Chapter 6

Intercompany Inventory and Land Profits

A brief description of the major points covered in each case and problem.

CASES

Case 6-1

In this case, students are asked to illustrate the impact of intercompany sales and unrealized profits in inventory on the separate entity and consolidated financial statements. Students are also asked to explain how basic accounting principles are applied when accounting for these intercompany transactions.

Case 6-2

In this case, adapted from a CPA exam, students are asked to resolve accounting issues related to the preparation of consolidated financial statements for an 80%-owned subsidiary and a 40%-owned investee company. Intercompany transactions and acquisition differential have not been properly accounted for.

Case 6-3

In this case, adapted from a CPA exam, management appears to be manipulating income to minimize the bonus paid to union employees. Students are required to analyze controversial accounting issues including the valuation of inventory, purchase returns and goodwill.

Case 6-4

This is a multi-subject case from a CPA exam. Students are asked to resolve a number of accounting issues including revenue and expense recognition, contributions to a partnership, contingent consideration and offsetting of assets against liabilities.

Case 6-5

In this case, adapted from a CPA exam, students are asked to resolve accounting issues in order to help a client obtain a term loan. The issues include non-monetary transactions, related party transactions and contingent gain.

PROBLEMS

Problem 6-1 (25 min.)

A short problem requiring calculation of selected accounts for consolidated statements when there are unrealized profits in inventory and an explanation of impact of intercompany transactions on non-controlling interest.

Problem 6-2 (20 min.)

This problem consists of a consolidated income statement that has been incorrectly prepared and requires correcting. Intercompany transactions and unrealized profits in opening and closing inventory have been overlooked.

Problem 6-3 (20 min.)

A short problem requiring calculation of selected accounts related to land for separate entity and consolidated financial statements for three years when there are unrealized profits in and an acquisition differential pertaining to land.

Problem 6-4 (40 min.)

A parent has used the cost method to account for its investments in its two subsidiaries. There are unrealized profits in the inventory of all three companies. The problem requires the preparation of a consolidated income statement, a calculation of consolidated retained earnings, a calculation of equity method income and an explanation of how the revenue recognition principle is applied when adjusting for unrealized profits.

Problem 6-5 (40 min.)

Unrealized inventory and land profits are involved over a two-year period. The problem calls for equity method journal entries as well as the calculation of consolidated net income each year, a statement showing changes in non-controlling interest, and a calculation of the balance in the investment account under the equity method.

Problem 6-6 (30 min.)

Three related companies are involved in selling goods to each other. The problem requires a calculation of consolidated profit and consolidated retained earnings when the parent used the cost method.

Problem 6-7 (70 min.)

A comprehensive problem requiring an acquisition differential calculation, amortization schedule, and a consolidated balance sheet and statement of changes in equity under the entity theory plus an explanation of how the debt to equity ratio would change under the parent company extension theory. The subsidiary was acquired seven years ago; there are intercompany profits (and losses) in land and inventory; and the parent has used the cost method to account for its investment.

Problem 6-8 (30 min.)

This problem involves intercompany sales of inventory. It requires the preparation of an income statement for two separate months for the parent, subsidiary and consolidated entity. Then, students are asked to explain the impact of switching to the equity method from the cost method and from upstream transactions to downstream transactions.

Problem 6-9 (25 min.)

This problem involves intercompany sales of inventory. It requires the calculation of account balances for specified accounts and two scenarios: 1) intercompany transactions were upstream and 2) intercompany transactions were downstream.

Problem 6-10 (40 min.)

Intercompany sales, interest and rental revenue, and unrealized profits in opening and closing inventory are involved in this problem that requires the preparation of a consolidated income statement and a calculation of consolidated retained earnings. The parent has used the cost method.

Problem 6-11 (40 min.)

Unrealized profits in opening and closing inventory and in land have to be taken into account in the preparation of a consolidated statement of changes in equity when the parent has used the cost method.

