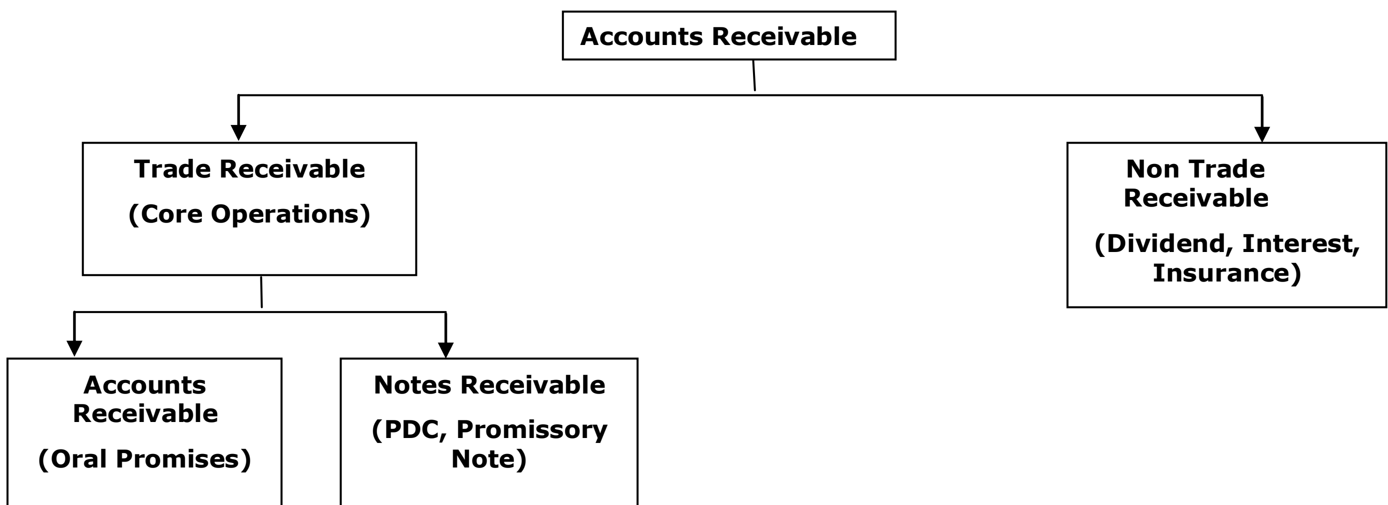
CHAPTER – 2 MEASUREMENTS, VALUATION & DISCLOSURE: INVESTMENTS & SHORT-TERM ITEMS

☞ **This chapter covers**

- ✓ **Receivables**
- ✓ **Inventory**
- ✓ **Investments**

A. ACCOUNTS RECEIVABLE: are the amounts owed to an entity by its customers.



2. Receivable should be separated into **current and non- current portions**. Generally receivables are classified as current assets as they are expected to be collected within 1 year or entity's normal operating cycle.

   a. **Current account receivable** are reported in the balance sheet at Net **realizable value (NRV)**

   NRV of accounts receivable = Gross Accounts receivable – Allowance for uncollectable accounts

   b. **Non Current receivables** are measured at **net present value of future cash flows** expected to be collected.

3. **Direct write off method** expenses bad debts when they are determined to be uncollectible. This is **not acceptable under GAAP** as it does not match revenue and expense period, but this method is **used for Tax purposes**

4. A provision must be made to account for Right of sales return. This should be consistent with matching principle.

PROVISIONS: The two methods to measure provisions are

1. Income statement approach (Percentage of credit sales)

2. Balance sheet approach (Percentage of receivables)

1. **Income Statement approach:** calculates bad debt expenses as a percentage of credit sales reported on income statement

2. **Balance sheet approach:** estimates the balance that should be recorded in the allowance based on the ending gross accounts receivable. An entity using the balance sheet approach generally prepares aging schedule for accounts receivable

3. **Write off of Accounts receivable:**

a. Write off of a particular bad debt has no effect on expenses.
b. This do not affect the carrying amount of net accounts receivable and hence has no effect on working capital

JOURNAL ENTRIES:

1. When credit sales are made (Goods sold on credit)

   Dr. A/C receivable (B/S =CA↓)

   To Sales (I/S = Rev↑)

2. When amount received from customers

   Dr. Bank A/C (B/S =CA↑)

   To A/C receivable (B/S =CA↓)

3. Provision for doubtful debts

   Dr. Bad Debts (I/S =Profit↓)

   To Provision (Allowance)

