Financial Accounting & Reporting 1

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Financial Accounting & Reporting 1

SOURCES OF GAAP AND BASIC FRAMEWORK AND CONCEPTS

I. INTRODUCTION

Generally accepted accounting principles (GAAP) are those accounting principles that have substantial authoritative support. Substantial authoritative support is a question of fact and a matter of judgment. The power to establish GAAP actually rests with the Securities and Exchange Commission (SEC); however, except for rare instances, it has essentially allowed the accounting profession itself to establish GAAP and self-regulate. Three bodies of the accounting profession have determined GAAP since 1939.

A. COMMITTEE ON ACCOUNTING PROCEDURE

The Committee on Accounting Procedure (CAP) was a part-time committee of the American Institute of Certified Public Accountants (AICPA) that promulgated Accounting Research Bulletins (ARB), which determined GAAP from 1939 until 1959.

B. ACCOUNTING PRINCIPLES BOARD

The Accounting Principles Board (APB) was another part-time committee of the AICPA. It issued Accounting Principles Board Opinions (APBO) and APB Interpretations, which determined GAAP from 1959 until 1973.

C. FINANCIAL ACCOUNTING STANDARDS BOARD

In 1973, an independent full-time organization called the Financial Accounting Standards Board (FASB) was established, and it has determined GAAP since then.

1. Statements of Financial Accounting Standards (SFAS)

These statements establish GAAP and define the specific methods and procedures for various accounting issues. Each statement is issued after extensive research, discussion memoranda, exposure drafts, and public comments.

2. FASB Interpretations

FASB Interpretations clarify GAAP by addressing issues that may be conflicting or ambiguous and may establish GAAP.

3. Technical Bulletins

Technical bulletins may expand upon or further clarify GAAP because of problems that may exist in accounting or reporting under the standard or interpretation.

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4. Statements of Financial Accounting Concepts (SFAC)

Statements of Financial Accounting Concepts (SFAC) are intended to establish the objectives and concepts for use by the FASB in developing accounting and reporting standards. They provide a common foundation and basic reasoning on which to consider the merits of the alternatives and a coherent system of interrelated objectives and fundamentals; however, they do not establish GAAP.

5. Emerging Issues Task Force Statements (EITF)

EITF statements address emergent issues and may show how to account for specific or unusual applications of GAAP. They are less authoritative than Category A pronouncements (see *Hierarchy of Sources of GAAP*).

6. FASB Implementation Guides

The FASB may also issue implementation guides (in a question/answer format) on certain accounting issues that the public may have questions on. These are even less authoritative than EITF Statements.

II. HIERARCHY OF SOURCES OF GAAP

In 2007, the Hierarchy of Generally Accepted Accounting Principles replaced Statement on Auditing Standards (SAS) No. 69 as the source of the hierarchy of sources of GAAP. This statement indicates the six most authoritative GAAP pronouncements (provided they are not superseded by another pronouncement). It is permissible, but extremely rare, to deviate from one of the six pronouncements if compliance would cause the financial statements to be misleading.

A. Accounting Research Bulletins (ARBs)

B. Accounting Principles Board Opinions (APBOs)

C. FASB Statements of Financial Accounting Standards

D. FASB Staff Positions

E. FASB Interpretations

F. FASB Statement Implementation Issues

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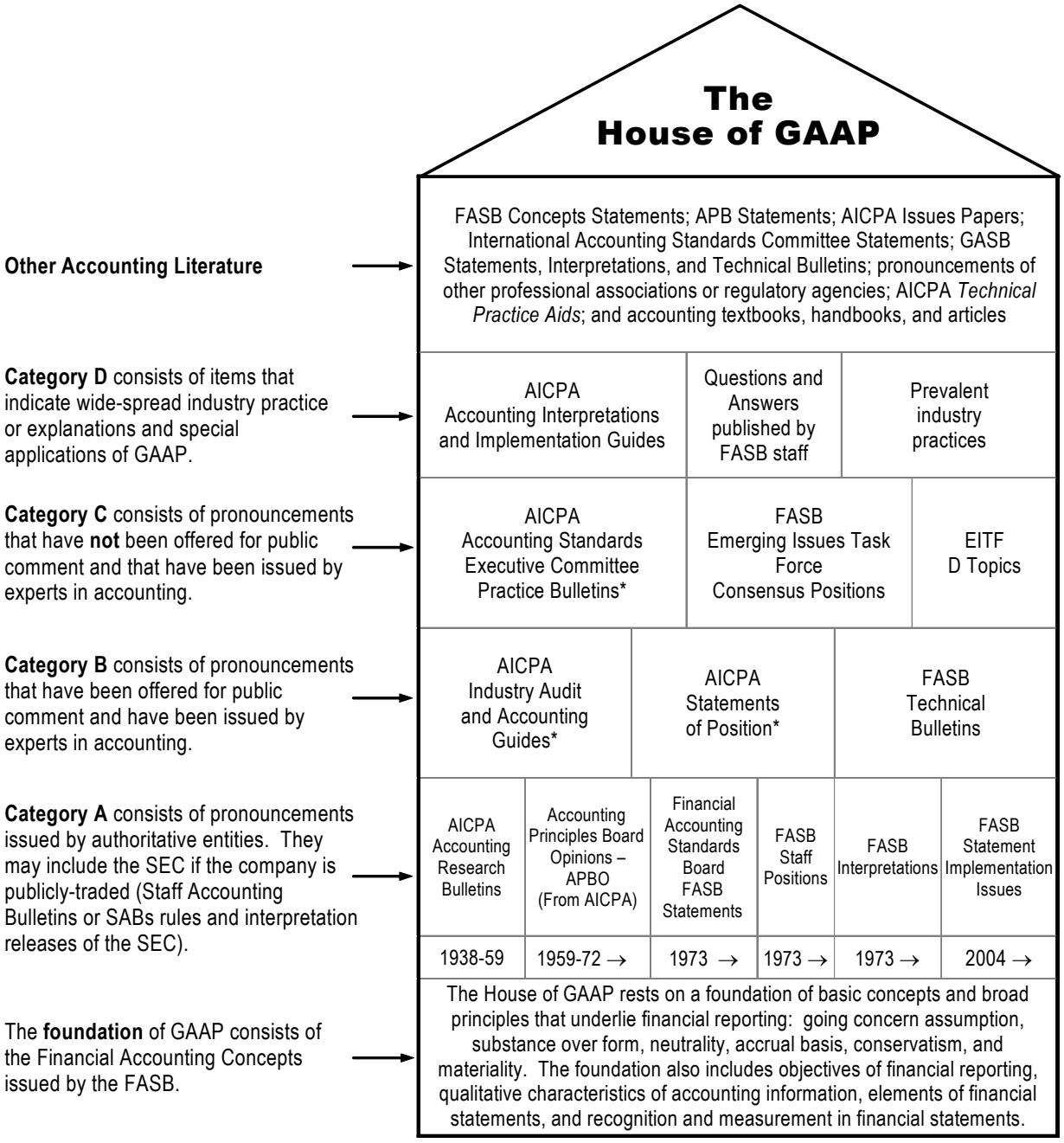

