Basic Concepts and Principles

1	**Accounting Entity**	» The entity is the specific business enterprise
2	**Going Concern**	» An accounting entity is viewed as theoretically continuing in operation in the absence of evidence in the contrary
3	**Time Periods**	» Provide information about the economic activities of an enterprise for specified time periods
4	**Measurement**	» Monetary units
5	**Substance over Form**	» Financial accounting emphasizes the economic substance of events, even though the legal form may differ (Leases)
6	**Accrual Accounting**	» Revenues are recognized when they are earned and expenses are recognized in the same period as the related revenue

Statement of Cash Flows

Shows the sources and uses of cash for the company

Helps users assess

- The ability of the company to generate positive future cash flows
- The reasons for differences between net income and net cash in/out flows
- The effect of investing and financing transactions on the company's financial position
- The company's need for external financing

Limitations of Statement of Cash Flows

- Only shows what cash flows were, and not how they happened
- Indirect method does not show clearly the sources and uses of cash

Statement of Cash Flows (Continued)

- Each activity in investing and financing activities has two sides.
- The rule is to **present cash inflows and cash outflows separately from each other** for a particular activity

Noncash Investing and Financing

Either investing or financing in nature, but did not involve cash in the transaction

- Converting debt to equity
- Buying or selling fixed assets for something other than cash
- Obtaining a building or other item by gift
- Buying fixed asset by obtaining a loan

No cash is involved in these transactions, but they are presented separately in a **schedule at the end of the SOCF**

Cash equivalents are considered to be cash and are therefore treated as cash in the SCF

Statement of Cash Flows (Continued)

The main difference between US GAAP and IFRS in respect to the Statement of Cash Flows has to do with the classification of activities

Interest and dividends received can be classified as either an operating or investing activity

Interest and dividends paid can be classified as either an operating or financing activity

Noncash investing and financing activities are disclosed in the Notes to the financial statements, and not in a schedule on the Statement of Cash Flows

Statement of Cash Flows (Continued)

Revenue

− COGS

− Salary Expense

− Rent Expense

− Depreciation Expense

+ Gain on Sale of Fixed Asset

Net Income

The starting point for the Operating Activities section is the income statement

Statement of Cash Flows (Continued)

		+/-	
	Revenue	Adjustment	Cash from customers
−	COGS	Adjustment	Cash paid to suppliers
−	Salary Expense	Adjustment	Cash paid to employees
−	Rent Expense	Adjustment	Cash paid for rent
−	Depreciation Expense	Adjustment	--------------------------
+	Gain on Sale of Fixed Asset	Adjustment	--------------------------
	Net Income		= Cash from Operating Activities

The **Direct Method** is done by adjusting each individual line of the income statement

Statement of Comprehensive Income (Continued)

Other Comprehensive Income items are set out below

Foreign currency translation adjustments

Unrealized holding gains and losses on **available-for-sale securities**

Subsequent decreases or increases in the fair value of available-for-sale securities **previously written down** as impaired

The **effective portion** of gains and losses on derivative instruments that are designated as, and qualify as, **cash flow hedges**

The **effective portion** of gains and losses on foreign currency transactions that are designated as economic **hedges of a net investment in a foreign entity**

Gains or losses associated with **pension or other postretirement benefits**

Prior service costs or credits associated with pension or other postretirement benefits

Transition assets or obligations associated with pension or other postretirement benefits

