Financial Accounting: Liabilities & Equities

Question 1 (24 marks)

The following transactions for Watcan Micros Co. have not been recorded in the general ledger. Refer to Exhibit A3-1, which is the balance sheet as of December 31, 20X5. Before you record these transactions, you must first analyze the balance sheet, and particularly the statement of retained earnings to determine what changes may be necessary and determine the number of shares outstanding.

a. On May 1, 20X5, Watcan declared a 10% stock dividend, distributed on June 1, 20X5. Immediately after the issuance of the dividend shares, the market price of the ordinary shares was €20. Market value should be used to record this dividend. The dividend is recorded when distributed on June 1, 20X5. For ordinary shares there were 100,000 shares authorized and 15,000 outstanding at the beginning of the year.

b. On July 1, 20X5, Watcan’s plant in Vienna (land and building) was expropriated by the government. The total amount of compensation received by Watcan was €1.75 million in cash. Assume that there are no tax consequences of this compensation.

c. On October 1, 20X5, Watcan declared a cash dividend of €0.15 per ordinary share. The dividend was paid on November 1, 20X5.

d. On November 1, 20X5, Watcan reacquired and retired 1,000 ordinary shares for €19.50 per share.

e. During 20X4, the company inadvertently understated depreciation expense for the plant in Salzburg by €15,000. This error has not been corrected in the general ledger as of December 31, 20X5, and thus accumulated depreciation is too low. Ignore the tax effect of this error.

Some of these journal entries entail a debit or credit to retained earnings in 20X5 (for example, dividends, error corrections, and share retirement “loss”). Instead of debiting or crediting retained earnings directly, create a temporary account in the equity account range (that is, balance sheet accounts) to record the item (for example, “dividends,” “error correction,” “share retirement”). These accounts will appear on the statement of retained earnings and would be closed to retained earnings at the end of the accounting cycle.

**Exhibit A3-1**

**WATCAN MICROS CO.** Page: 1

**Balance Sheet**

as of 31/12/X5

Current

YTD

Assets

Current Assets

Bank — current account € 160,000.00

Accounts receivable 350,000.00

Allowance for doubtful accounts 7,500.00

Inventory — raw materials 127,500.00

Inventory — work in progress 750,000.00

Inventory — finished goods 300,000.00

Prepaid insurance 39,600.00

Total current assets 1,719,600.00

Property, plant, and equipment

Plant (Vienna) 800,000.00

Accumulated depreciation, plant (Vienna) 216,800.00

Plant (Salzburg) 900,000.00

Accumulated depreciation, plant (Salzburg) 264,500.00

Machinery and equipment (Vienna) 680,000.00

Accumulated depreciation, mach and equip (Vienna) 249,160.00

Machinery and equipment (Salzburg) 200,000.00

Accumulated depreciation, mach and equip (Salzburg) 125,700.00

Furniture and fixtures (Vienna) 54,000.00

Accumulated depreciation, furn/ fixtures (Vienna) 28,340.00

Furniture and fixtures (Salzburg) 90,000.00

Accumulated depreciation, furn/fixtures (Salzburg) 49,800.00

Trucks (Vienna) 480,000.00

Accumulated depreciation, Trucks (Vienna) 201,200.00

2,068,500.00

Land (Vienna) 1,600,000.00

Land (Salzburg) 1,250,000.00

Total property, plant, and equipment 4,918,500.00

Total Assets €6,638,100.00

Liabilities and Equity

Current Liabilities

Accounts payable € 410,100.00

Income tax payable 210,130.00

Current portion of mortgage 300,700.00

Total current liabilities 920,930.00

Long-Term Liabilities

Demand loan payable 24,000.00

Mortgage payable — land/plant (Salzburg) 3,488,190.00

Bonds payable 170,000.00

Notes payable 61,000.00

Total long-term liabilities 3,743,190.00

Total liabilities 4,664,120.00

Shareholders’ equity

Ordinary shares 230,000.00

Retained earnings 1,091,550.00

Profit/(Loss) 652,430.00

Total shareholders’ equity 1,973,980.00

Total Liabilities and Equity € 6,638,100.00

Required

a. (3 marks)

List the new accounts you added in the chart of accounts. Include the account title (description), and which statement they would affect.

b. (12 marks)

Provide the adjusting entries necessary to account for the transactions described in the problem.

c. (9 marks)

Submit, in good form, a revised Statement of Retained Earnings for Watcan Micros Co. after making any adjustments that are appropriate. Marks will be deducted if the statement is not in good form.

