

GAAP VS. IFRS TREATMENT OF LEASES AND THE IMPACT ON FINANCIAL RATIOS

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CASE DESCRIPTION

As of January 1, 2013, most of the world financial market economies are using International Reporting Standards (IFRS) as the required framework for financial statements. A non-comprehensive listing includes the European Union Countries, Canada, Australia, Japan and New Zealand. In the United States, US Generally Accepted Accounting Principles (GAAP) is still required but adoption of IFRS has support of many accounting firms and professional organizations and is under consideration by the SEC. This case study focuses on differences in the treatment of leases and the impact of these differences on financial statements and selected financial ratios. Students take GAAP financial statements and prepare an IFRS based balance sheet, cash flow statement and income statement. It is necessary to understand both GAAP and IFRS rules regarding leases to address this case study. This case study is suitable for use at both the undergraduate and graduate levels. It may be used in an Intermediate Accounting II, Accounting Theory, Financial Statement Analysis or an International Accounting class, as well as an Investment Finance course. The case can be offered as an individual case study or as a group project.

JEL: M4, M41, M42, M48, M49

KEYWORDS: US GAAP, IFRS, Capital Lease, Operating Lease, Financing Lease, Ratios

CASE INFORMATION

ACE Corporation (ACE), a publically traded NASDAQ company (symbol ACE), is a manufacturer of electrical automobiles. It is based in Detroit, Michigan and the company has been operating since 1996. The company sells their electrical automobiles to auto manufacturers as well as the retail market on a worldwide basis. Its major clients are Ford, General Motors and Toyota. ACE has captured about 10 percent of the world market of the electrical automobile sales. Its stock sells at 25 US Dollars per share, and its 52-week price range is between 19.75 and 27.15 US Dollars, with a market cap of 10.6 billion dollars.

Their financial statements presented below for the year ending December 31, 2012 has been prepared using GAAP. The controller would like to see the effect of IFRS treatment of leases on the financial statements; you have been assigned this task. In particular, the controller would like to see the impact GAAP and IFRS differences have on balance sheet, income statement, cash flow statement and selected financial ratios. The company would like to adapt IFRS by as early as next year as it is considering a new stock issue in the Tokyo Stock Exchange, which requires IFRS compliance.

Table 1: US GAAP Balance Sheet for ACE Corp. at 12/31/2012 and 12/31/2011

ACE CORPORATION		
Balance Sheet (in 000 Except Par Value)		
As of December 31, 2012 and 2011		
ASSETS	2012	2011
Current Assets		
Cash	\$ 33,000	\$ 19,000
Accounts Receivable (net)	25,000	17,000
Inventory (FIFO)	<u>50,000</u>	<u>21,000</u>
Total Current Assets	108,000	57,000
Noncurrent Assets		
Security Available for Sale	\$ 10,000	0
Property, Plant and Equipment	100,000	\$136,000
less Accumulated Depreciation	<u>(30,000)</u>	<u>(28,000)</u>
	80,000	108,000
Intangible Assets		
Trademark	5,000	7,000
Goodwill	<u>7,000</u>	<u>7,000</u>
Total Noncurrent Assets	<u>12,000</u>	<u>14,000</u>
Total Assets	<u>\$200,000</u>	<u>\$179,000</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES		
Current liabilities		
Accounts payable	\$ 18,000	\$ 17,000
Accrued interest	2,000	2,000
Accrued operating expenses	13,000	19,000
Income taxes payable	<u>7,000</u>	<u>6,000</u>
Total current liabilities	40,000	44,000
Noncurrent Liabilities		
Deferred income taxes	\$ 5,000	\$ 4,000
Bonds Payable	<u>45,000</u>	<u>45,000</u>
Total noncurrent liabilities	<u>50,000</u>	<u>49,000</u>
Total Liabilities	90,000	93,000
SHAREHOLDERS' EQUITY		
Common stock (\$1 par)	20,000	18,000
Additional paid in capital	30,000	17,000
Retained earnings	<u>60,000</u>	<u>51,000</u>
Total Shareholders' Equity	<u>110,000</u>	<u>86,000</u>
Total Liabilities and Shareholders' Equity	<u>\$200,000</u>	<u>\$179,000</u>

Table 1 shows the Balance Sheet of Ace Corporation for the years ended 12/31/12 and 12/31/11 presented under US GAAP reporting. Note that the presentation is based on the order of liquidity-most liquid items followed by less liquid items.

