Exercises

E18-1. Why do financial reporting rules differ?

One important determinant of a country’s reporting standards arises from regulators’ actions and the demands of external statement users.

In jurisdictions where capital is raised from a broad range of outside investors—as is the case in the United States and Canada—these users require detailed and informative disclosures in order to make effective investment decisions. Their demand for information helps ensure passage of disclosure laws and the development of reporting standards which provide the necessary information.

But in countries where much of the capital needed by firms is raised privately—say, from banks or from related companies in the *keiretsu*—public disclosure rules are less important. The primary capital providers have direct contact with those firms which are raising capital as well as the power to request detailed information regarding the firms’ financial strengths and prospects. In these situations, the demand for informative public disclosures is lessened, and reporting standards are frequently weak.

E18-2. Overcoming reporting diversity

Uniform reporting standards would improve comparability to some extent in certain circumstances. Two examples will serve to illustrate the point. Capital lease accounting is not used in Japan. But insofar as long-term, non-cancelable leases that transfer property rights to the lessee exist in Japan, then comparisons between United States and Japanese firms are hampered. Uniform lease capitalization rules would enhance comparability here. A second example is The Netherlands where variable costing is allowed for inventory accounting. Again, comparisons between Dutch firms using variable costing and other firms in countries which require absorption costing are impeded. A uniform standard might help here.

But, uniform international reporting rules cannot overcome all obstacles. U.S.-type equity method accounting rules when applied to Japanese interlocking *keiretsu* investments—as discussed in the text—are an example. The philosophy underlying reporting rules like equity method accounting—i.e., 20% or greater ownership conveys some degree of control—do not apply in Japan. Many other examples of a lack of conformity between the objective of specific
reporting rules and institutional arrangements in certain countries undoubtedly exist. Uniform rules will not enhance comparability in such instances.

**E18-3. Alternative return measures**

**Requirement 1:**
Spanish GAAP ROA = $\frac{11,581}{8,906,012} = .0013$ or .13%

**Requirement 2:**
U.S. GAAP ROA = $\frac{92,213}{(8,906,012 - 157,475)}$

= $\frac{92,213}{8,748,537}$

= .0105 or 1.05%

**Requirement 3:**
There is no “better” ROA. The appropriate ROA measure to use is based on the following issues: (1) which ROA better reflects the firm’s economic performance, and (2) which ROA allows users of the financial report to compare Telefonica, S.A. to other firms of interest.

As stated in the chapter, some countries’ accounting standards are not intended to measure and report economic reality. Instead, the accounting standards are tied to the tax laws or other statutory reporting requirements of the country. In some cases, countries have not expended the resources necessary to develop a comprehensive set of accounting standards. For example, Spanish GAAP does not address the accounting for capital versus revenue expenditures. Firms reporting in accordance with U.S. GAAP would be required to capitalize the cost of overhauling machinery if the overhaul increased the efficiency of the asset, i.e., changed the economic performance of the assets. Firms reporting in accordance with Spanish GAAP could either capitalize or expense the cost of the overhaul. The lack of guidance could result in accounting data that do not reflect underlying economic circumstances.

It is important to note that Spanish GAAP has less stringent disclosure requirements than U.S. GAAP. Telefonica, when reporting in accordance with Spanish GAAP, would not have to disclose financial information that analysts typically use to adjust earnings and asset figures before calculating a firm’s ROA, e.g., nonoperating or nonrecurring items.
E18-4. Current cost accounting

Requirement 1:

Highrate Company
Current Cost Income Statement
For the Year Ended 2001

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$20,000</td>
</tr>
<tr>
<td>Cost of sales ($8,000 \times 1.25)</td>
<td>10,000</td>
</tr>
<tr>
<td>Gross margin</td>
<td>10,000</td>
</tr>
<tr>
<td>Depreciation ($2,000 + $1,000)</td>
<td>$3,000</td>
</tr>
<tr>
<td>Other operating expenses</td>
<td>8,000</td>
</tr>
<tr>
<td>Net income (loss)</td>
<td>($1,000)</td>
</tr>
</tbody>
</table>

Requirement 2:
Which income figure is more useful depends upon two sets of factors: 1) the procedures used to generate the current cost numbers, and 2) the specific type of analysis that is being undertaken by the user.

Some people find current costing to be attractive conceptually. But in real-world settings, this conceptual appeal might not be realized. One reason is the reliability of the company’s estimates of current cost. That is, is the measurement error large? Can accurate measures of the replacement cost of inventories and fixed assets be made? For inventories, the answer is frequently “yes” since purchases are usually continuous and the latest purchase price provides an estimate of replacement cost. For fixed assets, the reasonableness of the replacement cost estimate depends upon the availability of detailed price indices by specific asset category for things like buildings and readily available market price information for production equipment (e.g., “Redbook” values, “Bluebook” values, etc.). In certain industries, such data are available. To cite one example, in the airline industry, the Avmark Newsletter provides information on recent sales of used aircraft broken down by specific model and other specifications. Another procedure issue is how frequently firms revalue their assets. For example, revaluation is permitted in the United Kingdom. But once a firm has revalued its assets, there is no requirement that new revaluations must be made at specified intervals. Consequently, the current cost data being used may be several years old, i.e., not “current” at all! In countries like Mexico where current cost adjustments are required by Mexican GAAP, this is obviously not a problem.

The specific type of analysis being undertaken by the user is also an important determinant of usefulness. In the previous paragraph, some of the pitfalls of current costing were outlined. But the deficiencies of historical cost numbers for analytical use can be even worse. Chapter 10 (pp. 464–467) has an extensive discussion of the problems that arise when analysts use
historical cost numbers to undertake time-series analyses for an individual firm. Other problems arise when historical cost numbers are used in cross-sectional comparisons.

To summarize, which approach is more useful depends upon specific circumstances.

E18-5. General price-level accounting
(AICPA adapted)

General price-level depreciation expense for 2001 is $7,900, computed as follows:

<table>
<thead>
<tr>
<th>Date Acquired</th>
<th>Historical Cost (a)</th>
<th>Adjustment Factor (b)</th>
<th>General Price Level Depreciation (a) x (b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>$3,000</td>
<td>150/100</td>
<td>$4,500</td>
</tr>
<tr>
<td>2000</td>
<td>2,000</td>
<td>150/125</td>
<td>2,400</td>
</tr>
<tr>
<td>2001</td>
<td>1,000</td>
<td>150/150</td>
<td><strong>1,000</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td><strong>$7,900</strong></td>
</tr>
</tbody>
</table>

E18-6. Distinguishing between monetary and nonmonetary items

The nonmonetary items are:
(3) Minority interest (sometimes called noncontrolling interest)
(6) Equity investment in unconsolidated subsidiaries
(7) Obligations under warranties
(8) Accumulated depreciation of equipment

**Minority interest** is nonmonetary since it is comprised of:
Minority ownership % × (Assets - Liabilities).

Since many of the underlying assets and liabilities are nonmonetary, the net minority interest is nonmonetary.