Question 2 (10 marks)

Multiple choice (2 marks each)

Answer items (a) to (e) using the following information:

Adriatic Resorts reported the following accounts at its fiscal year ends, December 31, 20X7 and 20X6:

**Dec. 31, 20X7 Dec. 31, 20X6**

Preference shares € 500,000 € 860,000

Ordinary shares 700,000 450,000

Contributed capital on preference share retirement 40,000 0

Contributed capital on ordinary share retirement 0 31,000

Retained earnings 1,967,500 1,435,000

During 20X7, cash dividends of €350,000 were declared but not paid. An ordinary share stock dividend, valued at €246,000, was recorded. Preference shares were retired. Ordinary shares with an original issuance price of €216,000 were retired for €250,000. Ordinary shares were also issued for cash.

1. On the cash flow statement, what amount will be recorded as the cash used to retire preference shares?

1) € 320,000

2) € 360,000

3) € 389,000

4) € 400,000

1. On the cash flow statement, what amount will be recorded as cash paid for dividends?

1) € 0

2) € 350,000

3) € 596,000

4) € 603,000

1. How much was profit during the period?

1) € 508,500

2) € 858,500

3) €1,104,500

4) €1,131,500

1. On the cash flow statement, what amount will be disclosed as the cash used to retire ordinary shares?

1) € 216,000

2) € 221,000

3) € 250,000

4) € 279,000

1. On the cash flow statement, what amount will be recorded as cash received from the issuance of ordinary shares?

1) € 4,000

2) € 220,000

3) € 254,000

4) € 511,000

Question 3 (16 marks)

As of January 1, 20X6, Rhur Valley Vineyards (RVH) had outstanding 60,000 no-par ordinary shares. The shares had originally been issued for €14 each. Following a number of successful harvests, retained earnings for RVH stood at €660,000.

During the year, the following transactions affecting shareholders’ equity took place:

* Acquired 500 shares for treasury stock on the open market at €20 per share.
* Acquired another 500 shares for treasury stock on the open market at €22 per share.
* Sold 600 shares of treasury stock for €25 per share.
* Sold an additional 200 shares of treasury stock at €18 per share.
* Retired 100 shares of treasury stock.
* Split the ordinary shares on a 3-for-1 basis.
* Declared and paid a dividend of €0.75 per ordinary share.
* Profit for 20X6 was €45,000.

Required

1. Provide the journal entries to record the year’s transactions (ignore dates). **(12 marks)**

2. List the ending balances in any shareholders’ equity accounts. **(4 marks)**

Question 4 (14 marks)

a. (3 marks)

When accounting for treasury stock transactions, why are gains recorded in a contributed capital account while losses are sometimes charged against retained earnings?

b. (2 marks)

What is the purpose of restricting or appropriating retained earnings?

c. (4 marks)

When property dividends are declared and paid, a gain or loss sometimes must be reported. Explain this statement. How would your answer be different if the transaction were classified as a spin-off?

**Source:** Thomas Beechy and Joan Conrod, *Intermediate Accounting*, Vol. 2, First Edition (Toronto: McGraw-Hill Ryerson, 2000), Question 14-17, page 808. Adapted with permission.

d. (5 marks)

Why might a group of individuals choose to set up a company? What are some of the advantages and disadvantages?

Question 5 (16 marks)

Les Jouets Joyeux (LJJ) is authorized to issue unlimited €1.20 no-par preference shares and unlimited no-par ordinary shares. There are 5,000 preference and 8,000 ordinary shares outstanding. Over the past five years, annual dividends totalled €4,000, €40,000, €32,000, €5,000, and €42,000, respectively.

Required

Prepare a tabulation, including computations, of the dividends that would have been paid to each class of shares for each of the five years under the following ***independent*** assumptions. If applicable, the matching dividend per ordinary share was €3.

Case A: Preference shares are noncumulative and nonparticipating. **(3 marks)**

Case B: Preference shares are cumulative and nonparticipating. **(3 marks)**

Case C: Preference shares are cumulative and fully participating. **(5 marks)**

Case D: Preference shares are cumulative and partially participating to a maximum of an additional €0.40 per share. (**5 marks)**

**Source:** Thomas Beechy and Joan Conrod, *International Accounting*, Vol. 2, First Edition (McGraw-Hill Ryerson, 2000), Question P14-7, page 821. Adapted with permission.