Problem 6-12 (25 min.)

A parent has used the equity method to account for its investment. There are intercompany inventory profits involved. The problem requires the preparation of a consolidated income statement, a calculation of consolidated retained earnings and an explanation of the impact of using the parent company extension theory on the return on equity.

Problem 6-13 (70 min.)

This comprehensive problem covers everything illustrated to date and requires the preparation of a consolidated income statement, consolidated statement of financial position and consolidation

worksheet when the parent has used the equity method plus the calculation of goodwill and non-controlling interest under the parent company extension theory.

Problem 6-14 (70 min.) (Prepared by Peter Secord, Saint Mary's University)

A comprehensive problem requiring the preparation of a consolidated income statement, statement of financial position and consolidation worksheet when the parent has used the cost method. Also required is a calculation of goodwill and NCI using the trading price of the subsidiary's shares at the date of acquisition. There are intercompany profits in land and inventory.

Problem 6-15 (50 min.)

A comprehensive problem requiring the preparation of a consolidated income statement and the calculation of specified consolidated balance sheet accounts. Also required is a calculation of goodwill impairment loss and consolidated net income attributable to NCI when a business valuator measures the value of NCI at the date of acquisition. There are intercompany transactions and unrealized profits in land and inventory.

SOLUTIONS TO REVIEW QUESTIONS

1. The pants are similar to a single economic entity composed of a parent company and its three subsidiaries. The transfer of economic resources between the pockets in these pants simply changes the location of the resources but does not represent revenue or expense, or profit or loss, to the combined entity.

2. The types of intercompany revenue and expenses eliminated in the preparation of the consolidated income statement include sales and purchases, rentals, interest, and management fees. These eliminations have no effect on the amount of consolidated net income or the net income attributable to non-controlling interest.

3. Intercompany sales when collected and paid, intercompany cash sales, and intercompany borrowings do not alter the total cash of the consolidated entity. It is the same concept as an individual transferring cash among his/her bank accounts, or from one pocket to another.

4. The intercompany profit recorded in Period one is considered to be realized when the particular asset is sold outside the consolidated entity by the purchasing affiliate.

5. Revenue should be recognized when it is earned with a transaction outside of the reporting entity. The reporting entity for consolidated financial statements encompasses the parent and all of its subsidiaries. Since intercompany transactions are transactions within the reporting entity (not outside of the reporting entity), they must be eliminated when preparing consolidated financial statements.

6. This statement is true if the selling affiliate has an income tax rate of 40%. The $1,000 reduction from ending inventory reduces the consolidated entity's net income. A corresponding reduction of $400 in income tax expense transfers the tax from an expense to an asset on the consolidated balance sheet. When the $1,000 profit is subsequently realized, the $400 is transferred from the consolidated balance sheet to the consolidated income statement in order to achieve a proper matching of expense to revenue.

7. The matching principle requires that expenses be matched to revenues. When intercompany profits are eliminated from the consolidated financial statements, the income tax expense related to those profits must also be eliminated. When the previously unrecognized intercompany profits are recognized in a later period, the income tax on these profits must be expensed.

8. There is no adjustment to income tax expense corresponding to the elimination of intercompany revenue and expenses because there is no change to the income before tax for the consolidated entity; therefore, there should be no change to the tax expense for the consolidated entity.
Whatever tax was paid or saved for the two entities will not change for the consolidated entity since the income before tax did not change. Income tax expense is adjusted on consolidation when consolidated profits are changed due to adjustments for unrealized profits.

9. Ideally, intercompany losses should be eliminated in the same manner as intercompany gains. In turn, an impairment test would be carried out. If the recoverable amount were less than the carrying amount, an impairment loss would be reported. When the impairment loss is greater than the intercompany loss, one can get to the same result by not reversing the intercompany loss and simply reporting an impairment loss to bring the carrying amount down to the recoverable amount.