*AICPA Industry Audit and Accounting Guides and AICPA Statements of Position are included in Category B only if the FASB has cleared the pronouncements. AICPA Practice Bulletins are included in Category C only if cleared by the FASB. If not cleared by the FASB, AICPA Industry Audit and Accounting Guides and AICPA Statements of Position are included in Category D.

NOTE: If the accounting treatment of a transaction or event is **not** specified by a pronouncement in **"Category A"** (first floor), the auditor should consider whether one or more sources in Category (B), (C), or (D) is relevant to the circumstances. The auditor should be prepared to justify a conclusion that another treatment is generally accepted.

If there is a conflict between accounting principles relevant to the circumstances from one or more sources in Category (B), (C), or (D), the auditor should follow the treatment specified by the source in the more authoritative category – for example, follow Category (B) treatment over Category (C) – or be prepared to justify a conclusion that a treatment specified by a source in the less authoritative category **better** presents the substance of the transaction in the circumstances.

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III. CONCEPTUAL FRAMEWORK UNDERLYING FINANCIAL ACCOUNTING

As discussed earlier, the FASB has created a conceptual framework (set forth in pronouncements called Statements of Financial Accounting Concepts, or SFAC) that serves as a basis for all FASB pronouncements. Six SFAC provide a basis for financial accounting concepts for business enterprises (SFAC No. 4 relates to non-business enterprises).

A. SFAC NO. 1 "OBJECTIVES OF FINANCIAL REPORTING BY BUSINESS ENTERPRISES"

SFAC No. 1 defines the potential users of financial reporting as those who base their decisions on their relationships to and knowledge about the business enterprise. This group includes external users (e.g., investors, creditors, and customers) and those who advise these users.

The objectives essentially identify the purposes and goals of financial accounting and focus on providing information that is useful in making business and economic decisions to persons with reasonable knowledge of business and the economy.

The objectives provide:

1. Information useful in investment and credit decisions.
2. Information useful in assessing future cash flow prospects.
3. Information useful in assessing an enterprise's resources, the debt and equity claims to those resources, and the changes in them.

B. SFAC NO 2 "QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION"

The qualitative characteristics of accounting information provide the criteria used to select and evaluate accounting information so that it will meet the objectives set forth in SFAC No. 1. This statement identifies the hierarchy of qualitative characteristics that are to be considered when accounting alternatives are available in order to choose the alternative that produces the most useful information.

Financial information must be:

(i) Understandable to decision makers,

(ii) Relevant (timely information with predictive or feedback value),

(iii) Reliable (verifiable, faithfully representable, and neutral),

(iv) Comparable,

(v) Consistent,

(vi) Material, and

(vii) Less costly than the benefit provided.

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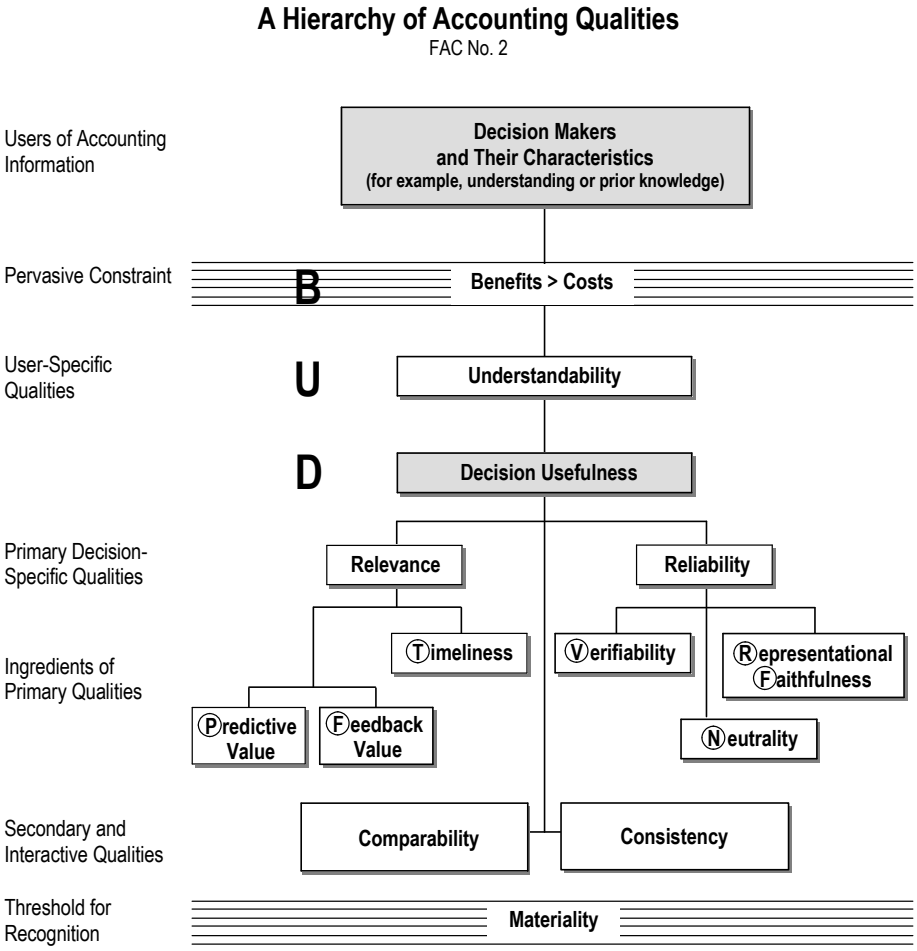
1. Illustration of Hierarchy of Accounting Qualities