Question 6 (20 marks)

Case analysis

Manufactured Products Limited (MPL) was incorporated in 20X0. It produces automobile parts under contract with specialty replacement parts operations, such as European Tire and Muffler King. The company is public, with ordinary shares listed on the Marseilles Stock Exchange (MSE). The board of directors is eager to get a listing on the Paris Stock Exchange (PSE) to improve the liquidity of its shares and hopefully improve the stability of its share price. Before the company will be eligible for a listing on the PSE, it will have to meet certain size tests for assets and sales. Currently it does not meet these criteria, but it is close. Asset and sales growth have been significant targets over this past year.

A member of the Board of Directors, who is on the audit committee, has approached you with the unaudited draft financial statements (see Exhibit A3-2). He has asked you to review the statements and to prepare a report that analyzes any issues that you feel he should be aware of before a scheduled audit committee meeting next Monday.

Required

Prepare the report to answer the Board of Directors. You must analyze the issues and present your recommendations. Do not recast (correct) the financial statements; simply provide an analysis.

# Exhibit A3-2

**MANUFACTURED PRODUCTS LTD.**

**Draft Summarized Financial Statements**

**Income Statement**

year ended December 31

(in thousands)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **20X8** | | | **20X7** |
| Net sales | € 2,972,966 | | | € 2,631,028 |
| Cost of goods sold | 2,200,408 | | | 2,418,994 |
|  | 772,558 | | | 212,034 |
| General and administrative expenses | 531,050 | | | 601,923 |
| Interest | 164,166 | | | 154,744 |
| Income (loss) before tax | 77,342 | | | (544,633) |
| Provision for (recovery of) income tax | 40,218 | | | (283,209) |
| Profit (loss) | € 37,124 | | | € (261,424) |
| MANUFACTURED PRODUCTS LIMITEDDraft Summarized Financial Statements **Balance Sheet**  December 31  (in thousands) | | | | | |
|  | | **20X8** | | **20X7** | |
| Assets | |  | |  | |
| Current | |  | |  | |
| Cash | | € 17,159 | | € 23,438 | |
| Available-for-sale investments | | 176,000 | | — | |
| Receivables | | 555,100 | | 556,718 | |
| Inventory | | 1,097,598 | | 1,083,822 | |
|  | | 1,845,857 | | 1,663,978 | |
|  | |  | |  | |
| Property, plant, and equipment, net | | 668,653 | | 642,242 | |
| Goodwill | | 117,104 | | 73,310 | |
|  | | € 2,631,614 | | € 2,379,53 | |
| Liabilities | |  |  | | |
| Current | |  |  | | |
| Bank indebtedness | | € 511,723 | € 362,270 | | |
| Current portion, long-term  debt | | 59,298 | 115,009 | | |
| Accounts payable | | 807,365 | 751,383 | | |
|  | | 1,378,386 | 1,228,662 | | |
| Long-term debt | | 624,841 | 659,605 | | |
| Shareholders’ equity | |  |  | | |
| Ordinary shares | | 372,678 | 272,678 | | |
| Retained earnings | | 255,709 | 218,585 | | |
|  | | 628,387 | 491,263 | | |
|  | | € 2,631,614 | € 2,379,530 | | |
|  | |  |  | | |

**Notes to the financial statements**

## **Note 1: Available-for-sale investments**

Available-for-sale investments represent 23,000 shares of Manufactured Products Limited ordinary shares, bought on the open market. These shares will be reissued in the coming year. The market value of these shares is €8.16 per share.

## **Note 2: Inventory**

Inventory consists of raw materials, work in process, and finished goods. All inventories are accounted for in accordance with IAS 2 and are carried at the lower of cost or market value.

## **Note 3: Property, plant, and equipment**

Property, plant, and equipment are amortized on a straight-line basis over their useful lives, which range between 10 and 25 years. Property, plant, and equipment represent manufacturing facilities and automotive equipment. During 20X8, manufacturing equipment was acquired from the majority shareholder of the company in exchange for ordinary shares. The transaction was valued at the market value of the ordinary shares. The manufacturing equipment was appraised at a value of €64,500.