Limitations of Financial Statements

Measurements are made only in terms of money

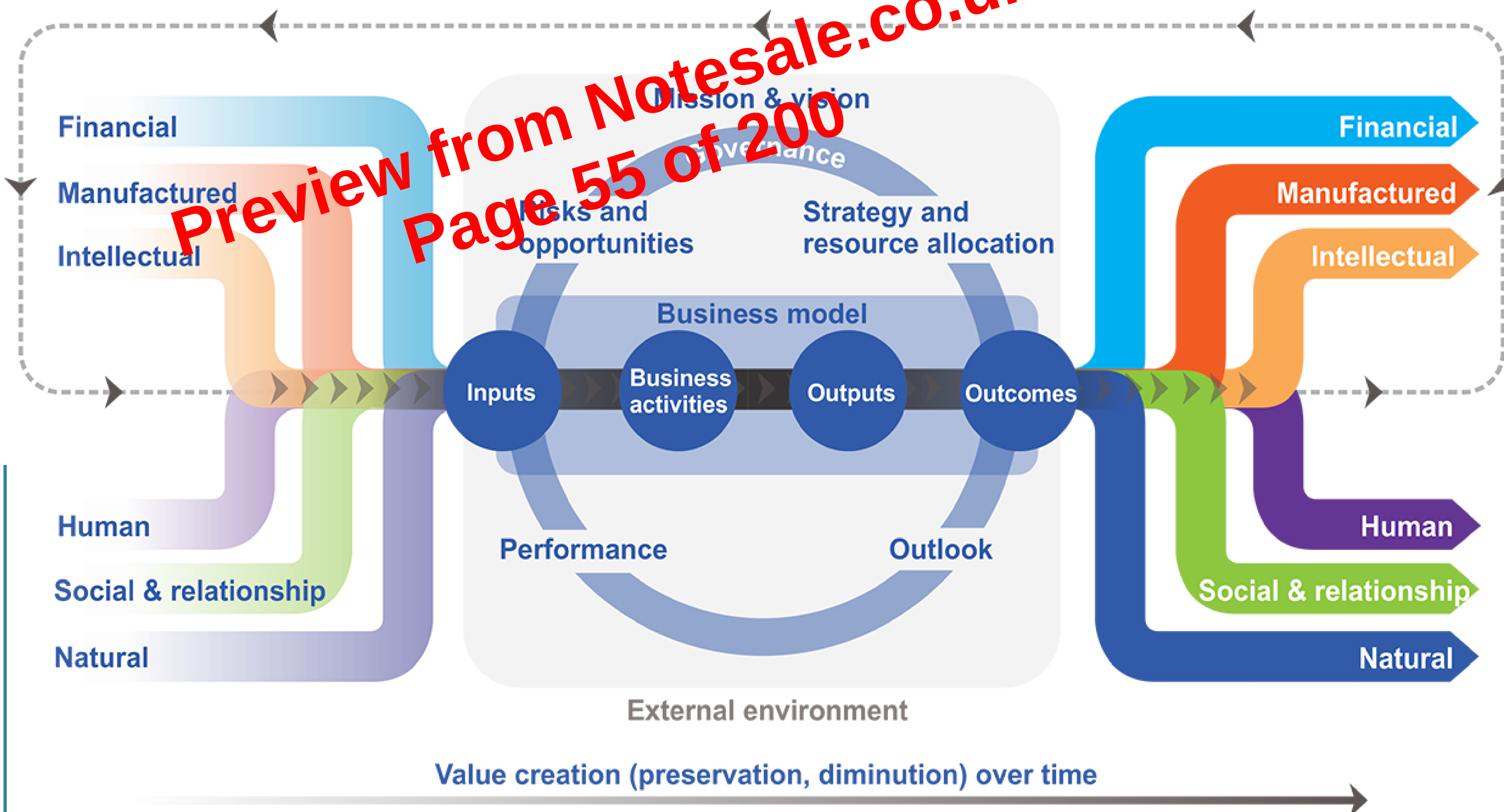
Information supplied by financial reporting involves estimation, classification, summarization, judgment, and allocation

Financial statements primarily reflect transactions that have already occurred; consequently, many aspects of them are based on historical cost

Only transactions involving an entity being reported upon are reflected in that entity's financial reports

Financial statements are based on the going-concern assumption

The Capitals and Value Creation



The Integrated Report

Move Forward International

Content of an Integrated Report

1. **Organizational overview and external environment**. What does the organization do, and what are the circumstances under which it operates?
2. **Governance.** How does the organization's governance structure support its ability to create value in the short, medium, and long term?
3. **Business model.** What is the organization's business model?
4. **Risks and opportunities**. What are the risks and opportunities that affect the organization's ability to create value over the short, medium, and long term, and how is the organization dealing with them?
5. **Strategy and resource allocation.** Where does the organization want to go and how does it intend to get there?
6. **Performance**. To what extent has the organization achieved its strategic objectives for the period, and what are its outcomes in terms of effects on the capitals?
7. **Outlook.** What challenges and uncertainties is the organization likely to encounter in pursuing its strategy, and what are the implications for its business model and future performance?
8. **Basis of presentation**. How does the organization determine what matters to include in the integrated report, and how are those matters quantified or evaluated?