2. Constraints

Two pervasive constraints (one on the top and one on the bottom of the illustration) must be considered.

a. Costs and Benefits

The benefits of accounting information must be greater than the costs of obtaining and presenting the information.

b. Materiality

The information must be material with respect to the financial statements (so that the lack of the information could make a difference in decisions made by the users).

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3. Understandability

The accounting information presented should be understandable to a wide variety of users who possess a reasonable amount of knowledge about the economy and are willing to exert a reasonable amount of effort to study the information presented. Understandability serves as a link between the characteristics of users and the decision-specific qualities of information.

4. Primary Qualities of Decision Usefulness

Decision usefulness is the primary quality of accounting information. It can be broken down into two specific categories:

a. Relevance

In order for information to be useful, it has to be relevant (i.e., make a difference) to the decision-making process. The quality of relevance has three sub-categories:

(1) Predictive Value

When information has predictive value, it has the ability to assist users in evaluating past, present, or future events.

(2) Feedback Value

Feedback value enables decision-makers to confirm prior expectations or to adjust or correct the assessment made.

(3) Timeliness

Timeliness is having the information available while it is able to influence decisions.

b. Reliability

In order for information to be reliable, the users must be able to reasonably depend on it to be free from error and bias and to be faithfully representative of what it claims to represent. The quality of reliability has three sub-categories:

(1) Neutrality

Neutrality means that the information is free from bias and free from outside influences.

(2) Representational Faithfulness

Representational faithfulness is agreement between financial reporting and the resources or events represented. It means that the information is valid (e.g., economic substance over legal form).

(3) Verifiability

If the information is verifiable (i.e., objective), it means that the same results could be duplicated with the same measurement techniques (which is the primary concern for auditors of financial statements).

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5. Secondary Characteristics

Comparability and consistency are secondary characteristics, which means that they apply to BOTH relevance and reliability.

a. Comparability

Comparability is the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena. It allows users to compare the information with similar information for other business enterprises.

b. Consistency

In order for users to be able to compare the performance of a company in one period with the performance of a company in another period, consistent accounting policies and procedures must be applied by the company from period to period. This does not mean that the company cannot change accounting policies if the new method more fairly presents the information; however, the cumulative effect of the change must be accounted for and disclosed in the financial statements (discussed later in this lecture).

C. SFAC NO. 3 "ELEMENTS OF FINANCIAL STATEMENTS OF A BUSINESS"

This statement was replaced by SFAC No. 6.

D. SFAC NO. 5 "RECOGNITION AND MEASUREMENT IN THE FINANCIAL STATEMENTS"

This statement sets forth the recognition criteria and guidance on what and when information should be incorporated in the financial statements.

1. Full Set of Financial Statements

a. Statement of Financial Position (the Balance Sheet)

b. Statement of Earnings (the Income Statement)

c. Statement of Comprehensive Income

d. Statement of Cash Flows

e. Statement of Changes in Owners' Equity

2. Fundamental Recognition Criteria

Recognition is the process of formally recording or incorporating an item in the financial statements of an entity and classifying it as asset, liability, equity, revenue, or expense.

a. Definitions (i.e., Does it meet the definition of an element defined in SFAC No. 6?)

b. Measurability

c. Relevance

d. Reliability

3. Measurement Attributes for Assets and Liabilities

a. Historical Cost

b. Current Cost

c. Net Realizable Value

d. Current Market Value

e. Present Value of Future Cash Flows

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4. Fundamental Assumptions

a. Entity Assumption

Economic activity can be accounted for when considering an identifiable set of activities (e.g., a separate corporation, division, etc.).

b. Going Concern Assumption

For financial accounting, it is presumed (subject to rebuttal by evidence to the contrary) that the entity will continue to operate in the foreseeable future.

c. Monetary Unit Assumption

It is assumed that money is an appropriate basis by which to measure economic activity. The assumption is that the monetary unit does not change over time; thus, the effects of inflation are not reflected in the financial statements.

d. Periodicity Assumption

Economic activity can be divided into meaningful time periods.

e. Historical Cost Principle

As a general rule, financial information is accounted for and based on cost, not current market value.

f. Revenue Recognition Principle

As a general rule, revenue should be recognized when it is earned and when it is realized or realizable.

(1) Earned

Revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.

(2) Realized or Realizable

Revenues and gains are recognized when products, merchandise, or other assets are exchanged for cash or claims to cash or when related assets received or held are readily convertible to known amounts of cash or claims to cash.

g. Matching Principle

Expenses are necessarily incurred to generate revenue. In accordance with the matching principle, all expenses incurred to generate a specific amount of revenue in a period are **matched** against that revenue. The matching principle does not govern the recognition of losses since they result from unusual events.

h. Accrual Accounting

Revenues are recognized when they are earned and expenses are recognized in the same period as the related revenue (matching or using a systematic and rational allocation or expensing in the period in which they expire), not necessarily in the period in which the cash is received or expended by the company.

i. Full Disclosure Principle

It is important that the user be given information that would make a difference in the decision process but not so much information that the user is impeded in analyzing what is important.