**Equity investment in unconsolidated subsidiaries** is nonmonetary for the same reason minority interest is nonmonetary. It represents an ownership % times net assets, many of which are nonmonetary.

**Obligations under warranties** are nonmonetary since these liabilities will be settled through use of nonmonetary assets and labor services.

**Accumulated depreciation of equipment** is nonmonetary since the equipment itself is nonmonetary.
E18-7. General price-level accounting  
(AICPA adapted)

The investment and long-term debt are both monetary items and would be shown at their historical cost balance sheet amounts, i.e., a debit balance of $60,000 and a credit balance of $80,000, respectively. The land would be shown on a general price-level accounting balance sheet amount of:

\[
$120,000 \times \frac{110}{100} = $132,000
\]

E18-8. Attitude of U.S. companies toward IASC standards

Requirement 1:
If foreign issuers of securities in the United States were allowed to use IASC standards rather than reconciling to U.S. GAAP in Form 20-F, controversy would undoubtedly ensue.

Some of the controversy would arise because there are differences between IASC and U.S. standards. But whether these differences would make the “playing field” unlevel is not clear. Those who argue that the more “lenient” IASC standards would put U.S. firms at a disadvantage contend one or more of the following:

a) Disclosures will be too cryptic to allow knowledgeable analysts to reconcile IASC standards to U.S. GAAP, thereby leading to noncomparability in evaluating U.S. versus foreign issuers.

b) Some less knowledgeable investors will be oblivious to the reporting differences and will judge foreign issuers who use IASC standards more favorably than their underlying economic performance warrants.

c) Foreign issuers with excellent prospects won’t “signal” their extraordinary potential in some way—say, by voluntarily supplying the more stringent U.S. GAAP data to allow meaningful comparisons and “showcase” their more favorable prospects.

On the other hand, consistent with the discussion solution to E18-2, it is not clear whether a single, uniform set of standards can adequately capture the subtle institutional and national differences that cause foreign firms’ operating environments and prospects to diverge from their U.S. competitors. In this view, since no single set of standards could ever completely reflect these differences, using different standards for foreign issuers might be no worse than the noncomparability that arises under the Form 20-F reconciliation.


Requirement 2:
It is unclear how U.S. managers will respond as the SEC debates whether to allow foreign issuers to use IASC standards. Some may oppose the proposal on “uneven playing field” arguments while others—for reasons discussed below—may privately hope the SEC allows IASC rules.

If the SEC does allow foreign issuers to use IASC standards, the position of top managers of U.S. companies becomes more predictable. Since IASC standards allow more latitude, many U.S. managers might prefer them to the more “stringent” U.S. rules and actually lobby for permission to use the IASC standards domestically instead of U.S. GAAP. In the ensuing political debate, the avowed rationale would be to “re-level the playing field.” The issue of contracting advantages arising from the more lenient rules would—of course—go unmentioned.
Problems
P18-1. Capital sources and disclosure differences

Requirement 1:
In Equityland, the primary users of the financial reports are the shareholders who buy and sell stock on the public stock exchanges. In Debtland, the primary users of the financial reports are the creditors who provide capital to Debtland companies.

Requirement 2:
Both types of users are interested in assessing the profitability of firms. Shareholders are concerned about profitability because they have dividend expectations. In addition, shareholders are concerned about a firm’s growth and growth potential because growth will have an impact on the firm’s market appreciation. Creditors are concerned about profitability because profitability is linked to long-term cash flows and creditors want to assess firms’ abilities to cover interest payments. In addition, creditors are concerned with liquidity. A firm’s liquidity is useful in assessing its ability to pay back its debts.

Requirement 3:

<table>
<thead>
<tr>
<th>Equityland</th>
<th>Debtland</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROE</td>
<td>ROE</td>
</tr>
<tr>
<td>ROA</td>
<td>ROA</td>
</tr>
<tr>
<td>EPS</td>
<td>Times interest earned</td>
</tr>
<tr>
<td>Current ratio</td>
<td>Debt-to-equity ratio</td>
</tr>
<tr>
<td></td>
<td>Current ratio</td>
</tr>
</tbody>
</table>

Requirement 4:
The disclosure environments of Equityland and Debtland might be quite different. Firms in Equityland would be expected to provide more public disclosures of financial and nonfinancial information simply because individual investors are not privy to company records. Firms in Equityland may provide more information about their financial position and operating performance via footnotes to the financial statements. In addition, Equityland firms may meet with financial analysts and other intermediaries to disseminate information. A demand for additional financial information exists in Debtland.
but firms often won’t publicly disclose the information. Public disclosures are not essential in these settings since creditors have the power to examine company records that shareholders typically cannot access.

P18-2. Overcoming reporting diversity

Requirements:

Requirement 1:
The footnote states that the reduction in the carrying value of certain assets represents the write-down of certain planning and development costs. U.S. GAAP does not allow planning and development costs to be capitalized. They must be expensed in the period incurred and reported as part of operating expenses. On the other hand, if the assets were legitimately included in property, plant, and equipment, the reduction in the carrying value may reflect an impairment of an asset. According to FASB No. 121, a loss on the impairment of a long-term asset should be reported as part of income from continuing operations, generally in the other expenses and losses section. The loss should not be reported as an extraordinary item.

Requirement 2:
Summary financial information, e.g., net income, total assets, stockholders’ equity, is a function of the accounting methods a firm employs in preparing its financial statements. Thus, one must exercise caution in comparing summary statistics across international firms because firms will be reporting in accordance with different sets of accounting standards. U.S. GAAP is more restrictive in its accounting method choices relative to other domestic GAAPs. However, even within U.S. GAAP, firms have discretion in selecting accounting methods. Thus, data services that provide only summary financial information are limited in their usefulness.

