**AGRANA'S JOINT VENTURES**

**TEACHING NOTE**

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**Critical Incident Overview**

Claire McNutt is considering investing in AGRANA Group in an effort to diversify her stock portfolio. In the process of reviewing AGRANA's latest annual report, she discovers an accounting method, proportionate consolidation, about which she knows nothing. She consults with a friend of hers who works in the international division of a consulting firm to find out what effect this method has on the financial statements, and why AGRANA Group is allowed to use this method. With a better understanding of proportionate consolidation, she determines that she must adjust the financial statements as if the company had used the equity method of accounting for joint ventures in order to make an investment decision.

**Suggested Courses**

This incident is appropriate for use in advanced financial accounting, financial statement analysis, or international accounting courses.

**Research Methods**

This critical incident was written based on information obtained from the company's website and annual report. The names of the individuals have been disguised to preserve anonymity.

**Learning Objectives**

After studying this critical incident, students will be able to:

1. Define joint ventures.

2. Discuss the accounting for joint ventures under International Financial Reporting Standards (IFRS) effective during 2012 and also under United States Generally Accepted Accounting Standards (U.S. GAAP).

3. Demonstrate the accounting for joint ventures using the equity method.

4. Illustrate the financial reporting differences between the two methods.

5. Evaluate which method is most useful for financial analysis.

**Questions**

1. (LO 1) What is a joint venture?

2. (LO 2) Until IAS No. 31 is revised by IFRS #11 (effective for fiscal years beginning after January 1, 2013) what methods are available to firms preparing financial statements in accordance with IFRS to account for joint ventures?

3. (LO 2) What method is used to account for joint ventures when preparing financial statements according to U.S. GAAP?

4. (LO 3) Assume that AGRANA acquired all its joint ventures on February 29, 2012 with the fair market values of AGRANA's share shown on the table under *Note 3 Scope of Consolidation* "Joint ventures" (ignore the revenue, expense and profit for the fiscal year ended February 29, 2012), there was no goodwill involved, and AGRANA chose to use the proportionate consolidation method to account for all the joint ventures. Prepare the journal entries to account for acquiring its investment in the joint ventures. What if AGRANA used the equity method? Prepare the journal entry to record the acquisition using the equity method.

5. (LO 3) Use the same assumptions as in question 4 above. Prepare the journal entries to record the revenue, expense and profit, as well as changes in the balance sheet accounts for the fiscal year ended on Feb. 28, 2013 for the company’s investments in joint ventures. What if AGRANA used the equity method? Prepare the journal entries as if AGRANA used the equity method.

6. (LO 4) Using your results from questions 4 and 5 above, prepare an adjusted income statement and balance sheet for fiscal year 2013 as if the company had employed the equity method for accounting for joint ventures. Compare these results to the reported income statement and balance sheet for fiscal year 2013.

7. (LO 5) Using the 2013 financial statements compared in 6 above compute the following ratios for AGRANA utilizing the information employing a) the proportionate consolidation method (as reported), and b) the equity method (as adjusted) : Current ratio, quick ratio, return on assets, profit margin, asset turnover, return on equity, and total liabilities to total assets. (Use year-end values for balance sheet items included in your calculations.) Under what conditions would proportionate consolidation be more informative for purposes of financial statement analysis?

**Questions and Answers**

**1. (LO 1) What is a joint venture?**

A joint venture is a business enterprise entered into by two or more parties (the parties are usually corporations, but do not have to be) who pool resources to pursue a specific project or for a specific purpose, such as research and development in a specialized area. The joint venture is a separate entity apart from the parties who created it. Usually the venture is of a limited life; that is, once the specific purpose has been met, the venture will be discontinued. The parties typically share decision making for the venture as well as the resulting profits or losses. Examples are two pharmaceutical companies forming a joint venture to conduct research and development of a specific vaccine, or two or more oil and gas companies forming a joint venture to refine petroleum into specific products, the output of the refinery being shared by the oil and gas companies on an as-needed basis, with each party to the venture committing to purchase a minimum amount of output per year.

The venture may be financed by resources contributed by the venturers (parties to the joint venture) in the case of those formed for research and development purposes, or may use the purchase commitments as collateral for outside financing in the case of the refinery joint venture.

