

FINANCIAL 1 CLASS NOTES

Welcome to **Financial Accounting & Reporting**. This exam has a reputation as being demanding and the relative size of our four textbooks shows why. Most students find these topics to be the more challenging:

- Consolidations and Investments [F-3]
- Leases [F-5]
- Bonds and Long-Term Liabilities [F-5]
- Pensions [F-6]
- Accounting for Income Taxes [F-6]
- Governmental and Not-for-Profit [F-8 and F-9]

The AICPA Content Specifications for FARE break down the exam into the following general areas and approximate percentages of exam points:

1. Concepts and standards for financial statements (17%-23%)
2. Typical items – recognition, measurement, valuation and presentation in financial statements (27%-33%)
3. Specific types of transactions and events – recognition, measurement, valuation and presentation in conformity with GAAP (27%-33%)
4. Accounting and reporting for governmental entities (8%-12%)
5. Nongovernmental not-for-profit entity accounting (8%-12%)

Financial 1 includes the following:

I. SOURCES OF GAAP AND BASIC FRAMEWORK AND CONCEPTS

- A. The hierarchy of sources is important, especially Category A (BOSSII).
- B. Terminology is key here - know the components of **relevance** and **reliability** (PFT and NRFV).

II. REPORTING NET INCOME

- A. Income Statement is an important topic.
 1. Know the **IDEA** mnemonic
 - I: **income** from continuing operations
 - D: income from **discontinued** operations
 - E: **extraordinary** items
 - A: **accounting principle** change (to R/E)

III. DISCONTINUED OPERATIONS

- A. Accounting for discontinued operations can consist of gain or loss on **current year's operations**, gain/loss on **sale** and **impairment loss**. Discontinued operations are shown net of tax.
 - 1. Any of these must be reported as part of discontinued operations in the year incurred. If the operations are being "**held for sale**," they are treated as discontinued.

IV. EXTRAORDINARY ITEMS

- A. Extraordinary items must be *unusual and infrequent*. "Unusual" requires the event be unrelated to the typical business activities of the firm. "Infrequent" means the event is not expected to occur again in the foreseeable future. They are shown "net of tax."
 - 1. Unusual or infrequent items are reported within the "upper" (I) part of the income statement and before tax.

V. ACCOUNTING CHANGES

- A. Accounting changes appear in three varieties: estimate, principle and entity.
 - 1. **Changes in estimates**, such as the useful life of a plant asset, are incorporated into the accounting records for the **current and future periods**. No adjustment of prior financial statements is required. A change in depreciation method is a change in accounting principle that is inseparable from a change in estimate, and is accounted for as a change in estimate.
 - 2. **Changes in principle** (or method) involve switching from one acceptable method to another. The cumulative effect is the change in retained earnings that results from restating prior years from the "old" method to the "new" method at the **beginning** of the earliest year presented. The **cumulative effect** is reported in the statement of retained earnings, net of tax.
 - a. **Changes in principle - Exception:**

When it is **impracticable to estimate** the change in retained earnings that would result from restating the prior years financial statements, the change in method is applied prospectively [like changes in estimate]. In this case, no restatement of prior years occurs and there is no cumulative effect reported in the statement of retained earnings: e.g., changing to LIFO from any other inventory method.
 - 3. **Change in entity** requires restatement of prior year's financial statements to conform with the new accounting entity when the prior financials are presented comparatively.

VI. PRIOR PERIOD ADJUSTMENTS (CORRECTIONS OF ERRORS)

- A. Reported net of tax in the statement of retained earnings.

VII. COMPREHENSIVE INCOME

- A. Comprehensive Income includes all changes in owners' equity **other than transactions with owners**. The formula shows that comprehensive income must include net income plus/minus other changes in owners' equity not resulting from transactions with owners. These other changes are known as "other comprehensive income" items.
- B. The mnemonic "**PUFE**" shows the four commonly tested sources of "other comprehensive income."
 - **Pension** funded status changes; covered in F6.
 - **Unrealized** gains and losses on AFS securities; covered in F3.
 - **Foreign** currency translation items; covered in F2.
 - **Effective** portion of cash flows hedges; covered in F7.
- C. Accumulated other comprehensive income is a cumulative sum of all of the individual components of other comprehensive income. Accumulated other comprehensive income is an owners' equity item.
- D. There are three acceptable ways to present the statement of comprehensive income.

VIII. BALANCE SHEET AND DISCLOSURES OVERVIEW

- A. Review the terminology and be able to recognize a **classified** balance sheet.
- B. The **Summary of Significant Accounting Policies** reflects the methods and policies employed by the firm.

IX. INTERIM FINANCIAL REPORTING

- A. Interim financial reporting uses the same GAAP as do annual financial reports. Timeliness is emphasized over reliability and income taxes are estimated each quarter based on the estimated average tax rate for the whole year.

X. SEGMENT REPORTING

- A. A reportable segment exists if it meets one of three tests:
 - 10% of **combined revenues** to internal and external parties.
 - 10% of **reported profit or loss** (as an absolute amount). You should be familiar with the definition of operating profit: Segment revenues from sales to internal and external customers less directly traceable costs and also less reasonably allocated costs equals segment operating profit (loss).
 - 10% of the **combined assets** of all operating segments.
- B. The "**75% reporting sufficiency test**" is a "catch all" requirement that may require identification of additional segments to attain the 75% level. This test requires that reportable segments total at least 75% of revenue from external parties.
- C. The "**90% single industry dominance test**" means if one segment individually contains 90% or more of the firm's revenues, profits **and** assets, then the segment reporting requirement is waived for that firm.

XI. DEVELOPMENT STAGE ENTERPRISES

- A. These firms have not yet started their primary operations or have generated insignificant revenues to date.
- B. Development stage enterprises use "regular GAAP" with a couple of differences regarding labeling and summation of cumulative reporting.

XII. FAIR VALUE MEASUREMENT

- A. Fair value is the price to sell an asset or transfer a liability in an orderly transaction between market participants, measured in the principal, or most advantageous, market for the asset or liability.
- B. Entities can use the market approach, the cost approach, or the income approach, or a combination of these approaches, when measuring fair value.
- C. The fair value hierarchy prioritizes the inputs used in the market, cost & income valuation techniques. Level I inputs have the highest priority and Level III inputs have the lowest priority.

FINANCIAL 2 CLASS NOTES

Financial 2 includes the following:

I. TIMING ISSUES: MATCHING CORRECTING AND ADJUSTING

- A. **Assets** are probable future economic benefits obtained as a result of past events and **liabilities** are probable future sacrifices of economic benefits. **Revenue** is recognized when earned and **expenses** when incurred and these two need to be **matched** in their appropriate period.
- B. **Deferrals**, such as **unearned** or **prepaid** accounts, push recognition of revenue and expense to future periods (**after** the related cash flow). **Accruals (receivables and payables)** recognize revenues and expenses **before** the related cash flow.
- C. **Franchise fees**, initial and continuing, are revenues to the franchisor and expenses to the franchisee. The initial franchise fee is recorded as an asset by the franchisee and expensed over the period benefited. It is revenue to the franchisor when earned. Continuing franchise fees are revenue to the franchisor and expense to the franchisee in the period incurred.