Requirement 3:

Income (loss) as originally reported ($1,282)
Add: Tax reimbursements 8 ($1,274)
Less:
Estimated expenses associated with contingent liabilities $111
Costs related to financial restructuring 406
Reduction in carrying value of certain assets 1,206 ($1,723)
Revised continuing income (loss) ($2,997)
In general, there is limited information to determine the proper classification of the items Euro Disney classified as exceptional items. For example, consider the gain reported due to payable forgiveness. In accordance with FASB Statement No. 114, if Euro Disney’s pre-restructure carrying amount of the debt exceeds the total future cash flows related to the restructured debt, then Euro Disney would report an extraordinary gain on the debt restructuring. However, if the total future cash flow after restructuring exceeds the total pre-restructuring carrying amount of Euro Disney’s debt, no gain would be reported. Income (loss) from continuing operations is an important calculation for the users of financial statements. The measure is considered to represent the firm’s sustainable earnings, i.e., earnings that will persist in the future. Expected earnings are used to estimate future cash flows, which are relevant in valuing a firm’s stock. Users of financial statements must realize that income (loss) from continuing operations reported on the income statement can vary depending upon the GAAP employed.

**P18-3. Overcoming reporting diversity**

**Requirement 1:**
The text identifies four approaches to bringing about uniformity to foreign issuers’ financial reporting.

a) Dual reporting

b) Reconciliations

c) Adopting an alternative set of standards

d) Reporting in accordance with an internationally acceptable set of accounting standards.

**Requirement 2:**
Yizheng Chemical Fibre Company has chosen to provide dual reporting (more than one set of financial statements) as well as to use an internationally acceptable set of accounting standards.

**Requirement 3:**

a) Turnover is another word for sales.

b) The operating section of the IASC profit and loss statement is highly condensed. The PRC accounting profit and loss statement provides more details (although still quite limited) and, thus, would be considered more useful in assessing the performance of Yizheng Chemical Fibre Company.
c) The differences in accounting method choices available under IASC relative to those available under PRC accounting standards causes the difference in operating profit. For example, differences in valuing inventory, valuing investments, calculating depreciation, accounting for leases and pensions, etc., all have an impact on operating income.

d) The profit figure used depends upon several factors. First, users may choose one profit figure over another because they are more familiar with one set of accounting standards over the other and, as a result, are better able to interpret the information. Second, if the profit figure is being used to compare Yizheng’s performance to another firm, the user will pick the profit figure calculated by the standards that correspond more closely to the accounting standards employed by the other firm. Based on information disclosed in the footnotes, the user might have to adjust the income statement numbers to account for any differences in the accounting method choices of the firms. Finally, if the financial report user believes that one set of standards better measures the economic performance of Yizheng, the profit figure calculated from those standards will be used.

In general, users of financial reports must be cognizant of the fact that the informativeness of the financial statements is a function of the accounting standards used to construct them. Some sets of accounting standards allow firms much more discretion in their choice of accounting methods (e.g., Swiss GAAP, Italian GAAP). In addition, some standards do not require as many financial disclosures (e.g., Norwegian GAAP, Finnish GAAP). Thus, firms preparing financial reports in accordance with one set of standards may generate a more “loose” set of financial information than firms following alternative sets of accounting standards. Analysts might, therefore, prefer to perform the analysis using the “tighter” GAAP measures since they presumably provide better interfirm comparability.

P18-4. Current cost ratio effects

**Requirement 1:**
The option to revalue assets provides management with additional accounting discretion. If management systematically revalues assets and is consistent in its measurement of revaluation, there is minimal concern about the consistency of accounting numbers over time, i.e., the ability to compare firm’s accounting numbers from one period to the next. However, if management does not systematically undertake revaluations, or changes the methods by which it estimates revaluations, then the comparability of accounting information is compromised.
The revaluation of assets can also cause difficulties when making interfirm comparisons. The revaluation of assets is often based on an estimate of market value rather than the objective measure of market value provided by an arm’s-length exchange of assets. The users of financial statements must be aware that firms have different methods of measuring the revaluation of fixed assets.

**Requirement 2:**
Note: The assessment of a ratio improving or weakening is made in very general terms. Assessing the consequences of changes in ratios is firm-specific.

a) Total shareholders’ equity to total assets would increase: Ratio improved. (Note: The ratio would be unaffected for an all-equity firm.)

b) Long term debt to assets would decrease: Ratio improved.

c) There would be no effect on the current ratio.

d) Return on assets would decrease: Ratio weakened.

**P18-5. Overcoming reporting diversity**

**Requirement 1:**
United Kingdom GAAP ROE = 1,811 / 3,142 = .576 or 57.6%

United States GAAP ROE = 913 / 7,230 = .126 or 12.6%

**Requirement 2:**
According to U.S. GAAP, the amortization of goodwill is reported as an operating expense on the income statement. The expense reduces net income that results in a decrease in earnings per share. The write-off of goodwill at the time of purchase affects ROE of the current period via the denominator of the ROE calculation. Stockholders’ equity will be reduced by an amount equal to the purchase price of the goodwill. Since the denominator is decreasing and the numerator, net income, is not affected by the goodwill write-off, ROE will be higher in the period of the write-off. As far as the impact on future periods’ ROE, the difference in stockholders’ equity due to the write-off will ultimately be eliminated; the amortization expense systematically reduces stockholders’ equity via net income. However, since net income measured in accordance with U.K. GAAP will be higher relative to U.S. GAAP net income, U.K. GAAP ROE will also be higher than U.S. GAAP ROE until the point in time that the goodwill is fully amortized.
Requirement 3:

One could argue that the U.K. GAAP ROE is a better measure of economic performance because net income is not garbled with a cost allocation estimate, i.e., goodwill amortization. However, since stockholders’ equity is reduced by the goodwill write-offs, the ROE may be overstated. ROE calculated under U.S. GAAP may not measure “true” economic performance either. Managers’ have discretion in choosing amortization periods which influences net income and, consequently, ROE. It isn’t the case that one ROE better reflects economic performance. Rather, the appropriate ROE should be based on the comparisons being made; Glaxo Wellcome to a U.K. firm that wrote off goodwill or Glaxo Wellcome to a U.S. firm or U.K. firm that capitalized goodwill.

P18-6. Overcoming reporting diversity

Requirement 1:
ROE = 81,257/778,364 = .1044 or 10.44%

Requirement 2:

Revised Shareholders’ Equity:
- Fixed assets at current value $858,000
- Less: Fixed assets at cost 692,913
- Addition due to revaluation 165,087
- Add: Shareholders’ equity at historical cost 778,364
- Shareholders’ equity restated $943,451

Revised Net Income:
- Net income as reported 81,257
- Less: Additional depreciation expense 12,106
- Net income restated $69,151

Revised ROE = 69,151/943,451 = .073 or 7.3%

Requirement 3:
The ROE in Requirement 1 is probably more relevant in comparing Stork’s performance to the performance of an industrial firm domiciled in the United States. However, even though U.S. GAAP requires historical cost accounting for its fixed assets, there may be other accounting method differences between Dutch GAAP and U.S. GAAP. Thus, while the ROE in Requirement 1 is more relevant than the restated ROE, it still might need to be adjusted to be comparable.
Requirement 4:
While ROE in Requirement 2 may be more relevant in comparing Stork’s performance to the performance of an Australian firm, there probably are differences between Australian GAAP and Dutch GAAP. Differences in the accounting method choices available under Dutch GAAP relative to the accounting method choices available under Australian GAAP would make the ROE in Req. 2 noncomparable unless further adjustments are made to Stork’s net income and stockholders’ equity to bring them in line with Australian GAAP.