Table 2: ACE Corp. US GAAP Income Statement for the Year Ended December 31, 2012

ACE Corporation		
Income Statement (in 000, Except Per Share Data)		
For the Year Ended December 31, 2012		
Sales		\$270,000
Cost of goods sold		<u>(175,000)</u>
Gross profit		95,000
Selling and administrative expenses	\$ 31,000	
Amortization and depreciation expense	10,000	
Interest expense	<u>4,000</u>	<u>(45,000)</u>
Income before taxes		50,000
Income tax expense		<u>(15,000)</u>
Income before extraordinary item		35,000
Extraordinary loss from hurricane (net of \$6,000 tax savings)		<u>(14,000)</u>
Net Income		<u>\$21,000</u>
Earnings per share:		
Earnings per share from continuing operations		\$1.75
Extraordinary loss per share		(0.70)
Earnings per share		<u>\$1.05</u>

Table 2 presents a statement of income for the year ended 12/31/12 prepared under US GAAP reporting. Also included is the earnings per share amount which is derived by taking net income and divided by the number of common shares outstanding.

Table 3: ACE Corp. US GAAP Cash Flow Statement for the Year Ended December 31, 2012

ACE Corporation Cash Flow Statement (in 000) For the Year Ended December 31, 2012		
Cash from Operating Activities		
Net income		\$21,000
Adjustments for noncash items:		
Loss from hurricane	\$14,000	
Depreciation expense	8,000	
Amortization expense	2,000	
Increase in accounts receivable	(8,000)	
Increase in inventory	(29,000)	
Increase in accounts payable	1,000	
Change in accrued operating expenses	(6,000)	
Change in income taxes payable	7,000	
Increase in deferred income taxes	<u>1,000</u>	<u>(10,000)</u>
Net Cash from Operating Activities		11,000
Cash from Investing Activities		
Insurance proceeds	\$10,000	
Purchase securities available for sale	<u>(10,000)</u>	
Net Cash from Investing Activities		-0-
Cash from Financing Activities		
Issue common stock	\$15,000	
Pay dividends	(12,000)	
Net Cash from Financing activities		<u>3,000</u>
Net increase in cash		\$14,000
Cash December 31, 2011		<u>19,000</u>
Cash December 31, 2012		<u>\$33,000</u>
Additional supplemental disclosure:		
Cash paid for income taxes		\$ 7,000
Cash paid for interest		\$ 4,000

Table 3 presents the Statement of Cash Flows for Ace Corp. for the year ended 12/31/12 under US GAAP. The cash flow presented is the indirect method. Alternatively, the Direct method-not presented here is also the other acceptable cash flow statement under both US GAAP and IFRS. The Direct Method is illustrated in the solution for question 5C where the Direct Method is presented in the solution under IFRS.

ADDITIONAL INFORMATION

1. ACE entered into a noncancelable lease on January 2, 2012 with the following terms:
 - A. ACE leased specialized machinery manufactured by the lessor, Bell Corp., which enables ACE to manufacture their electric cars in a much more efficient manner. This machinery does not have a resale market and was made specifically for ACE to meet its specifications.
 - B. The lease term is for 3 years with an annual lease payment of \$10,000. Payment is due on December 31 of each year, with the first payment due on December 31, 2012. At the end of the lease term, ownership reverts to the lessor. There is no option for ACE to buy the equipment.
 - C. The lessee will pay all executor costs of \$1,500/year which is included in 2102 selling and administration expenses.
 - D. The estimated useful life of the lease is 49 months (4 1/12 years.)
 - E. The fair market value of the equipment is \$30,000 on January 1, 2012.
 - F. The implicit rate of Bell Corp. is 6 percent, and the lessee, ACE, knows this.
 - G. ACE's incremental borrowing rate is 7 percent.