## **Note 4: Goodwill**

Goodwill is not amortized, but is tested annually for impairment. This year, €43,794 of costs were capitalized as goodwill. These costs represent legal and consulting fees regarding planned new share issuance and the transfer of registration from the MSE to the PSE.

## **Note 5: Bank indebtedness**

Bank indebtedness is secured against the general assets of the company excluding property, plant, and equipment. The annual interest rate is prime plus 2%.

## **Note 6: Provisions**

Manufactured Products Limited is responsible under law for the chemical waste emitted by its manufacturing facility, now stored at a vacant land site. At present, it is not clear how much this cleanup will cost, or when the cleanup will be undertaken. No provision for such costs is included in these financial statements.

## **Note 7: Long-term debt**

Long-term debt is due in instalments over the next five years. It is secured against the tangible property, plant, and equipment of the company and bears an annual interest rate of 8%.

## **Note 8: Share capital**

The company’s authorized share capital consists of an unlimited number of ordinary shares. On December 31, 20X8, 526,934 shares were issued, with 493,934 outstanding. During 20X8, 10,200 shares were issued for machinery. The transaction was valued at the market value of the ordinary shares, €96,500.

Suggested solutions

Question 1 (24 marks)

Part (a) — New accounts (3 marks)

Students must add the following accounts in the chart of accounts:

Accounting error correction — balance sheet

Cash dividends — balance sheet

Stock dividends — balance sheet

Excess of retirement price over issue — balance sheet

Loss on expropriation — income statement

Part (b) — Adjusting entries (12 marks)

Item (a) — June 1, 20X5 (distribution of stock dividend)

Dr Stock dividends 30,000

Cr Ordinary shares 30,000

To record the distribution of stock dividends

(15,000 × 0.10 = 1,500 shares at €20 each)

Item (b) — July 1, 20X5

Dr Loss on expropriation 135,500

Dr Bank — current account 1,750,000

Dr Accumulated depreciation — Plant (Vienna) 264,500

Cr Land (Vienna) 1,250,000

Cr Plant (Vienna) 900,000

To record the expropriation of land and plant in Vienna.

The total book value of €1,250,000 + €900,000 − €264,500

less compensation of €1,750,000 results in a loss of €135,500.

Item (c) — October 1, 20X5 (declaration date of cash dividend)

Dr Cash dividends 2,475

Cr Dividends payable 2,475

(15,000 + 1500) × (0.15)

November 1, 20X5 (date of dividend payment)

Dr Dividends payable 2,475

Cr Bank — current account 2,475

Item (d) — November 1, 20X5

Dr Ordinary shares 15,760

Dr Excess of retirement price over issue 3,740

Cr Bank — current account 19,500

To record retirement of 1,000 ordinary shares for €19.50 per share

1,000 × [(€230,000 + €30,000) ÷ (15,000 + 1,500)] = €15,758

Item (e) — December 31, 20X5

Dr Accounting error correction 15,000

Cr Accumulated depreciation — plant   
 (Salzburg) 15,000

To correct understatement of depreciation expense for Salzburg   
plant in 20X4.

Part (c) — Statement of retained earnings (9 marks)

**WATCAN MICROS CO.**

**Statement of Retained Earnings**

for the period 1/1/X5 to 12/31/X5

Beginning retained earnings

Retained earnings € 1,091,550.00

Accounting error correction 15,000.00

Adjusted retained earnings 1,076,550.00

Add: Net profit (Loss) 516,930.00

Deduct dividends:

Cash dividends 2,475.00

Stock dividends 30,000.00

Total dividends 32,475.00

Other adjustments to retained earnings

Excess retirement price over issue price 3,740.00

Total adjustments (3,740.00)

Ending retained earnings € 1,557,265.00

Question 2 (10 marks)

(2 marks each)

a. 1) €320,000

(€860,000 – €500,000) – €40,000

b. 1) €0

Cash dividends were not paid; stock dividends did not use cash.

c. 4) €1,131,500

Opening retained earnings, less dividends, less the excess of retirement price of ordinary shares over original issue and prior contributed capital: €1,435,000 – €350,000 – €246,000 – €3,000 (€216,000 – €250,000 + €31,000) = €836,000. Actual balance, €1,967,500, so the €1,131,500 difference is net profit.

d. 3) €250,000

Given

e. 2) €220,000

Opening balance, €450,000, less shares retired, €216,000, plus stock dividend, €246,000, equals €480,000. Actual closing balance, €700,000. The difference must equal shares issued.