10. The elimination of intercompany sales and purchases reduces sales revenue and cost of goods sold on the consolidated income statement. No other items on the consolidated statements are

affected. The elimination of intercompany profits in ending inventory affects the following elements of the consolidated statements: cost of goods sold is increased; income tax expense is decreased; net income is decreased; net income attributable to the parent is decreased; net income attributable to the non-controlling interest is decreased (if the subsidiary was the seller); the asset inventory is decreased; deferred income tax assets are increased; non-controlling interest in net assets is decreased (if the subsidiary was the seller); and consolidated retained earnings is decreased.

11. For a downstream transaction, the adjustment for unrealized profits is applied to the parent's income and is fully charged or credited to the parent. For an upstream transaction, the adjustment for unrealized profits is applied to the subsidiary's income which is shared between the parent and non-controlling interest. In other words, the non-controlling interest is affected by elimination of profit on upstream transactions but is not affected by the elimination of profit on downstream transactions.

12. At the end of Year 1, the unrealized profit is removed from ending inventory and added to cost of goods sold which decreases income. In Year 2, the unrealized profit is removed from beginning inventory, which decreases cost of goods sold for Year 2 and increases income for Year 2. Although Year 1 and Year 2 income both must be adjusted, the adjustments are offsetting. Therefore, the combined income for the two years does not change as a result of the adjustments.

13. It will not be eliminated again on the consolidated income statement for subsequent years. However, if the land remains within the consolidated entity, the unrealized gain will be eliminated in the preparation of all subsequent consolidated balance sheets and statements of retained earnings until such time as the land is sold to outside parties.

14. Adjustments are required on consolidation to bring the consolidated balances to the amounts that would have been on the subsidiary's books had it not sold the land to the parent. Therefore, any gain reported on sale would have to be eliminated. The revaluation surplus account would have to reflect the increase in fair value over the original cost of the land when it was purchased by the subsidiary.

15. The journal entry would be as follows:

Equity method incomexxx

Investment in subsidiary xxx

where xxx is equal to the parent's share of the unrealized profits.

16. Under IFRS, only the investor's percentage ownership in the associate times the profit in ending inventory is considered to be unrealized; since the investor cannot control the associate or the other shareholders of the associate, the profit in ending inventory times the percentage ownership of the other shareholders is considered to be a transaction with outsiders. Under ASPE, the entire profit in ending inventory is considered to be unrealized. ASPE states that the unrealized profit is same amount that would be considered to be unrealized for consolidated financial statements. For downstream transactions between a parent and subsidiary, the entire amount of unrealized profit is eliminated and charged to the parent's shareholders.

SOLUTIONS TO CASES

Case 6-1

Using the data provided in the question, the financial statements for the parent, subsidiary and consolidated entity would appear as follows for the 3 months:

	Parent		Subsidiary		Consolidated
	Aug	**Sept**	**JulyAug**	**July Aug**	**Sept**
BALANCE SHEET					
Inventory	480		400		400400
Prepaid tax					32
INCOME STATEMENT					
Sales		600		480	600
Cost of goods sold		480		400	400
Gross margin		120		80	200
Income tax expense		48		32	80
Net income		72		48	120

The following comments outline how all of the above financial statements present fairly the financial position and financial performance of the company in accordance with GAAP:

1. The parent and subsidiary are separate legal entities. Each entity will pay income tax based on the income earned by the separate legal entity. Therefore, the subsidiary will pay income

tax based on the profit it earned in August and the parent will pay income tax based on the profit it earned in September.

