numerous types of transactions that can create temporary differences between pre-tax book income and taxable income, thus creating deferred tax assets or liabilities. While tax, in itself, is a complicated matter to analyze, deferred tax assets and liabilities add another layer of complexity in tax accounting.

To understand what is driving these deferred taxes, it is helpful for an analyst to examine the tax footnotes provided by the company. Often, a company will outline what major transactions during the period have made changes to the balances of deferred tax assets and liabilities. Companies will also reconcile effective tax rates in these footnotes.

Understanding changes in deferred tax assets and deferred tax liabilities, or rather than the net value of the two, allows for improved forecasting of cash flows.

What Type of Information to Look For?

Below are just some major classes of information to look for in footnotes. Understanding this information should allow an analyst to make sense of the changes in deferred tax balances. These transactions are sometimes apparent in the income statement or balance sheet.

Information to look for includes:

1. Warranty, bad debt, and/or write-down estimates
2. Policy on capitalizing and depreciating fixed assets
3. Policy on amortizing financial assets
4. Revenue recognition policy

Analyzing the Effects of a Deferred Tax Handling

After understanding the changes and causes of the deferred tax balance, it is important to also analyze and forecast the effect this will have on future operations. For example, deferred tax assets and liabilities can have a strong impact on cash flow. An increase in deferred tax liability or a decrease in deferred tax assets is a source of cash. Likewise, a decrease in liability or an increase in deferred asset is a use of cash.

Analyzing the change in deferred tax balances should also help to understand the future trend these balances are moving towards. Will the balances continue growing, or is the likelihood of a reversal in the near future high?

These trends are often indicative of the type of business undertaken by the company. For example, a growing deferred tax liability could signal that a company is capital intensive. This is

because the purchase of new capital assets often comes with accelerated tax depreciation that is larger than the decelerating depreciation of older assets.

UNIT- 5 Equity transactions (per US GAAP and IFRS)

Paid in capital Vs. Retained Earning

For any company, the shareholder's equity portion of its Statement of Financial Position will consist of different equity instruments and reserves. Among these, the most common are paid-in capital, additional paid-in capital, and retained earnings.

Each of these balances represents a different aspect of the equity of a company. While these are all a part of the equity of a company, there is still some difference between them.

To better understand the similarities and differences between these balances, it is crucial to understand what each of these balances represents. Below is a general description of these balances.

What is Paid-in Capital?

Paid-in capital is a balance is the equity of a company that represents the par value of its issued shares. Every share issued by a company has a par value, which denotes the value of the share set in the corporate charter. That means the par value of a share does not change from one issue to another.

Therefore, the paid-in capital balance only consists of the total par value of all the issued shares of a company. The more share a company issues, the higher its paid-in capital balance is going to be.

Paid-in capital can also exist for the preferred shares of a company. Preferred shares are shares that give the shareholder a preference when it comes to dividends, and in case the company liquidates.

Preferred shares, like ordinary shares, also have a par value or face value, which the company defines beforehand. For all the preferred shares a company issues, it must record the total amount of their par value in the paid-in capital account.

Difference between paid-in capital and additional paid-in capital

For most companies, issuing shares will also give rise to another balance known as the additional paid-in capital balance. While this balance is closely related to the paid-in capital balance, and often depends on it, it represents a different aspect of equity.

What is Additional Paid-in Capital?

Additional paid-in capital consists of any additional amount above the par value of a share that a company receives for new share issues. The actual price a company charges for newly issued shares will almost always be different from its par value.

The actual price depends on various factors such as market conditions, company performance, environmental factors, etc. The company must split the paid-in capital amount from the total receipt for new shares and record the remaining amount in the additional paid-in capital account.

While additional paid-in capital balance represents a different amount and balance than the paid-in capital balance of a company, both of them are very closely related.

They make up the total equity a company received from its shareholders in exchange for issued shares, also known as contributed capital. There are also some rules and regulations that companies must follow when it comes to paid-in and additional paid-in capital balances.

What is Retained Earnings?

Retained earnings are also a part of the shareholders' equity of a company. However, retained earnings do not relate to the finance a company generates from its shareholders. Instead, retained earnings represent the internally generated finance of a company that it makes through its operations.