   For doubtful debts (B/S – A/R CA↓)

   Dr. Bad debts (Exp – I/S↓ P)

   Cr. Allowance for doubtful debts

4. For Writing off uncollectable receivables

   Dr. allowance for doubtful debts
   Cr. Accounts receivables } B/S adjustments. No affect on Net receivable/Net Income

FACTORING:

1. Transfer of receivable to a third party (Factor) who assumes the responsibility of collection
2. Factoring discounts receivables on a non recourse basis. Thus payments by the debtors on the transferred assets are made to the factor
3. If the transferor(seller) surrenders control, then transaction is a sale
   a. **If a sale is without recourse**, the **transferee assumes the risk** and receives the rewards for collection. This sale is FINAL. The seller has no further liabilities to the transferee. Accordingly the receivables are no longer reported on seller's book.
   b. **If a sale is with recourse** the seller may be required to make payments to the **transferee to buy back receivable.**

The main reasons for factoring are as follows:

1. A Factor usually receives high financing fee plus a fee for collection
2. A factor operates more efficiently because of field specialization
3. Entity using Factor tries to speed up the collection.
4. Cost saving benefit to the entity
5. Bad debts are eliminated from entity's financial statements

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B. INVENTORY

1. Inventory is the total of tangible personal property
   a. **Held for sale** in the ordinary course of business
   b. **Work- in- process** to be completed and sold in the ordinary course of business
   c. To be used up currently in producing goods or service for sale
   d. It **does not include long term assets** subject to depreciation
2. They are generally **classified as Current Asset** in financial statement
3. **Inventory of retailer = Goods purchased to be sold without modification**
4. **Inventory of manufacturer = Raw Material, Work in process, Finished goods**

Objective of Inventory Control:

1. Safeguarding Inventory
2. Accurate reporting of inventory in financial statement
3. Ensuring availability of inventory items
4. Preventing excessive accumulation of inventory items

Inventory Verification: A physical inventory or count of inventory should be taken near year end to make sure that the quantity of inventory reported in the financial statement is accurate.

Net Cost of Purchase:

Purchase Price
Add Freight In
Less Purchase returns
Less Purchase allowance
Less Purchase discounts

NET COST OF PURCHASE
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} Dr. Inventory
Cr. Supplier

COST BASIS OF INVENTORY:

1. The cost of inventory includes all costs incurred in bringing the inventories to their existing location and ready to use condition
2. The cost of purchased inventories includes
    a. The price paid to acquire the inventory (net of trade discounts, rebates etc)
    b. Import duties & other unrecoverable taxes
    c. Other directly attributable costs (Handling, insurance etc.)
3. The cost of manufactured inventories include cost of direct material & Conversion cost

INVENTORY ACCOUNTING SYSTEM

There are two types:

1. Perpetual Method
2. Periodic Method

1. Perpetual Method:

a. The inventory account is updated after each purchase or sale.
b. More suitable for entities that sell relatively expensive and heterogeneous items and requires continuous monitoring
c. Purchases and other items related to inventory costing are charged directly to inventory
d. Inventory & cost of goods sold are adjusted as sales occur

Advantage: The amount of inventory on hand and the cost of goods sold can be determined at any time

Disadvantage: Book keeping is more complex and expensive

2. Periodic Method:

a. The inventory & cost of goods sold are updated at specific intervals (quarterly, annually)
b. More suitable for entities that sell relatively inexpensive and heterogeneous items
c. Goods bought from supplier and other items related to inventory costs are tracked during the period in separate temporary account
d. Beginning inventory balance remains unchanged until the end of the period when the purchase account is closed
e. Changes in inventory and cost of goods sold are recorded only at the end of the period based on physical count.

Advantage: Book keeping is easier and simpler

INVENTORY PERIOD END PHYSICAL COUNT

1. Under perpetual System, a physical count helps to detect misstatements in records, thefts of inventory.
2. The difference between physical count and inventory in books are recognized in cost of goods sold or as separate line item
3. Under Periodic system, the amount of inventory and cost of goods sold can be determined based only on the results of a physical count. Thus the amount of cost of goods sold for the period includes both inventory cost of goods sold and inventory shortages or overages.
4. For the physical count to be accurate, the entity must count all items considered to be inventory (Goods in transit – (FOB Shipping point, FOB Destination), Goods out on consignment)

INVENTORY ESTIMATION:

An estimate of inventory may be needed when an exact count is not feasible. The Gross Profit method may be used or inventory estimation

Gross Profit Margin (%) = Gross Profit/Sales.

