

## Module 7 – Emerging Issues and Managerial Options in Financial reporting

### 7.1 Introduction

- Managers are free to determine their detailed financial reporting procedures within the accounting framework
- The pressure on managers to show growth in their profits and earnings per share is called 'short termism' – largely created by investment analysts
- If this externally imposed target on companies is not easily achievable through normal trading activities, management can take steps to trim expenditure or adopt accounting principles which give the appearance of an upward trend in performance
- There are financial instruments companies can use to finance their business and fend off takeovers

### 7.2 Research and Development

- Hi-tech companies can spend up to 10% of sales on R&D
- R&D is a corporate investment in the present to secure a better future – so it should appear as an asset in the balance sheet
- However, R&D is often written off in the P&L rather than capitalized because it is a risky activity and is of uncertain value
- According to SSAP 13 (the accounting standards), research expenditure must be written off but development expenditure may be capitalized if
  - (i) It is a clearly defined project
  - (ii) Related expenditure is separately identifiable
  - (iii) its technically feasible and commercially viable
  - (iv) adequate resources exist or will exist to enable project to be completed
- Many computer and smaller companies capitalize some R&D to avoid a major hit to profits and so to Earnings per share
- This may adversely effect working capital should the technical difficulties be encountered in R&D that require further expenditure
- Auditors need to weigh management's view against the R&D track record of success – he may decide that previously capitalized expenditure should now be written off in the P&L – this can have a devastating effect on profits and on market confidence

### 7.3 Off Balance Sheet Transactions:

- A highly geared company may want to drive further borrowing off its balance sheet, especially if its share price has been reduced in anticipation of a share rights issue

#### 7.3.1 Quasi-Subsidiaries

- Company X avoids owning more than 50% of company Y but still retains control of managerial decisions. For example, company X can own all the ordinary shares of company Y but a friendly third party owns more than 50% of the equity shares. So company X controls voting rights to appoint a board but company Y is not an official subsidiary.
- Accounting standards would insist that company X regards company Y as a quasi subsidiary. So all assets and liabilities of Y appear in company X's accounts.
- Company X is involved in a joint venture:
  - (i) X must consolidate the financial affairs of the JV if it is in effect the lead partner
  - (ii) to avoid consolidation, the risks and rewards of ownership must be fully transferable to the JV and one company cannot buy back its assets at anything other than full market value
  - (iii) to avoid consolidation of accounts, both companies must share profits, losses, dividends and/or loan guarantees equally

These issues are covered in the accounting standard FRS 5.

A company that is controlled by another even though the other company does not have more than 50% of the equity shares is termed a quasi-sub subsidiary – it is the control that is important.

### 7.3.2 Consignment Inventories

- Manufacturers may send their dealers products to sell but not request payment until the product is actually sold
- Where the dealer can return unsold products without incurring a significant penalty, he can avoid putting this inventory & its associated financing on his balance sheet
- Where the dealer does have to pay whether they are sold or not, the inventory (and its financing) needs to be accounted for on the balance sheet

### 7.3.3 Sale and repurchase agreements

- Sometimes companies 'sell' inventory to a third party (often a bank) with an agreement to re-purchase it back at a later stage. The re-purchase price would include interest
- FRS 5 says this agreement should not appear as a 'sale' in the accounts but as a short term loan, with an interest charge appearing in the P&L account in the year when the stock is re-purchased
- Inventories are unchanged, cash increases, creditors increase (short term loan)

### 7.3.4 Debt Factoring

- Companies who wait for money from debtors may have to borrow money to fund their working capital until payment is received
- To avoid this, companies can sell or 'factor' their debts to a finance house to collect the debts on its behalf
- If the finance house has no recourse to the company in the event of bad debts then it's a straightforward commercial transaction – cash goes up, debtors goes down and the difference is written off as an expense in the P&L
- If there is recourse, then FRS 5 says that the company should treat the factoring as a short term loan until the factoring company recovers all the debts

## 7.4 Accounting for Acquisitions and Mergers

- Acquisition accounting is used to reflect normal takeovers where the 'predator' (or holding) company acquires more than 50% of the equity share capital of the target for cash, shares in the holding company or a combination of the two

Example:

Forth offers to acquire the entire share capital of Clyde. Its offering one of Forth's shares worth \$5 for each of Clyde's one million shares. Before the offer, their balance sheet looked like this:

	Forth Ltd (\$M)	Clyde Ltd (\$M)
Net Assets	6	4
<b>Represented by:</b>		
Share Capital (\$1 ord.)	1	1
Distributable reserves	<u>5</u>	<u>3</u>
	6	4

Forth Group balance sheet after the offer is accepted:

	Forth Group (\$M)
Net Assets	10
Goodwill	<u>1</u>
	11
<b>Represented by:</b>	
Share Capital (\$1 ord.)	2
Share premium	4
Distributable reserves	<u>5</u>
	11

Note: Share premium is \$4m because Forth had to issue 1 million share @ \$5 = \$5m. The share premium is the difference between this and the nominal amount : 1 million @ \$1 = \$1m. This money is not normally available to the Forth Group shareholders.

- Merger accounting presumes agreement between the two parties to pool their respective interests rather than for one to hand over its assets to the other
- Merger accounting restate the two companies accounts as if they had always been one.

Example:

Using the example above, in a merger situation the combined balance sheet would look like:

	Forth-Clyde group (\$m)
Net Assets	10
<b>Represented by:</b>	
Share Capital (\$1 ord)	2
Distributable reserve	<u>8</u>
	10

- No Goodwill to write off
- More flexibility, management under a merger has free access to reserves, whereas in an acquisition it has no access to the share premium
- A merger is only a merger when (according to FRS6)
  - (i) none of the parties see itself as acquirer or acquired
  - (ii) none of the parties dominates the management of combined entity
  - (iii) relative size of the two entities are not completely disparate
  - (iv) each of the parties to the combo receives primarily equal shares
  - (v) no equity shareholders of either of the combining entities retains any material interest in the future performance of only part of the combined entity

### 7.5 Goodwill

- Goodwill is excess over book value that a company is prepared to pay for another company's net assets – its an intangible asset
- A technical adjustment needs to be made when a company is acquired – the book value of the assets which are being bought need to be adjusted to reflect their fair value
- Goodwill can be:
  - (i) written off at the moment of acquisition against the groups reserves *or*
  - (ii) capitalize the amount paid as an asset and amortize (depreciate) the asset over its useful economic life
- By writing off Goodwill, the company is reducing its net worth (share capital plus reserves) even though earnings are not only not effected but should be improved by the synergistic effects of the acquisition. But at least the reported profit is unaffected, as is the EPS
- By capitalizing, the reported profit figure takes a hit over the depreciation period and thus earning per share are adversely effected
- The 'impairment' test should be used – a detailed consideration of the inherent value underlying the number for Goodwill. If its value is significant in the long term then capitalize, otherwise write off
- Write off should occur either over the useful economic life or 20 years, whichever is lowest – it should never go above 40 years

### 7.6 Brands

- Brands are the names of consumer products which, because they are so well known, can be seen as having value to the companies who own them and are therefore assets
- Brands are becoming important because
  - (i) Companies who wish to avoid a takeover or wish to increase the bid price for a takeover increase their net assets and therefore their price by putting a value on their brands in their balance sheet
  - (ii) Aggressive companies who wish to buy another company using its own shares use brands in the balance sheet to drive up their share price