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j. Conservatism Principle

When selecting alternative GAAP methods, the method that is least likely to overstate assets (and revenues/gains) and understate liabilities (and expenses/losses) in the current period should be selected.

(1) Recognize revenues/gains when the earnings process is complete (or virtually completed).

(2) Recognize expenses/losses immediately.

E. SFAC NO. 6 "ELEMENTS OF FINANCIAL STATEMENTS"

Elements are the components of the financial statements. They must be measurable and meet the recognition requirements previously discussed. Ten elements provide the information required in the objectives stated in SFAC No. 1.

1. Comprehensive Income

Comprehensive income includes all differences between beginning equity and ending equity other than transactions with owners (i.e., net income plus other comprehensive income).

2. Revenues

Revenues are inflows, enhancements of assets, or reductions of liabilities from delivering goods or services as a part of normal operations. Recognize revenue at the gross amount (less allowances for returns and discounts given).

3. Expenses

Expenses are outflows, uses of assets, or the incurrence of liabilities from delivering goods or services as part of normal operations.

4. Gains

Gains are increases in equity from peripheral transactions and other events except revenue and investments from owners.

5. Losses

Losses are decreases in equity from peripheral transactions and other events except expenses and distributions to owners.

6. Assets

Assets are probable future economic benefits to be received by the company as a result of past transactions or events. Valuation accounts may be used to show reductions to or increases in an asset that reflect adjustments beyond the historical cost or carrying amount of the asset.

7. Liabilities

Liabilities are probable future sacrifices of economic benefits arising from a present obligation of the company to transfer assets or provide services to other entities in the future as a result of past transactions or events.

8. Equity (of Net Assets)

Equity is the residual interest in the assets of the company that remains after deducting its liabilities.

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9. Investments by Owners

Investments by owners are the increases in assets from transfers of cash, property, or services from owners.

10. Distributions to Owners

Distributions to owners are decreases in assets from transfers of cash, property, or services, or the incurrence of a liability to owners.

F. SFAC NO. 7 "USING CASH FLOW INFORMATION AND PRESENT VALUE IN ACCOUNTING MEASUREMENTS"

SFAC No. 7 provides a framework for accountants to employ when using future cash flows as a measurement basis for assets and liabilities, especially when the factors to consider in the measurement are complex. It also provides a set of principles that govern the use of present value, especially when the timing and/or amount of future cash flows are uncertain.

1. Measurements Based on Future Cash Flows Only

SFAC No. 7 only applies to measurement issues for assets and liabilities that are determined using future cash flows only.

2. Five Elements of Present Value Measurement

The FASB identified five elements of present value (or economic value) measurement that were used as the basis for determining the measurement objective of SFAC No. 7.

a. Estimate of Future Cash Flow

b. Expectations about Timing Variations of Future Cash Flows

c. Time Value of Money (the Risk-free Rate of Interest)

d. The Price for Bearing Uncertainty

e. Other Factors (e.g., Liquidity Issues and Market Imperfections)

3. Fair Value Objective

If fair value cannot be determined in the marketplace, the objective must be to obtain an estimate of fair value (i.e., a present value of future cash flows).

4. Present Value Computations

SFAC No. 7 allows the use of two approaches to determine present value (each considering the interest method of allocation), depending on the circumstances.

a. Traditional Approach

The traditional approach (i.e., one discount rate used to take the present value of a future cash flow stream) to present value computations may be used when assets and liabilities have contractual (i.e., fixed) cash flows that are not expected to vary. In this approach, interest rate selection is paramount.

b. Expected Cash Flow Approach

In more complex cases, the expected cash flow approach is to be used. Rather than focusing on the interest rate selection, this approach uses only the risk-free rate of return as the discount rate and then turns its attention to the expected future cash flows, considering uncertainties (e.g., default risk) as adjustments to the future cash flows.

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(1) Expected Cash Flow

The expected cash flow approach considers a range of possible cash flows and assigns a (subjective) probability to each cash flow in the range to determine the weighted-average, or "expected," future cash flow.

(2) Risk and Uncertainty Adjustments to Cash Flows

Adjustments to the expected cash flows used in complex present value computations (rather than interest rate adjustments) are required for uncertainties (e.g., default risk).

5. Liability Measurement Considers Additional Factors

The FASB determined that, when using present value, the objective of estimating the fair value of a liability must consider certain other factors, including:

a. Costs to Settle

b. Credit Standing of the Company

6. Changes in Estimated Cash Flows Using the Catch-up Approach

To use this approach, simply adjust the carrying amount of the asset or liability to the present value determined using the revised estimates and discount using the original effective interest rate.

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REPORTING NET INCOME

I. USES AND TERMINOLOGY

The purpose of the income statement is to provide information about the uses of funds in the income process (i.e., expenses), the uses of funds that will never be used to earn income (i.e., losses), the sources of funds created by those expenses (i.e., revenues), and the sources of funds not associated with the earnings process (i.e., gains).

A. USES OF THE INCOME STATEMENT

The income statement is useful in determining profitability, value for investment purposes, and credit worthiness. The income statement is also useful in predicting information about future cash flows (e.g., the amounts, timing, and uncertainty of cash flows) based on past performance.

B. TERMINOLOGY

1. Cost and Unexpired Costs

a. Cost

Cost is an amount (measured in money) expended for items such as capital assets, services (e.g., payroll), and merchandise received. Cost is the amount actually paid for something.

b. Unexpired Costs

Unexpired costs are costs that will expire in future periods and be charged (allocated in a systematic and rational manner or matched) against revenues from future periods.

c. Examples

Unexpired Costs (Asset)		**Expired Costs** (Expense)
(1) Inventory	→	Cost of goods sold
(2) Unexpired (prepaid) cost of insurance	→	Insurance expense
(3) Net book value of fixed assets	→	Depreciation expense
(4) Unexpired cost of patents	→	Patents expense (amortization)

2. Gross Concept (Revenues and Expenses)

a. Revenues

Revenues are reported at their gross amounts (less allowance for returns and discounts given).

b. Expenses

Expenses (costs that only benefit the current period or the allocation of unexpired costs to the current period for the benefit received) are reported at their gross amounts.