II. INTANGIBLE ASSETS

- A. Some intangibles are **identifiable** [copyrights and patents, e.g.] while one is unidentifiable [goodwill]. Purchased identifiable intangible assets should be recorded at cost plus additional expenditures necessary to purchase.
- B. Amortizing identifiable intangibles with finite lives is done over the shorter of the estimated economic life and the legal life. Goodwill and identifiable intangibles with indefinite lives are not **amortized** and are subject to impairment testing.

III. START-UP COSTS

- A. In financial accounting, start-up costs are expensed as incurred. [Note: tax rules permit these costs to be capitalized.]

IV. RESEARCH & DEVELOPMENT COSTS

- A. GAAP requires research & development expenditures be **expensed as incurred**.
 - 1. Assets with alternative future uses can be expensed over time.
 - 2. When parties contract for R&D services to be performed by another firm, the buyer of R&D will expense amounts as paid to the provider. The seller will expense costs as cost of goods sold.
 - 3. The text shows a list of items not considered R&D.

V. COMPUTER SOFTWARE DEVELOPMENT COSTS

- A. If to be sold, leased or licensed, the timeline in notes is the key. **Expense** development costs from concept to technological feasibility. **Capitalize** costs from technological feasibility through the start of selling activity. **Resume expensing** further development costs after selling has started.

1. Costs capitalized between technological feasibility and the start of selling are amortized using the greater of two methods: **percentage of revenue or straight-line**.
- B. If to be used **internally**, the development costs need to be amortized on the straight-line basis.

VI. IMPAIRMENTS

- A. Think of this as two impairment tests: **recoverability** and **calculating the impairment loss**.
 1. An asset fails the recoverability test if the asset's carrying value > the sum of future *undiscounted* net cash flows.
 2. Then, if the asset's carrying value > the asset's fair market value, the excess is the impairment loss.

VII. LONG-TERM CONSTRUCTION CONTRACTS

- A. Completed contract method recognizes income upon completion of job, it **does not match** revenues and expenses over long term.
- B. Percentage of completion method recognizes revenue as job is in progress based upon estimated profitability and cost estimates following a **four-step process**.
- C. **Both methods recognize estimated losses immediately.**

VIII. INSTALLMENT SALES & COST RECOVERY

- A. Installment sale method is used when collectibility cannot be reasonably estimated. Revenue is recognized as cash is collected **based on gross profit rate** at time of sale.
- B. Cost recovery method is more conservative than the installment method and is used when collectibility is more doubtful. Revenue is not recognized **until the cost of the asset sold is recovered**.

IX. ACCOUNTING FOR NONMONETARY EXCHANGES

- A. Exchanges **having commercial substance** affect future cash flows.
 1. Recognize gains/losses in the exchange based on the 'old' asset's carrying value in comparison to 'old' asset's fair value.
 2. New asset's carrying amount will always equal the fair value of the asset given plus cash paid (or minus cash received).
- B. Exchanges **lacking commercial substance** do not change future CF.
 1. All losses are recognized in these exchanges.
 2. Gains are not recognized in these exchanges unless boot (cash) is received.
 - a. If boot < 25% of total consideration, then recognize gain in proportion to the boot received.
 - b. If boot > 25% of total consideration, recognize all gain.

X. PARTNERSHIPS

- A. **Contributions** by a partner to a partnership are recorded at fair value less the present value of liabilities assumed by partnership.
- B. Admission of new partners may be by the **exact**, **bonus** or **goodwill** method. The **bonus** method adjusts the partners' capital accounts for any difference and the **goodwill** method adjusts the assets and the existing partners' capital accounts for the difference.
- C. **Withdrawals** of partners also use the bonus and goodwill methods.
- D. When a partnership is liquidated, assets are sold, gains or losses are allocated to partners, liabilities are paid and the partners are entitled to receive the **balance in their capital account**. Partners who wind up with debit (overdrawn) balances owe that deficiency to the partnership and the other partners.

XI. FINANCIAL REPORTING AND CHANGING PRICES

- A. Financial statements may be restated to demonstrate the effects of changes in purchasing power of the dollar or the current cost of specific items. GAAP financials are "**Historic Cost/Nominal Dollar**" and can be restated to **current costs** and/or **constant dollar**.
- B. Monetary assets and liabilities are "fixed" in terms of dollars while non-monetary assets and liabilities are not. Holding net monetary assets during inflation results in a **loss of purchasing power**.

XII. FOREIGN CURRENCY ACCOUNTING

- A. Foreign currency transactions are transactions denominated in a currency other than that used for financial reporting.
- B. Foreign currency transactions require adjusting the receivable or the payable at any year-end for changes in the dollar equivalent of the foreign currency denominated transaction since the transaction date. This adjustment records the gain or loss in the year when that gain or loss occurred.
- C. Foreign financial statement translation is a two-step process involving **remeasurement** to the functional currency and **translation** to the reporting currency (provided that the functional currency is not the reporting currency).
 - 1. Remeasurement gains and losses are reported on the income statement.
 - 2. Translation gains and losses are reported in other comprehensive income (PUFE).

FINANCIAL 3(A) CLASS NOTES

Financial 3 includes the following:

I. MARKETABLE SECURITIES

- A. Marketable securities have readily determinable fair values. These include equity and/or debt securities.
 - 1. There are three marketable securities portfolio classifications: **trading securities**, **available-for-sale** securities and debt securities intended to be **held until maturity**.
 - 2. The trading securities portfolio can contain debt and/or equity securities **intended for active trading**. The portfolio itself is carried at cost and is reported at fair value in the financial statements through the use of a valuation account. Unrealized gains or losses are reported on the income statement.
 - 3. The available-for-sale securities portfolio can contain debt and/or equity securities that **do not fit into either of the other two portfolios**. The portfolio itself is carried at cost and is reported at fair value in the financial statements through the use of a valuation account. Unrealized gains or losses are reported in Other Comprehensive Income (the “U” in PUFE).
 - 4. The held-to-maturity portfolio can contain only debt securities where the investor has the **ability and intent** to hold to maturity. The portfolio itself is reported in the financial statements at **amortized cost**.
 - 5. Special rules apply to **reclassifications** and **impairment**.

II. DETERMINING THE CORRECT METHOD TO USE

- A. Use the cost method when the investor **cannot exercise significant influence** over the investee - generally ownership of **less than 20%** of outstanding voting shares.
- B. Use the equity method when the investor **can exercise significant influence** (generally from **20% to 50%** of ownership of outstanding shares).
- C. Usually consolidate when “**control**” is present - **50+%** ownership.
- D. Special circumstances may affect significant influence or control.

III. THE COST METHOD

- A. Record the investment at cost. Generally, dividends received by the investor are treated as **dividends revenue**. Dividends in excess of earnings, or liquidating dividends, reduce the investment account.
- B. Sale of a cost method investment merely involves comparing the proceeds with the cost basis of the securities sold to determine the realized gain/loss. [Note that liquidating dividends *lower* the cost basis.]

IV. THE EQUITY METHOD

- A. Record the investment at cost. Generally, dividends received from the investee **reduce the Investment account** and the investor “picks up” its share of investee’s earnings by **increasing the Investment account** and recognizing the earnings on its income statement. Under the equity method, the Investment account is similar to a bank account.