The retained earnings of a company usually comprise of its accumulated profits less any dividends it pays to its shareholders.

READ Accounting Entry for the Bonus Share Issue: Explanation with Example

A company generates profits through its operations. Sometimes, it may also make a loss instead of a profit. Either way, the retained earnings of a company reflects its performance over its lifetime. Retained earnings is also a type of finance that a company can use in its operations.

It is the lowest cost finance that a company can use since the company generates it internally. However, retained earnings may be finite depending on the resources and performance of the company.

Unlike with paid-in and additional paid-in capital, a company can distribute its retained earnings. Therefore, retained earnings represent the distributable profits of a company. These distributions come in the form of dividends. Every time the company pays dividends to its shareholders, it must deduct them from its retained earnings.

When companies initially start, their paid-in capital and additional paid-in capital balance will exceed their retained earnings balance. However, as they establish themselves and make profits, their retained earnings balance can exceed their paid-in and additional paid-in capital balances.

However, if they make a lot of losses instead of profits, the retained earnings balance may also become negative or go into a deficit. Paid-in and additional paid-in capital balances will never become negative for companies.

Three main balances will exist in the shareholders' equity of companies including paid-in capital, additional paid-in capital, and retained earnings. Paid-in capital represents the total par value of

the issued shares of a company, and additional paid-in capital represents the amount in excess of the par value of shares a company receives.

Lastly, retained earnings represent the total profits minus the total dividends paid by a company. Paid-in and additional paid-in capital are similar and often related to each other. However, they are different from retained earnings.

Accumulated other comprehensive income is a separate line within the stockholders' equity section of the balance sheet. This line accumulates the effects of items known as other comprehensive income, which are reported in each period's statement of comprehensive income. It is analagous to retained earnings which is accumulating the revenues and expenses that are reported on each period's income statement.
Some examples of the items which comprise *accumulated other comprehensive income* include:

- Unrealized gains/losses on hedge/derivative financial instruments
- Foreign currency translation adjustments
- Unrealized gains/losses on postretirement benefit plans

In short, the above examples will impact the balance sheet and the statement of comprehensive income. However, the examples will not affect net income, the income statement, or retained earnings.

Difference Between Stock Dividend vs Stock Split

Cash Dividend means dividend which is paid to shareholders in Cash/ Bank. When a company doesn't have cash for payment of dividends, it gives dividends in the form of equity or we can say that additional shares of the Company are allotted to the shareholder. This term is called Stock Dividend. Stock Split is one of the forms of Corporate Action. Stock Split and Stock Dividend are different, and cannot be used interchangeably. Let's understand the Stock Split. As the name itself tells the meaning, Stock Split means splitting of Stock or Equity Shares. Stock splits are splitting of already issued shares to increase the no. of shares of the Company.

Stock Dividends

A stock dividend is a form of dividends that is issued by a corporation instead of issuing cash dividends. Thus instead of actual outflow of cash, the stockholders further receive stocks with no change in the value of their original holding. Stock dividends:

- Primarily aid company to combat with cash crunches;
- Have no impact on shareholders wealth at the time of issue;
- Lead to dilution of earnings per share.

For stock dividends, there are two types: small stock dividend and a large stock dividend. A small stock dividend occurs when a company issues a dividend that is 20 to 25 percent of the company's currently issued stock. In that case, the dividend is recorded at fair market value. A large stock dividend then is when the company issues a dividend that is

more than 20 to 25 percent of the currently issued stock. Since it is such a large amount that could influence the market value, those are recorded at par value.

As you can see, there is a range of 20 to 25 percent and that is because there are other factors that can influence whether or not a stock dividend is considered a small stock dividend or a large stock dividend.

Stock Splits

A stock split is different in that additional shares are issued to stockholders. The split is essentially when the management decides that it is going to split its share price, so it can bring its share price to a lower amount to stimulate investing by smaller investors. What happens is the par value or the stated value of the share is reduced, while the number of shares outstanding increases.

Basically, if a stock is $250 and the company wants to bring that share price down to $125 the next day, it can announce a stock split. Shareholders who already own those shares will have two shares for every share, but these two shares will be lower in value and worth $125. In other words, both share will equal to what it was for one share before ($250).