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3. Net Concept (Gains and Losses)

a. Gains

Gains are reported at their net amounts (i.e., proceeds less net book value). A gain is the recognition of an asset either not in the ordinary course of business (e.g., gains on the sale of a fixed asset) or without the incurrence of an expense (e.g., finding gold on the company's property).

b. Losses

Losses are reported at their net amounts (i.e., proceeds less net book value). A loss is cost expiration either not in the ordinary course of business (e.g., loss on the sale of investment assets) or without the generation of revenue (e.g., abandonment).

II. PRESENTATION ORDER OF THE MAJOR COMPONENTS OF AN INCOME AND RETAINED EARNINGS STATEMENT

Reported on Income Statement

A. INCOME (OR LOSS) FROM CONTINUING OPERATIONS (REPORT "GROSS OF TAX")

Income from continuing operations includes operating activities (i.e., revenues, costs of goods sold, selling expenses, and administrative expenses), non-operating activities (e.g., other revenues and gains and other expenses and losses), and income taxes.

B. INCOME (OR LOSS) FROM DISCONTINUED OPERATIONS (REPORT "NET OF TAX")

Income from discontinued operations is presented net of tax.

C. EXTRAORDINARY ITEMS (REPORT "NET OF TAX")

Extraordinary items are presented net of tax and include items that are unusual in nature and infrequent in occurrence.

Reported on Statement of Retained Earnings

D. CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE (REPORT "NET OF TAX")

The cumulative effect of a change in accounting principle is presented net of tax. It is the cumulative effect (calculated as of the beginning of the earliest period presented in the period of implementation of the new method) of a change from one acceptable method of accounting to another ("GAAP to GAAP") because the new method presents the financial information more fairly than the old method.

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Company Name

INCOME STATEMENT

For the Year Ended XXXX

Net sales		XXX
Cost of sales		(XXX)
Gross profit		XXX
Selling expenses		(XXX)
General & administrative expenses		(XXX)
Operating income		XXX
Other income (expense)		
Interest income (expense)	(XXX)	
Gain (loss) on transactions in foreign currencies	XXX	XXX
Income before unusual items and income tax		XXX
Unusual or infrequent items		
Gain on litigation settlement	XXX	
Gain on sale of available-for-sale investments	XXX	XXX
Income from continuing operations before income tax		XXX
Income tax		
Current	XXX	
Deferred	XXX	XXX
(I) Income from continuing operations		XXX
(D) Discontinued operations		
Loss from operations of Division A (including disposal loss of $XX and less income tax benefit of $XX)		XXX
Income (loss) before extraordinary item		XXX
(E) Extraordinary items [Note_____(less applicable income taxes of $XX)]		XXX
Net income		XXX

PASS KEY

The examiners will ask specific questions regarding the placement on the income and retained earnings statements of various items. Remember "IDEA," and you will have the answer quickly!

REPORTING RULES

Rule 1: Line items above "income from continuing operations" are shown "gross" (i.e., before tax).

Rule 2: Line items below "income from continuing operations" are shown "net" (i.e., after tax).

(I) ncome from continuing operations – "gross"
(D) iscontinued operations – "net"
(E) xtraordinary items – "net"
} Income Statement

(A) ccounting principle change – "net"
} Retained Earnings Statement

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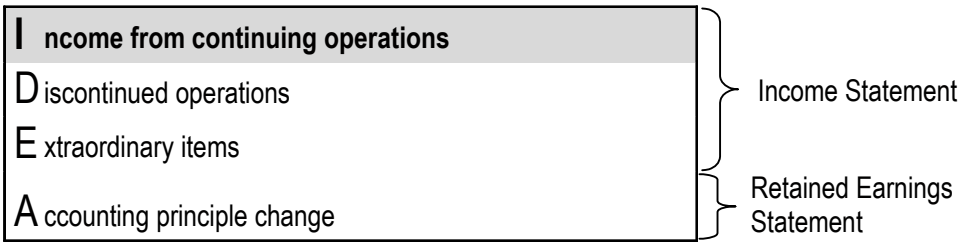
INCOME FROM CONTINUING OPERATIONS



I. SINGLE STEP INCOME STATEMENT

In the single step income statement presentation of income from continuing operations, total expenses (including income tax expense) are subtracted from total revenues; thus, the income statement has a single step. The benefits of a single step income statement are its simple design and the fact that the presentation of types of revenues or expenses do not appear to the user to be classified as more important than others.

Radon Industries, Inc.
Income Statement (single step)
For the Year Ended December 31, 20X1 (in thousands)

Revenues and other items		
Sale of goods	Σ (I) = $650 (Refer to multiple-step I/S on next page.)	(I) $350
Sale of services		(I) 200
Interest income		170
Rental income		(I) 100
Gain on sale of fixed assets (e.g., equipment)		50
Other income		130
Total revenues and other items		**$1,000**
Expenses and other items		
Cost of goods sold (including freight in)	$410 (Refer to multiple-step I/S on next page.)	$200
Cost of services sold		150
Cost of rental income		60
Selling expenses (including freight out)		100
General and administrative expenses (including property tax, insurance, officers' salaries, and legal expense)		70
Interest expense		50
Depreciation expense		80
Loss on sale of fixed assets (e.g., equipment)		40
Loss on sale of available-for-sale securities		100
Income tax expense (provision for income tax)		100
Total expenses and other items		**$950**
Net income (or income from continuing operations, if necessary)		$50

Statement of Retained Earnings

Add: Retained earnings at the beginning of the period	500
Subtotal	$550
Less: Dividends declared	(30)
Cumulative effects of change in accounting principle (less applicable income taxes of $60)	90
Retained earnings at the end of the period	$610

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II. MULTIPLE STEP INCOME STATEMENT

The multiple step income statement reports operating revenues and expenses separately from non-operating revenues and expenses and other gains and losses. The benefit of the multiple step income statement is enhanced user information (because the line items presented often provide the user with readily available data with which to calculate various analytical ratios).