In some instances, accounting standards might seem similar when, in fact, the standards are quite different. For example, in 1997, U.S. accounting standard setters issued a standard on segment reporting, as did the International Accounting Standards Committee. On the surface a user might think that the two standards would generate similar financial information. However, due to the differences in the way the standards define a business segment, a firm could end up reporting very different segment data depending upon whether it followed U.S. GAAP or the IASC standard.

P18-7. Overcoming reporting diversity

The conceptual framework of U.S. GAAP defines expenses as the use or outflows of assets during a period from delivering or producing goods, rendering services, or carrying out the activities that constitute the entity’s normal business operations. Since none of the special items disclosed in the footnote appear to be incurred in conjunction with Electrolux’s normal business activities, they should be reclassified as nonoperating gains or losses if Electrolux is preparing U.S. GAAP financial statements. Specifically, the following reclassifications should be made:

<table>
<thead>
<tr>
<th>Special item</th>
<th>Income Statement Presentation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital gains on sales of real estate</td>
<td>Other income section</td>
</tr>
<tr>
<td>Losses on sales of operations</td>
<td>Discontinued operations–net of taxes</td>
</tr>
<tr>
<td>Capital gains on sale of shares in Email Ltd.</td>
<td>Other income section</td>
</tr>
</tbody>
</table>

By reporting these special items as operating expenses, Electrolux increased operating expenses by seven million Swedish Kroners and buried the 325 million Kroner loss from discontinued operations in the body of the income statement.
P18-8. GAAP differences

Requirement 1:

a) Generally, if inventory levels are increasing, Novo Nordisk’s earnings would be lower under Danish GAAP relative to U.S. GAAP because of the expensing of direct labor and production overhead costs. This issue is discussed in Chapter 8. However, if inventory levels decreased, Novo Nordisk’s Danish GAAP net income would be higher than its net income measured in accordance with U.S. GAAP.

b) Danish GAAP earnings would be higher than U.S. GAAP earnings since amortization expense is not recorded on intangible assets.

c) Dividends have no effect on earnings.

d) Danish GAAP earnings would be lower than U.S. GAAP earnings since construction interest is expensed rather than capitalized.

Requirement 2:

a) Inventory would have a higher carrying value under U.S. GAAP relative to Danish GAAP. Thus current assets, total assets, and stockholders’ equity would all be larger under U.S. GAAP.

b) Since intangible assets are being amortized under U.S. GAAP, U.S. GAAP would result in a lower carrying value for intangible assets and, in the aggregate, lower total assets. Because income would be lower, stockholders’ equity would also be lower.

c) Dividends declared are recorded as a liability in the declaration period under U.S. GAAP. Thus, Novo’s current liabilities would increase if Novo prepared a U.S. GAAP balance sheet.

d) Under U.S. GAAP, Novo would have to capitalize construction interest. This would result in larger fixed asset and stockholders’ equity balances.

P18-9. GAAP differences

Requirement 1:

One difference is the order of the accounts. In the United States, firms list assets in descending order of liquidity—most liquid to least liquid. Remy lists its long-term assets first and its current assets towards the bottom of the balance sheet. Another difference is in the reporting of prepaid and deferred charges. Remy reports them as a separate line item in a non-classified category of assets. In the United States, prepaid assets are usually classified
as current and deferred charges can be either long-term or current. Remy does not report accounts receivable separately from notes receivable nor does Remy report them at their net realizable value. There is just one category for investments. It is not clear if the investments are long-term or short-term.

At the time Remy’s balance sheet was prepared, French GAAP did not require firms to estimate bad debts and set up an allowance for doubtful accounts. French GAAP was linked to tax reporting which did not allow a deduction for bad debts unless the firm owing the accounts receivable was in bankruptcy or receivership. Thus, the asset valuations reported on the balance sheet were dependent on the tax rules in effect.

In addition to the differences in accounting methods across alternative sets of GAAP, there can be substantial differences in GAAP disclosure requirements. Some GAAPs require extensive disclosures to be part of the published financial report (e.g., U.S. GAAP). Other GAAPs do not require as many financial disclosures (e.g., German GAAP). Firms can voluntarily provide financial disclosures to supplement those required by the GAAP employed and, thus, the variation in disclosure practices across GAAPs generally is less of a concern than the variations in accounting methods.

In summary, firms can voluntarily improve their financial reporting by increasing their financial disclosures and/or preparing their financial reports in accordance with a more stringent set of accounting standards, i.e., standards that restrict a firm’s choice of accounting methods. Strong firms can “signal” their strength by choosing more stringent standards.

**Requirement 2:**
Intangible fixed assets would include the value of Remy’s brand names. Given the nature of Remy’s business, brand names are critical to Remy’s economic success.

**Requirement 3:**
U.S. GAAP requires the cost of purchased brand names or trademarks to be capitalized and amortized over their estimated useful lives. Costs related to internally generated brand names and trademarks must be expensed in the period incurred. In adjusting Remy’s statements, reasonable estimates of amortization expense would need to be calculated and deducted from net income for the current period. Under U.S. GAAP, the cost of brand names would be amortized over the brand name’s estimated useful life using the straight-line method. Accumulated amortization, i.e., the sum of the amortization expense since the brand names were acquired, would be subtracted from the carrying value of the intangible fixed assets and from retained earnings. As a consequence, total assets and stockholders’ equity would be decreased for the accumulated amortization.
Cases
C18-1. Tyler Corporation (2): Adjusting reported trend data

Requirement 1:
For illustrative purposes, we will assume that the adjustment procedure was applied to quarterly data. Notice that Tyler adjusted income statement items to year-end purchasing power so each quarter’s sales were adjusted as follows:

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Price-index adjustment factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st</td>
<td>12/31/79 CPI</td>
</tr>
<tr>
<td></td>
<td>1st Qtr '79 Ave CPI</td>
</tr>
<tr>
<td>2nd</td>
<td>12/31/79 CPI</td>
</tr>
<tr>
<td></td>
<td>2nd Qtr '79 Ave CPI</td>
</tr>
<tr>
<td>3rd</td>
<td>12/31/79 CPI</td>
</tr>
<tr>
<td></td>
<td>3rd Qtr '79 Ave CPI</td>
</tr>
<tr>
<td>4th</td>
<td>12/31/79 CPI</td>
</tr>
<tr>
<td></td>
<td>4th Qtr '79 Ave CPI</td>
</tr>
</tbody>
</table>