Inventory (Continued)

Consigned goods

Inventory transfers from producer directly to purchaser

The company holding the goods in on consignment never records the goods

Out on Consignment – Included

In on Consignment – Not included

Just as if we held the inventory – all of the costs necessary to get the item available for sale to the customer

Goods Out On Approval

Should be included in inventory by the seller at the original cost until either:

- the customer accepts the goods or
- the time to return the goods expires

Obsolete Inventory

It is NOT inventory and not recorded as inventory

Inventory (Continued)

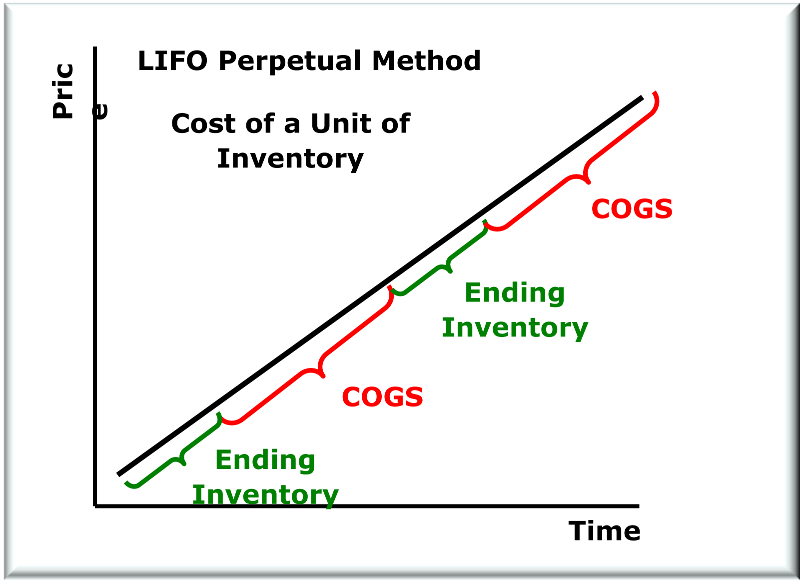
Periodic — Determination done once at the end of the period

Perpetual — Each time inventory is purchased, the oldest, newest and average cost are determined

FIFO perpetual is the same as FIFO periodic. The oldest is always the oldest, no matter how many new units are purchased

LIFO perpetual – Every time new inventory is purchased, it becomes the newest inventory. If new inventory is purchased before all old inventory was sold, layers are created

Moving Average (Perpetual) – Every time new inventory is purchased, new average cost is calculated. This is more administratively difficult than it is mathematically difficult



Inventory (Continued)

Recovery of Previous Decline

Inventory can be written back up to original cost, if recovery happens in the period of the write down of the inventory

Under IFRS the value used for market is net realizable value
Written down inventory that recovers can be written back up to original cost

Investments (Continued)

Levels of Equity Investment

1. No influence (less than 20% ownership)
2. Significant influence (20-50% ownership)
3. Control (more than 50% ownership)

Six Methods of Accounting

- Amortized cost
- Fair value through OCI
- Fair value through Income Statement
- Cost (less impairment, if any)
- Equity
- Consolidation

Investments (Continued)

Held to Maturity

Carried at amortized cost.

Unrealized gains and losses are not recorded.

Interest and realized gains and losses are reported in net income.

Available for Sale Debt Securities

Accounted for at fair value.

Adjusted each period to fair value.

Unrealized G/L on the balance sheet as part of other comprehensive income.

Interest and realized gains and losses are reported in net income.

Investments (Continued)

2. NO Determinable Fair Value

- Carried at cost and assessed each period for impairment.
- Additionally, if there is an observable price change for the shares, the carrying value should be adjusted upwards or downwards for this observable change.

Dividends Without Significant Influence

A. Cash dividends
B. Stock dividends
C. Liquidating dividends

A. Cash Dividends

The following entry is made on the date of record when the company has a legal right to the dividend.

Dr	Dividend receivable	X	
Cr	Dividend income		X

When the dividend is received:

Dr	Cash	X	
Cr	Dividend receivable		X

Investments (Continued)

1. Initial Recording

- Recorded at cost.
- Dr Invest. in Company A (bal. sheet) X
- Cr Cash (balance sheet) X

2. Investor's Share of Profit/Loss

Investment account adjusted for investor's share of investee profit or loss.
Reported on income statement of investor.

Dr	Investment in Company A		*X*
Cr	Income from investment in Co. A	*X*	
Dr	Loss from investment in Co. A	*X*	
Cr	Investment in Company A		*X*

3. Cash Dividends Received

Carrying amount of investment decreased by dividends.
Investment account may not be reduced below zero.