Stock splits are usually done by companies whose stock prices get really high and it is desired to lower their value. This allows them to get more investors because they can appeal to a broader base of investors. One of the examples is Apple. At one point, Apple stock price was over $700 a share, so they did a 7-for-1 stock split in 2014. What that meant is that for every one share a shareholder had before at $700, they now had 7 shares at $100 each. Another stock split was done just recently.

Stock Split vs Stock Dividend

As you can see, there are big differences between these two terms. Both of these are written down in the financial accounting records. However, no journal entry is needed to account for a stock split. A memorandum notation in the accounting records indicates the decreased par value and an increase in the number of shares. The financial accounting for stock dividends is more detailed and does require journal entries.

Similarities:

- Value to investors
- Market capitalization
- Percentage holding

Differences:

- Purpose
- Change in share capital
- Accounting entry

Stock splits are better if you are someone that is such a small investor that you cannot really afford some of these more expensive stocks, like a Google stock or an Amazon. So, if you only have like $100-$300 to invest, you cannot even buy those shares. In this case, the stock split is the best thing for you. In most cases though, the share prices are not that high, and most serious investors can afford them. Even beginners, small investors have a wide choice of company stocks they can buy.

Stock dividends are nice and one of the primary reasons for investing in a particular company. Beginner investors, though, put more value on the dividends being paid than on the future prospects of the company and other factors. A dividend usually matters if you are looking for income to come in. So, maybe you have a lot of money invested in a stock or you are a retiree and do not want to sell stocks, reinvest, etc. In this case, dividends are preferable so you can collect dividends and have your money.

Other investors prefer companies to used that cash to grow, create new products or services, improve the current ones, and so on instead of paying out to their shareholders. In the long term, this will mean that the share price will grow and the investor will gain more.

What is a Stock Option?

A stock option is a contract between two parties that gives the buyer the right to buy or sell underlying stocks at a predetermined price and within a specified time period.

A seller of the stock option is called an option writer, where the seller is paid a premium from the contract purchased by the buyer.

Stock Option Types

There are two types of stock options:

- A stock **call option**, which grants the purchaser the right but not the obligation to buy stock. A call option will increase in value when the underlying stock price rises.
- A stock **put option**, which grants the buyer the right to sell stock short. A put option will increase in value when the underlying stock price drops.

Investment bankers may purchase either of these two types of options individually or in conjunction with each other to apply certain trading techniques, such as a covered call.

Strike Price

Stock options come with a pre-determined price, called a strike price. Investors can purchase call AAPL contracts at the strike price of $108, for example, even though the current market price is $110. Alternatively, they can purchase the call option at a strike price of $113.

In the above example, an option strike price of $108 is called in-the-money, and the strike price $113 is out-of-the-money. In-the-money options, when exercised, result in a profit, while out-of-the-money options, when exercised, will result in a loss.

Settlement/Expiration Dates

Each option has a different expiration date and rule for settlement. There are two option styles in the markets.

- An **American-style** option which allows the holder of the option to exercise the call/put option any time before expiration
- A **European-style** option which only allows the option to be exercised on the expiration date.

In the past, when the holder of an option exercised his right, the transaction was processed and the certificates of stocks delivered to the holder. In the modern market, all settlements occur in cash, based on the value of the underlying stock.

Concept of Business Combinations:

Business combinations may be defined as follows:

Business combinations are combinations formed by two or more business units, with a view to achieving certain common objective (specially elimination of competition); such combinations ranging from loosest combination through associations to fastest combinations through complete consolidations.

L.H. Haney defines a combination as follows:

"To combine is simply to become one of the parts of a whole; and a combination is merely a union of persons, to make a whole or group for the prosecution of some common purposes."

Read this article to know about the causes of formation of business combination.

Causes of Business Combinations:

Some of the outstanding causes leading to the formation of business combinations are described below:

(i) Wasteful Competition:

Competition, which is said to be the 'salt of trade', by going too far, becomes a very powerful instrument for the inception and growth of business combinations. In fact, competition, according to Haney, is the major driving force, leading to the emergence of combinations, in industry.