Question 3 (16 marks)

Requirement 1 (12 marks: 1 mark each for entries a, b, f, and g; 2 marks for c; and 3 marks each for d and e)

To record initial sale of shares (not required):

Cash 840,000

Ordinary shares (60,000 shares × €14) 840,000

a. To record purchase of 500 shares of treasury stock at €20:

Treasury stock 10,000

Cash (500 shares × €20) 10,000

b. To record purchase of 500 shares of treasury stock at €22:

Treasury stock 11,000

Cash (500 shares × €22) 11,000

c. To record sale of 600 shares of treasury stock at €25:

Cash (600 shares × €25) 15,000

Treasury stock (Average cost = €21,000/1,000 = €21 × 600) 12,600

Contributed capital from treasury stock transactions 2,400

d. To record sale of 200 shares of treasury stock at €18:

Cash (200 shares × €18) 3,600

Contributed capital from treasury stock transactions 600

Treasury stock (200 shares × €21) 4,200

e. To record retirement of 100 shares of treasury stock:

Ordinary shares (100 × €14\*) 1,400

Retained earnings 700

Treasury stock (100 × €21) 2,100

\* Original issue price, or €840,000/60,000 shares.

This is a retirement and thus the contributed capital from prior treasury stock transactions (resale) may not be used as the debit.

f. Memo entry: Split ordinary shares 3 for 1; there are now 179,700 (59,900 × 3) shares outstanding, of which 300 (100 × 3) are in the treasury.

g. To record dividend payment of €0.75 per ordinary share:

Retained earnings (or dividends) (179,700 – 300) × €0.75 134,550

Cash 134,550

h. To close income for fiscal 20X6 to retained earnings:

Income summary 45,000

Retained earnings 45,000

This entry need not be made, as long as the increase in retained earnings is included in the closing balance in requirement 2.

Requirement 2 (4 marks)

Amounts should be consistent with entries.

Ordinary shares (€840,000 – 1,400) € 838,600

Contributed capital from treasury stock transactions (€2,400 – 600) 1,800

Retained earnings (€660,000 + €45,000 – €700 – €134,550) 569,750

Treasury stock (300 shares × average cost, €7)… (2,100)

Question 4 (14 marks)

a. (3 marks)

The IASB *Framework* definition of “gains” and “losses” excludes gains and losses on transactions affecting a corporation’s own shares. Essentially, a corporation cannot recognize a gain or loss from transactions involving its own equity. Therefore, any gains are recorded as contributed capital, appropriately designated. Losses, to the extent that they cannot be offset against appropriate contributed capital accounts, are debited to retained earnings on the presumption that they represent a return ***of*** equity to the shareholder involved in the transaction.

b. (2 marks)

The purpose of restricting or appropriating retained earnings is to constrain a certain amount of accumulated earnings for a specific purpose. This communicates to financial statement readers the fact that retained earnings are not available for distribution, because of either an outside restriction or an internal decision.

c. (4 marks)

When a property dividend is declared, the dividend is recorded at the market value of the property distributed. Therefore, a gain or loss on disposal of the property must be recorded. The gain or loss is the difference between the market value and carrying value of the property distributed, measured at the declaration date.

A spin-off is a distribution of non-cash assets to shareholders, where the non-cash asset is a share of another company. It is recorded at book value, not market value. (This measurement rule is deemed appropriate because in substance there has been no change in control over the investment shares.)

d. (5 marks)

A group of individuals might choose to incorporate to establish limited legal liability for the partner/owners, to facilitate capital accumulation, or to make it easier to transfer ownership. Negative aspects of incorporating include the potential for increased taxation in various ways, difficulties of control, the more limited power of (always outvoted) minority shareholders, and generally higher legal and accounting costs of operation.