Dr	Cash	X
Cr	Investment in Company A	X

Property, Plant and Equipment (Continued)

Straight-line | Double declining balance | **Sum-of-the-years'-digits** | Units of production | Group and composite depreciation

Sum of the Years' Digits = n(n + 1) / 2

The sum of the years' digits to use for the denominator for an asset with a five-year useful life will be:
5(5 + 1) / 2 = 15
Proof: 1 + 2 + 3 + 4 + 5 = 15

Depreciable Amount * Fraction

A 5 year asset will be depreciated as follows:
Year 1: Depreciable Amount * 5/15
Year 2: Depreciable Amount * 4/15
Year 3: Depreciable Amount * 3/15
Year 4: Depreciable Amount * 2/15
Year 5: Depreciable Amount * 1/15
Overall 15/15 (100%) is depreciated

Property, Plant and Equipment (Continued)

- Straight-line
- Double declining balance
- Sum-of-the-years'-digits
- Units of production
- Group and composite depreciation

Determine the number of units the asset will be able to produce over its useful life

Each period recognize depreciation expense equal to the % of total capacity produced during the period

Property, Plant and Equipment (Continued)

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Straight-line

Double declining balance

Sum-of-the-years'-digits

Units of production

Group and composite depreciation

- Group depreciation used for similar assets
- Composite depreciation used for dissimilar assets

A weighted average useful life and a depreciation rate are applied to the group

No gain or loss is recognized on disposal of group depreciated asset

Property, Plant and Equipment (Continued)

Impairment under IFRS

The undiscounted sum of the future cash flows expected to be generated through the use and eventual sale of the asset

Book value of the asset

Impairment under IFRS

If book value > future cash flows the asset is **impaired** and it is written down to its fair value.
The amount **written down is reported as a loss during that period.**

Dr Impairment loss amount
Cr Accumulated depreciation amount

- Carrying value compared to recoverable amount
- The recoverable amount is either the 1) fair value of the asset if sold minus any costs of sale, or 2) the discounted future cash flows it will generate
- Loss is on the income statement unless it is a write down from a previous upward revaluation of the fixed asset

Payables and Accrued Liabilities (Continued)

Classifying Warranties

The company should consider the following factors:

- Is the warranty required by law?
- What is the length of the warranty coverage period?
- What is the nature of the tasks that the company promises to perform?

1) Assurance-Type Warranties

Losses are to be accrued if:

a) it is **probable** that an obligation has been incurred, and
b) the amount of the obligation can be **reasonably estimated**.

Recording the Warranty

Dr	Assurance-type warranty expense		*as calculated*
	Cr	Assurance-type warranty liability	*as calculated*

This entry **matches** the expense of the future warranty claims with revenues that were recognized from the sale of those items.

Classified on the balance sheet as current or non-current depending on remaining time period that the warranty is valid.

Accounting for Income Taxes (Continued)

Deferred Tax Expense OR Benefit

Change in deferred tax asset or liability position during year

Deferred tax **benefit** if position **improves**:
- Deferred tax asset gets bigger, or
- Deferred tax liability gets smaller

Deferred tax **expense** if position **worsens**:
- Deferred tax asset gets smaller, or
- Deferred tax liability gets bigger

Deferred Tax Asset or Liability

Caused by temporary timing differences

Temporary timing differences – Arises when a revenue or expense item is recorded in different periods for book and tax purposes

Accounting for Income Taxes (Continued)

Calculating the Amount of the Deferred Asset or Liability

The amount of the temporary difference in the current period is multiplied by the enacted tax rate that is in effect for the period the difference will reverse in

	Difference
x	Enacted tax rate for period of reversal
=	**Deferred tax asset or liability**

Enacted Tax Rate

The rate that has been passed by the government as the tax rate in the future

Year	Deposits Received	Enacted Tax Rate	Def. Tax Asset
Year 1	$50,000	25%	*$12,500*
Year 2	$ (25,000)	30%	$7,500
Year 3	$ (25,000)	35%	$8,750
Total			**$16,250**

Owners' Equity (Continued)

Common Stock Dividends

Dividends are the distribution of current profits and/or the retained earnings of the company to its owners

Cash dividends

Property dividends

Stock dividends

Liquidating dividends

Owners' Equity (Continued)