Radon Industries, Inc.
Income Statement (multiple step)
For the Year Ended December 31, 20X1 (in thousands)

Net sales (including goods, services, and rentals)			$650
Cost of sales (including goods, services, and rentals)			(410)
Gross margin			$240
Selling expenses		$100	
General and administrative expenses		70	
Depreciation expense		80	(250)
Income (loss) from operations			$ (10)
Other revenues and gains:			
Interest income		170	
Gain on sale of fixed assets (e.g., equipment)		50	
Other income		130	350
Other expenses and losses:			
Interest expense		50	
Loss on sale of fixed assets (e.g., equipment)		40	(90)
Income before unusual items and income tax			$250
Unusual or infrequent items			
Loss on sale of available-for-sale securities			(100)
Income before income tax			150
Provision for income taxes			
Current	180		
Deferred	(80)		(100)
Net income (or "income from continuing operations")*			$ 50

* "Income from continuing operations" would be used if other categories are applicable, such as "discontinued operations," or "extraordinary items."

1. **Inventory Cost**..... Purchase price, freight in
2. **Selling Expense**..... Freight out, salaries and commissions, advertising
3. **General & Administrative**..... Officers' salaries, accounting and legal, insurance
4. **Non-operating**..... Auxiliary activities, interest expense

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DISCONTINUED OPERATIONS

I. INTRODUCTION

The treatment of discontinued operations, previously accounted for under APB 30, now follows SFAS No. 144 (which also replaced SFAS No. 121 related to the impairment of long-lived assets, discussed in lecture F-4). Discontinued operations are still reported separately from continuing operations in the income statement according to the IDEA mnemonic, net of tax. The (normally) loss from discontinued operations can consist of an impairment loss, a gain/loss from actual operations, and a gain/loss on disposal. All of these amounts are included in discontinued operations in the period in which they occur (anticipated losses are no longer allowed as called for by APBO No. 30).

II. DEFINITIONS

A. COMPONENT OF AN ENTITY

A component of an entity is a part of an entity (the lowest level) for which operations and cash flows can be *clearly distinguished, both operationally and for financial reporting purposes,* from the rest of the entity. A component of an entity may be:

1. An operating segment,
2. A reportable segment (as those terms are defined in segment reporting),
3. A reporting unit (as that term is defined in goodwill impairment testing),
4. A subsidiary, or
5. An asset group.

B. ASSET GROUP

An asset group is a collection of assets to be disposed of together as a group in a single (disposal) transaction and the liabilities directly associated with those assets that will be transferred in that same transaction.

C. HELD FOR SALE

A component of a business is classified as "held for sale" in the period in which ALL of the following criteria are met:

1. Management commits to a plan to sell the component.
2. The component is available for immediate sale in its present condition.
3. An active program to locate a buyer has been initiated.
4. The sale of the component is probable and the sale is expected to be complete within one year.
5. The sale of the component is being actively marketed.
6. Actions required to complete the sale make it unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

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III. ACCOUNTING RULES

A. TYPES OF ENTITIES TO BE CONSIDERED

The results of operations of a component of an entity will be reported in discontinued operations if either the component:

1. Has been disposed of, or
2. Is classified as held for sale.

B. CONDITIONS THAT MUST BE PRESENT

All related costs shall be recognized when the obligations to others exist, not necessarily in the period of commitment to a plan. **Both** of the following conditions must be met in order to report in discontinued operations the results of operations of a component that has been disposed of or is held for sale:

1. Eliminated from Ongoing Operations

The operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal.

2. No Significant Continuing Involvement

The entity will not have any significant continuing involvement in the operations of the component after the disposal.

C. REPORT RESULTS OF OPERATIONS IN PERIOD COMPONENT IS DISPOSED OF OR IS CLASSIFIED AS HELD FOR SALE

1. Types of Items Included in Results of Discontinued Operations

a. Results of Operations of the Component

b. Gain or Loss on Disposal of the Component

c. Impairment Loss (and Subsequent Increases in Fair Value) of the Component

(1) Initial and Subsequent Impairment Losses

A loss is recognized for recording the impairment of the component (i.e., any initial or subsequent write-down to fair value less costs to sell).

(2) Subsequent Increases in Fair Value

A gain is recognized for any subsequent increase in fair value minus the costs to sell (but not in excess of the previously recognized cumulative loss).

2. Report in the Period Disposed of or Held for Sale

The results of discontinued operations of a component are reported in discontinued operations (for the current period and for all prior periods presented) in the period the component is either disposed of or is held for sale. The results of subsequent operations of a component classified as held for sale are reported in discontinued operations in the period in which they occur.

3. Depreciation and Amortization

Assets within the component are no longer depreciated or amortized.

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D. ANTICIPATED FUTURE GAINS OR LOSSES

A gain or loss not previously recognized that results from the sale of the component is recognized at the date of sale and not before (i.e., gains or losses anticipated to occur in future periods are **not** recognized until they occur).

E. SUBSEQUENT ADJUSTMENTS TO AMOUNTS PREVIOUSLY REPORTED

Adjustments to amounts previously reported in discontinued operations that are *directly related* (see definition in item E.2, below) to the disposal of a component of an entity in a prior period are classified in the current period in discontinued operations.

1. Examples

a. Resolution of contingencies related to terms of the disposal transaction (e.g., purchase price adjustments and indemnification issues)

b. Resolution of contingencies directly related to the operations the component before it was disposed of (e.g., warranty obligations and environmental responsibilities)

c. Settlement of employee benefit plan obligations

2. Definition of "Directly Related"

In order for a settlement to be considered directly related to a component of an entity, it must:

a. Have a demonstrated cause-and-effect relationship and

b. Occur no later than one year after the date of the disposal transaction (unless circumstances beyond the control of the entity exist).