2. The consolidated statements combine the statements of the parent and subsidiary as if they were one entity i.e., one set of statements for the family.
3. Accounting principles should be and have been properly applied for all of the individual financial statements. The main principles involved with these statements are the historical cost principle, the revenue recognition principle, and the matching principle.
4. The historical cost principle requires that certain items such as inventory be reported at historical cost. This has been done for all 3 financial statements. Note that the historical cost for the inventory from a consolidated perspective was $400 which is the cost paid by the subsidiary when it purchased the goods from outsiders.
5. The revenue recognition principle requires that revenue be reported when it is earned i.e., when the benefits and risks of ownership are transferred to the buyer. When the subsidiary sold to the parent, the benefits and risks were transferred to the parent. Accordingly, the subsidiary reported revenue. However, from the consolidated perspective, the family retained the benefits and risks; they were not transferred to an outside entity. Therefore, no revenue is reported on the consolidated income statement for August.
6. When the parent sells to an outside entity in September, it reports revenue on its separate entity income statement. Since the family has sold the inventory to an outside entity, the family has earned the revenue. Accordingly, the revenue is reported in September on the consolidated income statement.
7. The matching principle requires that costs be expensed in the same period as the revenue to which it relates. This provides the best measure of performance. Since the subsidiary reported revenue in August, it reported cost of goods sold in August in order to match expenses to revenue in August. Similarly, the parent reported cost of goods sold in September to match expenses to revenue in September. Since revenue was reported in September from a consolidated viewpoint, the cost of goods sold is reported as an expense in September as well. The cost from a consolidated viewpoint was the amount paid by the subsidiary when it bought the inventory from outsiders.
8. Income tax must also be matched to the income to which it relates. In August, the subsidiary reported income tax expense of $32 to match against the pre-tax income of $80. Since no income was reported in the consolidated income statement for August, no tax expense should be reported in income. Given that the subsidiary probably paid the tax to the government, the tax is considered to have been prepaid from a consolidated viewpoint because the tax was not yet due from a consolidated viewpoint.

Case 6-2

Memo to: Audit Partner

From: Audit Senior

Re: D Ltd. – Consolidated Financial Statements

As requested, I have prepared the following memorandum, which outlines the important financial accounting issues of D and N, its subsidiary, and K, its investee company.

1. The shares issued by D to purchase N and K should be measured at their fair value at the date of acquisition. For now, I will assume that the fair value of 160,000 common shares was $2,000,000 when D purchased its investments in N and K.
2. It appears that there has been no allocation of the $640,000 acquisition cost excess for N in the consolidated financial statements. The excess should be first be allocated to identifiable assets. Any remaining excess should be allocated to goodwill. The goodwill should be checked for impairment at the end of each year and written down if there is an impairment loss.
3. Given that N had capitalized some research and development expenditures, there may be some value in what they were developing. The projects that met the conditions for capitalization should be measured at fair value at the date of acquisition assuming that the assets can be separately identified and reliably measured. In turn, these assets should be amortized over their useful lives. Amortization should commence once the assets are being used in operations and are generating revenue for the company.
4. D can use either the entity theory or parent company extension theory in preparing the consolidated financial statements. Under these theories, N's assets and liabilities would be measured at fair value at the date of acquisition. It appears that the consolidated financial statements were prepared using the parent company theory because non-controlling interest is measured at $590,000, which is 20% of the carrying amount of N's net assets at the end of Year 2 (i.e. common shares of $1,000,000 plus retained earnings of $1,950,000). I will assume that D will use the entity theory. Non-controlling interest at the date of acquisition should have been $1,000,000 calculated as follows:

Acquisition cost for 80% interest in N	$4,000,000
Implied value for 100% interest in N (4,000,000 / .8)	5,000,000
NCI's share (20%)	1,000,000

This assumes that there is a linear relationship between the value of 80% and the value of 100% of N.

5. Intercompany transactions and balances between D and K must be eliminated. Sales and cost of sales should be reduced by the intercompany sales of $1,200,000. The unrealized profit of $200,000 ($1,200,000 – $1,000,000) should be taken out of ending inventory and added to cost of goods sold. Since this was an upstream sale, non-controlling interest will be affected by this adjustment.

6. The investment in K has been accounted for using the cost method. This method is not acceptable under IFRS. With a 40% interest in K, D would normally have significant influence. If so, the equity method would be appropriate. For the purpose of this discussion, I will assume that D does have significant influence and the equity method should be used.

