

ACCO 425 NOTES

Chapter 10

Environmental, Social, and Governance Information

-Investors

- Longer investment time horizon → increasingly examine business issues related to environmental and social factors
 - Consider bottom line impact on revenue, costs, product offerings, customer/employee loyalty, reputation and government/regulatory approvals

-Factors

- It's the right thing to do- corporate values
- You have to do it- Compliance
- Make money- Competitive advantage
- Reduce risk- Risk management

-Who's interested

- Senior Management
- Particularly the CFO
- In-house counsel
- Members of audit committee

-Environmental Factors

- Affect performance and therefore will impact value
- Greenhouse gas emissions
- Water usage, scarcity and quality
- Energy Usage
- Waste and waste management
- Air pollutants emitted

-Social Factors

- Human Rights
- Health and safety
- Community and other stakeholder relations
- Relations with indigenous peoples
- Corruption payments to foreign public officials

-Governance

- Processes and structures of the board of directors
- Knowledge and skills of directors
- Independence of board members
- Mandates and committees of the board
- Compensation of directors and officers
- Canadian reporting issues have been required to disclose information about practices

-Corporate Social Responsibility

-The way firms integrate social, environmental, and economic concerns into their values, culture, decision making, strategy and operations in a transparent and accountable manner, and thereby establish better practices within the firms, create wealth and improve society.

-Sustainability

-Development that meets the needs of the present without compromising the ability of future generations to meet their own needs

-Business strategy should reflect this goal

-TBL (Triple Bottom Line) → People, Planet, Profit

-Companies need to measure how they perform socially, environmentally, and economically

-Why issuers are interested

-Internal pressures

-Directors, senior managers, employees

-Positive bottom line effects

-Examples

-Cost savings, increased revenue streams through innovative products, an advantage in attracting, retaining and motivating employees, improved risk management, enhanced reputation and customer loyalty

-Sustainability is a competitive necessity (Survey of executives, and managers)

-CFO's role in sustainability is increasing

-Employees have emerged as an important stakeholder group

-Some studies have found that companies that integrate environmental and social issues into their strategy outperform those that do not

-External Pressures

-Investors, financial institutions, insurers, customers, supply chains, governments, communities, and non-governmental organizations want more information and action on relevant environmental and social issues

-Investors want to know how a company managements risk including environmental and social ones

-Freshfield Report

-2006

-Address concern that investors would only legally address financial issues when making decision

-Commissioned by the Asset Management Working Group of the UN Environmental Programme finance initiative

-Legal Opinion

-Conclusion: Integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguable required in all jurisdictions

-UN principles of responsible Investing (PRI)

1. Incorporate ESG issues into investment analysis and decision making processes
2. Be active owners and incorporate ESG issues into our ownership policies and practices
3. Seek appropriate disclosure on ESG issues by entities in which we invest
4. Promote acceptance and implementation of the principles within the investment industry
5. Work together to enhance our effectiveness in implementing the principles
6. Report on our activities and progress towards implementing the Principles

-Other initiatives

-Carbon Disclosure Project

-Equator Principles: Credit risk management framework for determining, assessing, and managing environmental and social risk in project finance (Capital exceeds \$10 million U.S.)

-Extended to project-related corporate and bridge loans; June 4, 2013- Monitor human rights and climate change

-Insurers: Principles for sustainable insurance

-Canadian Involvement

-UN PRI Signatories

-Caisse de depot et placement du Quebec

-Canada Pension Plan Investment Board

-TD Asset Management

-Equator Principles Signatories

-Bank of Montreal

-Bank of Nova Scotia

-Canadian Imperial Bank of Commerce

-Export Development Canada

-Manulife financial

-RBC

-TD Bank Financial Group

-Key Principles for Business Conduct

-UN initiative

-Started in 2000

-Over 10,000 participants, including over 7000 businesses from 145 countries

-48 Canadian business participants (Bell Canada, Bombardier, Hudson's Bay...)

-UN doesn't assess performance but it can remove companies when it substantiates an external complaint or when the company does not submit a progress report within 2 years

-Current Canadian Requirements

- SEC: Must disclose all material information including material information about environmental/social issues
- October 2010- CSA Staff notice 51-333: Environmental Reporting guidance
 - Annual information form
 - MD&A
 - Corporate Governance disclosure
 - Audit Committee

-Materiality

- Information relating to environmental matters or social issues is likely material if a reasonable investor's decision whether or not to buy, sell, or hold securities of the issuer would likely be influenced or changed if the information was omitted or misstated
- Where reluctant to disclose information due to confidentiality concerns, management should carefully consider who already has access to the information. It is unlikely to be confidential when groups such as employees, suppliers, or competitors are already aware of it

-Key Principles for Business Conduct

-Human Rights

1. Businesses should support and respect the protection of internationally proclaimed human rights
2. Businesses should make sure that they are not complicit in human rights abuses

-Labour

1. Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining
2. Businesses should eliminate all forms of forced and compulsory labour
3. Businesses should abolish child labour
4. Businesses should eliminate discrimination in respect of employment and occupation

-Environment

1. Businesses should support a precautionary approach to environmental challenges
2. Businesses should undertake initiative to promote greater environmental responsibility
3. Businesses should encourage the development and diffusion of environmentally friendly technologies

-Anti-Corruption

1. Businesses should work against corruption in all its forms, including extortion and bribery

Public Sector Entities

- Controlled by the government

- Three levels of government: Federal, provincial, local
- Wide range of government organizations that provide public services such as partnerships, hospitals, and school boards
- All rules found in CICA Public Sector Accounting (PSA)