**2. (LO 2) Until IAS No. 31 is revised by IFRS #11 (effective for fiscal years beginning after January 1, 2013) what methods are available to firms preparing financial statements in accordance with IFRS to account for joint ventures?**

Under IAS No. 31 venturers can choose to account for their proportionate share of a joint venture either by using the equity method or using proportionate consolidation. When using proportionate consolidation, the venturer includes its share of the joint venture's accounts with its own accounts on an item-by-item basis. Thus, the individual assets, liabilities, retained earnings, revenues and expenses of the venturer will be increased by the venturer's proportionate share of the joint venture's accounts.

**3. (LO 2) What method is used to account for joint ventures when preparing financial statements according to U.S. GAAP?**

The only method allowed by U.S. GAAP is the equity method for accounting for investments in joint ventures.

**4. (LO 3) Assume that AGRANA acquired all its joint ventures on February 29, 2012 with the fair market values of AGRANA's share shown on the table under *Note 3 Scope of Consolidation* "Joint ventures" (ignore the revenue, expense and profit for the fiscal year ended February 29, 2012), there was no goodwill involved, and AGRANA chose to use the proportionate consolidation method to account for all the joint ventures. Prepare the journal entries to account for acquiring its investment in the joint ventures. What if AGRANA used the equity method? Prepare the journal entry to record the acquisition using the equity method.**

**Proportionate consolidation method:**

(€000)

|  |  |  |  |
| --- | --- | --- | --- |
|  |  | **DR** | **CR** |
| Non-current assets  Inventories  Receivables and other assets  Cash, cash equivalents and securities | | 99,536 |  |
| 25,571 |  |
| 79,628 |  |
| 10,055 |  |
|  | Non-current liabilities |  | 10,104 |
|  | Current liabilities |  | 113,557 |
|  | Cash |  | 91,129 |

**Equity method:**

(€000)

|  |  |  |  |
| --- | --- | --- | --- |
|  |  | **DR** | **CR** |
| Investment in joint ventures | | 91,129 |  |
|  | Cash |  | 91,129 |

**5. (LO 3) Use the same assumptions as in question 4 above. Prepare the journal entries to record the revenue, expense and profit, as well as changes in the balance sheet accounts for the fiscal year ended on Feb. 28, 2013 for the company’s investments in joint ventures. What if AGRANA used the equity method? Prepare the journal entries as if AGRANA used the equity method.**

**Proportionate consolidation method:**

(€000)

|  |  |  |  |
| --- | --- | --- | --- |
|  |  | **DR** | **CR** |
| Inventories  Cash, cash equivalents and securities  Noncurrent liabilities  Current liabilities  Equity  Expenses | | 838 |  |
| 7,906 |  |
| 4,752 |  |
| 12,996 |  |
| 25,163 |  |
| 331,867 |  |
|  | Revenues |  | 358,580 |
|  | Noncurrent assets |  | 4,868 |
|  | Receivables and other assets |  | 20,074 |

**Equity method:**

(€000)

|  |  |  |  |
| --- | --- | --- | --- |
|  |  | **DR** | **CR** |
| Investment in joint ventures | | 26,713 |  |
|  | Investment revenue |  | 26,713 |

|  |  |  |  |
| --- | --- | --- | --- |
|  |  | **DR** | **CR** |
| Cash | | 25,163 |  |
|  | Investment in joint ventures |  | 25,163 |

Note that total equity of the joint ventures increased by only € 1,550 (in thousands) but that profit for the period from the joint ventures was € 26,713. With the assumptions stated in the question, this would indicate that the joint ventures made payments (distributions) to AGRANA of € 25,163.