2. ACE Corporation did not sell any plant assets; however plant assets with a cost of \$36,000 and accumulated depreciation of \$6,000 were destroyed in a hurricane. Insurance proceeds of \$10,000 were collected by the company.
3. Two million shares of common stock were issued at the beginning of 2012.
4. Securities available for sale were purchased on December 31, 2012.
5. Cash dividends were paid during 2012.
6. ACE's bonds payable have several covenants that involve net income and cash from operating activities. The controller is especially concerned that IFRS treatment of leases does not violate those covenants. She is concerned that renegotiating the debt covenants will be costly to ACE.

QUESTIONS

1. Differentiate between an operating lease and a capital/ financing lease for financial reporting purposes.
2. Under GAAP, has this been treated as a capital lease / financing lease or an operating lease by ACE? Why?
3. Under IFRS, should this lease be classified as an operating or a financing lease? Why?
4. Describe the different reporting results between GAAP and IFRS and make the necessary adjusting entries to conform the financial statements to IFRS compliance for 2012.
5. In answering the following parts, keep in mind companies usually prefer to report higher net income and higher cash from operating activities (although accounting research has identified exceptions to this).
 - A. Prepare an income statement under IFRS for 2012.
 - B. Prepare balance sheet under IFRS on December 31, 2012.
 - C. Prepare a cash flow statement under IFRS for 2012.
6. Compute the following ratios for 2012, under both IFRS and GAAP reporting:
 - Current Ratio
 - Quick Ratio
 - Cash Ratio
 - Times Interest Earned
 - Debt to Capital Ratio
 - Debt to Shareholder Equity Ratio
7. Comment on your findings in 6 above.

REFERENCES

International Financial Accounting Standards (IFRS). IAS numbers: 2, 3, 36, 37, 38, 39. PWCoopers.org

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The Analysis and Uses of Financial Statements, White, Sondhi, Fried, Wiley, 3rd Edition, 2008.

U.S Generally Accepted Accounting Principles (US GAAP).

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TEACHING NOTES

CASE DESCRIPTION

This case focuses on GAAP and IFRS differences in the treatment of leases and the grounds for classification as an operating or capital lease. It is designed to have students conduct research on GAAP and IFRS pronouncements. They must compare and contrast the differences in the treatment of leases under the two frameworks. It also requires students to prepare the adjusting entries for the conversion to IFRS. They will prepare IFRS statements, and compute and compare financial ratios for both GAAP and IFRS statements. Finally, they will discuss the status of IFRS lease adoption and the impact of its adoption in the US. Since this case requires research into GAAP and IFRS pronouncements, it is most appropriate for students who have completed or are currently enrolled in intermediate financial accounting II. It can be used at the graduate or undergraduate levels in a variety of additional financial reporting courses including accounting theory, international accounting, and financial statement analysis, as well as an investment finance course.

CASE LEARNING OBJECTIVES

The case is designed to have students identify reporting issues and apply U.S. and international authoritative accounting literature by researching the FASB Accounting Standards Codification and the International Financial Reporting Standards (IFRS).

The specific learning objectives are for the student to:

- a) Identify differences in GAAP and IFRS treatment of leases:
- b) Prepare adjusting entries to convert GAAP based financial statements to IFRS income statement and balance sheet,
- d) Prepare an IFRS income statement, cash flow statement and balance sheet and
- e) Calculate several ratios to illustrate the impact adopting IFRS accounting for leases could have on them.

Suggested Teaching Approach

The case may be offered as an individual case study or as a group project. For more advanced accounting students, this case should be an individual project. It could have a weight of 10-15 % of the final course grade. When offered as an individual project, students will need three to six hours to research and prepare the case solution.

For less advanced students, the case may be offered as a collaborative group project. This would enable students to demonstrate and develop team-working skills. The case presents an opportunity to discuss the status of IFRS implementation in the US and the impact IFRS had on ACE Corp. The in-class review of the solution and case discussion can be completed as part of a 50-minute class.

In grading the case write-ups, instructors should evaluate the identification of relevant issues, proper accounting for the IFRS conversion and computation of the ratios including the computational accuracy of numbers, quality and depth of research as evidenced by proper citations of the literature. We suggest that the instructor explain the basis for grading at the outset.

Pointers for Classroom Discussion

After the review of the IFRS statements, the instructor may wish to discuss the impact of IFRS. Suggested questions to ask the class are: What impact will IFRS have on ACE Corp.'s income statement, cash flow statement and balance sheet? What are the benefits of adopting IFRS? What are the disadvantages of IFRS?