-9 Characteristics of Public Sector Entities

1. Public Accountability: The rights, power and responsibility of public entities involve a broad accountability to public, and their elected representatives
2. Multiple Objectives: Don't care about profits, rather to provide services and goods to society
3. Rights, Power, and Responsibilities: Not enjoyed by businesses or private not-for-profit. Only public sector NPOs. Right to tax, penalize, and fine, license, legislate activities and set monetary and fiscal policy.
4. Lack of Equity Ownership: Often organized without share capital. If shares happen to be issued, they are held by government
5. Operating and Financial Frameworks set by legislation: Must operate and show compliance with the law, but also operating and financial frameworks
6. Importance budget: The budget is a key tool used government managers for financial management and control. Public accountability is provided by comparing the budget with actual results
7. Government Structure: Governance → provided by BOD or other body that provides oversight over the entity's financial and operating policies
8. Nature of Resources: Often relate to their role as service providers, therefore may not result in future cash flows (Road infrastructure, heritage, cultural resources)
9. Non- Exchange Transactions: Many government revenues are confiscatory by nature. Therefore, they have right to tax and do not directly exchange or give up economic resources when they levy taxes or impose fines and penalties.

-Objective of PS Financial Reporting

1. Show the full nature and extent of the financial affairs and resources that the government including those related to activities of its agencies and enterprises.
2. Describe the government's financial position at the end of its accounting period
3. Describe changes in financial position of the government in the accounting period

4. Demonstrate the accountability of a government for the resources, obligations, and financial affairs for which it is responsible

-Qualitative Characteristics of PS Financial Reporting

- Relevance
- Reliability
- Comparability
- Understandability and clear presentation

-Elements of the F/S

- Elect to choose to adopt PSA or continue to apply the NPO framework
- Assets: Financial and non-financial assets
- Liabilities
- Revenues
- Expenses

-Has to include:

1. Statement of Financial Position: Indicator of financial position on the B/S → Net debt and accumulated surplus/deficit

2. Statement of Operations: Has to have the operating surplus/deficit

3. Statement of changes in net debt: Explains the difference between the operating surplus or deficit and the change in net debt

4. Statement of Cash Flow: How cash was used and generated and the change of it during the period

5. Anything else that provides benefits to users

-Should an item be recorded, only if:

1. Appropriate basis of measurement
2. Reasonable estimate can be made of the amount
3. Economic benefit in the future, it is expected that such benefits will be obtained or given up

Net Debt Indicator

-Net Debt= Financial Assets- Liabilities

-Measure of the net debt is an indicator of a public sector NPO financial position

-Indicator of the financial capacity or constraints facing the public sector entity

-Funds are presented on a combined basis in financial statements under the PSA reporting framework. This aids in understanding financial capacity or constraints facing the public sector entity

-To support accountability, the operating and change in net debt statements include a comparison of results with the budget.

-How much control does the government have?

-Primary Criteria

-Reporting entity is those that the government controls

-Government organization: One that the government controls

-Any of the following 3 criteria shows government control

1. Government could establish an organizations fundamental purpose and limit their ability to make future decisions by predetermining its financial and operating policies

2. Direct financial and operating policies of an organization on an ongoing basis

3. Vote, overrule or modify the financial and operating policies established by an organization

-If none of the above criteria are met, then an organization may still be part of government reporting entity. You have to look at secondary criteria:

-Persuasive evidence and other indicators

-Type of Government Organizations

-GBE

-Separate legal entity

-Power to contract its own name

-Can sue and be sued

-Delegated the financial/operational authority to carry on a business

-Sells goods and services to individuals and organizations outside of the government reporting entity as its principal activity

-Maintain its ops and pay its liabilities from its operations

-Use IFRS and the equity based method

-Government NPO

-Same characteristics as a NPO and has counterparts outside the public sector

-PSA or PS 4200+ PSA → Consolidated line by line

-Other Government Organizations

-All other organizations controlled by the government

-Use PSA or IFRS and consolidated line by line

-GBE-Modified Equity Method

-Financial position and operating results are presented as they are using the equity method, in that the net asset position is shown as a single line on the statement of financial position, and the operating results are shown on a single line on the statement of operations

-When they report OCI, it is reported on a single line on the statement of measurement gains or losses

-No adjustments to the financial position statement or statement of operations.

-Government Partnerships

-Shared control

-Government reports its economic interest in a partnership in 2 ways

1. Government business partnerships as reported on using the modified equity method
2. Other partnerships are reported using the proportionate consolidation method.

-Unique Transactions

-Public Sector NPOs have different relationship with its stakeholders

-Portfolio investments with concessionary terms

-Portion of investment that the government' doesn't expect to recover (grant) should be recognized as an expense.

-Portion that is remaining should be discounted when terms are discretionary

-Concessionary: Rates < market rate

-Loan Receivable

-Include loan paid through future appropriations

-Account as expense

-Financial asset if not recorded by the government

-Forgivable

-Accounted for as a grant (expense), unless it qualifies as a loan receivable and there is sufficient evidence of its recovery

-Loans with significant concessionary terms

-Same as portfolio investments above

-Liability for contaminated sales

-Site management of contaminated sites that will require remediation at some point

-Liability is recognized when **conditions are met:**

1. Environment standard exists
2. Contamination exceeds an environmental standard
3. A public sector entity is directly responsible, or accepts responsibility
4. Economic benefits are expected to be given up
5. A reasonable estimate of the costs can be made

-Cost= anticipated= entry (including operation, maintenance, and monitoring of site.