7. Under the equity method, the acquisition cost would have to be allocated in a manner similar to what is done for consolidation purposes. The acquisition differential would be allocated to identifiable net assets where the fair value is different than carrying amount. This fair value difference would have to be amortized and an adjustment made to the investment account on an annual basis. We do not have sufficient information at this point to determine the adjustment for Year 1.

8. Since D paid less than the fair value of K's identifiable net assets, there is negative goodwill in this acquisition cost. Negative goodwill is calculated to be $233,333 ($2,100,000 / .9 – $2,100,000). If we used the same principles applied for consolidation purposes, this negative goodwill would be reported as a gain on purchase. Before recording the gain on purchase, we need to ensure that the fair value of the identifiable net assets is $2,333,333 ($2,100,000 / .9)

9. Under the equity method, D's share of the unrealized profit from intercompany transactions would have to be eliminated. Since K made an after-tax profit of $120,000 ([$1,200,000 – $1,000,000] x [1 – 0.4]) on sales to D, $48,000 (40% x $120,000) would have to be eliminated from the investment account. Since D and K are related parties, the details of intercompany transactions would need to be disclosed in the notes to the consolidated financial statements.

10. Based on the discussion above, I have recalculated the following account balances for the consolidated financial statements in the schedules below:

Goodwill
Investment in K (under equity method)
Non-controlling interest on balance sheet
Profit

Allocation and amortization of acquisition cost for investment in N

Cost of 80% investment, September, Year 1		4,000,000
Implied value of 100% investment (4,000,000 / .8)		5,000,000
Carrying amounts of N's net assets:		
Common shares	1,000,000	
Retained earnings	1,850,000	
Total shareholders' equity		2,850,000
Acquisition differential		2,150,000
Allocation:	FV–CA	
Land	800,000	
Plant and equipment	700,000	
Research and development expenditures	- 90,000	
Existing goodwill	- 60,000	1,350,000
Balance – newly calculated goodwill		800,000

	Balance Sept 1 Year 1	**Amortization Year 2**	**Balance Aug. 31 Year 2**
Land	800,000		800,000
Plant and equipment	700,000	70,000	630,000
Research and development	- 90,000		- 90,000
Old goodwill	- 60,000		- 60,000
New goodwill	800,000		800,000
	2,150,000	70,000	2,080,000

Investment in K

Investment in K, at date of acquisition		2,100,000
Retained earnings of K, Aug. 31, Year 2	1,710,000	
Retained earnings of K, at acquisition	1,760,000	
Change	- 50,000	
Less: Unrealized after-tax profit in ending inventory (upstream) (200,000 x [1 - .4])	- 120,000	
Adjusted increase	- 170,000	
D's ownership %	40%	- 68,000

Investment in K, Aug. 31, Year 2		2,032,000

Non-controlling interest on balance sheet

Common shares of N		1,000,000
Retained earnings of N	1,950,000	
Less: Unrealized after-tax profit in ending inventory		
(upstream) ([850,000 – 630,000] x .6)	- 132,000	1,818,000
Total shareholders' equity		2,818,000
Unamortized acquisition differential		2,080,000
		4,898,000
		20%
Non-controlling interest, Aug. 31, Year 2		979,600

Calculation of consolidated profit – Year 2

Profit of D		600,000
Less: Dividends from N (200,000 x 80%)	160,000	
Dividends from K (150,000 x 40%)	60,000	220,000
		380,000
Profit of N	300,000	
Less: Unrealized after-tax profit in closing inventory		
(upstream) (220,000 x .6)	- 132,000	
amortization of acquisition differential	- 70,000	
Adjusted profit		98,000
Profit of K	100,000	
Less: Unrealized after-tax profit in closing inventory		
(upstream) (200,000 x .6)	- 120,000	
Adjusted profit	- 20,000	
D's ownership %	40%	- 8,000
Consolidated profit, Year 2		470,000
Attributable to:		
Shareholders of D		450,400
Non-controlling interests (20% x 98,000)		19,600
		470,000

Case 6-3

REPORT ON ACCOUNTING POLICIES USED IN THE FINANCIAL STATEMENTS OF GOOD QUALITY AUTO PARTS LIMITED FOR THE YEAR ENDED FEBRUARY 28, YEAR 11.