(ii) Economies of Large-Scale Organization:

Organisation of production on a large scale brings a large number of well-known advantages in its wake – like technical economies, managerial economies, financial economies, marketing economies and economies vis-a-vis greater resistance to risks and fluctuations in economic

activities. Economies of large scale operations, thus become, a powerful force causing increased race for combinations.

(iii) Desire for Monopoly Power:
Monopoly, a natural outcome of combination, leads to the control of market and generally means larger profits for business concerns. The desire to secure monopolistic position certainly prompts producers to join together less than one banner.

(iv) Business Cycles:
Trade cycles, the alternate periods of boom and depression, lead to business combinations. Boom period i.e. prosperity period leading to an unusual growth of firms to reap rich harvest of profits results in intense competition; and becomes a ground for forming combinations.

Depression, the times of economic crisis-with many firms having to only option to close down-prompts business units to combine to ensure their survival.

(v) Joint Stock Companies:
The corporate form of business organization is a facilitating force leading to emergence of business combinations. In joint stock companies, control and management of various corporate enterprises can be concentrated, in a 'small group of powerful persons through acquiring a controlling amount of shares of different companies.

(vi) Influence of Tariffs:
Tariffs have been referred to as **"the mother of all trusts".** (A trust is a form of business combinations). Tariffs do not directly result in combinations; they prepare the necessary ground for it. In fact, imposition of tariffs restricts foreign competition; but increases competition among domestic producers. Home producers resort to combinations, to protect their survival.
(vii) Cult of the Colossal (or Respect for Bigness):
In the present-day-world, business units of bigger size are more respected than units of small size. Those who believe in the philosophy of power and ambition, compel small units to combine; and are instrumental in forming powerful business combinations, in a craze for achieving bigness.

(viii) Individual Organising Ability:
The scarcity of organizing talent has also induced the formation of combinations, in the business world. Many-a-times, therefore, combinations are formed due to the ambition of individuals who are gifted with organising ability. The number of business units is far larger than the skilled business magnates; and many units have to combine to take advantage of the organising ability of these business brains.

Types of Business Combinations:
Business combinations are of the following types:
(i) Horizontal Combinations.

(ii) Vertical Combinations.

(iii) Lateral or Allied Combinations:
Lateral combination refers to the combination of those firms which manufacture different kinds of products; though they are allied in some way.

Lateral combination may be:
(a) Convergent lateral combination:
In convergent lateral combination, different industrial units which supply raw-materials to a major firm, combine together with the major firm. The best illustration is found in a printing press, which may combine with units engaged in supply of paper, ink, types, cardboard, printing machinery etc.

(b) Divergent lateral combination:
Divergent lateral integration takes place when a major firm supplies its product to other combing firms, which use it as their raw material. The best example of such combination may be found in a steel mill which supplies steel to a number of allied concerns for the manufacture of a variety of products like tubing, wires, nails, machinery, locomotives etc.

(iv) Diagonal (or Service) Combinations:
This type of combination takes place when a unit providing essential auxiliary goods / services to an industry is combined with a unit operating in the main line of production. Thus, if an industrial enterprise combines with a repairs workshop for maintaining tools and machines in good order; it will be effecting diagonal combination.