-Any tools required only for that should be included in that amount

-NPV of the value

-Reduced by any recoveries expected to be received

-Solid waste landfill closure and post-closure liabilities

-Liability as soon as the site starts to accept waste

-Expense on the proportion of waste accepted each period

- Liability builds as capacity goes down
- Estimate total expenditure → (Cumulative Cap used/ Total estimated Cap)
- All- expenditures previously recognized
- Value-based on estimated future cash flow discounted at the government's average long-term borrowing rate

-Loan Guarantees

- If losses are likely, then establish a liability, and record an expense
- Losses in terms of principle and interest

-Government Transfers

- Transferring: Records expense in the period of transfer is authorized and all criteria are met by the recipient
- Receiving records as revenue unless criteria is not met
- Liability is measured in future periods as to be consistent with the circumstances and evidence used to support its initial recognition. The government receiving the transfer would reduce the liability, recognize the revenue.

-Tax Revenue

- Recognize the revenue when its authorized and taxable event occurs
- Measured at realizable value
- Taxes receivable when likely and not recognized if not likely
- Governments use their tax systems to facilitate the redistribution of income, enhance comparability of F/S, the standard requires payments or reductions in taxes payable to be classified as either transfer through tax system (not change in tax assessed) or tax concessions (reduction in tax).

Integrated Reporting

Integrated reporting (IR) in corporate communication is a process that results in communication, most visibly a periodic “integrated report”, about value creation over time. An integrated report is a concise communication about how an organization’s strategy, governance, performance, and prospects lead to the creation of value over the short, medium and long term.

It means the integrated representation of a company’s performance in terms of both financial and other value relevant information. IR provides greater context for and may help make company decision making more long-term. While the communications that result from IR will be benefit to a range of stakeholders, they are principally aimed at providers of financial capital allocation decisions

IR helps to complete financial and sustainability reports. A framework has been published, but some questions remain in order to know how to apply it. Do we need a report? Do we need 1

report. Other questions could have been raised, such as who is really working for an integrated reporting, and who has interests in it.

-Reporting Cycle

- Integrated reporting and thinking creates value over the short, medium and long term
- Creates efficient and productive capital allocation
 - Improve quality of information available
- Creates financial stability and sustainability
- “connectivity of information”

-Primary Purpose: Explain to providers of financial capital how an organization creates value over time

-Users: Employees, customers, suppliers, business partners, local communities, legislators, regulators, and policy makers

<IR>: A New Focus



-Interdependence

- Range of factors that affect value over time
- Capitals that the organization uses or affects
- Capacity of the organization to respond to key stakeholders' legitimate interests and needs
- How the organization tailors its business model and strategy to respond to its external environment and the risks and opportunities it faces
- The organization's activities, performance (financial and other) and outcomes in terms of capitals-Past, Present, and Future

-Framework: Guiding Principles

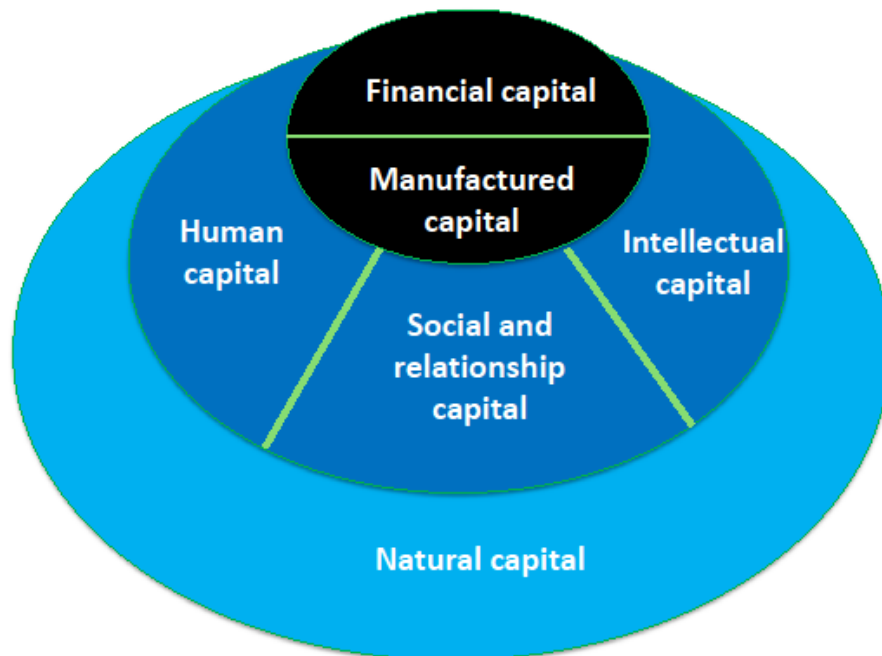
- Designed to be flexible but allow for comparability
- Does not prescribe specific key performance indicators, measurement methods, or disclosure
- Could be independent report or part of another report or communication
- Should contain a statement by those charged with governance accepting responsibility for the report

-Capitals

- Stocks of values that are increased, decreased, or transformed through the activities and outputs of the organization

The Framework

Fundamental Concepts: The Capitals



-Guiding Principles

- Strategic focus and future orientation
- Connectivity of information
- Stakeholder relationships
- Materiality
- Conciseness
- Reliability and completeness
- Consistency and comparability

-Content Elements

- Questions to be answered
- Unique story
- Connections apparent
- Not a set sequence
- Not isolated, standalone sections
- Organizational overview/external environment
- Governance
- Business Model
- Risk and Opportunities
- Strategy and resource allocation
- Performance
- Outlook
- Basis for preparation and presentation
- General reporting guidance

-Improving Reporting

1. Communicating vs Complying
2. Reporting the intangibles
3. Breaking down Silos
4. Increasing Transparency

Who is the IIRC?