- B. Differences between the price paid for an investment and the book value of the investee's net assets are allocated first to the **FMV of assets** and then to **Goodwill**. Excess fixed asset FMV is depreciated, while the excess value of Land and Goodwill are not amortized.
- C. In a step-by-step acquisition, Goodwill is computed separately for each transaction. When significant influence is obtained, the equity method may be applied **retroactively** to prior periods when the cost method was applicable. Increased ownership may also require changing the investment classification from available-for-sale to equity.

V. CONSOLIDATED FINANCIAL STATEMENTS [Ownership over 50%]

- A. The purchase is recorded for the **fair value** of any consideration paid. Direct expenses are added to cost and securities issuance costs reduce Additional Paid-In Capital.
- B. If the purchase price exceeds the fair value of the net identifiable assets acquired, the excess is **goodwill**.
- C. If the purchase price is less than the fair value of the net identifiable assets acquired, the shortfall is used to **reduce proportionately the book values of non-current assets acquired** (other than non-current investments). If these non-current assets acquired have been reduced to zero without having used up the shortfall entirely, the remaining shortfall is treated as an **extraordinary gain**.

The consolidating journal entry eliminates the owners' equity accounts of the subsidiary (common stock, A.P.I.C. and retained earnings), eliminates the Investment account, recognizes the minority interest (MI percent ownership of subsidiary's equity), adjusts acquired assets to their fair values and recognizes goodwill in the consolidated balance sheet. The mnemonic **CARIMAG** is used for the elements of the eliminating journal entry. When later years' balance sheets are shown, it is necessary to adjust RE back to purchase date.

VI. INTERCOMPANY TRANSACTIONS

- A. Eliminate 100% regardless of whether there is a minority interest.
- B. Eliminate all intercompany accounts. Examples: (a) interest revenue and interest expense, (b) interest receivable and interest payable.
- C. Intercompany inventory transactions require the elimination of the intercompany sales and cost of goods sold and any intercompany profit that remains in **ending inventory** of the buying entity.
- D. Intercompany bond transactions require the elimination of the Bonds Payable account from the issuer's balance sheet and the Investment in Bonds account from the balance sheet of the investor. Do not assume the issuer sold these bonds directly to the investor.
- E. Intercompany transactions involving land require an elimination making the consolidated financial statements look **as though the transaction had not even occurred**. Put the Land account back to the value that had been in the seller's books and also eliminate the gain/loss.
- F. Intercompany transactions involving depreciable assets involve essentially the same steps as for land with two complications. There is an Accumulated Depreciation account that has to be put back where it was at the time of the intercompany transaction, and depreciation expense after the sale must be adjusted back to what it would have been **had the transaction never occurred**.

VII. PUSH DOWN ACCOUNTING

The subsidiary's books are adjusted to reflect the **fair values** of assets and liabilities as seen by the parent firm by "pushing down" the consolidation adjustments to the financial statements of the subsidiary. If goodwill was implicit in the purchase price, the goodwill is recorded **explicitly** in the subsidiary's books. The owners' equity accounts of the subsidiary are adjusted to make the sub's book balance after these adjustments. The **SEC** requires push down accounting for all "substantially owned" subsidiaries.

The **Pooling of Interests** method of accounting for ownership is **no longer GAAP**; however, it may still be used for entities that qualified for the treatment prior to June 30, 2001. The Homework Reading contains a detailed description of the method and requirements for pooling treatment.

The **Becker Simulations** are an important part of the exam preparation process and there are two excellent F3 simulations on Consolidations.

FINANCIAL 3(B) CLASS NOTES

Financial 3 includes the following:

I. MARKETABLE SECURITIES

- A. Marketable securities have readily determinable fair values. These include equity and/or debt securities.
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- D. Intercompany bond transactions require the elimination of the Bonds Payable account from the issuer's balance sheet and the Investment in Bonds account from the balance sheet of the investor. Do not assume the issuer sold these bonds directly to the investor.
- E. Intercompany transactions involving land require an elimination making the consolidated financial statements look **as though the transaction had not even occurred**. Put the Land account back to the value that had been in the seller's books and also eliminate the gain/loss.
- F. Intercompany transactions involving depreciable assets involve essentially the same steps as for land with two complications. There is an Accumulated Depreciation account that has to be put back where it was at the time of the intercompany transaction, and depreciation expense after the sale must be adjusted back to what it would have been **had the transaction never occurred**.

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FINANCIAL 4 CLASS NOTES

Financial 4 includes the following:

I. WORKING CAPITAL AND ITS COMPONENTS AND RELATED ISSUES

- A. **Working Capital** is a measure of the solvency of an entity. The **Current Ratio** and **Quick Ratio** are used for analysis purposes.
- B. Current assets and liabilities generally must meet the one year test.

II. CASH AND CASH EQUIVALENTS

- A. Cash must be **readily available**. Cash equivalents are highly liquid debt securities with maturity dates within 90 days of the date purchased. The only occasion when time to maturity matters is at the purchase date.
 - 1. Restricted cash must be segregated from other cash.
- B. Bank reconciliations reconcile ending balances per bank and book adding and subtracting items causing differences between the two balances. Outstanding items are adjustments on the bank side and adjusting journal entry information are adjustments on the book side.

III. ACCOUNTS RECEIVABLE

- A. Valuing accounts receivable requires reductions for expected bad debts, expected sales returns & allowances and expected sales discounts. This results in a **net** accounts receivable balance approximating **cash expected to be collected**.
 - 1. Sales discounts are offered to encourage earlier payment by customers. Sales and related receivables can be recorded either using the **gross** or theoretically preferred **net** method.
 - 2. Trade discounts are applied sequentially and receivables are recorded net of any trade discount.
- B. Estimating Uncollectibles
 - 1. **Direct** write-off method, used for tax, is **not** GAAP.
 - 2. Allowance method is GAAP. The allowance for uncollectible accounts is a contra-asset. Percentage of sales method (**income statement approach**) determines bad debt expense as a percentage of sales or credit sales for the period. In the **balance sheet approach** (percent of ending A/R and aging method) the ending balance in the allowance account must equal an amount determined by an analysis of the A/R schedule.
 - 3. In the allowance method, writing off an account receivable involves debiting the allowance and crediting accounts receivable.
 - 4. When collecting an account previously written off, restore the account receivable and the allowance and then record the collection in the normal way.
- C. **Factoring** receivables can be done *with* or *without recourse*. **With recourse** means the transferor retains the risk of uncollectibility. Factoring **without recourse** is a sale of the receivable and the assignee assumes the risk of loss.

- D. Transfers and servicing financial assets requires accounting at the component level. There are three tests to determine if control has been surrendered and there has been a sale. If control has not been surrendered, or if there is some continuing involvement, then the transaction is treated as a loan.

IV. NOTES RECEIVABLE

- A. Discounting notes receivable involves transferring the note to a third party, usually for cash. This transfer can be with or without recourse. If done with recourse, a contingent liability is created for the transferor.
- B. Determining the proceeds to be received requires deducting the banker's discount interest from the maturity value of the note. **Discount** is calculated using **maturity value**, **discount rate** and **time left to maturity**.