To the members of the union, Good Quality Auto Parts Limited:

I have been engaged to analyze the financial statements of Good Quality Auto Parts Limited (GQ) for the year ended February 28, Year 11 and determine whether there are any controversial accounting issues. For the purposes of this report, "controversial accounting issues" will be defined as accounting policies that have the effect of reducing payments under the profit-sharing plan to the union members.

The existence of the profit-sharing contract creates incentives for the management of GQ to make accounting choices that reduce net income and thereby reduce the payments that must be made to the union members. Accounting standards for private enterprises (ASPE) allow considerable flexibility and judgment by the preparers of financial statements in selecting accounting policies. Since the company is privately owned, the costs (real or perceived) of reporting lower income may be small relative to the savings generated. For example, the effect of lower income on new or existing lenders may be considered less important than the savings derived from reduced profit sharing. In addition since the term of the contract is only three years, some of the income deferral may yield permanent savings if the profit-sharing component is not renewed in subsequent contracts.

In analyzing the accounting policies, I will be taking as strong a position as can be justified to support the union's objective of making net income as large as possible. This is in conflict with the objective of management, which is to reduce net income.

Inventory write-down

Accounting practice requires that inventory be measured at the lower of cost and net realizable value. Thus, if the inventory cannot be sold, management can justify its write-off. However, since much of the inventory has been on hand for several years, the decision to write it off this year raises a question as to the motivation for the write-off. Management could be writing off the inventory solely to reduce income, thereby reducing the payments required under the profit-sharing plan. The problem must be considered from two points of view. First, is the inventory genuinely unsaleable? If not, then the entry to write down the inventory must be reversed, resulting in a higher net income figure. Assuming that the inventory is unsaleable, the next question is whether the write-off legitimately belongs in the current period. If the inventory became unsaleable in the current year, then the write

belongs in the current period. If the inventory was unsaleable in prior years, it should have been written down in prior years. In that case, the financial statements should be retroactively restated to correct the error in the appropriate period.

Allowance for returns

The return estimate represents a legitimate cost of doing business during the period. What is in question is whether the more conservative estimate represents a genuine reflection of a change in economic conditions or an opportunistic use of accounting judgment to reduce net income. GQ's auditor would probably not object to the increased expense since conservatism is a key accounting principle. However, the union's interests are not served by conservatism.

Use of accelerated depreciation

There is no requirement that all assets owned by a firm be depreciated in the same way. Thus, GQ can argue that the use of an accelerated method on the new equipment better reflects the pattern in which the asset's future economic benefits are expected to be consumed by GC. We can argue that the portfolio of manufacturing equipment acquired to produce similar products should be accounted for similarly. If there is no difference between the new and old equipment with respect to the effect of technological obsolescence, then either the new asset should be depreciated on a straight-line basis or similar assets acquired previously should be depreciated on the accelerated method. The financial impact of using the same depreciation method for both cannot be determined at this point.

Write-off of goodwill

Goodwill should be written down or written off if there has been a permanent impairment of its value i.e. if the recoverable amount of the cash generating unit in which the goodwill is located is less than the carrying amount of the net assets, including goodwill, of the cash generating unit. The fact that the auto parts industry is suffering through poor economic times does not necessarily imply that what was purchased (the company name, its customers, etc.) no longer has any value. The auto industry is very sensitive to economic cycles, and it is expected that such downturns will occur. (Indeed, their occurrence should have been factored into the acquisition cost paid by GQ).