Chair: Prof Mervyn King
CEO: Paul Druckman

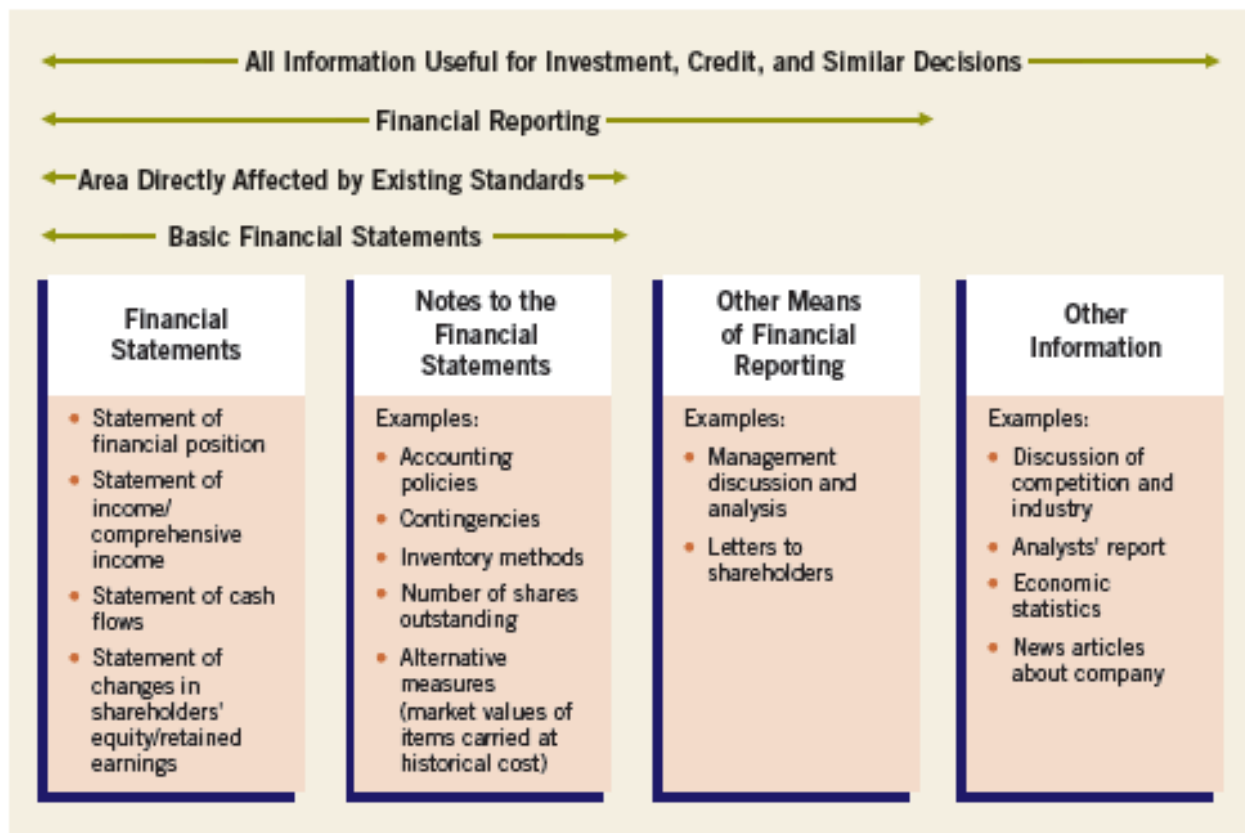
CHAPTER 23: OTHER MEASUREMENT AND DISCLOSURE ISSUES

-Importance of Disclosure

- Information disclosure is an important part of capital markets
 - Financial statements are only one source of information for investors
 - Other sources include:
 - Annual information forms
 - Management's discussion and analysis (MD&A)
 - New Releases
 - Users must use caution because not all disclosure is good disclosure

-Full Disclosure Principle

- Calls for financial reporting of significant facts affecting the judgment of an informed reader
- The problems of implementing this principle are costs of disclosure or information overload
- Over the past several decades, disclosures for public companies have significantly increased



-Increase in Reporting Requirements

- Reasons for increasing reporting requirements of public companies:
 1. Complexity of the business environment (Example: derivatives, business combinations, pensions)
 2. Need for timely information (Example: Interim data, financial forecasts)

3. Accounting used as a control and monitoring device (example: disclosure of management compensation, related-party transactions, errors and irregularities)

-Segmented Reporting

-Information on how the segment contributes to the total business operations

-Investors want information from the income statement, statement of financial position, and statement of cash flows about individual segments

-Reporting segmented information helps users:

1. Better understand the enterprise's performance
2. Better assess future net cash flows prospects
3. Make more informed judgments about the company

-ASPE: No guidance for reporting segmented information

-IFRS: Financial statements must include selected information on a single basis of segmentation

-Segments are evident from their organizational structure (operating segments)

-Called the **management approach**

-Includes information the perspective of the chief operating decision maker

-Operating segment

-Component of an enterprise that:

1. Engages in business activities from which it earns revenues and incurs expenses
2. Has the chief operating decision maker regularly review results to:
 - Assess performance
 - Allocate resources
3. Has discrete financial information available

-Operating segments may be aggregated if they have the same basic characteristics:

1. Nature of products/services provided
2. Nature of production process
3. Type/class of customer
4. Methods of product/service distribution
5. Nature of regulatory environment (If applicable)

-Reportable Segments

-Operating segment is significant and thus identified as a reportable segment if it satisfies one or more of the following criteria

1. Revenue criterion
 - 10% or more of the combined revenue of all operating segments**
2. Profit/loss criterion
 - 10% or more of the GREATER of:**
 - a) **Combined profit of all operating segments not showing a loss**
 - b) **Combined loss of all operating segments reporting a loss**
3. Identifiable assets criterion
 - 10% or more of the combined assets of all operating segments**

-Three other factors are considered in addition to above tests:

1. Segment results are 75% or more of combined sales to unrelated customers
2. No more than 10 segments are required to be disclosed
3. Segment may be presented separately on grounds that separate information would be useful to users (even if not meet any of the tests)