Question 5 (16 marks)

Case A (3 marks)

Preference non-cumulative, non-participating:

*Year Total Paid Preference Ordinary*

1 € 4,000 € 4,000 € 0

2 € 40,000 € 6,000 € 34,000

3 € 32,000 € 6,000 € 26,000

4 € 5,000 € 5,000 € 0

5 € 42,000 € 6,000 € 36,000

Case B (3 marks)

Preference cumulative, non-participating:

1 Partial € 4,000 € 4,000 € 0

2 Arrears € 2,000

Current 6,000 € 32,000

Total € 40,000 € 8,000 € 32,000

3 € 32,000 € 6,000 € 26,000

4 Partial € 5,000 € 5,000 € 0

5 Arrears € 1,000

Current 6,000 € 35,000

Total € 42,000 € 7,000 € 35,000

Case C (5 marks)

Preference, cumulative, fully participating:

1 Preference, current (partial) € 4,000 € 4,000 € 0

2 Preference, in arrears € 2,000

Preference, current 6,000

Ordinary, to match € 24,000

Balance: preference 1/5, ordinary 4/5\* 1,600 6,400

Total € 40,000 € 9,600 € 30,400

3 Preference, current € 6,000

Ordinary, to match € 24,000

Balance: preference 1/5, ordinary 4/5\* 400 1,600

Total € 32,000 € 6,400 € 25,600

4 Preference, current (partial) € 5,000 € 5,000 0

5 Preference, in arrears € 1,000

Preference, current 6,000

Ordinary, to match € 24,000

Balance: preference 1/5, ordinary 4/5\* 2,200 8,800

Total € 42,000 € 9,200 € 32,800

\* Participation: Preference = 1/5 = €6,000 / (€6,000 + €24,000)

Ordinary = 4/5 = €24,000 / (€6,000 + €24,000)

Case D (5 marks)

Preference, cumulative, partially participating up to an additional €0.40/share or €2,000  
(5,000 × €0.40):

1 Preference, current (partial) € 4,000 € 4,000 € 0

2 Preference, in arrears € 2,000

Preference, current 6,000

Ordinary, to match € 24,000

Balance, preference 1/5 (not to exceed

5,000 × €0.40 = €2,000), ordinary 4/5 1,600 6,400

Total € 40,000 € 9,600 € 30,400

3 Preference, current € 6,000

Ordinary, to match € 24,000

Balance: preference 1/5 (limit €2,000),

ordinary 4/5 400 1,600

Total € 32,000 € 6,400 € 25,600

4 Preference, current (partial) € 5,000 € 5,000 € 0

5 Preference, in arrears € 1,000

Preference, current 6,000

Ordinary, to match € 24,000

Balance: preference 1/5 (limit €2,000),

ordinary 4/5 or remainder 2,000 9,000

Total € 42,000 € 9,000 € 33,000

Question 6 (20 marks)

Case analysis solution

**Overview**

Manufactured Products Limited (MPL) is a public company and must comply with GAAP to receive an unqualified audit opinion and meet the requirements of any stock exchange. To earn a listing on the PSE, it must meet size thresholds, where size is measured as assets and sales. Maximizing these items is therefore an objective of financial reporting. The company is volatile and therefore risky, as is shown by the reference to its volatile stock market price and losses reported in 20X7. The payables of the company are significant. This situation would argue for conservative accounting policies (minimize assets and income).

Financial statement users, in addition to shareholders and regulators, include bankers and other lenders. All these parties will be interested in ascertaining the true financial position of the company and would be well served by conservative financial accounting policies. These conservative policies may be in conflict with the internal objective of maximizing sales and assets, but the need for conservatism is more important.

**Issues**

1. Treasury stock

2. Valuation of shares issued for property, plant, and equipment

3. Classification of legal and consulting costs

4. Environmental liability

5. Financial statement disclosure

**Analysis and Recommendations**

1. Treasury stock

MPL is reporting, as an available for sale investment, 23,000 of its own shares acquired for €176,000. This obviously increases assets and meets the company’s objective of reporting higher assets. However, acquisition of one’s own shares intended for resale gives rise to treasury shares, which are reported as a deduction from equity. This accounting treatment is required under IASC 32 and cannot be avoided. Therefore, the investment must be reclassified. This better reflects the assets of the company and provides better information for creditors.

2. Valuation of shares issued for property, plant and equipment

MPL valued 10,200 shares issued for property, plant and equipment at their market value, or €9.46 per share. This resulted in capitalizing machinery at €96,500. There are two reasons to be concerned about this valuation. First, the market value of the machinery was reported to be €64,500 and thus property, plant and equipment is overstated. Second, the market value of MPL’s ordinary shares, as shown by the treasury stock information, has been €7.65 (€176,000/23,000), and then €8.16 at year‑end. In general, the value assigned to a non-monetary transaction is the value of the assets given up (in this case, the shares) if a reliable market value can be established. Is the share price reliable? The shares are volatile, and one would suggest that this price is not reliable. Furthermore, property, plant, and equipment should never be recorded at a value higher than its fair market value.