Reported sales for each quarter would be multiplied by the appropriate adjustment factor to convert nominal dollars into 12/31/79 year-end purchasing power. The sum of these four quarterly adjustments equals $546,992,000. The inflation adjustment increased sales by ($546,992 - $519,242)/$519,242, or 5.3%. If sales and inflation occurred evenly over the year, the adjustment should have been the 13.3% CPI increase divided by 2. The 5.3% is lower than this, thereby implying that sales in the second half of the year were higher and/or the inflation rate was uneven.
**Requirement 2:**
The $458,952,000 number was derived using a procedure similar to that illustrated above. For example, the first quarter adjustment would be:

\[
\text{Reported 1st Qtr 1978} \times \frac{12/31/79 \text{ CPI}}{1\text{st Qtr '78 Ave CPI}}
\]

Nominal sales $s

Repeating this procedure for each quarter expresses 1978 sales in year-end 1979 dollars, thereby facilitating evaluation of period-to-period *real* sales growth. It would require $458,952,000 at December 31, 1979, to have the same purchasing power, on average, as $390,873,000 (reported 1978 nominal sales in C15-2) did at mid-year 1978.

**Requirement 3:**
The 5-year summary helps answer this question.

\[
\frac{($546,992 - $458,952)}{$458,952} = 19.2\%.
\]

Notice that this is sales growth after factoring out overall inflation; however, this does not adjust for the acquisition of Thurston.

**Requirement 4:**
It is easy to adjust for both inflation and the acquisition simultaneously. The key is to apply the inflation adjustment factors to the pro-forma sales data given in C15-2, rather than to the income statement data themselves.

We saw in Requirement 1 that the inflation adjustment factor for 1979 was 5.3%. The factor for 1978 is:

\[
\frac{($458,952 - $390,873)}{$390,873}, \text{ or 17.4}\%.
\]

The simultaneous adjustment approach proceeds as follows:

<table>
<thead>
<tr>
<th>Pro Forma Sales No.</th>
<th>Adjustment Factor</th>
<th>Adjusted Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979</td>
<td>1.053</td>
<td>$568,964,330</td>
</tr>
<tr>
<td>1978</td>
<td>1.174</td>
<td>$563,576,350</td>
</tr>
<tr>
<td>Increase</td>
<td></td>
<td>$5,387,980</td>
</tr>
</tbody>
</table>

Adjusting for both the acquisition and inflation results in a year-to-year computed increase of $5,387,980, which is less than a 1% change in real sales.
C18-2. Tyler Corporation (3): Borrowing strategies under inflationary conditions

The Credit Commitments footnote shows that gross long-term debt increased by $46,633,000 during 1979 (i.e., $78,561,000 - $32,928,000) which is only slightly greater than the approximately $45,500,000 cash purchase price for Thurston. This is consistent with Tyler’s disclosure that “long-term debt has been the primary vehicle for financing the acquisition of each of the four operating units.” However, more than 100% of the debt increase is attributable to floating-rate debt ($43,000,000 at 106% of prime and $4,150,000 at prime).

Tyler stated that shareholders benefited from inflation because the debt was repaid “with dollars having less purchasing power.” But floating rate debt is designed to negate this wealth transfer between lenders and borrowers since interest payments increase in response to inflation. Thus, it is unclear how Tyler intended to benefit shareholders by financing the Thurston acquisition with floating rate debt.

It might be worthwhile pointing out to students that the direction of the wealth transfer can’t be known with certainty ex ante even with fixed rate debt. Lenders are not oblivious to inflation and a quoted fixed interest rate of, say, 9% might be comprised of a desired “real” return of 5% plus anticipated inflation of 4%. Borrowers benefit from inflation only if the ex post realized inflation rate over the duration of the loan turns out to be higher than the anticipated 4% inflation factor built into the interest rate. If realized inflation is only 2%, then the lender (who earned an unexpectedly large return) benefits at the expense of the borrower.

C18-3. Tyler Corporation (4): Inflation’s effect on GAAP ratios

Requirement 1:
The instructor may wish to mention that the 11-year period covered in the ad represented the most sustained and significant level of inflation in the United States since the Korean War.

Under GAAP accounting rules, inflation injects a two-fold upward bias on reported ROE—both a “favorable” numerator effect and a “favorable” denominator effect.

The numerator effect is usually most pronounced for capital-intensive firms, that is, those with high proportions of long-lived assets as a percentage of total assets. This effect is attributable to historical cost reporting for the assets and consequent “underdepreciation” (in comparison to current value) on the income statement. This makes income “too high” and (ceteris paribus) overstates ROE. Other numerator overstatements include, as examples, LIFO dipping, and various inflation-induced debt “games” (e.g., debt-for-debt swaps) discussed in Chapter 10.
Since assets exceed liabilities for virtually all going concerns, the GAAP failure to adjust assets understates the denominator when prices are rising, especially for capital-intensive firms. During inflation, GAAP historical cost accounting for fixed rate debt overstates liabilities’ real burden (and, thus, overstates the denominator). But since assets exceed liabilities for most firms, the asset effect dominates. (Of course, for firms with significant amounts of floating rate debt–like Tyler–there is a reduced denominator effect from inflation since the book value and market value of floating rate debt should be roughly equal.)

The ad shows that GAAP ROE has averaged close to 20% over the 11-year period. Over the period covered by the ads, GAAP ROE would have been overstated each year in comparison to inflation-adjusted ROE. Since the effect of inflation is cumulative, this means that inflation-adjusted ROE was falling over the period covered by the ad.