-Measurement Principles

-Accounting principles used for segment reporting and for consolidated statements **don't** have to be the same

-Some accounting principles may not apply at the segment level

-For example: common costs are not required to be allocated among the segments

-Such allocation is arbitrary and may not produce an objective division of costs among segments

-Required Segmented Information

-IFRS: Requires reporting of the following:

1. General information about its reportable segments
2. Segment profit and loss, assets, liabilities, and related information
3. Reconciliation of segment revenues, profits, and losses, and segment assets and liabilities
4. The amount of revenues from external customers for products/services
5. Information about geographical areas and if amounts are material, foreign information (example: revenue) must be disclosed by country
6. Information about major customers (if 10% or more of revenue from 1 customer, must disclose)

-Interim Reporting

-IFRS: Does not mandate which entities need to provide interim information

-Annual reports and interim reports must use the same accounting principles (example: Inventory cost formula, revenue recognition)

-Costs and expenses other than products costs (period costs) are often recorded in the interim period as they are incurred

-ASPE: Doesn't provide guidance on interim reporting

-Condensed statement of position, comprehensive income statement, statement of changes in equity, statement of cash flows, and selected notes are required (minimum)

-EPS information is also required IF company must present this information in its annual information

-Statement of financial position: Should be presented as at the end of the current interim period with a comparative statement of financial position as of the end of the immediately preceding fiscal year

-Income statement: Should be presented for the current interim period and interim year to date with comparatives

-**Statement of changes in equity:** Should be presented cumulatively for the current fiscal year to date with comparatives

-**Statement of cash flows:** Should be presented cumulatively for the current fiscal year to date with comparatives

-Minimum disclosure requirements include:

1. Compliance with IFRS regarding financial statements
2. Accounting policies and methods
3. Any seasonal or cyclical period considerations
4. Nature and amount of unusual items
5. Nature and amount of estimate changes
6. Issuances, repurchases, and repayments of debt and equity securities
7. Dividends paid
8. Information about reportable segments
9. Subsequent events
10. Changes in composition of entity
11. Any other information required for fair presentation and/or material to understanding of period

-Problem Areas

1. Changes in Accounting
 - Changes applied retroactively to prior interim periods
 - Comparable interim periods from previous fiscal years also restated
2. EPS
 - Each interim period EPS is stand alone
3. Seasonality
 - Defer recognition of costs and expenses only if it would also be appropriate at year-end
4. Continuing Controversy
 - Auditor's involvement in the interim reporting process
 - Timeliness of information

-Companies are increasingly disclosing financial information through websites

-Corporations can reach more users using the Internet

-Internet reporting can make traditional reports more useful

-Corporations can report more timely information

-They can also report disaggregated data, therefore financial reports are more relevant

-The major concerns are equality of access to electronic reports, and reliability of information distributed via the Internet

Chapter 15: Partnerships

-Definition

-Association of two or more persons to carry on as co-owners of a business for profit

-Attributes:

1. Agreement, expressed or implied
2. Operated for making a profit
3. Members must be co-owners

-Advantages

1. Permits pooling of resources without complexities of a corporation
2. Easier and less costly to establish
3. Not subject to as much governmental regulation as a corporation
4. Partners able to operate with more flexibility
5. Income not subject to taxation at partnership level

-General Partnership

-Each member is a general partner

-Characteristics

- Mutual Agency
- Right to dispose of partnership interest
- Unlimited liability
- Limited or uncertain life

-Limited Partnership

-At least one general partner and one limited partner

1. General Partner

- Manage the firm
- Liable for obligations

2. Limited Partner

- Invest capital only
- Limited Liability
- No participation in management

-Allows general partners to raise capital without giving up management control

-Joint Ventures

-Arrangement by 2+ parties to accomplish a single or limited purpose for their mutual benefit

- Life limited to that of the undertaking
- Relationship governed by written agreement
- Each party participates in overall management
- Commonly organized as corporations or partnerships

-Agreements should include:

1. Name of the firm and identity of the partners
2. Nature, purpose, and scope of the business
3. Effective date of organization
4. Length of time partnership is to operate
5. Location of place of business
6. Provision for allocation of profit and loss
7. Provision for salaries and withdrawals by partners
8. Rights, duties, and obligations of each partner
9. Authority of each partner in contract situations
10. Procedures for admitting a new partner
11. Procedures on withdrawal or death of a partner
12. Procedures for arbitration of disputes
13. Fiscal period of partnership
14. Identification and valuation of initial asset investments and capital interest
15. Situations for partnership dissolution and provisions for terminating or continuing the business
16. Accounting practices to be followed
17. Whether or not an audit is to be performed

-Capital Interest vs Profit Interest

-Capital Interest: Claim against net assets of partnership

-Interest in income/loss: How partner's capital will increase/decrease as a result of subsequent operations

-Accounting for a Partnership

-Adhere to GAAP

-Small/specialized partnerships may utilize either:

1. Cash basis
2. Tax Basis

-Partnership equity section

-Capital Account

-Drawing Account

-Typically debited to record withdrawals of assets in anticipation of profitable operations or payments of personal expenses of a partner from partnership assets

-Closed to capital account

Exercise 15-2: Tom and Julie formed a management consulting partnership on January 1, 2008. The fair value of the net assets invested by each partner follows:

	<u>Tom</u>	<u>Julie</u>
Cash	\$13,000	\$12,000
Accounts receivable	8,000	6,000
Office supplies	2,000	800
Office equipment	30,000	—
Land	—	30,000
Accounts payable	2,000	5,000
Mortgage payable	—	18,800

During the year, Tom withdrew \$15,000 and Julie withdrew \$12,000. Net profit for 2008 was \$50,000, which is to be allocated based on the original net capital investment.