You may wish to have students research the status of the FASB/IASB discussions on leases..

SUGGESTED SOLUTION

Question 1: Differentiate between an operating lease and a Capital/ Financing Lease for financial reporting purposes.

Solution 1: Operating lease payments are treated as rent expense and recorded on the income statement. An operating lease is an off balance sheet transaction and is preferred by companies because it lowers liabilities, the debt ratio and does not result in “frontloading expenses” in the early years as does a capital lease.

A GAAP capital lease is treated as a purchase of Property, Plant and Equipment and, therefore, capitalized on the Balance Sheet. Capital leases are termed “financing (or finance) leases” under IFRS. The present value of minimum lease payments required on the lease are recorded as a liability on the balance sheet. The discount rate is the lessee’s incremental borrowing or the implicit rate of the lease, if it is lower and known by the lessee. The liability is separated into its current and long-term components, which affects the current ratio.

Pointers for Classroom Discussion

Discuss the differences between rules based US GAAP versus principles based IFRS requirements for distinguishing between operating versus capital/financing leases.

Question 2: Under US GAAP, is the lease treated as a capital lease / financing lease or an operating lease?

Solution 2: Under GAAP, if the lessee has a noncancelable lease and meets at least one of the four tests listed below, the lease is treated as a capital lease; otherwise, it is an operating lease.

Test 1: Transfer of Ownership Test: If at the end of the lease term, ownership transfers to lessee, then this test is satisfied. Test 1 is not met in this case, as there is no transfer of ownership at the end of 2014.

Test 2: Bargain Purchase Option: If the lessee has the option to purchase the lease at a bargain purchase price, then this test is satisfied. In this case, there is no purchase option (bargain or not), so test 2 is not met.

Test 3: Economic Life Test: If the lease term is equal to or greater than 75% of the economic life of the asset, it is a capital lease. In this case, the lease term is 36 months divided by the economic life of 49 months, yields 73%; Test 3 is not met.

Test 4: Economic Recovery Test: If the present value of the minimum lease payments is 90 percent or greater of the fair market value of the asset then it is a capital lease. In this case, the present value of the minimum lease obligation is \$26,730 (see Table 3). This divided by the fair market value of the leased asset of \$30,000 is 89 percent; just shy of the 90% requirement. Test 4 is not met.

Since none of the four tests is met, the lease is treated as an operating lease to the ACE Corp. under US GAAP. Note should be made that ACE just missed some of these tests by fractional amounts.

Table A: Minimum Lease Payments

Date	Payment	Interest (6%)	Principal	Liability Balance
Jan. 2, 1012				\$ 26,730
Dec. 31, 2012	\$ 10,000	\$ 1,604	\$ 8,396	18,334
Dec. 31, 2013	10,000	1,100	8,900	9,434
Dec. 31, 2014	<u>10,000</u>	<u>566</u>	<u>9,434</u>	0
Totals	<u>\$ 30,000</u>	<u>\$ 3,270</u>	<u>\$ 26,730</u>	N/A

Table A shows the interest and principle payments for each year of the lease. It also shows the liability at the end of each year. The interest expense is the beginning of the year lease obligation multiplied by the 6% interest rate.

Pointers for Classroom Discussion

Discuss why a corporation has an incentive for making a lease classification as operating rather than capital. The reasons, as discussed above are avoiding recording current and noncurrent liabilities and the frontloaded expenses in the early years; however, there is one positive aspect of a capital lease – under operating leases, the lease payment is classified as an operating cash payment which reduces cash from operating activities. As a capital lease the interest part of the lease payment is classified as an operating activity but the principal reduction payment is classified as financing. Treatment under IFRS of the cash payment on a finance lease is the same.

Question 3: Under IFRS, should this lease be classified as an operating lease or a financing lease?

Solution 3: Under IFRS, this lease is clearly a financing/capital lease as the criteria of lease type is based on principles, and not rules. Under IFRS, if the lessee assumes the economic benefit and risks of the leased asset, and the facts of the situation are such that the lease resembles a financing lease, then it is treated as a financing lease. The fact that this machine is specialized in nature for ACE’s use, and many of the tests under GAAP are nearly met are indicators of a finance lease rather than operating lease. The lessor manufactured this equipment to ACE’s specifications and in effect transferred the risk to ACE upon the inception of the lease. Further, ACE was able to circumvent the capital lease rules under GAAP by making estimates work to its advantage.