**Requirement 2:**
Inflation-adjusted ROE was falling for the overwhelming majority of Fortune 500 companies over this period, not just Tyler. But the disparity between GAAP ROE and inflation-adjusted ROE was not the same across Fortune 500 firms. Firms with a higher proportion of long-lived assets as a percent of total assets will have a relatively higher overstatement in ROE under GAAP. Thus, the validity of the comparison between Tyler’s ROE over the period and the median of the Fortune 500 depends upon the relative capital intensity of Tyler in comparison to the average of the other 499.
C18-4. Robinson Company: General price level and current cost adjustments

Requirement 1:

Robinson Company
Statement of Historical Cost/Constant Dollar Income
Year Ended December 31, 2001

Sales revenues \( \left( \frac{8,600 \times 200}{190} \right) \) $9,053

Cost of goods sold \( \left( \frac{4,000 \times 200}{178} \right) \) $4,494

Depreciation \( \left( \frac{1,000 \times 200}{100} \right) \) 2,000

Historical cost/constant dollar income from continuing operations 2,559

Loss on net monetary items 820#

Total historical cost/constant dollar income \( \overline{1,739} \)

Calculation of Loss on Net Monetary Items

<table>
<thead>
<tr>
<th>Historical $s</th>
<th>Restatement Ratio</th>
<th>Constant $s December 31, 2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net monetary assets, Jan. 1, 2001 $5,000 x ( \frac{200}{180} ) = $5,556</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase in net monetary assets: From sales revenues 8,600 x ( \frac{200}{190} ) = 9,053</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Decrease in net monetary assets: To pay dividends ( (3,600) ) x ( \frac{200}{190} ) = (3,789)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net monetary assets in 12/31/01 dollars 10,820</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net monetary assets in historical dollars, 12/31/01 ( \overline{10,000} ) (10,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss on net monetary items $820</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Robinson Company
Historical Cost/Constant Dollar Statement of Financial Position
December 31, 2001

<table>
<thead>
<tr>
<th>Assets</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$10,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>4,494</td>
</tr>
<tr>
<td>Fixed asset</td>
<td>20,000</td>
</tr>
<tr>
<td>Less: Accum. dep.</td>
<td>(12,000)</td>
</tr>
<tr>
<td>Owners’ Equity</td>
<td>$22,494</td>
</tr>
</tbody>
</table>

Direct Calculation of Owners’ Equity

January 1, 2001 Owners’ equity in 1/1/01 constant dollars:

Cash               $5,000
Inventory          8,090
Fixed asset        9,000

Adjustment factor to roll-forward to 12/31/01 $s

January 1, 2001 Owners’ equity in 12/31/01 constant dollars = 24,544

Plus: 2001 Constant dollar income 1,739
Minus: 2001 Dividend (3,789)

$22,494
**Requirement 2:**

Robinson Company
Statement of Current Cost Income
Year Ended December 31, 2001

Sales revenues $8,600
Current cost of goods sold ($875 \times 5) $4,375
Current cost depreciation ($7,000/5) 1,400

Current cost income from continuing operations $2,825

Robinson Company
Current Cost Statement of Financial Position
December 31, 2001

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$10,000</td>
<td></td>
</tr>
<tr>
<td>Inventory ($890 \times 5)</td>
<td>4,450</td>
<td></td>
</tr>
<tr>
<td>Fixed asset</td>
<td>$14,000*</td>
<td></td>
</tr>
<tr>
<td>Less: Accumulated</td>
<td></td>
<td></td>
</tr>
<tr>
<td>depreciation</td>
<td>(8,400)</td>
<td>5,600</td>
</tr>
<tr>
<td>Owners’ Equity</td>
<td>$20,050*</td>
<td>$20,050</td>
</tr>
<tr>
<td></td>
<td>$20,050</td>
<td>$20,050</td>
</tr>
</tbody>
</table>

*Computation of fixed asset and depreciation

January 1, 2001 replacement cost of an identical fixed asset $7,000
Imputed value of 5-year-old asset if it were new: $7,000 \times 2 = $14,000
Accumulated depreciation: ($14,000/10) \times 6 \text{ years} = ($8,400)
Direct Calculation of Owners’ Equity

1/1/01 Current cost balance (Cash, $5,000; + Inventory, $8,100; + Fixed asset, $7,000) $20,100

Plus: Current cost income from continuing operations 2,825

Increases in inventory current costs (holding gains):
10 units @ ($875 - $810) = 650
5 units @ ($890 - $875) = 75

Less: Dividend (3,600)

December 31, 2001 Owners’ equity balance $20,050

Whether the $2,825 current cost income figure represents the payout that would facilitate maintenance of physical capital is open to some question in this specific setting.

Notice that Robinson Company did not immediately reinvest the sales proceeds. Because the replacement cost of the five units of inventory has increased still further since the time of sale (i.e., $890 vs. $875), a shortfall may exist. This underscores the fact that the standard physical capital maintenance computation assumes virtually immediate reinvestment of sales proceeds into nonmonetary assets.

On the other hand, the $2,825 figure may be overly conservative. The problem states that Robinson sets prices in order to earn a target return of 20% on original cost. A hidden assumption of the physical capital maintenance approach is that output prices adjust virtually instantaneously to changes in input costs. This is clearly not the case when a company utilizes historical cost pricing. Obviously, the prevalence of historical cost pricing in actual practice is unknown. In the absence of tax effects, however, it may be possible for Robinson to maintain physical capital with a payout in excess of $2,825 provided that the company can continue to earn a 20% return on the actual future asset costs it incurs.

Finally, the technological change issue complicates matters. The $2,825 income figure assumes eventual replacement of the identical assets currently employed. Since the technologically improved asset is more expensive, the reported current cost number does not incorporate potential replacement with improvement assets. SFAS No. 33 specified, however, that depreciation should reflect the current cost of the existing assets (unless the net amount of cash expected to be recoverable from the use or sale of the asset—i.e., the “recoverable amount”—is lower).
Requirement 1:
The financial reporting philosophy implicit in the Japan Finance Ministry announcement appears to be based on “social/economic engineering.” That is, financial reporting rules are being used in an attempt to achieve specific economic and social objectives. These objectives are two-fold: 1) to prop up Japanese share prices, and 2) to allay fears about the health of Japanese banks. In the United States, these types of goals are usually pursued through the use of fiscal and monetary policy and through passage of laws, tax reform, investment tax credits, etc. Financial reporting itself is rarely used this way in the United States. The dominant goal in the U.S. reporting philosophy is to “tell-it-like-it-is” in order to facilitate efficient resource allocation. There have been one or two notable exceptions, however. Many believe that SFAS No. 15 (“Troubled Debt Restructurings” issued in June 1977), deliberately avoided recognizing the full extent of bank credit losses and, thus, was similar in philosophy to the Finance Ministry approach. SFAS No. 123 (“Accounting for Stock-Based Compensation” issued in October 1995) is another example; here, political pressures caused the FASB to abandon measurement of the estimated value of stock options issued to employees and settle for footnote disclosures.

Requirement 2:
The negative financial data that banks would be permitted to withhold related to loan losses and reserves. Apparently, the announcement meant that realistic loan loss reserves would not be imposed on banks, nor would the Finance Ministry require that bad loans be written off.

Requirement 3:
Answering this question takes us out of the realm of financial reporting and forces us to forecast human behavior. One might argue that the Japan Finance Ministry approach could have exacerbated the problem. Here’s how.