The next question is whether the valuation at €64,500 is reliable. If it is, then this is the value that should be used for the transaction. If it is not verifiable, then effort must be made to determine the fair value of the manufacturing equipment. Further investigation may be necessary.

This recommendation reduces assets and equity and goes against the company’s stated objectives, but serves other users well.

3. Legal and consulting costs

Share issue costs, the legal and consulting fees now included in goodwill, may be either offset against the proceeds of the new share issue (not yet taken place for MPL), or directly debited to retained earnings. Because the expenditures are not goodwill and would have to be reclassified, a separate deferred charge (organization costs and so on) could be established until the shares are actually issued.

The conservative approach would be to charge retained earnings directly, as the future benefits associated with the payment are tenuous at best. Since the outside creditors in this risky company are of primary importance, I recommend that the payments be charged directly to retained earnings.

4. Environmental liability

An environmental liability is an example of an estimated provision. There is an ethical responsibility to make financial statement users aware of the potential liability, but also a responsibility not to misstate the financial statements. The liability is certain, but its amount is indeterminable. Without a reliable estimate, a provision cannot be recorded and must be disclosed instead. This is the approach taken by the company, and it is acceptable. The alternative is to try harder to obtain a cost estimate and begin to accrue the amount. Neither alternative affects the major internal corporate reporting objectives, since total assets and sales are unaffected. Outside creditors are alerted to the obligation in a note, but one suspects that they would be better served by accrual. This issue should be explored in more depth, to see if it would be possible to get a cost estimate that is reliable and can be accrued. If not, the existing policy is acceptable.

5. Financial statement disclosure

Financial statement note disclosure appears minimal. More details for many financial statement elements must be presented — exact repayment schedule for the next five years for debt, breakdown of components of inventory and property, plant and equipment, and so on. There is also no cash flow statement. These deficiencies must be rectified for the statements to be in accordance with IAS 1

Marking key

Note:

This marking key is provided for guidance and is not intended to be a complete solution. Since there is no right answer to a case analysis, the marking key provides for more than the maximum mark allocation. Use considerable judgment in applying the key. Award marks for valid approach and commentary, and keep in mind that no student will cover all the points.

**Overview**

Public company, GAAP (1/2)

Size objective, maximize assets and sales (1/2)

Volatile/risky company, evidence: stock price and earnings (1)

Creditors, outside shareholders major users (1)

Need for conservative policy (1)

Conflict between policies, use conservative policies (1)

Maximum 4

**Issues**

Treasury stock, share issue valuation, legal and consulting, environmental, disclosure (1/2 each)

Maximum 2.5

**Analysis**

***Treasury stock***

Temporary investment is company’s own shares (1)

GAAP requires treasury to be shown as contra equity (1)

Does not maximize earnings but is conservative (1)

***Share issue valuation***

Shares and machinery valued at €9.46 (1)

Problem: machinery valued at higher than FMV (1)

Problem: Share price volatile (1)

Look at treasury for evidence of price (€8.16 and €7.65) (1)

Value non-monetary transactions/quote rule (1)

Discuss relative reliability of values (1)

Relate to internal objectives to max assets (1)

Relate to conservatism (1)

***Legal and consulting fees***

Like share issue costs (1)

Three alternatives for accounting, list (1)

Cannot net with share issue price because shares not issued yet (1)

Deferred charge alternative:

Maximizes assets (1)

Must be reclassified from goodwill (1)

Debit retained earnings directly:

Asset might not have future benefits (1)

Conservative (1)

***Environmental liability***

Estimated provision, disclosed because estimate not available (1)

Acceptable (1)

Ethical significance of liability disclosure (1)

Alternative is to get better estimate and accrue (1)

Is it possible to get a better estimate? Explore (1)

Effect on users (1)

***Disclosure***

Disclosure not adequate to comply with GAAP (1)

Examples (½ each, max 1½)

***Other valid points***(1 each)

Maximum 16

**Recommendations**

A sensible recommendation, consistent with analysis

0 for no recommendation or illogical recommendations

1 for a weak recommendation

2 for an intelligent recommendation

Maximum 2

**Communication**

Organization, quality of expression

0 for unacceptable communication skills

1 for weak communication skills

2 for acceptable communications skills

Maximum 2

Overall —

maximum 20

**100**