INVENTORY COST FLOW METHODS:

1. First In First Out [FIFO]
2. Last In First Out [LIFO]
3. Specific
4. Average

1. First In First Out :

a. Assumes that the first goods purchased are first sold. Thus, ending inventory consists of the latest purchases
b. Cost of goods sold includes the earliest goods purchased
c. Year end inventory and cost of goods sold for the period are the same regardless of whether the perpetual or periodic inventory accounting system is used.

2. Last In First Out :

a. Assumes that the newest items of inventory are sold
b. Under this perpetual and periodic systems may result in different values for yearend inventory & cost of goods sold.

3. Specific:

a. Requires determining which specific items are sold and therefore reflects the actual physical flow of goods

4. Average:

a. Assumes that the goods are indistinguishable and are therefore measured at an average of the costs incurred.
b. Has two methods moving average and weighted average method.

METHOD	Ending Inventory	COGS	GP/NP/RE/Equity
INFLATION			
FIFO	Higher	Lower	Higher
LIFO	Lower	Higher	Lower
DEFLATION			
LIFO	Higher	Lower	Higher
FIFO	Lower	Higher	Lower

INVENTORY MEASUREMENT: Inventory is measured at the **Lower of Cost or Market (LCM) under GAAP**. Inventory should be written down to market if its utility is less than its cost at the end of the annual reporting period.

- Cost = Price at which the inventory was purchased
- CRC = Current replacement cost. Purchase price of goods in current market condition
- NRV = Net realizable value [Ceiling]. The difference between sales and selling expenses
- Floor = The difference between NRV and Normal Profit

Replacement Cost:

- If RC> Ceiling - Market Price = Ceiling
- If Ceiling >RC >Floor – Market Price = RC
- If Floor>RC – Market Price = Floor

Note: Put CRC, NRV and Floor in order of their values from highest to lowest and select Middle value as Market

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C. INVESTMENTS:

Classification of Investments: [HAT]

1. **T –** Trading securities - Highly Liquid (Cash equivalents)
2. **A –** Available for sale – Shares
3. **H –** Held to Maturity – Bonds (Municipal bonds with maturity date)

- Trading Securities – Debt, Security
- Available for Sale – Debt, Security
- Held to Maturity – Debt

Types of Investment	Initial Record	Income Received	Unrealised Gain/Loss	End of Period Reporting
Trading Security	COST	Income Statement	Income Statement	Fair Market Value
Available for sale	COST	Income Statement	Comprehensive Income Statement	Fair Market Value
Held to Maturity	COST	Income Statement	N/A	Ammortised Cost

Investment Valuation:

A [Investor] B[Investee]

< 20%	Refer above table
>20% - <50%	Equity
>50%	Consolidation

BUSINESS COMBINATION & CONSOLIDATED FINANCIAL STATEMENTS:

1. **A Business Combination** is a transaction in which an acquirer obtains control of one or more businesses
   a. Control: An entity is presumed to have control when it acquires more than 50% of voting interests
   b. Parent: is an entity which controls one or more subsidiaries
   c. Subsidiary: is an entity in which another entity known as Parent holds a controlling financial interest.

2. **ACQUISITION METHOD:**
   a. A Business combination must be accounted for using acquisition Method
   b. This method involves identifying acquirer & acquisition date
   c. At the acquisition date, the acquirer must recognize and measure identifiable assets acquired, liabilities assumed, Any non controlling interest, Goodwill.
   d. The above should be measured at acquisition date fair value
   e. A non controlling interest is the portion of the equity in a subsidiary not attributable directly or indirectly to the parent.
   f. Goodwill is recognized only in Business combination.
   g. Acquisition fees are expensed as incurred.

3. **CONSOLIDATED FINANCIAL STATEMENTS:**
   a. When one entity owns another entity, consolidated statement should be issued irrespective of the percentage of ownership
   b. It is a general purpose financial statement of a parent company with one or more subsidiary.

TYPES OF EXPENSES AND LIABILITIES

1. **Purchase Commitment** – (A commitment to acquire goods in future not recorded at the time of agreement)
2. **Warranty Liability** – (A written guarantee of the integrity of a product or service)
   a. **Inseparable warranty:** If warranty expense is probable, the amount can be estimated and recognized when the related revenue is recognized
   b. **Separable Warranty:** When the warranty is sold separately from the product, the revenue is deferred and is recognized on the straight line basis over the term of the contract
3. **Contingencies** – A contingency is an existing condition or circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.