Question 4: Describe the different reporting results between GAAP and IFRS and make the necessary adjusting entries to conform the financial statements to IFRS compliance for 2012.

Solution 4: In each of the three years of the lease, GAAP treats the operating lease payment of \$10,000 as rent expense on the income statement and no liability is recorded on the balance sheet.

A: Year of lease Inception (2012):

Under IFRS, the financing/ capital lease is treated as a purchase of property, plant and equipment and capitalized on the balance sheet as such for \$26,730. Additionally, the minimum lease obligation is shown on the balance sheet as a liability of \$18,334 (\$26,730 less the year 1 payment of \$8,396). Of this amount, \$8,900 is classified as a current liability and \$9,434 is classified as a long term liability. On the income statement, depreciation expense is \$8,910 (26,730 divided by the lease term of 3 years) and interest expense is \$1,604, for a total of \$10,514.

B: Subsequent to Year of Inception - 2013 and 2014 of lease payments:

IFRS: The \$10,000 lease payment is treated as an interest expense as calculated above; \$1,100 in 2013 and \$566 in 2014 in addition to a depreciation expense of \$8,910. Over the 3-year period, the total expense will be the same (\$30,000) under both methods of reporting (operating v. capital/financing.)

ADJUSTING ENTRIES 2012 TO CONFORM TO IFRS

- 1- This is a summary journal entry that records the leased asset as a capital lease, records the current and noncurrent portions of the lease liability (as of December 31, 2012), and “reclassifies” the December 31, 2013 lease payment from rent expense to interest expense and a reduction of the lease liability.

Lease asset	26,730	
Interest expense	1,604	
Lease obligation – current liability		8,900
Lease obligation – noncurrent liability		9,434
Selling and administrative expenses	10,000	

- 2- This entry records the leased asset amortization expense for 2012. using straight line amortization.

Amortization expense	8,910	
Accumulated amortization		8,910

3. This entry reclassifies the extraordinary loss into the body of the income statement, see the discussion below (in 4) for the reason. The income tax effect of the loss is also discussed in 4, below.

Loss from hurricane	20,000	
Extraordinary loss from hurricane		20,000

There is no prompt in the case for the reclassification in 3. Students must demonstrate critical thinking by identifying that IFRS does not allow for the use of an extraordinary item. It is important to point out that we should not be so focused on one issue (lease treatment) that we overlook other issues that should be apparent.

- 3a. Entry 3 assume that ACE made the following entries during 2012 when the loss, insurance recovery and related tax savings were recorded:

Cash	10,000	
Accumulated depreciation	6,000	
Extraordinary loss from hurricane	20,000	
Property, plant and equipment		36,000
Income tax payable	6,000	
Tax savings from hurricane loss		6,000

The tax savings was netted against the extraordinary loss on the US GAAP.

4. This entry reclassifies taxes saved from the hurricane loss (which GAAP netted with the extraordinary loss, but IFRS would include with income tax expense); the entry also records the deferred tax effect of switching to IFRS for public reporting purposes, but not switching for income tax purposes.

Tax savings from hurricane loss	6,000	
Deferred income taxes	154	
Income tax expense		6,154

Adjusting entry 4 assumes ACE made the following summary entry to record income taxes in 2012:

Income tax expense	15,000	
Deferred income taxes		1,000
Tax savings from hurricane loss		6,000 (netted against the hurricane loss)
Income taxes payable		1,000
Cash		7,000

It also assumes that ACE would continue to report the lease as a operating lease for income tax purposes, therefore the tax ACE owed for 2012 would not change, but there would be a reduction of deferred income taxes for the tax rate times the difference between the expenses reported under a financing lease (amortization expense plus interest expense) and the rent expense reported under an operating lease [30% * (8,910+1,604)-10,000].

Pointers for Classroom Discussion

Show that under capital/financing lease treatment, the expense will be greater in the early year(s), resulting in lower income, and lower in the latter year(s), showing a higher income. In the entire term of the lease, each method will yield identical expense totals. Use of the amortization schedule will illustrate this clearly. However, it is worth pointing out that the IFRS treatment of a financing lease is favorable to the company's reported cash from operating activities on the cash flow statement.