Exercise 15-2: A₍₁₎. Prepare journal entries to record the initial investment in the partnership for **Tom**.

Cash	13,000	
Accounts receivable	8,000	
Office supplies	2,000	
Office equipment	30,000	
Accounts payable		2,000
Tom, Capital		51,000

Exercise 15-2: A₍₁₎. Prepare journal entries to record the initial investment in the partnership for **Julie**.

Cash	12,000	
Accounts receivable	6,000	
Office supplies	800	
Land	30,000	
Accounts payable		5,000
Mortgage payable		18,800
Julie, Capital		25,000

Exercise 15-2: A₍₂₎. Record the withdrawals.

Tom, Drawing	15,000	
Cash		15,000
Julie, Capital	12,000	
Cash		12,000

Exercise 15-2: A(3). Close the Income Summary and Drawing accounts.

Income summary	50,000	
Tom, Capital		33,553
Julie, Capital		16,447
Tom, Capital	15,000	
Tom, Drawing		15,000
Julie, Capital	12,000	
Julie, Drawing		12,000

-Allocation of Net Income/ Net Loss

-Partnership agreement should indicate how income and losses are allocated

-Based on:

1. Fixed Ratio
2. Ratio based on capital balances
3. Interest on capital investment
4. Fixed salary allocation
5. Bonus as % of income

Exercise 15-5: On January 1, 2008, Tony and Jon formed T&J Personal Financial Planning with capital investments of \$480,000 and \$340,000, respectively. The partnership agreement provides that profits are to be allocated as follows:

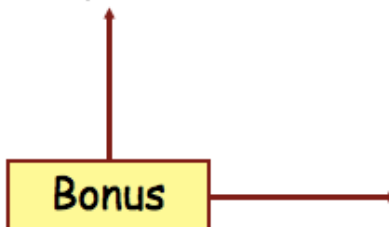
1. Annual salaries of \$42,000 and \$66,000 are granted to Tony and Jon, respectively.
2. Jon is entitled to a bonus of 10% of net income after salaries and bonus but before interest on capital investments is subtracted.
3. Each partner is to receive an interest credit of 8% on the original capital investment.
4. Remaining profits are allocated 40% to Tony and 60% to Jon.

On December 31, 2008, the partnership reported net income before salaries, interest, and bonus of \$188,000.

Exercise 15-5: Calculate the 2008 allocation of partnership bonus.

Bonus Calculation

$$\begin{aligned}
 B &= .10 \times (\text{income after salaries} - B) \\
 B &= .10 \times [(\$188,000 - \$108,000) - B] \\
 B &= .10 \times (\$80,000 - B) \\
 B &= \$8,000 - .10 \times B \\
 1.10 \times B &= \$8,000 \\
 B &= \$7,273
 \end{aligned}$$



<u>Proof:</u>	
Net Income	\$188,000
Salaries	(108,000)
Bonus	<u>(7,273)</u>
Net income subject to bonus	<u>\$72,727</u>
$B = .10 \times \$72,727$	
$B = \$7,273$	


Exercise 15-5: Calculate the 2008 allocation of partnership profit of **\$188,000**.

	<u>Tony</u>	<u>Jon</u>	<u>Total</u>
Salary	\$42,000	\$66,000	\$108,000
Bonus (previous slide)	0	7,273	7,273
Interest on capital	38,400	27,200	65,600
Total	<u>80,400</u>	<u>100,473</u>	<u>180,873</u>
Remainder (40%/60%)	2,851	4,276	7,127
Income allocation	<u><u>\$83,251</u></u>	<u><u>\$104,749</u></u>	<u><u>\$188,000</u></u>

-Insufficient Income to cover allocation

-Amount by which salary and/or interest exceeds net income is allocated to individual partners in their agreed ratio for allocating residual income

For example, assume that Adams and Brown agree to divide profits as follows:

1. Salary: Adams, \$4,000; Brown, \$2,000
2. Interest: 8% on average capital balances - Adams, \$77,500; Brown, \$37,500 
3. Remainder: To be divided equally

A net income of \$11,000 would be allocated as follows:

	<u>Adams</u>	<u>Brown</u>	<u>Total</u>
Salary	\$ 4,000	\$ 2,000	\$ 6,000
Interest	6,200	3,000	9,200
	<u>10,200</u>	<u>5,000</u>	<u>15,200</u>
Excess allocation	(2,100)	(2,100)	(4,200)
Income allocation	<u>\$ 8,100</u>	<u>\$ 2,900</u>	<u>\$ 11,000</u>

-Salaries and Interest as an expense

-Same change in capital accounts as if salaries and interest were considered an allocation of profit

-Since normal practice is to recognize salaries and interest as an allocation of profit, any such amounts treated as an expense should be adequately disclosed

-Statement reader can properly evaluate the operating performance of the firm

-Adjustment of income of prior years

-Problems in allocation of profit and loss can result if:

1. Errors are discovered that occurred in specific prior years
2. Partners have altered profit and loss agreement since period in which error occurred

-Corrections are allocated to partners' capital accounts

-Financial Statement Presentation

-Differences from GAAP:

1. Changes in partner's equity should be disclosed
2. Salary allowances are generally **not** an expense
3. No income tax expense
4. Interest allowance on capital investment is considered an allocation of profit

Exercise 15-2: B. Prepare a statement of changes in partners' capital for the year ended December 31, 2008.