V. INVENTORIES

- A. All inventories owned by an entity should be included in the inventory account. FOB shipping terms can be used to establish when a purchase or sale has occurred. Sales with a right of return still count as sales if returns are estimable and other conditions are met. Consigned goods belong to the **consignor**.
- B. Inventory account valuations should include all the costs necessary to make ready for intended use (sale).
 - 1. **Lower-of-cost-or-market** is a departure from cost basis caused by a decline in the inventory's utility.
 - 2. When the inventory's **replacement cost** is lower than cost basis, a current period inventory write down may be indicated based on the relationship between replacement cost and the market **ceiling** and **floor**.
- C. **Perpetual** and **periodic** inventory systems control how we account for purchases and sales of inventory.
 - 1. Perpetual system records purchases with a debit to inventory. Periodic system records purchases with a debit to purchases.
 - 2. Perpetual system records inventory sales in **two** journal entries. The periodic system only records the receivable and revenue at time of sale. The inventory account is updated **at the end of the period** after taking a physical count.
- D. Inventory methods include first-in, first-out (**FIFO**), last-in, first-out (**LIFO**) and **weighted average**. These methods may apply to both periodic and perpetual systems. Since FIFO values inventory at most recent costs, it will generally result in a **higher** net income than other methods in a period of rising prices. Weighted average is called "**moving average**" in perpetual.
- E. The **gross profit** and **retail** inventory methods attempt to estimate ending inventory based on the historical gross profit or cost complement percentage. With perpetual inventory systems there is generally no need to estimate ending inventory.
- F. Firm purchase commitments may require current loss recognition.

VI. FIXED ASSETS

- A. Fixed assets are valued at historic cost to **acquire and put into use** with few exceptions. Donated fixed assets are recorded at fair value and a gain or revenue is recognized equal to that value.
- B. Additions or improvements increase the cost basis of the fixed assets.
- C. Accounting for replacements depends on how the accounting records have been kept for the asset being replaced.
- D. **Ordinary** repairs that maintain the asset should be expensed. **Extraordinary** repairs, such as overhauls or major replacements, should be capitalized.
- E. Land should be recorded to reflect all the costs necessary to make the land **ready for its intended use**. Land improvements have finite lives and should be depreciated.
- F. Constructed fixed assets should include **capitalized interest** on weighted average expenditures incurred during the construction period.
- G. The **composite** and **group** depreciation methods depreciate an entire class of assets over a single life.
- H. The **straight-line**, **sum-of-the-years' digits** and **declining balance** methods are the three major methods of depreciation.
- I. **Units-of-production** method is similar to the straight-line method except that the life is defined in number of units expected to be produced.
- J. **Depletion** is similar to the units-of-production method except the former is applied to 'wasting' assets. Restoration costs should be included.

VII. IMPAIRMENT

- A. The **recoverability test** is met when the carrying value of the asset exceeds the sum of the undiscounted future operating net cash flows.
- B. Having met the recoverability test, the **impairment test** is met if the carrying value of the asset exceeds its fair value.
- C. If the impaired asset is held for use, the asset is written down to fair value and subsequent depreciation is based on that fair value. If the fair value were to subsequently 'rebound', no restoration is permitted.
- D. If the asset is held for disposal, depreciation is discontinued. If the fair value were to partially recover prior to sale, a restoration is permitted. This restoration result is similar to discontinued operations items in F1.

FINANCIAL 5 CLASS NOTES

Financial 5 includes the following:

I. ACCOUNTING FOR OPERATING LEASES

- A. **Operating leases** are essentially 'rentals' and all cash flows have to be **straight-lined** over the lease period as the periodic expense to the lessee and as lease revenue to the lessor (matching principle). Cash payments intended to be **returned** to the lessee are excluded from the expense/revenue calculation and are treated as deposits.
- B. **Leasehold improvements** by a lessee must be expensed over the **shorter** of the remaining lease term or the life of the improvement.

II. CAPITAL LEASES AND LESSEES

- A. Lessees account for **capital leases** as though purchased if one or more of 4 (OWNS) tests is met:
 - 1. **Ownership** transfers to lessee at end of lease
 - 2. **Written** bargain purchase option exists [PO<estimated fair value]
 - 3. **Ninety** percent of the leased property's fair value is less than or equal to the present value of the minimum lease payments
 - 4. **Seventy-five** percent of the asset's economic life will be consumed in the lease term.
- B. Lessees record the capital leased asset and the lease liability at the **present value of the minimum lease payments**, not to exceed fair value of asset.
- C. Minimum lease payments include the required periodic payments and the bargain purchase and/or guaranteed residual value (if any). **Executory** costs (maintenance, insurance, taxes, etc.) are excluded.
- D. The interest rate used is the **lesser** of the rate implicit in the lease (if known) or the lessee's incremental borrowing rate. The lease liability is amortized using the **effective interest method**.
- E. Depreciation is based on the lease term unless the lease has a bargain purchase option or ownership transfers to lessee at end of the term.

III. CAPITAL LEASES AND LESSORS

- A. Lessors with capital leases may have **sales type** or **direct financing** leases. Lessors have capital leases when meeting one of the 4 OWNS tests as described for lessees above. In addition, there can be no material uncertainties about collectibility or unreimbursable costs.
- B. **Sales type leases** recognize a dealer profit or gross margin at lease inception. As payments are received, interest revenue will also be recognized by the effective interest method.
- C. In a **direct-financing type lease**, the lessor acts essentially as a finance company and does not recognize gross profit on sale. Interest revenue is recognized by the effective interest method.

IV. SALES AND LEASEBACKS

- A. If the seller/lessee retains substantially all (90+%) of the rights, any gain is deferred over the leased asset.
- B. “Minor” (<10%) retention allows full recognition of any gain.
- C. Mid-range rights retention (10%-90%) requires that any gain be deferred up to the present value of the minimum lease payments (operating lease) or capitalized asset (capital lease), with any excess gain recognized immediately.

V. LONG-TERM LIABILITIES AND BONDS PAYABLE

- A. Bonds are long-term debt instruments issued by an entity. **Debentures** are unsecured. Bonds may also be **convertible** into common stock and may have **detachable warrants**. Typically the face value of individual bonds will be \$1,000. Interest at the coupon rate may be payable annually or semiannually and bond prices are quoted as **100's** (% of face value). The market will adjust the price paid for the bond to reflect the market, or **effective**, interest rate.
- B. Bond selling price is the sum of the present value of the total face value of the bond plus the present value of future interest payments, both discounted at the **effective (market) interest rate**. When the bond coupon rate **exceeds** the market rate the bond will sell at a **premium**. If the bond coupon rate is **below** the market, the market will adjust and the bond will sell at a **discount**.
- C. Bonds can be issued for more or less than their face amounts. If sold above the 100 face value, the excess is **premium**. If sold below 100, the difference is **discount**. Premium and discount result from market interest rate fluctuations and they are amortized to interest expense using the **straight-line** or **effective interest** (GAAP) method. Unamortized discount or premium is a component of the **carrying value** of a bond. Carrying value is eventually face value at the maturity of the bond and it is used to calculate the interest expense when using the effective interest method of premium/discount amortization.
- D. Bond issue costs are amortized using the straight-line method over the period the bonds are outstanding.
- E. When bonds are issued between interest payment dates, the selling price includes the accrued interest to date.
- F. Interest is accrued at year-end from the last interest payment date.
- G. Convertible bondholders have the option of converting the bonds into common equity. The two accounting methods for conversion are **Book Value** and **Market Value**. The Market Value method can result in a gain or loss on conversion.
- H. **Detachable** stock purchase warrants have a value **separate** from the bond and the value of the warrants is part of stockholders' equity. The **warrants only** or **market value** method may be used.
- I. Extinguishment of debt can occur at maturity or earlier (if the issuer calls the bond). **Early extinguishment** can result in an **extraordinary gain or loss** if it is **both** unusual and infrequent.