Suppose that, prior to August 19, 1992, the consensus in the financial community was that 30% of the loans on the books of Japanese banks were in jeopardy. Further assume that financial decision-makers widely believed that their consensus estimate was fairly common knowledge and known to the Finance Ministry. In this setting, the Finance Ministry announcement could have been interpreted as a signal that the real loss percentage exceeded the 30% consensus estimate. Accordingly, rather than restoring confidence, the announcement could have heightened fears regarding the true extent of the losses that were apparently too large to be “safely” revealed.

**Requirement 1:**
During 1991 and 1992, German GAAP income was lower than U.S. GAAP income due to provisions, reserves, and valuation differences (or hidden reserves). Since U.S. GAAP does not allow hidden reserves, Daimler-Benz was adding to its hidden reserve during the two years by increasing its expenses. This suggests that the two years were probably “good” earnings years, and, consequently, Daimler-Benz was “saving” some of its income for future years when the company might not be doing so well. In fact, 1993 appears to be a year of “bad” earnings. The pre-tax German GAAP income of Daimler-Benz was higher by DM 4,262 million due to using the hidden reserves to absorb current year losses. (See 1993 item “Changes in appropriated retained earnings...”) Thus, by creating additional expenses during “good” earnings years, such as 1991 and 1992 for Daimler-Benz, German companies are able to bolster their earnings during “bad” earnings years such as 1993.

The following excerpt from the 20-F filing explains how Daimler-Benz had created the hidden reserves:

The adjustments to stockholders’ equity of DM 5,770 and DM 9,931 would have reduced other provisions at December 31, 1993 and 1992 by DM 4,883 and DM 8,105, respectively. The remainder of the adjustments would have increased property, plant, and equipment, inventories and other receivables under U.S. GAAP.

“Other provisions” appears to indicate that a substantial majority of the hidden reserve was the result of creating various accrued liabilities. However, some of the hidden reserves were created through extra depreciation expense and conservative valuation of inventories.

From a net worth standpoint, the German approach to creating hidden reserves has resulted in conservative financial reporting. At the end of 1993 and 1992, the company added about DM 5.77 billion and DM 9.93 billion, respectively, to its retained earnings to eliminate the hidden reserves. Consequently, over the prior years, the company must have recorded more expenses than required based on realistic business expectations. However, from an income statement standpoint, while the German approach results in smoother income figures, it is not always more conservative than the U.S. approach. This is because the creation and the depletion of the hidden reserve is very much at the discretion of management. For instance, while the hidden reserves approach led to lower German income during 1991 and 1992, it led to a higher income number in 1993 under German GAAP.
Requirement 2:
Daimler-Benz essentially uses the completed contract method even when the U.S. GAAP would require the percentage of completion method. Consequently, the question we are answering is whether the completed contract method is more or less conservative than the percentage of completion method. While both methods immediately report all expected losses, the completed contract method reports gains only after the contracts are completed. Consequently, the completed contract method (German GAAP) is more conservative than the percentage of completion method (U.S. GAAP).

This is obvious from the additions made to the retained earnings at the end of 1993 and 1992 (DM 207 million and DM 131 million, respectively). However, the adjustments to the net income figures provide a different picture. For instance, in contrast to 1993, Daimler-Benz reported higher income in 1991 and 1992 by using the completed contract approach. This might be because the gross profits of long-term contracts completed during 1991 and 1992 were greater than the gross profits on the work performed during the same period. Note that the work on some of the long-term contracts completed during 1991 and 1992 would have been performed in the prior years. In 1993, it appears that the gross profits on the work performed was greater than the gross profits on the completed contracts.

Requirement 3:
Under German GAAP, goodwill need not be amortized to the income statement. Instead, it can be written off directly to retained earnings without flowing through the income statement as an expense. The reconciliation of the retained earnings suggests that this is what Daimler-Benz must have done in its German GAAP financial statements. Since such direct write-offs are not allowed under U.S. GAAP, goodwill must be added back to the retained earnings. From the income standpoint, since goodwill must be amortized as an expense under U.S. GAAP, the income statement reconciliation shows a reduction from German GAAP income to arrive at the U.S. GAAP income. However, regardless of the amortization rules, the net book value of the goodwill can never be negative (at the worst, it can be zero). Consequently, although the retained earnings are lower under German GAAP due to the direct write-off, the net income is higher due to omitting the goodwill amortization expense.

Requirement 4:
Under U.S. GAAP, any gain on sale of discontinued operations is postponed until the gain is actually realized. In contrast, under German accounting, it appears that both gains and losses from discontinued operations can be recognized when the contract to sell is signed. It appears that the contract to sell AEG KABEL was signed during 1991, but the actual cash from the sale
was realized only during 1992. Since the sale resulted in a gain, U.S. GAAP rules do not allow Daimler-Benz to recognize this gain until 1992. Consequently, the gain on sale is subtracted from the 1991 German income and added to the 1992 German income to bring the income statements into conformity with U.S. GAAP.

An interesting point is that the amount subtracted from the 1991 income (DM 490 million) is different from the amount added to the 1992 income (DM 337 million). Daimler-Benz provides the following explanation for this disparity:

In addition, applying the differing accounting principles between German and U.S. GAAP results in differing book values of the underlying businesses. As a result, the German and U.S. GAAP accounting gain or loss on a business disposition may be different.

To illustrate, the net book value under German GAAP is likely to be lower due to existence of the hidden reserves. Consequently, the gain on sale reported under the German GAAP (DM 490 million) is higher than the gain on sale under the U.S. GAAP (DM 337 million). When Daimler-Benz eliminated the hidden reserves, the net book value of the discontinued operations must have gone up.

**Requirement 5:**
German GAAP allows companies to use the entry age method for pension cost as defined in the German tax code. However, U.S. GAAP requires companies to use the projected unit credit method.

For OPEB, U.S. GAAP has required the use of the accrual method since the early 1990s. However, it appears that Daimler-Benz uses cash basis accounting under German GAAP. Note that the income statement reconciliation shows the cumulative effects of adopting SFAS No. 106 as an adjustment to the German GAAP net income.

Overall, it appears that the German accounting methods for pension and OPEB result in a less conservative book value for net worth. At the end of 1993 and 1992, Daimler-Benz subtracted DM 1.82 billion and DM 1.21 billion, respectively, from its German GAAP retained earnings to arrive at the U.S. GAAP numbers.