**Statement of Changes in Partners' Capital
For the Year Ended December 31, 2008**

	<u>Tom</u>	<u>Julie</u>	<u>Total</u>
Capital balances, Jan. 1	\$ -	\$ -	\$ -
Add: Additional investments	51,000	25,000	76,000
Net income allocation	33,553	16,447	50,000
Totals	<u>84,553</u>	<u>41,447</u>	<u>126,000</u>
Less: Withdrawals	15,000	12,000	27,000
Capital balances, Dec. 31	<u>\$69,553</u>	<u>\$29,447</u>	<u>\$99,000</u>

-Changes in Ownership of the Partnership

-Dissolution may be:

- Voluntary (Mutual Agreement)
- Involuntary (Bankruptcy)

-Does not automatically result in termination of business activity

-Methods of Recording Changes in Membership

-Two methods are frequently used:

1. Bonus Method

-Assets are increased by the amount of the assets invested by the partner being admitted

-Any difference between assets invested and credit to new partner's capital account is adjusted to capital accounts of other partners

2. Goodwill Method

-A new asset is recorded that is based on the difference between the value implied by the amount of consideration and the values reported in the partnership books

SECTION A: Admission of New Partner

Exercise 15-7: Phil Phoenix and Tim Tucson are partners in an electrical repair business. Their respective capital balances are \$90,000 and \$50,000, and they share profits and losses equally. Because the partners are confronted with personal financial problems, they decided to admit a new partner to the partnership. After an extensive interviewing process they elect to admit Don Dallas into the partnership.

Prepare the journal entry to record the admission of Don Dallas into the partnership under each of the following conditions:

Exercise 15-7: 1. Don acquires one-fourth of Phil's capital interest by paying \$30,000 directly to him.

Phil Phoenix, Capital	22,500	
Don Dallas, Capital		22,500

$$\begin{array}{l} \$90,000 \times 25\% = \$22,500 \\ \text{(Phil's Capital)} \end{array}$$

...

Exercise 15-7: 2. Don acquires one-fifth of each of Phil's and Tim's capital interests for \$25,000 and \$15,000, respectively.

Phil Phoenix, Capital	18,000	
Tim Tucson, Capital	10,000	
Don Dallas, Capital		28,000

$\$90,000 \times 20\% = \$18,000$
(Phil's Capital)

$\$50,000 \times 20\% = \$10,000$
(Tim's Capital)

Exercise 15-7: 3. Don acquires a one-fifth capital interest for a \$60,000 cash investment. Total capital after the admission is to be \$200,000.

Cash	60,000		} 50:50
Don Dallas, Capital		40,000	
Phil Phoenix, Capital		10,000	
Tim Tucson, Capital		10,000	

Phil Tim Cash Total Capital
 $\$90,000 + \$50,000 + \$60,000 = \$200,000;$

Dallas, capital = $\$200,000 \times 20\% = \$40,000$

Exercise 15-7: 4. Don invests \$40,000 for a one-fifth interest in capital. **Goodwill** is to be recorded.

Don's investment	\$40,000
Interest in partnership	/ 20%
Total capital	<u>200,000</u>
Less:	
Phil's capital	90,000
Tim's capital	50,000
Don's investment (capital)	<u>40,000</u>
Goodwill	<u><u>\$20,000</u></u>

Exercise 15-7: 4. Don invests \$40,000 for a one-fifth interest in capital. **Goodwill** is to be recorded.

Cash	40,000	
Don Dallas, Capital		40,000
Goodwill	20,000	
Phil Phoenix, Capital		10,000
Tim Tucson, Capital		10,000
		} 50:50

Acquisition of an Interest by Investing Assets

Three situations

			<u>Bonus or Goodwill</u>
1	Fair value of assets invested.	=	Book value of capital interest acquired → None
2	Fair value of assets invested.	>	Book value of capital interest acquired → To existing partners
3	Fair value of assets invested.	<	Book value of capital interest acquired → To new partner

Exercise 15-9: Beth, Steph, and Linda have been operating a small gift shop for several years. The partners concluded that the business needed to expand in order to provide an adequate return to the partners. The following balance sheet is for the partnership prior to the admission of a new partner, Mary.

Cash	\$160,000
Other Assets	640,000
	<u>\$800,000</u>
Liabilities	\$200,000
Beth, Capital (40%)	265,000
Steph, Capital (40%)	215,000
Linda, Capital (20%)	120,000
	<u>\$800,000</u>

Figures shown parenthetically reflect profit-loss percentages.

Exercise 15-9: Prepare the necessary journal entries to record the admission of Mary assuming: 1. Mary is to invest sufficient cash to receive a one-sixth capital interest. The admission is to be recorded without recognizing goodwill or bonus.

Beth, Capital	\$265,000
Steph, Capital	215,000
Linda, Capital	<u>120,000</u>
Total existing capital	600,000
Existing partners ownership interest (5/6 th)	<u>/ 83.33%</u>
Total capital after investment (100%)	720,000
Less: Existing capital	<u>600,000</u>
Mary's investment	<u><u>\$120,000</u></u>

Exercise 15-9: Prepare the necessary journal entries to record the admission of Mary assuming: 1. Mary is to invest sufficient cash to receive a one-sixth capital interest. The admission is to be recorded without recognizing goodwill or bonus.

Cash	120,000	
		Mary, Capital
		120,000

Exercise 15-9: Prepare the necessary journal entries to record the admission of Mary assuming: 2. Mary is to invest \$160,000 for a one-fifth capital interest.

Bonus Method

Amount invested > Book value acquired

Beth, Capital	\$265,000
Steph, Capital	215,000
Linda, Capital	120,000
Mary's investment	<u>160,000</u>
Total invested capital	760,000
Mary's interest (1/5 th)	<u>x 20%</u>
Book value acquired	<u><u>\$152,000</u></u>

Exercise 15-9: Prepare the necessary journal entries to record the admission of Mary assuming: 2. Mary is to invest \$160,000 for a one-fifth capital interest.