**6. (LO 4) Using your results from questions 4 and 5 above, prepare an adjusted income statement and balance sheet for fiscal year 2013 as if the company had employed the equity method for accounting for joint ventures. Compare these results to the reported income statement and balance sheet for fiscal year 2013.**

**Income Statement**

|  |  |  |
| --- | --- | --- |
| €000 | **As reported**  **2012/13** | **Equity method**  **2012/13** |
| Revenues (\*\*\*) | 3,170,949 | 2,839,082 |
| Cost of materials and other operating costs | 2,953,126 | 2,621,259 |
| Operating profit | **217,823** | **217,823** |
| Finance income | 16,475 | 16,475 |
| Finance expense | (44,131) | (44,131) |
| Net financial items | **(27,656)** | **(27,656)** |
| Profit before tax | **190,167** | **190,167** |
| Income tax expense | (33,685) | (33,685) |
| Profit for the period | **156,482** | **156,482** |

**Balance Sheet**

|  |  |  |
| --- | --- | --- |
| €000 | **As reported**  **2012/13** | **Equity method**  **2012/13** |
| Investment in joint ventures | -0- | 92,679 |
| Other non-current assets | 1,097,794 | 1,003,126 |
| Inventories | 851,492 | 825,083 |
| Receivables and other assets | 483,355 | 423,801 |
| Cash, cash equivalents and securities | 145,607 | 127,646 |
| Current assets | 1,480,454 | 1,376,530 |
| **Total assets** | **2,578,248** | **2,472,335** |
|  |  |  |
| Equity | 1,212,096 | 1,212,096 |
| Non-current liabilities | 519,139 | 513,787 |
| Current liabilities | 847,013 | 746,452 |
| **Total equity and liabilities** | **2,578,248** | **2,472,335** |

(\*\*\*) Note that total reported revenues are calculated as the sum of the following items on the consolidated income statement: revenue, changes in inventories of finished and unfinished goods, own work capitalized and other operating income.

Student answers will vary, however, the following general comments might be included:

* Income Statement Observations
  + Revenues and costs of materials and other operating costs are €331,86 thousand less under the equity method than as reported. This amount represents that total joint ventures’ expenses for the period.
  + All other income statement items are the same under the equity method and proportionate consolidation method including operating profit and total profit for the period.
* Balance Sheet Observations
  + Total assets and total equity and liabilities are €105,913 thousand less under the equity method than as reported. This amount represents the net effect of adding AGRANA’s share of the joint ventures’ assets, liabilities and equity under the proportionate consolidation method.
  + Total equity remains the same under both the proportionate consolidation and equity methods.

**7. (LO 5) Using the 2013 financial statements compared in 6 above compute the following ratios for AGRANA utilizing the information employing a) the proportionate consolidation method (as reported), and b) the equity method (as adjusted) : Current ratio, quick ratio, return on assets, profit margin, asset turnover, return on equity, and total liabilities to total assets. (Use year-end values for balance sheet items included in your calculations.) Under what conditions would proportionate consolidation be more informative for purposes of financial statement analysis?**

|  |  |  |
| --- | --- | --- |
| €000 | **As reported**  **2012/13** | **Equity method**  **2012/13** |
| Current ratio | 1.75 | 1.84 |
| Quick ratio | 0.74 | 0.74 |
| Return on assets | 6.1% | 6.3% |
| Profit margin | 4.9% | 5.5% |
| Asset turnover | 1.23 | 1.15 |
| Return on equity | 12.9% | 12.9% |
| Total liabilities to Total assets | 53.0% | 51.0% |

Student answers will vary, however, the following general comments might be included:

* Regardless of method used for accounting for joint ventures, the quick ratio and return on equity ratio are the same, as the underlying data are the same for the computation of these ratios.
* The current ratio, return on assets, profit margin, asset turnover and total liabilities to total assets ratios will differ under the two methods due to the increase in assets, liabilities and equity included in the proportionate consolidation method to represent the company’s share of joint ventures. Therefore, the financial health of the underlying joint ventures will drive the changes in these ratios. Thus, it is imperative that a user of this data understands the accounting methodology employed to ensure they are comparing “apples to apples” when trying to make an informed decision.

**Suggested References**

Hoyle, Joe B., Thomas F. Schaefer, Timothy S. Doupnik. Advanced Accounting. McGraw-Hill Irwin, 2013.

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Stickney, Clyde P., Paul R. Brown, and James M. Wahlen. Financial Reporting, Financial Statement Analysis, and Valuation: A Strategic Perspective. 6th edition, Thomson South-Western, 2007.