F. MEASUREMENT AND VALUATION

A component classified as held for sale is measured at the lower of its carrying amount or fair value less costs to sell. Costs to sell are the incremental direct costs to transact the sale.

G. PRESENTATION AND DISCLOSURE

1. Present as a Separate Component of Income

The results of discontinued operations, net of tax, are reported as a separate component of income before extraordinary items.

2. Disclose in Face or in Notes

A gain or loss recognized on the disposal shall be disclosed either on the face of the income statement or in the notes to the financial statements.

IV. EXAMPLE

See the required homework reading in this section for examples on reporting, presenting, and measuring the results of discontinued operations.

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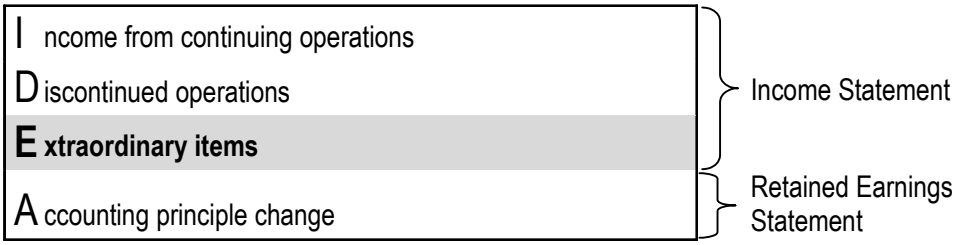
EXTRAORDINARY ITEMS



EXTRAORDINARY ITEMS

I. EXTRAORDINARY ITEMS

A. DEFINED (UNUSUAL AND INFREQUENT)

According to APB Opinion No. 30, extraordinary items are transactions and other events that are:

1. Material in nature,
2. Of a character significantly different from the typical or customary business activities,
3. Not expected to recur in the foreseeable future, and
4. Not normally considered in evaluating the ordinary operating results of an enterprise.

B. HOW TO CLASSIFY

Extraordinary items are usually determined by informed professional judgment, taking into consideration all the facts involved in a particular situation. Since the issuance of SFAS No. 145, the provisions of APB Opinion No. 30 dictate the classification of all extraordinary items.

C. SEPARATE DISCLOSURE

Extraordinary items must be separately disclosed in the income statement, net of any related tax effects, after discontinued operations.

D. EXAMPLES OF EXTRAORDINARY ITEMS

1. The abandonment of, or damage to, a plant due to an infrequent earthquake or an infrequent flood
2. An expropriation of a plant by the government
3. A prohibition of a product line by a newly enacted law or regulation
4. Certain gains or losses from extinguishment of long-term debt, provided they are not part of the entity's recurring operations and, thus, meet the criteria of APB Opinion No. 30 (per SFAS No. 145).

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E. EXAMPLES OF NONEXTRAORDINARY ITEMS

The following gains or losses are NOT extraordinary (they are presented as a separate component of "continuing operations"):

1. Gain or loss from sale or abandonment of property, plant, or equipment used in the business
2. Large writedowns or writeoffs of:
    a. Receivables
    b. Inventories
    c. Intangibles (including goodwill)
    d. Long-term securities (permanent decline)
3. Gain or loss from foreign currency transactions or translation, whether from major devaluations or otherwise (provided these occur on a regular basis as part of normal business operations)
4. Losses from major strike by employees
5. Long-term debt extinguishments that are part of a common management strategy (i.e., **not** unusual and infrequent)

II. MATERIAL UNUSUAL OR INFREQUENT ITEMS

Items of income or loss that are either unusual or infrequent are **not** extraordinary (e.g., gain on the sale of a factory building). If material, these items should be reported as a separate line item as part of income from continuing operations (and not net of tax). The nature of the item and the financial effects should be disclosed on the face of the income statement or in the footnotes.

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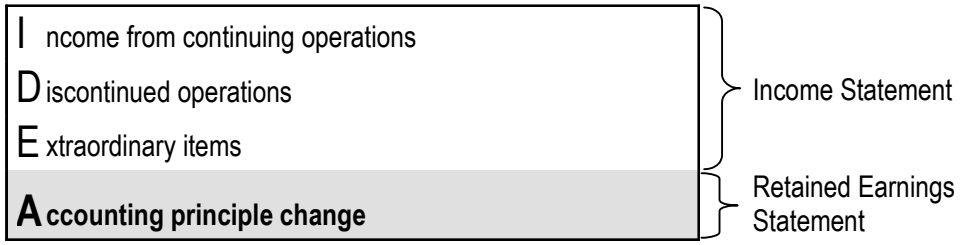
ACCOUNTING CHANGES AND PRIOR PERIOD ADJUSTMENTS



ACCOUNTING CHANGES

I. GENERAL

Accounting changes are broadly classified as:

(i) Changes in accounting estimate,

(ii) Changes in accounting principle, and

(iii) Changes in accounting entity.

Note that prior period adjustments are not considered accounting changes.

ACCOUNTING ESTIMATES

II. CHANGES IN ACCOUNTING ESTIMATE (PROSPECTIVELY)

A change in accounting estimate occurs when it is determined that the estimate previously used by the company is incorrect.

A. EVENTS RESULTING IN ESTIMATE CHANGES

1. Changes in the lives of fixed assets
2. Adjustments of year-end accrual of officers' salaries and/or bonuses
3. Write-downs of obsolete inventory
4. Material non-recurring IRS adjustments
5. Settlement of litigation
6. Changes in accounting principle that are inseparable from a change in estimate (e.g., a change from the installment method to immediate recognition method because uncollectible accounts can now be estimated)

EXAMPLE

Carlin Company buys a truck for $90,000. The truck is expected to last 10 years. During the third year, Carlin Company realizes that the truck is only going to last a total of 5 years. The truck is depreciated on the straight-line basis and has no estimated salvage value.