VI. TROUBLED DEBT RESTRUCTURING

- A. A **troubled debt restructuring** generally involves a creditor giving concessions to a debtor that would not be likely under normal circumstances. The debtor will recognize a gain in the excess of the carrying amount of the payable (including accrued interest) over the fair value of the assets given up. The restructuring gain may be an **extraordinary item** if it meets the requirements for such treatment. An ordinary gain or loss may result from the difference between the FMV and the NBV of the asset transferred.
- B. If an **equity interest** is transferred, there may be a gain to the extent that the FMV of the equity transferred exceeds the face of the payable. This gain may also be classified as extraordinary if it meets the requirements.
- C. If there is a **modification of terms**, the debtor does not change the carrying amount of the debt unless it exceeds the total future cash payments under the new terms.
- D. A restructuring may involve a combination of asset transfers, equity transfers and modification of terms.
- E. From the creditor's standpoint, these loans are treated as **impaired** and a loss accrual may be necessary.

Present Value techniques are in the introductory part of the F5 lecture. Since these apply to many topics, they are important to understand. Capital leases, bonds and pension plans are just three of the accounting topics that require present value computations.

Investments in Debt Securities is also covered in this class. Prior to this, the topic was also covered in F3 - Marketable Securities. Investments in debt securities may be classified as "**held-to-maturity**" if management has the intent and ability to do so.

The general subject of **Liabilities** is given more extensive coverage in the **Required Reading** section. **Imputing** interest on payables (and receivables) is also covered in the readings.

The F5 lecture covers two of the more difficult subject areas in leases and bonds payable. Doing the simulations will definitely help to solidify the concepts for you.

FINANCIAL 6 CLASS NOTES

Financial 6 includes the following:

I. EMPLOYER ACCOUNTING FOR PENSION PLANS

- A. Pension plans can be broken out into defined benefit plans and defined contribution plans. The CPA exam has emphasized **defined benefit** plans in which an employer provides an employee with defined retirement benefits in exchange for **current** or **past** services. As employees work, the pension benefits accumulate and actuarial computations are necessary to determine the present value of the future payments due.
- B. A defined benefit pension plan has two main components:
- a. **Plan Assets** - The cash and investments set aside by the employer to pay retirement benefits. Plan assets are measured at fair value. The change in plan assets during an accounting period is calculated as follows:

$$\begin{array}{l} \text{Beginning fair value of plan assets} \\ + \text{Contributions} \\ - \text{Benefits paid} \\ + \text{Actual return on plan assets} \\ \hline \text{Ending fair value of plan assets} \end{array}$$
 - b. **Pension Plan Liability** - The actuarial present value of the pension benefits owed to employees for current and past service. There are two measures of pension plan liability:
 - 1. The Accumulated Benefits Obligation (**ABO**) is the actuarial present value of benefits based on current and past compensation levels.
 - 2. The Projected Benefit Obligation (**PBO**) is the actuarial present value of benefits based on expected future compensation levels.
- C. SFAS No. 158 requires that companies report the funded status of all pension plans on the balance sheet. A plan's funded status is calculated as follows:

$$\begin{array}{l} \text{Fair value of plan assets} \\ - \text{PBO} \\ \hline \text{Funded status} \end{array}$$

A negative funded status indicates that the pension is **underfunded**. Underfunded pension plans are aggregated and reported as a current liability (to the extent that benefits payable in the next 12 months exceed the fair value of the plans' assets), a noncurrent liability, or both.

A positive funded status indicates that the pension is **overfunded**. Overfunded pension plans are aggregated and reported as a noncurrent asset.
- D. Changes in the funded status of a pension plan due to gains or losses, prior service cost and net transition assets or obligations are reported, net of tax, in other comprehensive income (**PUFE**) in the period incurred. Accumulated other comprehensive income is adjusted when the gains and losses, prior service costs, and net transition assets or obligations are recognized as components of net periodic pension cost through amortization.

- E. Net periodic pension cost (**SIRAGE**) is the net of six components:
1. + Current **service** cost [normal service cost]
 2. + **Interest** cost
 3. - Expected **return** on plan assets
 4. +/- **Amortization** of prior service costs (cost of retroactive benefits due to changes in plan)
 5. +/- Amortization of excess cumulative deferred **gains/losses**
 6. +/- Amortization of **existing** net obligation or net asset at implementation of plan
- According to SFAS No. 158, the tax effects of the components of net period pension cost must be recognized when net period pension cost is recorded.

II. ACCOUNTING FOR POSTRETIREMENT BENEFITS OTHER THAN PENSIONS

- A. The cost of retirement health care and other benefits is accrued if the obligation is attributable to **services already rendered**, these rights accumulate or "**vest**," payment is **probable** and the amount can be reasonably **estimated**.
- B. Benefits are accrued over the **attribution period**, the period from the **date of hire to the date fully eligible for the benefit**.
- C. Postretirement benefit plans must be reported as outlined in SFAS No. 158, as described above for pension plans.

III. ACCOUNTING FOR POSTEMPLOYMENT BENEFITS

- A. These benefits (severance pay, salary continuation, etc.) are enjoyed after employment and are not the same as post retirement benefits.
- B. GAAP requires the **accrual of a liability** if the same four criteria as for postretirement benefits are met.

IV. CONTINGENCIES

- A. Contingencies are existing conditions whose outcome depends on some future event or occurrence. The three categories of contingencies are **probable**, **reasonably possible** and **remote**.
- B. Loss contingencies that are **probable** and can be **reasonably estimated** must be accrued. If a range of losses is given, the **minimum** amount is accrued and the remaining amount is disclosed in a footnote. Gain contingencies that are probable are not accrued but are disclosed.
- C. The nature and amount of a loss or gain contingency that is **reasonably possible** is disclosed in the footnotes and is not accrued.
- D. **Remote** contingencies are generally ignored.
- E. **Unasserted claims** follow similar rules for disclosure and/or accrual.