Unless GQ can come up with strong evidence that the intangibles purchased have been impaired, there is no justification for the write-off even though GQ's auditors supported it. It is important to emphasize that their support may rest in conservatism: auditors are willing to accept accounting treatments that are conservative. However, conservatism is inconsistent with the union's objectives. The value of the asset acquired in Year 5 must still exist unless there is specific evidence of its impairment. GQ should provide evidence of impairment.

Unrealized profits from intercompany sales

The unrealized profit from intercompany sales should be eliminated when preparing consolidated financial statements. CG has not made any adjustments for these intercompany transactions for Year 11. The unrealized profit in ending inventory is $28,000 (10% x $800,000 x 35%). When this profit is eliminated, CG's net income will decrease by $28,000. The unrealized profit in beginning inventory is $70,000 ($200,000 x 35%). When adjusting for this profit, CG's net income will increase by $70,000. Therefore, CG's Year 11 net income should be increased by $42,000 ($70,000 – $28,000).

Bonus to president and chairman

The compensation approach selected by the senior managers has a significant effect on the money paid to the union members. Since bonuses are deducted from income whereas dividends are not, the maximum effect of the change in compensation for union members is $500,000 (an average of $2,500 per employee). If the amount of compensation has remained more or less the same as in prior years, with only the method of payment changing, then an argument can be made that GQ is violating the spirit of the contract by changing the method.

Change to tax allocation

Under ASPE, CG has the choice to use either the taxes-payable method or the liability method of accounting for income taxes. Accordingly, the new method is acceptable under ASPE. We could argue that the change is in violation of the contract, as the contract was signed on the understanding that major accounting policies would remain the same. The arbitrator may accept this argument. The arbitrator, however, would likely demand consistent treatment of accounting changes.

Case 6-4

REPORT TO PARTNER ON PLEX-FAME CORPORATION

Overview

PFC is a public corporation. Therefore, the financial statements will be used by stakeholders for a variety of purposes, including the evaluation of the company and its management. As a result, the managers have incentives to increase or smooth earnings to influence the share price or present a favourable impression of themselves to the stakeholders. In addition, the company is expanding rapidly and, therefore, may need to raise capital. By using accounting choices to increase earnings or otherwise improve the appearance of the financial statements, management may be attempting to reduce the cost of capital by lowering the cost of debt or increasing the selling price of the shares. The company may have a competing objective of minimizing tax by choosing accounting policies that reduce income in cases where Revenue Canada requires for tax purposes the same accounting policies that are used in the general-purpose financial statements. PFC also wants to ensure it does not violate the debt covenant and wants to keep the debt to equity ratio below 2:1.

Given that PFC is a public company and that it may raise capital, it is likely that management would choose accounting policies that increase income. Its financial statements must be in compliance with IFRS.

The issues are discussed below. The impact of the accounting and reporting on the key metrics (income, debt and equity) are shown in the appendices. Appendix I shows the accounting impact for the issues where the accounting was not specified in the case. Appendix II shows the impact when the company's policies must be changed to be in accordance with GAAP.

Penalty payment

PFC received a $2 million payment from a contractor who built a theatre complex for PFC in Montreal. The payment was for completing the project late. In its attempt to increase income, management will want to record the penalty as revenue.

Arguments could be made for treating the penalty payment either as income (revenue or reduction of expenses) or as a reduction in the capital cost of the complex (balance sheet).

If PFC incurred additional costs because of the delay in opening the new complex, and the penalty was compensation for those additional costs incurred, then the penalty should be used to offset those costs incurred. If the additional costs incurred related to the capital cost of the complex, then the penalty should be used to reduce the capital cost of the complex. Analogies might be drawn with the IFRS standard on government grants (IAS 20). This section recommends that payments such as grants should be treated as cost reductions. The parallel here is that the penalty payment is like a grant and therefore should be treated as a reduction in the capital cost of the complex or in costs expensed as incurred.