Question 5A: Prepare an Income Statement under IFRS for 2012. Assume that the net income remains the same under IFRS as it does for GAAP and any difference is reconciled in the tax expense and tax payable accounts.

Solution 5A:

Table B: ACE Corp. IFRS Income Statement for the Year Ended December 31, 2012

ACE Corporation		
Income Statement (in 000, except per share data)		
For the Year Ended December 31, 2012		
Sales		\$270,000
Cost of goods sold		<u>(175,000)</u>
Gross profit		95,000
Selling and administrative expenses	31,000 – 10,000(1) = 21,000	
Amortization and depreciation expense	10,000 + 8,910 (2) = 18,910	
Interest expense	4,000 + 1,604 (1) = 5,604	
Loss from hurricane	(3) <u>20,000</u>	<u>(65,514)</u>
Income before taxes		29,486
Income tax expenses	15,000 – 6,154 (4) =	<u>(8,846)</u>
Net Income		<u>\$ 20,640</u>
<u>Earnings per share:</u>		<u>\$1.03</u>

Table B shows the impact on the income statement of the conversion to IFRS. The numbers in parenthesis refer to the adjusting entry made to record the conversion to IFRS.

Table D presents the Cash Flow Statement under IFRS using the Direct Method.

Question 5B: Prepare a Balance Sheet under IFRS for 2012.**Solution 5B:**

Table C: ACE Corp. IFRS Balance Sheet as of December 31, 2012.

ACE Corporation		
Balance Sheet (in 000 except par value) using IFRS		
As of December 31, 2012 and 2011		
	2012	2011
ASSETS		
Intangible Assets		
Trademark	\$5,000	\$7,000
Goodwill	<u>7,000</u>	<u>7,000</u>
Total Intangible Assets	12,000	\$14,000
Noncurrent Assets		
Property, Plant and Equipment ¹	\$126,730	
less Accumulated Depreciation & Amortization ²	<u>(38,910)</u>	136,000
	87,820	<u>(28,000)</u>
Security Available for Sale	<u>10,000</u>	0
Total Noncurrent Assets	97,820	108,000
Current Assets		
Inventory (FIFO)	50,000	21,000
Accounts Receivable (net)	25,000	17,000
Cash	33,000	<u>19,000</u>
Total Current Assets	<u>108,000</u>	<u>57,000</u>
Total Assets	<u>\$217,820</u>	<u>\$179,000</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
EQUITY		
Share capital	\$20,000	\$18,000
Share premium	30,000	17,000
Retained earnings *	59,640	<u>51,000</u>
Total Shareholders' Equity	<u>\$109,640</u>	\$86,000
LIABILITIES		
Noncurrent Liabilities		
Lease obligation – noncurrent liability ³	9,434	0
Deferred income taxes ⁴	4,846	4,000
Bonds Payable	45,000	<u>45,000</u>
Total noncurrent liabilities	<u>59,280</u>	49,000
Current liabilities		
Accounts payable	18,000	17,000
Accrued interest	2,000	2,000
Accrued operating expenses	13,000	19,000
Income taxes payable	7,000	6,000
Lease obligation – current liability ⁵	<u>8,900</u>	0
Total current liabilities	<u>48,900</u>	<u>44,000</u>
Total Liabilities	<u>90,000</u>	<u>93,000</u>
Total Liabilities and Shareholders' Equity	<u>\$217,820</u>	<u>\$179,000</u>

Table C shows the IFRS Balance Sheet after conversion. Where adjustments were necessary, they are indicated next to the account. Note that IFRS recommends listing accounts in reverse order of liquidity. The common stock is shown as share capital and additional paid in capital as share premium.