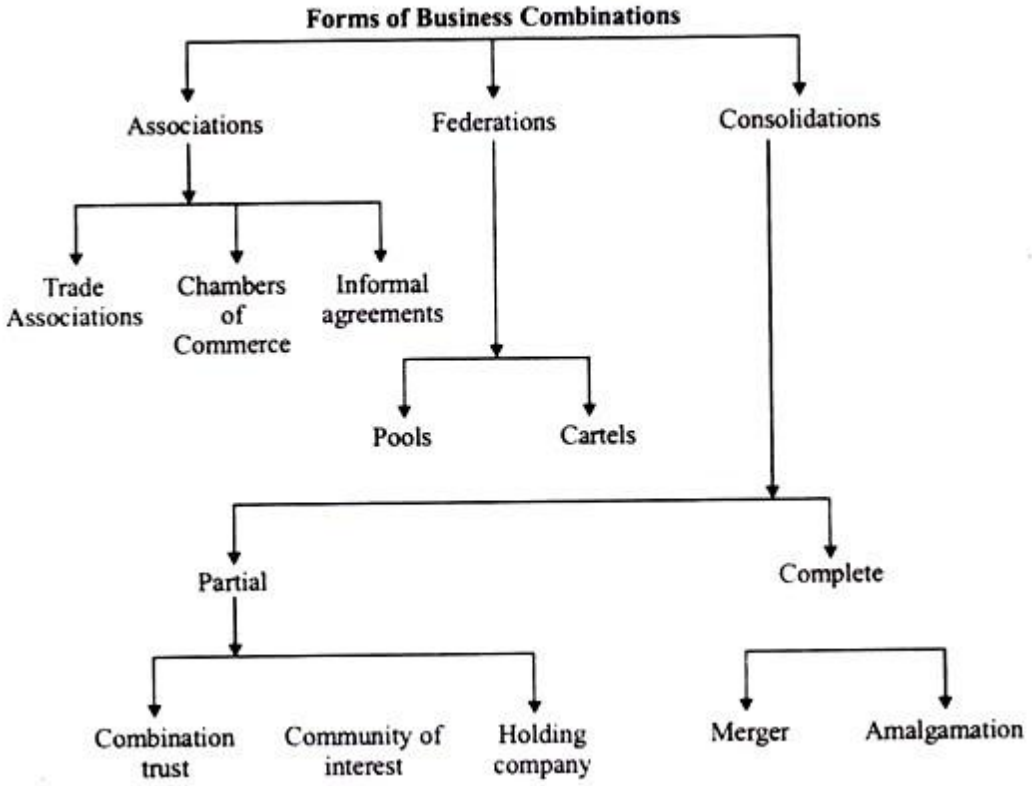
(v) Circular (or Mixed) Combinations:
When firms engaged in the manufacture of different types of products join together; it is known as circular or mixed combination. For example, if a sugar mill combines with a steel works and a cement factory; the result is a mixed combination.

Forms of Business Combinations:
By the phrase 'forms of combinations', we mean the degree of combination, among the combining business units.

According to Haney, combinations may take the following forms, depending on the degree or fusion among combining firms:
(I) Associations:
(i) Trade associations
(ii) Chambers of commerce
(iii) Informal agreements
(II) Federations:
(i) Pools
(ii) Cartels
(III) Consolidations – Partial and Complete:
(a) Partial Consolidations:
(i) Combination trusts
(ii) Community of interest
(iii) Holding company
(b) Complete Consolidations:

(i) Merger
(ii) Amalgamation

The following chart depicts the above forms of business combinations:



Following a brief account of the above forms of business combinations:

(I) Associations:

Forms of Combinations, in this Category are:

(i) Trade Associations:

A trade association comes into being when business units engaged in a particular trade or industry or in closely related trades come together for the promotion of their economic and business interests. Such an association is organized on a non-profit basis and its meetings are used largely for a discussion of matters affecting the common interests of members such as problems of raw- materials, labour, tax-laws etc.

Most of the trade associations are organised on a local or territorial basis. A trade association is the loosest form of combination and it does not interfere with the internal management of a member unit.

(ii) Chambers of Commerce:

Chambers of commerce is voluntary associations of persons connected with commerce and industry. Their membership consists of merchants, brokers, bankers, industrialists, financiers etc.

Chambers of commerce is formed in the same way as associations, with the ultimate objective of promoting and protecting the interests of business community. But they differ from trade

associations in that they do not confine their interests only to a particular trade or industry; but stand for the business community in a particular region, country, or even the world, as a whole.

Chambers of commerce act as spokesmen of business community and make suggestions to the government regarding legislations that will foster trade and industry. The constitution and composition of chambers of commerce vary from country to country. In most of the countries, they are voluntarily organised by businessmen; though the government maintains close contacts with them.

(iii) Informal Agreements:
Informal agreements are types of business combinations which may be formed for the purpose of regulating production or for dividing the markets or for fixation of prices etc. Such agreements require the surrender of some freedom by the combining business units; though ownership and control of combining units is not affected.

Informal agreements among business magnates are often concluded secretly at social functions like dinners or at meetings of trade associations etc. These agreements are merely understanding among the parties and no written documents are prepared. As they depend mainly on the honour and sincerity of members; they are referred to as Gentlemen's agreements.