On the other hand, if the penalty payment was compensation for lost revenue, then an argument might be made for treating the penalty as revenue. If the penalty is treated as revenue, then we must consider whether it should be disclosed separately. Since the penalty payment is non-recurring, financial statement users would find separate disclosure informative because the portion of revenue and income that is non-recurring can be valued differently by the market and by individual investors and influence the evaluation of management. Therefore, if material, the penalty should be disclosed as a separate revenue item either on the face of the income statement or in the notes.

"Rue St. Jacques"

<u>Ticket proceeds</u>

PFC would prefer to recognize revenue as early as possible with the earliest date being the sale of the tickets. However, the most appropriate treatment for recognizing revenue for ―Rue St. Jacques‖ is when the show is performed.

IFRS 15, paragraph 31 states that ―An entity shall recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (i.e., an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.‖

Performance is the critical event in the earnings process, and therefore revenue is not earned until the show is put on. There is no assurance that the production will be completed, or that any performance for which tickets are sold will take place (for example, the show could be closed down before it begins its run or even after it begins its run). In that case, it will be necessary to refund the acquisition cost of tickets to buyers.

<u>Interest on ticket proceeds</u>

PFC earns a significant amount of interest by holding the money paid in advance by ticket purchasers. The interest revenue could be treated as either income or deferred revenue depending on the facts and circumstances. Management's preference will be to include the interest in income since it will serve to improve the bottom line. Immediate recognition of interest revenue is justifiable. If the show is cancelled, PFC will be able to keep the interest revenue—only the amount paid for the tickets will be refunded. In addition, by buying their seats in advance, purchasers guarantee their seats but pay a premium for the guarantee (the interest earned by PFC and forgone by the purchasers).

On the other hand, interest may be factored into the price and constitute a discount from future higher

made for treating the penalty as revenue. If the penalty is treated as revenue, then we must consider made for treating the penalty as revenue. If the penalty is treated as revenue, then we must consider prices. That is, PFC may be providing a discount to people who purchase their tickets in advance. Prices may rise in the future. If this is the case, then treating the interest as deferred revenue may make sense.

Pre-production costs

PFC has incurred significant costs in advance of the opening of ―Rue St. Jacques.‖ We must determine whether these costs should be capitalized and amortized, or expensed as incurred. PFC would likely prefer to capitalize costs since this treatment would minimize the current effect on income at a time when it is considering going to the capital markets. In principle, capitalization and amortization of the costs over the life of the show appears reasonable. The issue is whether the show will generate adequate revenues (in excess of the capitalized costs) to justify including them on the balance sheet as assets. It is very difficult, however, to determine whether a theatre production will be successful. Indications are that the show will be a success, given its long run in Paris and the extent of advance ticket sales. These facts support capitalization; expensing would likely be too conservative in light of these facts. However, despite these indicators of success, the show could still bomb if costs are excessive or it does not suit the tastes of Canadian theatre goers. As long as the definition of as asset can be met, setting it up as an asset is acceptable.

If PFC chooses to capitalize the pre-production costs, they must be amortized over a reasonable period of time. One method is to expense costs against net revenues dollar for dollar until the pre-production costs are covered (i.e. cost recovery first method). With this method the show will generate no income until the pre-production costs have been recovered. A second alternative is to amortize over the estimated life of the show.

Of course, once the show opens, ongoing production costs should be expensed as incurred.

Advertising and promotion

PFC paid $12 million for advertising and promotion costs a large part of which related to the ―Rue St. Jacques‖ show. These costs should be expensed as incurred because it is difficult to assess the effectiveness of advertising costs i.e. to determine whether they provide future benefit.

Debt defeasance

PFC has structured the debt-retirement transaction as an in-substance defeasance of debt. The effect of the transaction is to remove debt from the balance sheet and thereby reduce the amount of debt reported (thus, for example, decreasing the debt-to-equity ratio). Unfortunately, IFRS does not allow the use of this type of arrangement.

*** acquisition cost as calculated above**