**Requirement 6:**
Under U.S. GAAP, both gains and losses from derivative instruments to hedge anticipated or future transactions are marked to market, i.e., the unrealized gains and losses flow through the income statement. In contrast, under German GAAP, it appears that while the German Commercial Code requires a provision for unrealized losses on such instruments, unrealized
gains are not recorded until they are realized. (Note that this is an example of how the commercial law in Germany drives the financial reporting standards.) Consequently, this results in more conservative financial reports under German GAAP. Consistent with this, we find that Daimler-Benz added DM 381 million (DM 580 million) at the end of 1992 (1991) to its German GAAP retained earnings to conform to the U.S. GAAP requirements.

**Requirement 7:**
If Daimler-Benz were using the equity method, then consolidation of Deutsche Aerospace Airbus would have had no impact on the net income of Daimler-Benz. This is because Daimler-Benz’ share of Deutsche Aerospace Airbus’ net income will have been included under the equity method. While consolidation will change the components of the income statement, the bottom line will be unaffected. Therefore, it appears that Daimler-Benz was using the cost basis approach to report the investment in the equity securities of Deutsche Aerospace Airbus.

C18-7. BP Amoco: Understanding non-U.S. financial statements

**Requirement 1:**

a) Group statements are what are called *consolidated* statements in the United States. The United Kingdom rules which govern when subsidiaries must be consolidated are more stringent than U.S. rules. In both the United States and the United Kingdom, consolidation is required when the parent exerts *control* over the subsidiary; control is currently defined in the United States as more than a 50% ownership of voting stock. More than 50% ownership of voting stock indicates control under U.K. GAAP, too. But in the United Kingdom, control can exist even in situations where less than 50% of voting stock is owned. Examples include: 1) where the parent has the right to appoint or remove board members entitled to exercise a majority of the voting rights; 2) where the parent owns convertible debt or options that allow it to gain control; and 3) other, more technical, conditions.

b) *Stocks* is inventories  
*Debtors* is accounts receivable  
*Creditors* is accounts payable and other accrued short- as well as long-term liabilities  
*Capital and reserves* is owners’ equity  
*Called up share capital* is common stock par or stated value  
*Share premium account* is paid-in capital in excess of par or stated value  
*Reserves* is retained earnings (and, potentially, other special items like revaluation surplus)
c) **Turnover** is sales revenue

*Exceptional items* are material items that merit separate disclosure. They are shown pre-tax and are, thus, roughly equivalent to U.S. “above the line” special or unusual items. However, U.K. accounting differentiates between *non-operating* exceptional items (profits or losses on disposals of fixed assets or an entire operation, and reorganization costs) and all other exceptional items. Non-operating exceptional items are shown below a line labeled “operating profit.” U.S.-type extraordinary items that are shown net of tax are virtually prohibited in the United Kingdom.

*Investments in associated undertaking* is investments where the investor exerts significant influence (defined as 20% or more ownership). These are accounted for using the equity method.

**Requirement 2:**

a) **Stock holding gains** are the realized inventory holding gains that were discussed in both Chapters 9 and 18. LIFO is not allowed in the United Kingdom so these gains flow through to the bottom line under historical cost inventory accounting when prices are rising.

Adding-back realized inventory holding gains or losses to replacement cost income—as BP Amoco does—results in a traditional historical cost income number. Again, this is discussed in both Chapters 9 and 18.

Energy costs are easily observable by consumers. The costs of heating their homes or apartments as well as fueling their cars are important budget outflows. This makes oil companies politically vulnerable if consumers seek a “scapegoat” for rising energy expenditures. BP Amoco has used this disclosure format for stock holding gains for many years. One conjecture is that it hopes that informed statement readers will not confuse high historical cost profits with “price-gouging.” Separating holding gains makes it easier to see its real, sustainable margin.

b) These are examples of exceptional items discussed in Requirement 1.c., above. Both would be considered “above-the-line” items in U.S. GAAP disclosure and, thus, be shown pre-tax. They are also shown pre-tax in the BP Amoco statement. However, both are considered nonoperating exceptional items and are, thus, shown below the line labeled replacement cost operating profit.

c) U.S. balance sheets list assets in descending order of liquidity, starting with cash. Many European balance sheets begin with fixed assets. The BP Amoco balance sheet format is:

\[ \text{Assets} - \text{Liabilities} = \text{Equity}. \]
What “balances” is that the computed gross equity number (£43,281 at December 31, 1999) is then reconciled to the detailed equity components.

The BP Amoco balance sheet computes working capital—i.e., current assets minus current liabilities—which is £202 at December 31, 1999. This number is not highlighted and must be computed by readers of U.S. balance sheets.

d) The format differences here are numerous. In U.S. statements, interest received and paid, as well as dividends received are classified as operating cash flows. In the U.K. statement, these are in a separate section labeled “Servicing of finance and returns on investments.” To some observers, the U.K. classification seems better. These items are included in the operating cash flow section in U.S. reports and many believe that:

1) interest and dividends received are really better classified as investing cash inflow, and

2) interest paid should be treated as a financing cash flow.

Since interest and dividends received do not need to be separately disclosed in U.S. reports, this alleged “misclassification” cannot be adjusted, and the U.K. approach would be preferred by some.

The BP Amoco breakdown of what is termed “Investing Cash Flows” in a U.S. statement is also slightly more detailed. Capital expenditures and asset sales are reported separately from acquisitions and dispositions of entire businesses. These are usually reported together in a single section in U.S. statements.

Most of the other differences are minor. For example, taxes paid are shown separately on the face of BP Amoco's cash flow statement while taxes paid are usually disclosed in a footnote in U.S. reports.

Requirement 3:

a) This is the holding company which has legal ownership of the various operating subsidiaries and entities.

b) Since the holding company is not an operating entity, income and cash flow statement disclosures would not be particularly informative.

c) The £6,588 balance in the debtors account is comprised primarily of advances made by the holding company to the operating subsidiaries.
The equivalence of the amounts of called-up share capital and share premium account in the “parent” and “group” columns exists because the holding company owns the operating subsidiaries. Hence, the group share capital plus share premium must be identical to that of the parent.

d) Often in other (continental) European countries, separate parent data are also provided for the income statement. There is no clearly apparent economic reason for providing separate parent data unless the parent—which is a separate legal entity—has its own operating activities. However, these balance sheet disclosures are required in all cases by the European Economic Community (now called the European Union) in the Seventh Company Law Directive on consolidated accounts, which was adopted in 1983.

e) Differentiating between group and parent statements provides an opportunity for harmonization even in countries where book-tax conformity is required. Here’s how. The book-tax conformity could be satisfied using the parent statements while the group accounts could use reporting rules that are different from the tax rules. Harmonization could proceed without disrupting conformity between book and tax accounting since the conformity would exist on the parent’s books.