(II) Federations:

Forms of Business Combinations in this Category are:

(i) Pools:
Under the pool form of business combination, the members of a pooling agreement join together to regulate the demand or supply of a product without surrendering their separate entities, in order to control price.

Important Types of Pools are:

(a) Output Pools:
Under these pools, the current demand for the product of the industry is estimated; and quotas of output for various member units are fixed. Member units are expected to produce only up-to the quota, and sell their products at a price determined by the pooling association.

(b) Traffic Pools:
Such pools are formed by shipping companies, airlines, railway companies and road transport agencies; with the basic objective to limit competition through a division of the area of operation.

(c) Market Pools:
These pools are formed with the objective of ensuring a certain demand to each member. For this purpose, the entire market is divided among the members in any of these three ways by customers, or by products or by territories.

(d) Income and Profit Pools:
In these pools, members of the pooling association are required to deposit a very high percentage (say 80%) of the gross receipts in the common pool for re-distribution among members on an agreed basis.

(ii) Cartels (Kartells):
Basically cartel is the European name for the American pools. According to Von Beckereth, **"A cartel is a voluntary agreement of capitalistic enterprises of the same branch for a regulation of the sales market with a view to improving the profitableness of its members' business."**
Von Beckereth mentions the following broad types of cartels:

(a) Price-Fixing Cartels:
In this type, prices are fixed for goods and members cannot sell below those prices.

(b) Term-Fixing Cartels:
In this type, terms regarding sales e.g. rate of discount, period of credit; terms of payment etc. are prescribed.

(c) Customer Assigning Cartels:
In this type, each member unit is allotted certain customers.

(d) Zonal Cartels:
In this type, division of market among units takes place; but generally these cartels are formed for dividing the world market.

(e) Quota-Fixing Cartels:
In this type, production quotas are fixed for each member; and no member would produce more than the allotted quota.

(f) Syndicates (or Cartels Proper):
This type of cartel is brought into existence, through an agreement among a number of competing producers to establish a joint selling agency (called syndicate) for the exclusive sales of their products. Member units sell their products to the syndicate at a price called the accounting price.

The syndicate sells to consumers at a price higher than the accounting price; and the profits earned are distributed among members on an agreed basis.

(III) Consolidations:
As a Form of Business Combinations, Consolidations may be:
(a) Partial Consolidations:
Under partial consolidations, the combining units surrender their freedom for all practical purposes to the combination organisation; but retain respective individual entities nominally.

Popular Types of Partial Consolidation are the following:
(i) Combination Trusts:
A combination trusts is an arrangement by which the business control is entrusted to the care of trustees, by a number of business concerns. It consists in the transfer to trustees of the voting rights arising from the possession of shares.

The trust has a separate legal existence. The control and administration of the combining units are consolidated; and they have to forgo a large measure of their independence and autonomy in directing their affairs. The shareholders of combining companies get trust certificates from the Board of Trustees; which show their equitable interest in the income of the combination.

(ii) Community of Interest:
When trusts were declared illegal in the U.S.A.; the business leaders devised a new form of combination 'Community of interest', for keeping a number of companies under some kind of common control.

A community of interest may be defined as form of business combination in which, without any central administration, the business policy of several companies is controlled, by a group of common shareholders or directors.

(iii) Holding Company:
A holding company is a concept recognized by law in India and most other countries. A holding company is any company which holds more than half of the equity share capital of other companies or controls the composition of the board of directors of other companies (called the subsidiary companies).

Further, a company which is a subsidiary of another subsidiary company will be the subsidiary of that other holding company too. If e.g. C is a subsidiary of B; and B is a subsidiary of A; then C will be deemed to be a subsidiary of A through the medium of B.

(b) Complete Consolidations:
Complete consolidation is that form of business combination under which there is a complete fusion of the combining units and the separate entities of these units are surrendered in favour of the consolidated unit.

There are Two Forms of Complete Consolidation:
(i) Merger:
In merger, one or more companies merge with another existing company. The absorbing company retains its entity and enlarges its size through merger. The company which is absorbed, on the other hand, loses its entity in the absorbing company.