V. INTERPERIOD ACCOUNTING FOR INCOME TAXES

- A. GAAP and tax accounting rules differ considerably. Some of the differences are **permanent** because they never reverse. Other differences are **temporary** because they involve mere timing differences between the financial and tax accounting rules.
- B. **Only temporary differences cause deferred tax consequences.**
- C. Tax expense is subdivided into two components: current tax expense [CTE] and deferred tax expense [DTE].
- D. Current tax expense [CTE] is merely the result of **multiplying taxable income from the tax return by the tax rate**. The exam routinely ignores estimated tax payments by firms.
- E. The deferred tax account(s) in the balance sheet must be adjusted at the end of each year to reflect the appropriate amount of deferred tax liability [DTL] or the appropriate amount of a deferred tax asset [DTA].
- F. Permanent differences, such as tax-exempt interest on municipal bonds, or life insurance premiums when the corporation is beneficiary, are embedded in tax law and **will not reverse in the future**; therefore they only affect current tax paid and not the deferred tax accounts.
- G. Temporary differences will "turn around" in the future and are part of the deferred tax calculations. GAAP requires accrual accounting, while tax law treats some items on a "cash basis": e.g., estimated liabilities or bad debt expense. Since these are recognized for book purposes before they are deductible for tax purposes, a deferred tax asset (DTA) will result. Using straight-line depreciation for the books and MACRS for tax purposes will result in lower taxable income in the early years of the asset life and a deferred tax liability (DTL). The **Corporate Taxation Summary** on page **F6-48** gives an excellent breakdown of various differences between book and tax income.
- H. DTAs and DTLs must be re-calculated each year based on **enacted** tax rates in the year(s) in which the taxable item is expected to be realized or paid.
- I. For Balance Sheet presentation, deferred tax items are classified as they relate to current or noncurrent assets and liabilities. DTAs and DTLs classified as current **are netted together** and only one account appears on the Balance Sheet. Noncurrent DTAs and DTL's receive similar treatment.
- J. If it is **more likely than not** that all or part of a deferred tax asset will not be realized, a **valuation allowance** must be set up to reduce the asset.
- K. **Operating loss carrybacks** are "assured" and can be recognized as a reduction in the book loss in the year of the loss. An **operating loss carryforward** is a DTA and is recognized to the extent that it is "more likely than not to be realized." Undistributed earnings of an investee are presumed to be distributed in the future and are a temporary difference.

Intraperiod tax allocation relates to apportioning the total tax provision among the various Income Statement sections (IDEA) from F1.

The **Required Reading** reviews Other Liabilities that have some history on the CPA exam. There are also two appendices adding more detail on defined benefit pension plans.

FINANCIAL 7 CLASS NOTES

Financial 7 includes the following:

I. FINANCIAL INSTRUMENTS

- A. Financial instrument fair value disclosures and disclosures about concentrations of credit risk are required by all firms except 'small' private firms (assets < \$100 million and no derivatives).
- B. Market risk disclosure is **encouraged** but not required.
- C. Derivatives get their values from some other instrument. Option, forward, futures and swap contracts are examples. Derivatives have terms indicating 'price', quantity and a settlement amount (or payment provision). Derivatives are reported at fair value.
 - 1. If there is **no hedging designation** any gain or loss must be reported in the income statement.
 - 2. When hedging the **fair value** of an asset or liability currently in the balance sheet, the gain/loss on the asset/liability and the loss/gain on the hedge are both reported in the income statement for the current year. The hedge must be expected to be highly effective in reducing the risk (or you're speculating).
 - 3. If hedging the variability in future cash flows, the effective portion of the hedge goes into other comprehensive income and the ineffective portion is reported in net income for the current period. The effective portion is the 'E' in PUFE from F1.
 - 4. Hedging foreign currency risks generally parallels comments above in C2.
 - 5. Hedging future cash flow variability in connection with foreign currency parallels comments above in C3.

II. STOCKHOLDERS' EQUITY

- A. The **owners' equity section** is illustrated on page F7-7 and should be reviewed for the details contained within it.
- B. **Capital stock** includes these terms: authorized, issued and outstanding. Treasury stock is issued but not outstanding.
- C. **Common shareholders' equity** equals total stockholders' equity reduced for the claims of preferred shareholders.
- D. **Book value per share** is the common shareholders' equity divided by the number of common shares outstanding at year-end.
- E. **Preferred shares** are "first in line," before common shareholders for dividends and payment in liquidation. P/S may also be cumulative, participating or convertible.
- F. **Additional paid-in capital** can come from several sources in addition to any amount paid above the par value of shares issued.
- G. **Retained earnings** can be increased or decreased by a large number of events including: income, losses, cash dividends, property dividends, stock dividends, prior period adjustments, cumulative effects of changes in accounting principles and quasi-reorganizations.
- H. **Quasi-reorganizations** eliminate deficit balances in retained earnings by reducing the amount in C/S or APIC.

- I. **Accumulated other comprehensive income** is an equity account into which the components of other comprehensive income flow.
- J. **Treasury stock** may be accounted for by the **cost** method or the **legal** (par value) method.
- K. **Donated shares** result in a credit to contributed capital.
- L. **Stock subscriptions** are contracts to buy stock at a future date.
- M. **Stock rights** provide existing shareholders with the opportunity to buy additional shares and do not affect equity until exercised.
- N. **Dividends declared** reduce R/E on declaration date.
- O. **Liquidating dividends** are dividends in excess of R/E.
- P. **Property dividends** are recorded at their fair value at the declaration date. Gain or loss is recognized on that date.
- Q. **Stock dividends** occur in two sizes: small and large. The "break point" is 20% to 25% of outstanding C/S. **Small stock dividends** tend to be on the exam more often.
- R. **Stock splits** do not require a journal entry and total book value of C/S is unchanged.
- S. **Compensatory stock option** plans are now accounted via the **fair value method** (per SFAS 123R).
- T. **Stock appreciation rights** entitle an employee to receive as compensation an amount tied to an increase in stock price.

III. EARNINGS PER SHARE

- A. **Basic earnings per share** assumes no potentially dilutive securities. Basic EPS divides 'income available for common shareholders' by the **weighted average** number of common shares outstanding.
- B. Diluted EPS employs the "**if converted**" and/or "**treasury stock**" method to re-compute EPS as it would be if any dilutive securities such as convertible bonds or preferred stock, rights, warrants and options were exercised. **Antidilutive** securities are not considered.
- C. Preferred stock, especially cumulative issues, cause calculation difficulties since preferred claims are not available for common shareholders and preferred dividends do not reduce net income.
- D. **Contingent shares**, if dilutive, are part of the **Basic EPS** calculation if all conditions for issuance are met.
- E. Basic and Diluted EPS are disclosed by income statement component (IDEA) for a proper presentation.

IV. STATEMENT OF CASH FLOWS

- A. **This statement is comprised of three sections: Cash Flows from:**
 - 1. **Operating Activities** - includes the normal recurring commercial activities, income statement items, and transactions involving trading securities.
 - 2. **Investing Activities** - includes transactions in property, plant & equipment, investments and lending activities (noncurrent asset transactions).
 - 3. **Financing Activities** - includes all cash transactions with long-term debt-holders and owners (debt and equity transactions).

- B. Cash equivalents (treated as cash) are debt securities with an **original** maturity date of three months or less.
- C. Under the Indirect Method, the Operating Activities section adjusts **Net Income to Cash provided, or Used, by Operating Activities**. The mnemonic **CLAD** is useful to remember the various adjustments.
- D. When the Indirect Method is used, a supplemental disclosure of Cash Paid for Interest and Income Taxes is required.
- E. Under the Direct Method, the operating activities section shows the major classes of cash receipts and disbursements in their gross amounts to arrive at net cash provided by (used in) operating activities.
- F. When the Direct Method is used, a supplemental disclosure entitled the Reconciliation of Net Income to Cash Provided by Operating Activities is required.
- G. Under both the direct and indirect methods, a disclosure of Noncash Investing and Financing Activities is required.