Bonus Method - When amount invested is > book value acquired, bonus goes to existing partners.

Cash	160,000	
Mary, Capital		152,000
Beth, Capital (40% x \$8,000)		3,200
Steph, Capital (40% x \$8,000)		3,200
Linda, Capital (20% x \$8,000)		1,600

Exercise 15-9: Prepare the necessary journal entries to record the admission of Mary assuming: 2. Mary is to invest \$160,000 for a one-fifth capital interest.

Goodwill Method

Book value acquired < Amount invested.

Mary's investment	\$160,000
Mary's interest (1/5 th)	/ 20%
Total implied capital	800,000
Less: Total invested capital	760,000
Goodwill	\$40,000

Exercise 15-9: Prepare the necessary journal entries to record the admission of Mary assuming: 2. Mary is to invest \$160,000 for a one-fifth capital interest.

Goodwill Method - When book value acquired is < amount invested, goodwill goes to existing partners.

Goodwill	40,000
Beth, Capital (40% x \$40,000)	16,000
Steph, Capital (40% x \$40,000)	16,000
Linda, Capital (20% x \$40,000)	8,000
Cash	160,000
Mary, Capital	160,000

Exercise 15-9: Prepare the necessary journal entries to record the admission of Mary assuming: 3. Mary is to invest \$160,000 for a one-fourth capital interest.

Bonus Method

Book value acquired > Amount invested.

Beth, Capital	\$265,000
Steph, Capital	215,000
Linda, Capital	120,000
Mary's investment	<u>160,000</u>
Total invested capital	760,000
Mary's interest (1/4 th)	<u>× 25%</u>
Book value acquired	<u><u>\$190,000</u></u>

Exercise 15-9: Prepare the necessary journal entries to record the admission of Mary assuming: 3. Mary is to invest \$160,000 for a one-fourth capital interest.

Bonus Method - When book value acquired is > amount invested, bonus goes to new partner.

Cash	160,000	
Beth, Capital (40% × \$30,000)	12,000	
Steph, Capital (40% × \$30,000)	12,000	
Linda, Capital (20% × \$30,000)	6,000	
Mary, Capital		190,000

Exercise 15-9: Prepare the necessary journal entries to record the admission of Mary assuming: 3. Mary is to invest \$160,000 for a one-fourth capital interest.

Goodwill Method

Book value acquired > Amount invested.

Current partner's capital	\$600,000
Current partner's interest	/ 75%
Total implied capital	<u>800,000</u>
Less: Total invested capital	<u>760,000</u>
Goodwill	<u><u>\$40,000</u></u>

Exercise 15-9: Prepare the necessary journal entries to record the admission of Mary assuming: 3. Mary is to invest \$160,000 for a one-fourth capital interest.

Goodwill Method - When book value acquired is > amount invested, goodwill goes to new partner.

Cash	160,000	
Goodwill	40,000	
Mary, Capital		200,000

SECTION B: Withdrawal of a Partner

-A partner **cannot** be prevented from withdrawing from a partnership

-It is assumed partners mutually agree to the withdrawal such that:

1. Withdrawing partner sells interest to outside party
2. Withdrawing partner sells interest to remaining partners
3. Partners transfer partnership assets to withdrawing partner

-**Payment to Retiring Partner** (in excess of book value)

-Bonus method: Remaining partners are charged with the amount of the payment that exceeds the book value of the retiring partner's capital balance

-Goodwill method: Used if:

1. Existing partners will not agree to reduce their capital balances
2. Partnership agreement specifies how withdrawal is to be recorded
3. Partners agree that intangible should be recognized

Exercise 15-13: Kazma, Folkert, and Tucker are partners with capital account balances of \$30,000, \$75,000, and \$45,000, respectively. Income and losses are divided in a 4:4:2 ratio. When Tucker decided to withdraw, the partnership revalued its assets from \$225,000 to \$252,000, which represented an increase in the value of inventory of \$8,000 and an increase in the value of land of \$19,000. Tucker was then given \$15,000 cash and a note for \$40,000 for his withdrawal from the partnership.

Exercise 15-13: Prepare the journal entry to record the revaluation of the partnership's assets.

Inventory	8,000	
Land	19,000	
Kazma, Capital ($\$27,000 \times 40\%$)		10,800
Folkert, Capital ($\$27,000 \times 40\%$)		10,800
Tucker, Capital ($\$27,000 \times 20\%$)		5,400

Exercise 15-13: Prepare the journal entry to record the withdrawal using the **bonus method**.

Tucker, Capital ($\$45,000 + \$5,400$)	50,400	
Kazma, Capital ($\$4,600 \times 50\%$)	2,300	
Folkert, Capital ($\$4,600 \times 50\%$)	2,300	
Cash		15,000
Note Payable		40,000

Exercise 15-13: Prepare the journal entry to record the withdrawal using the **partial goodwill method**.

Goodwill ($\$15,000 + \$40,000 - \$50,400$)	4,600	
Tucker, Capital		4,600

Tucker, Capital ($\$45,000 + \$5,400 + \$4,600$)	55,000	
Cash		15,000
Note Payable		40,000

Exercise 15-13: Prepare the journal entry to record the withdrawal using the **full goodwill method**.

Goodwill ($\$4,600/20\%$)	23,000	
Kazma, Capital ($\$23,000 \times 40\%$)		9,200
Folkert, Capital		9,200
Tucker, Capital		4,600

Tucker, Capital	55,000	
Cash		15,000
Note Payable		40,000

-Payment to Retiring Partner (less than book value)

-A partner may agree to accept less than their interest for of reasons:

1. May view the future of the company negatively
2. May need operating capital for personal reasons
3. Business associations may no longer be acceptable

-In such cases use of the bonus method is justified