Vol. 19 No. 1 January 2016

2 Bloor Street West, Suite 2603, Toronto, Ontario M4W 3E2
Telephone: (416) 961-5612 Fax: (416) 961-6158
E-mail: valuators@marmerpenner.com

Marmer Penner Inc. Newsletter

Written by Pier Sperti, BBA, CPA, CA, CBV
Edited by Steve Z. Ranot, CPA, CA•IFA, CBV

The Hidden Truth: When Accounting Policies Affect the Valuation Exercise

Readers of financial statements should be aware that not all financial statements are presented in the same manner. There are a number of accounting standards that can be used for reporting purposes, one of which is known as the Accounting Standards for Private Enterprises (ASPE). ASPE was introduced a number of years ago to better serve the purposes of smaller, privately held enterprises. In this edition, we focus on ASPE as these represent the financial statements provided to us by most of our clients.

Companies using ASPE will not necessarily record similar transactions in the same way, as those standards allow for the adoption of different accounting policies for the reporting of assets, liabilities and income figures.

Consider the valuation of Opco, a company that builds roads and bridges for municipalities. In its year ended December 31, 2015, Opco was in the middle of completing a $10 million contract. The company had completed half of the work and billed $5 million. As is customary in construction related services, the municipality held back 10% or $500,000 until successful completion and inspection of the project. Assuming no other expenses and a 20% tax rate, one would expect Opco's statement of income to report $5 million of pre-tax income less

$1 million of tax. Its balance sheet at December 31, 2015 would be expected to look as follows:

Assets		**Liabilities**	
Cash	$4,500,000	Taxes payable	$1,000,000
		Equity	
Holdback receivable	500,000	Retained earnings	4,000,000
	$5,000,000		$5,000,000

However, under ASPE, the company can adopt an accounting policy where income taxes are accounted for by using the taxes payable method under which the company reports as an expense only the cost of current income taxes.

Based on this accounting policy, no tax expense would be recorded on the $500,000 holdback receivable, thereby lowering tax by $100,000 and increasing after-tax income to $4.1 million. The balance sheet would look as follows:

Assets		**Liabilities**	
Cash	$4,500,000	Taxes payable	$900,000
		Equity	
Holdback receivable	500,000	Retained earnings	4,100,000
	$5,000,000		$5,000,000

The balance sheet of the company in the above example would overstate equity by $100,000 since it ignores the 20% deferred tax on the uncollected holdback receivable. For valuation purposes, such a liability must be considered as it is both imminent and known and the full amount of revenue of $5M has already been recorded on Opco's income statement.

Now, let's assume that Opco adopts an accounting policy which allows for revenue from contracts to be recorded as income on a completed contract basis. This is permitted under ASPE.

As Opco progress-bills and collects on all of its contracts, the amount of revenue is not recognized in income until completion of the contract. In that case, the balance sheet would look like this:

Assets		**Liabilities**	
Cash	$4,500,000	Unearned revenue	$5,000,000
		Equity	
Holdback receivable	500,000	Retained earnings	0
	$5,000,000		$5,000,000

Same company. Different accounting policies applied under ASPE. As a result, you see vastly different looking financial statements. You are probably thinking that the third set of financial statements indicate no retained earnings because of unbilled work in progress ("WIP") and that this would be discovered upon asking for the quantum of unbilled WIP at year end. Guess what? Both companies have no unbilled WIP. It's all just a matter of which accounting policy they follow.