¹ $100,000 + 26,730 (1) = 126,730$ * Retained earnings Dec. 31, 2011 \$51,000

² $30,000 + 8,910 (2) = (38,910)$ IFRS net income 20,640

³ (1) \$9,434 Dividends declared -12,000

⁴ $\$5,000 - 154 (4) = 4,846$ Retained earnings Dec. 31, 2012 \$59,640

⁵ $8,900 (1) = 8,900$

The numbers in parenthesis refer to the adjusting entry made to record the conversion to IFRS

Table D: ACE Corp. IFRS Cash Flow Statement as of December 31, 2012

ACE Corporation		
Cash Flow Statement (in 000) using IFRS		
For the Year Ended December 31, 2012		
Cash from Operating Activities		
Cash collected from customers ¹		262,000
Cash paid for inventory ²		(203,000)
Cash paid for selling and administrative costs ³		(27,000)
Cash paid for income taxes ⁴		<u>(7,000)</u>
Net Cash from Operating Activities		25,000
Cash from Investing Activities		
Insurance proceeds ⁵	\$10,000	
Purchase securities available for sale ⁶	<u>(10,000)</u>	
Net Cash from Investing Activities		-0--
Cash from Financing Activities		
Issue common stock ⁷	15,000	
Cash paid for interest ⁸	(5,604)	
Payment on financing lease ⁹	(8,396)	
Pay dividends	<u>(12,000)</u>	
Net Cash from Financing activities		<u>(2,604)</u>
Net increase in cash		\$14,000
Cash December 31, 2011		<u>19,000</u>
Cash December 31, 2012		<u><u>\$33,000</u></u>

Noncash investing and financing activity: Ace recorded a \$26,730 finance leased asset. (This could also be disclosed in the notes to the financial statements.)

¹ Sales	\$270,000	² Cost of goods sold	\$(175,000)
Increase in acct. rec.	<u>(8,000)</u>	Increase in inventory	(29,000)
	<u>\$262,000</u>	Increase in acct. pay.	<u>+ 1,000</u>
			<u><u>\$(203,000)</u></u>
³ Selling & admin. exp.	\$(21,000)	⁴ Income tax expense	\$(8,846)
Dec. in accrued oper. exp.	<u>(6,000)</u>	Increase in income tax payable	1,000
	<u><u>\$(27,000)</u></u>	Increase in deferred tax liability	<u>846</u>
			<u><u>\$(7,000)</u></u>
⁵ Given in case		⁶ Given in case	
⁷ Chance in common stock (share premium)	\$ 2,000	⁸ Interest expense	\$(5,604)
Change in APIC (share premium)	<u>13,000</u>	Change in interest payable	<u>0</u>
			<u><u>\$(5,604)</u></u>

Question 6: Ratio Calculations on December 31, 2012

Solution 6:

	<u>GAAP</u>	<u>IFRS</u>
Current Ratio=current assets/current liabilities	2.70	2.21
\$108,000/\$40,000		\$108,000/\$48,900
Quick Ratio=current assets-inventory/current liabilities	1.45	1.19
(108,000-50,000)/40,000		(108,000 – 50,000)/48,900
Cash Ratio=cash/current liabilities	0.83	0.67
33,000/40,000		33,000/48,900
Times Interest Earned =EBIT/ Interest Expense	8.50	8.83
34,000/4,000		49,486/5,604
Debt to Capital Ratio=Total Liabilities/Total Assets	0.45	0.50
90,000/200,000		108,180/217,820
Debt to Shareholder Equity Ratio=Liabilities/Shareholder' Equity	0.82	0.99
90,000/110,000		108,180/109,640

Financial ratios: The ratios presented above compare the effects of using US GAAP versus IFRS. Solution 7 presented below, provides an overview conclusion of the effects of using US GAAP versus IFRS and the resulting financial consequences on these key 6 ratios.

Question 7: Comments

Solution 7: The ratios clearly indicate that IFRS rules result in more conservative ratio results with respect to the current and long-term creditor when compared to US GAAP. Every liquidity ratios is lower under IFRS and the differences are significant. Similarly, all long-term ratios are also more conservative when compared to US GAAP. The implications here is that IFRS will have far greater negative implications on bond covenant agreements as well as other long and short-term creditor legally binding agreements than US GAAP.

CONCLUSION

IFRS is the future of worldwide financial reporting and should be included as a major part of any accounting and/or business curriculum in the US, as well as the rest of the world. This case illustrates a situation where a Balance Sheet and Income Statement is prepared using GAAP as a basis and converted to IFRS for comparison purposes, with the focus being from the creditor point of view. In this case study, IFRS rules are discussed, and key lease GAAP and IFRS accounting similarities and differences are addressed and the implications on the corporation's creditors.

BIOGRAPHY

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