As you can see, there is a lot to cover in F7 and, once again, the **simulations** will bring out most of the important concepts to know.

There is a Required HW Reading on **Ratio Analysis** detailing the key Liquidity, Activity, Profitability, Investor and Long-Term Debt-Paying Ability Ratios. The second Required Reading contains detailed **Treasury Stock** examples using the Cost and Par Value Methods. An Optional Reading demonstrates detailed **Statements of Cash Flow** and an excellent summary on page **F7-58**.

FINANCIAL 9 CLASS NOTES

Financial 9 includes the following:

I. GOVERNMENTAL ACCOUNTING (PART B)

- A. **Government-wide financial statements** are prepared on the **accrual** basis reflecting the **economic resources measurement focus**.
- B. Funds have financial statements prepared using their specific accounting method in order to better demonstrate *compliance* with government leaders' decisions (**fiscal accountability**) and the extent to which operating objectives have been met (**operational accountability**).
- C. The **integrated approach** requires a **reconciliation** between operational and fiscal accountability. The sequence of financial reporting presentation is:
 - 1. Governmental entity's financial statements start with **management's discussion and analysis (MD&A)**
 - 2. Government-wide financial statements and fund financial statements follow (including a **reconciliation** between **modified accrual** governmental funds and government-wide financials on the **accrual** basis). Internal Service funds are included with the governmental funds (GRASPP) in the reconciliation as **Governmental Activities**. Enterprise funds are included as **Business Type Activities**. Fiduciary funds are **not included** in GWFS since they are custodial in nature.
 - 3. **Notes** to the financial statements
 - 4. Required **supplementary** information (RSI) (other than MD&A)
- D. The financial reporting entity is the primary government entity.
- E. **Special-purpose local governments** will be treated as a primary governmental entity if they have **separately elected** leaders, are **legally separate** entities and are **fiscally independent**. [**SELF**]
- F. **Component units** do not meet the SELF criteria and may be **blended** in with the primary government if they are "intertwined" with it. A **discrete** presentation is required if the component is legally separate but financially accountable to the primary government. Most component units should use discrete presentation.
- G. MD&A must be easily readable and analyze material variances.
- H. Government-wide financial statements are presented in **net asset** format. (A - L = NA) Net assets consists of three components:
 - 1. **Invested** in capital assets **net** of accumulated depreciation and related debt
 - 2. **Restricted** net assets (external restrictions)
 - 3. **Unrestricted** net assets (no external restrictions)
- I. Capitalized assets will include **infrastructure-type** assets unless the government elects to use the modified approach. The modified approach includes infrastructure data in RSI: 1) a condition assessment of assets, and 2) annual estimate of the amounts required to maintain the assets.
- J. Depreciation is **required**; however, if the **modified** approach is used for infrastructure assets, ordinary expenditures are expensed and **additions or improvements are capitalized**.

- K. Donated artwork and historical treasures should be capitalized at their fair values but capitalization is optional if they will be exhibited, preserved and the proceeds of any sale will be used to acquire other assets for the collection.
- L. The government-wide **statement of activities** will include program revenues (SOC) resulting from exchange-type (charges for **services**) or non-exchange-type transactions such as **operating** or **capital** grants.
- M. Fund financial statements require establishing the criteria for **major funds**. There are two criteria (**10%** of GRASPP **or** E and **5%** of GRASPP **and** E) must be met for a fund to be considered major. Internal service funds are excluded from major fund consideration.
- N. Reconciliation between modified accrual governmental funds and government-wide accrual basis financial statements is performed for the Balance Sheet (GALS BARE) and the Statement of Revenues, Expenditures and Changes in Fund Balance (GOES BARE).
- O. Required **supplementary information** other than MD&A will include **budgetary comparisons** of the original and final budgets as well as the actual amounts. Computing **variances** is **optional**.
- P. Interfund activity may include interfund **loans** (due to/from), interfund **services provided or used**, and interfund **transfers or reimbursements**.
- Q. **Within columns** we will **eliminate** interfund activity and **between columns** we will **not eliminate** interfund activity.

II. NOT-FOR-PROFIT ORGANIZATIONS IN GENERAL

- A. Not-for-profit entities depend significantly on donations or contributions. The accounting rules for these entities come from **FASB**. These entities include: hospitals, colleges, voluntary health and welfare organizations and other not-for-profit entities.
- B. All of these entities use **accrual** accounting.
- C. The required financial statements include the **Statement of Financial Position, Statement of Activities, Statement of Cash Flows** and (for Voluntary Health and Welfare organizations) **Statement Functional Expenses**.
- D. Net assets are comprised of three elements:
 - 1. **Unrestricted net assets** (no external restrictions)
 - 2. **Temporarily restricted net assets** (external restrictions as to **time** of use or **manner** used)
 - 3. **Permanently restricted net assets** (principal cannot be used)
- E. When a donor-imposed restriction is satisfied, the amount ceases being **temporarily restricted** and is re-classified to **unrestricted**.
- F. **Program services** represent the major or main activities of the organization. **Support services** represent administration-type functions within the organization.
- G. **Combined costs** need to be allocated between program and support services using any reasonable means.
- H. In the **statement of cash flows** most donations are operating activities except for certain **restricted** donations that are financing activities.
- I. The **statement of functional expenses** displays three major categories of expenses: **program support, fund-raising** and **administrative-type**.
- J. Contributions count as revenues or other support. Revenues usually reflect 'exchange-type' transactions. Other support usually includes donations.

- K. **Unconditional promises** (pledges) are recorded as revenues for the portion considered collectible after treating the entity's estimate of uncollectibility as a contra-asset. **Conditional promises** are not recognized until the condition has been satisfied.
- L. **Donated services** are not recognized unless the donated service is essential and the **SOME** requirements are met.
- M. **Donated collection items** are subject to the same rules as for governments; i.e., capitalize at fair value unless exhibited, preserved and proceeds of any sale will be used to acquire other assets for collection.
- N. **Donated materials** to be used will increase assets and support (revenues) at the time of the donation.
- O. **Agency** transactions result in an asset and a liability. These amounts are really the property of another party.
- P. **Gifts in kind** (non-cash) are accounted for at fair value. The cost of premiums in an **exchange** transaction is a fund-raising expense.
- Q. Transfers of assets to a NFP organization or charitable trust that holds contributions for others are treated as "an extension of the equity method of accounting." If **variance power** is present, treat inflows as **revenue**. If **no variance power** is present, treat inflows as **liabilities**. Beneficiaries recognize their rights to assets held by others unless the recipient is explicitly granted variance power.
- R. Investments in securities are reported at fair value. Gains and losses are reported in the Statement of Activities as increases or decreases in unrestricted net assets unless use is restricted (by donor).