Cash Dividends

Three steps in the process

Declaration Date

DR	Retained earnings	XXX
CR	Dividend payable	XXX

Record Date

the date upon which ownership for the dividend is determined

Payment Date

is the date on which the dividend is paid. On this date the liability is eliminated and the cash account is decreased

Owners' Equity (Continued)

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Example

On July 1, Lemond Company declared a dividend consisting of common stock it owned in Devery Corporation. The carrying value of the Devery stock on July 1 was $1,000,000 and the market value of the stock on that date was $1,250,000. Lemond Company records the following journal entry to recognize the gain and the property dividend declaration

DR	Equity Investments	250,000	
CR	Unrealized Holding Gain		250,000
DR	Retained Earnings	1,250,000	
CR	Property Dividends Payable		1,250,000

When the property dividend is distributed on August 1, Lemond records the distribution as follows

DR	Property Dividends Payable	1,250,000	
CR	Equity Investments		1,250,000

Owners' Equity (Continued)

Scrip Dividends

A promise to pay a dividend in the future – a "Scrip Dividend Payable" is recorded. This liability is eliminated when it is paid

Liquidating Dividends

A dividend paid when there are no retained earnings.
This dividend is a **return of capital** to the shareholder rather than a **return on capital** to the shareholder. In the journal entry the debit is to APIC instead of Retained Earnings

Stock Dividends

The company distributes additional shares in the form of a dividend. The issue for stock dividends is the valuation of the shares that are distributed

- Small stock dividends are distributions of 25% or less (Shares are valued at their FMV on the date of declaration)
- Large stock dividends are dividends of more than 25% (Shares are valued at their par value)

In both types of stock dividends, note that there is no dividend payable recorded

DR	CS – issuable as a dividend	Par
CR	Common Stock	Par

Owners' Equity (Continued)

Preferred shares may also participate in the common dividend if they are set up that way in the registration of the shares

Fully participating

Preferred shares are treated as if they were common shares and will receive the entire common dividend

Partially participating

Shares have some limit on the amount of the common dividend that can be received

Revenue Recognition

Long-Term Contracts

1. There are two acceptable methods for recognizing the revenue on a long-term contract.
2. Point in time method
3. Over time method

Criteria for Over-Time Recognition

1. The customer simultaneously receives and consumes the benefits provided by the company's performance as the company is performing its contract obligations.
2. The company's performance creates or enhances an asset such as work in process **that the customer controls** as the work is being done.
3. The company's performance does **not** create an asset with an alternative use to the company, and the company has an enforceable right to payment for performance completed to date.

Point-in-Time Method

The contract is recognized on the company's balance sheet as it is being satisfied, but the revenue, cost, and gross profit are recognized at a point in time—when the customer has obtained control of the asset.

Revenue Recognition

The CIP Account

The CIP asset account is in some ways similar to a **work-in-process inventory account** in a manufacturing company.

However, the costs in the CIP account do not move to finished goods and then COGS as the costs in a WIP inventory account do.

Instead, the CIP account is a temporary "holding" account.

Recognizing Invoice Issuance

The journal entry to record an invoice issued is:

Dr	Accounts receivable		x
	Cr	Billings on construction in process (BCP)	x

Billing on Construction in Process

The BCP account is not a revenue account because revenue is not recognized when invoices are issued.

The BCP account is a **contract liability account** because once an invoice is issued and the client pays the invoice, the company constructing the asset owes the customer a building.

US GAAP – IFRS Differences

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US GAAP is rules driven

IFRS is principles based

Areas for exam

- Inventory
- Long-lived assets
- Impairment of assets
- Intangible assets
- Leases
- Revenue and expense recognition

- LIFO not allowed under IFRS
- Under IFRS, inventory is valued at the lower of cost or net realizable value
- Under IFRS previous write-downs of inventory may be recovered up to the original cost of the inventory. Gains cannot be recognized on appreciated inventory, but previous losses can be reversed

US GAAP – IFRS Differences (Continued)

Inventory	Long-lived assets	Impairment of assets	Intangible assets	Leases	Revenue and expense recognition

- Internal development costs of intangible assets are capitalized when the technological and economic feasibility of the project can be demonstrated
- A previously recognized impairment loss on an intangible asset may be reversed if the estimates of the recoverable amount have changed
- If there is a specific, active market for the intangible asset, the intangible asset may be written up in value to that fair value