(ii) Amalgamation:
An amalgamation implies the creation of a new company by a complete consolidation of two or more combining units. Under amalgamation none of the existing companies retains its entity. There is a complete fusion of various existing companies, leading to the formation of an altogether new company.

We live in an increasingly global economy, so it's important for business owners and accounting professionals to be aware of the differences between the two predominant accounting methods used around the world. International Financial Reporting Standards (IFRS) – as the name implies – is an international standard developed by the International Accounting Standards Board

(IASB). U.S. Generally Accepted Accounting Principles (GAAP) is only used in the United States. GAAP is established by the Financial Accounting Standards Board (FASB).

Let's look at the 10 biggest differences between IFRS and GAAP accounting.

1. **Local vs. Global**

IFRS is used in more than 110 countries around the world, including the EU and many Asian and South American countries. GAAP, on the other hand, is only used in the United States. Companies that operate in the U.S. and overseas may have more complexities in their accounting.

2. **Rules vs. Principles**

GAAP tends to be more rules-based, while IFRS tends to be more principles-based. Under GAAP, companies may have industry-specific rules and guidelines to follow, while IFRS has principles that require judgment and interpretation to determine how they are to be applied in a given situation.

However, convergence projects between FASB and IASB have resulted in new GAAP and IFRS standards that share more similarities than differences. For example, the recent GAAP standard for revenue from contracts with customers, Auditing Standards Update (ASU) No. 2014-09 (Topic 606) and the corresponding IFRS standard, IFRS 15, share a common principles-based approach.

3. **Inventory Methods**

Both GAAP and IFRS allow First In, First Out (FIFO), weighted-average cost, and specific identification methods for valuing inventories. However, GAAP also allows the Last In, First Out (LIFO) method, which is not allowed under IFRS. Using the LIFO method may result in artificially low net income and may not reflect the actual flow of inventory items through a company.

4. **Inventory Write-Down Reversals**

Both methods allow inventories to be written down to market value. However, if the market value later increases, only IFRS allows the earlier write-down to be reversed. Under GAAP, reversal of earlier write-downs is prohibited. Inventory valuation may be more volatile under IFRS.

5. **Fair Value Revaluations**

IFRS allows revaluation of the following assets to fair value if fair value can be measured reliably: inventories, property, plant & equipment, intangible assets, and investments in marketable securities. This revaluation may be either an increase or a decrease to the asset's value. Under GAAP, revaluation is prohibited except for marketable securities.

6. **Impairment Losses**

Both standards allow for the recognition of impairment losses on long-lived assets when the market value of an asset declines. When conditions change, IFRS allows impairment losses to be reversed for all types of assets except goodwill. GAAP takes a more conservative approach and prohibits reversals of impairment losses for all types of assets.

7. **Intangible Assets**

Internal costs to create intangible assets, such as development costs, are capitalized under IFRS when certain criteria are met. These criteria include consideration of the future economic benefits.

Under GAAP, development costs are expensed as incurred, with the exception of internally developed software. For software that will be used externally, costs are capitalized once technological feasibility has been demonstrated. If the software will only be used internally, GAAP requires capitalization only during the development stage. IFRS has no specific guidance for software.

8. **Fixed Assets**

GAAP requires that long-lived assets, such as buildings, furniture and equipment, be valued at historic cost and depreciated appropriately. Under IFRS, these same assets are initially valued at cost, but can later be revalued up or down to market value. Any separate components of an asset with different useful lives are required to be depreciated separately under IFRS. GAAP allows for component depreciation, but it is not required.

9. **Investment Property**

IFRS includes the distinct category of investment property, which is defined as property held for rental income or capital appreciation. Investment property is initially measured at cost, and can be subsequently revalued to market value. GAAP has no such separate category.

10. **Lease Accounting**

While the approaches under GAAP and IFRS share a common framework, there are a few notable differences. IFRS has a de minimus exception, which allows lessees to exclude leases for low-valued assets, while GAAP has no such exception. The IFRS standard includes leases for some kinds of intangible assets, while GAAP categorically excludes leases of all intangible assets from the scope of the lease accounting standard.

Understanding these differences between IFRS and GAAP accounting is essential for business owners operating internationally. Investors and other stakeholders need to be aware of these differences so they can correctly interpret financials under either standard.