III. SPECIFIC INDUSTRY APPLICATIONS: COLLEGES

- A. Colleges use **accrual** basis of accounting.
- B. Tuition revenues are recorded at **gross amounts**.
- C. Any price breaks given to students as scholarships or because of any relationship to faculty/staff are treated **both** as expenses and revenues.
- D. The main category of revenue comes from tuition and fees. **Non-operating** revenues include government aid, government grants, government contracts, private gifts and grants, endowment income. **Other operating** revenue includes 'peripheral' types of revenue (e.g., bookstore).

IV. SPECIFIC INDUSTRY APPLICATIONS: HOSPITALS

- A. Patient service revenues are recorded at **gross amounts**.
- B. Discounts given to third party payers are treated as **sales discounts**. Patient service revenues are recorded gross of these discounts, if any.
- C. **Charitable services** (charity care) are **not** recorded as revenues because there was no intention to collect.
- D. **Other operating** revenue includes donated supplies/equipment, cafeteria revenue, parking fees and gift shop revenue.
- E. **Non-operating** revenue includes all unrestricted gifts and donations plus donated services (mnemonic SOME).

V. SPECIFIC INDUSTRY APPLICATIONS: VOLUNTARY HEALTH AND WELFARE ORGANIZATIONS

- A. Most resources to VHWO are **donations**.
- B. VHWOs use **accrual** accounting.
- C. VHWOs are **required** to report a statement of functional expenses.

FINANCIAL 8 CLASS NOTES

Financial 8 includes the following:

I. GOVERNMENTAL ACCOUNTING OVERVIEW

- A. Governmental financial reporting is designed to demonstrate **operational accountability** for the entity as a whole and **fiscal accountability** for specific funds. Standards for accounting are established by the Governmental Accounting Standards Board (**GASB**). The Government Accountability Office (**GAO**) governs audits under the **Single Audit Act**.

Funds are separate, independent self-balancing sets of accounts, similar to a “checkbook.” The three major categories of funds are **Governmental (GRASPP)**, **Proprietary (SE)** and **Fiduciary (PAPI)**.
- B. **Government-wide financial statements** are prepared using the **accrual method** of accounting to permit an **economic resources measurement focus**. This method is essentially the same as used in ‘for profit’ accounting and is covered in more detail in F9.
- C. **Governmental** funds use **modified accrual basis** of accounting and provide a **current financial resources measurement focus**. Revenues are recognized when **measurable and available**. **Expenditures** (not “expenses”) are generally recognized when resources are spent. There are **no non-current assets** in governmental funds. The five governmental (**GRASPP**) funds are the **General**, **Special Revenue**, **Debt Service**, **Capital Projects** and **Permanent** funds.
- D. **Proprietary (SE)** funds use **full accrual** accounting and the **economic resources measurement focus**. The **Internal Service** and **Enterprise Fund** are the two proprietary funds.
- E. **Fiduciary (Trust)** funds use **full accrual** accounting and the **economic resources measurement focus**. The “**PAPI**” funds are **Pension**, **Agency**, **Private Purpose** and **Investment Trust** funds.

II. APPLICATIONS OF MODIFIED ACCRUAL ACCOUNTING

- A. Most governmental (GRASPP) funds record **budgets**, **activity** and **encumbrances** during the year and close them out at the end of each year. [**BAE BAE**]
- B. Recording the budget at the start of the year requires creating a journal entry involving **Estimated Revenues**, **Appropriations** and **Estimated Other Sources/Uses**. Any excess, or projected **surplus**, is **credited to Budgetary Fund Balance**. A projected shortfall, or **deficit**, would be **debited** to that account. This entry is closed at the end of the year.
- C. Revenue is recorded in the real accounts when it is measurable and available. Real property taxes are accrued **when billed** to property owners with related revenue recognition subject to measurable and available criteria. Sales taxes, if measurable and collected **within sixty days** after fiscal year-end (available) are considered revenue.
- D. Expenditures are recorded as funds are **spent** or a current liability is accrued. **Operating** and **capital** expenditures are handled the same way. Expenditures for supplies, (prepaid) insurance and inventory can be accounted for by the **Purchase Method** or **Consumption Method**.
- E. Transfers out to other funds, or **Interfund Transfers**, represent a use of financial resources, **not an expenditure**.
- F. Governmental expenditures are classified as **Function (Program)**, **Organizational Unit**, **Activity**, **Character** or **Object Class**.

- G. Fixed Assets purchased, constructed or leased are **not capitalized**; however, they are reported on the **Government-Wide F/S (F9)**. Likewise, long-term debt is **not recorded as debt** in a governmental fund, it is an **Other Financing Source**. LTD also goes to the **Government-Wide F/S**.
- H. Open purchase orders represent an **encumbrance** of a governmental fund. An **Encumbrance** (debit) is set up with a credit to **Reserve for Encumbrances** when the order goes out. When the order is filled, the Encumbrance J/E is **reversed for the amount originally recorded** and the actual **Expenditure** is recorded in a separate J/E.
- I. Governmental funds will prepare a **Balance Sheet** and a **Statement of Revenues, Expenditures, and Changes in Fund Balance** (not I/S).

III. GOVERNMENTAL FUNDS [MODIFIED ACCRUAL BASIS] GRASPP

- A. There is only one **general fund** in a particular governmental entity.
- B. **Special revenue funds** contain funds 'earmarked' for particular purposes. Users of these funds services are expected to provide *less* than 50% of the costs. Expendable trusts are special revenue funds. Forfeiture accounts are special revenue funds.
- C. **Debt service funds** (DSF) pay for the **principal** and **interest** related to **general obligation** debt. This is debt incurred by **governmental** funds. Other (SE-PAPI) funds service their own debt.
- D. **Capital projects funds** are created for each project underway for better accountability of resources budgeted for each project. Only projects for governmental funds are accounted for within a capital projects fund. These funds will use **BAE-BAE** accounting. Financing sources may be long-term **debt** issues, capital **grants**, government grants or **special assessments** charged to property owners benefited by the project.
- E. **Permanent funds** are legally restricted. Only income can be spent with the principal amounts 'permanently' restricted from spending.

IV. PROPRIETARY FUNDS [ACCRUAL BASIS] SE

- A. **Internal service funds** serve other governmental units. The financial statements of an IS fund are the **Statement of Net Assets** a **Statement of Revenues, Expenses and Changes in Net Assets**, and a **Statement of Cash Flows**. Net Assets are classified as **Unrestricted**, **Restricted** and **Invested in capital assets, net of related debt**.
- B. **Enterprise funds** serve users that are expected to provide **over 50%** of the resources to fund the operation. The financial statements of an Enterprise Fund are the same as those for an Internal Service Fund.

V. FIDUCIARY FUNDS [ACCRUAL METHOD] PAPI

- A. **Pension trust funds** account for government-sponsored pension and post-retirement plans. **Additions** and **Deductions** replace Revenues and Expenses as activity classifications in the Statement of Changes in Fiduciary Net Assets.
- B. **Agency trust funds** are custodial funds. Their assets equal their liabilities and there is **no fund balance**.
- C. **Private purpose trust funds**, such as an Escheat Property Fund, contain resources for the benefit of other parties or entities.
- D. **Investment trust funds** are generally reported using fair value.