Depreciation Schedule Illustration

Year	Depreciation
1	$9,000 [$90,000/10]
2	$9,000 [$90,000/10]
3	$24,000 [$72,000/3]
4	$24,000 [$72,000/3]
5	$24,000 [$72,000/3]
	$90,000

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B. REPORTING A CHANGE IN ESTIMATE

1. Prospectively

Changes in accounting estimate are accounted for prospectively (i.e., implement in the current period and continue in future periods). They do not affect previous periods (i.e., no effect on previously reported retained earnings).

2. Change in Estimate Affecting Future Periods

If a change in accounting estimate affects several future periods (e.g., a revision of service lives of depreciable assets), the effect on income before extraordinary items, net income, and the related per share information for the current year should be disclosed in the notes to the financial statements.

Note: Changes in ordinary accounting estimates (e.g., uncollectible accounts and inventory adjustments) usually made each period do not have to be disclosed unless they are material.

III. CHANGES IN ACCOUNTING PRINCIPLE (RETROSPECTIVE APPLICATION)

A change in accounting principle is a change in accounting from one acceptable method of GAAP to another acceptable method of GAAP (i.e., GAAP to GAAP).

A. RULE OF PREFERABILITY

An accounting principle may be changed only if the alternative principle is preferable and more fairly presents the information. Justification for the change may stem from certain current and future AICPA Statements of Position and AICPA Industry and Audit and Accounting Guides.

B. NONRECURRING CHANGES

An accounting change should not be made for a transaction or event in the past that has been terminated or is nonrecurring.

C. EFFECTS OF A CHANGE

1. Direct Effects

The direct effects of a change in accounting principle are adjustments that would be necessary to restate the financial statements of prior periods.

2. Indirect Effects

The indirect effects of a change in accounting principle are differences in nondiscretionary items based on earnings (e.g., bonuses) that would have occurred if the new principle had been used in prior periods.

3. Cumulative Effect

If non-comparative financial statements are being presented, then the cumulative effect of a change in accounting principle is equal to the difference between the amount of beginning retained earnings in the period of change and what the retained earnings would have been if the accounting change had been retroactively applied to all prior affected periods. It includes direct effects and only those indirect effects that are entered in the accounting records. If comparative financial statements are being presented, then the cumulative effect is equal to the difference between beginning retained earnings in the first period presented and what retained earnings would have been if the new principle had been applied to all prior periods.

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EXAMPLE

Cumulative Effect of a Change in Accounting Principle

On January 1, 20X5, Harbor Construction Company decided to switch to the percentage-of-completion method in accounting for all of its long-term construction contracts. Prior to 20X5, Harbor used the completed contract method for some of its contracts. Harbor's effective tax rate is 30%. For income tax purposes, Harbor continues to use the completed contract method for all its contracts.

Contract information is as follows:

	Pretax Income from Percentage-of-Completion	Pretax Income from Completed Contract
Prior to 20X5	$800,000	$600,000

Cumulative effect adjustment as of 1/1/20X5 =	$200,000
Less income tax effect @ 30%	(60,000)
Cumulative effect net of income tax	$140,000

The Journal Entry to record the change is:

Construction in Progress (see F-2)	200,000	
Deferred Tax Liability (see F-6)		60,000
Retained Earnings		140,000

D. REPORTING CHANGES IN AN ACCOUNTING PRINCIPLE

The consistency characteristic of accounting information requires that once an accounting principle has been adopted it should not be changed. However, a change is sometimes desirable for various reasons. The general rule is that such changes should be recognized by adjusting beginning retained earnings in the earliest period presented for the cumulative effect of the change, and, if prior period financial statements are presented, they should be restated (retrospective application). There are, of course, exceptions to this general rule.

1. Exceptions to the General Rule

a. Impracticable to Estimate

To prepare a change in accounting principle handled retrospectively, the amount of the cumulative effect adjustment must be calculated as of the beginning of the first period presented. If it is considered "impractical" to accurately calculate this cumulative effect adjustment, then the change is handled **prospectively** (like a change in estimate). An example of a change handled in this manner is a change in inventory cost flow assumption to **LIFO**. Since a cumulative effect adjustment to LIFO would require the reestablishment and recalculation of old inventory layers, it is considered impractical to try and rebuild those old cost layers. This change is therefore handled prospectively. The beginning inventory of the year of change is the first LIFO layer. Additional LIFO layers are added on from that point forward.

b. Change in Depreciation Method

A change in the method of depreciation, amortization, or depletion is considered to be both a change in accounting principle and a change in estimate. These changes should be accounted for as changes in estimate and are handled prospectively. The new depreciation method should be used as of the beginning of the year of the change in estimate and should start with the current book value of the underlying asset. No retroactive or retrospective calculations should be made, and no adjustment should be made to retained earnings.

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2. Applications of the General Rule

a. The amount of cumulative effect to be reported on the retained earnings statement is the difference between:

(1) Retained earnings at the beginning of the earliest period presented, and

(2) Retained earnings that would have been reported at the beginning of the earliest period presented if the new accounting principle had been applied retrospectively for all prior periods, by recognizing only the direct effects and related income tax effect.

b. The new accounting principle is used for all periods presented (prior periods are restated).

c. If an accounting change is not considered material in the year of change but is reasonably expected to become material in later periods, it should be fully disclosed in the year of change.

EXAMPLE

Julie Enterprises, Inc. has been using the completed contract method of accounting for its long-term construction contracts since start-up of operations on January 1, 2004. No contracts were completed during 2004 or 2005. During 2006, Julie decided to change to the percentage-of-completion method for financial statement purposes. They have used, and continue to use, the completed contract method for tax purposes. Income statements for 2004 and 2005 are as follows:

Julie Enterprises, Inc.
Income Statements
2004 and 2005

	2004	2005
Sales	$3,560,000	$4,120,000
Cost of goods sold	(2,130,000)	(3,005,000)
Gross profit	1,430,000	1,115,000
Selling, general and administrative expenses	(860,000)	(810,000)
Operating income	570,000	305,000
Interest expense	(85,000)	(79,000)
Income before tax	485,000	226,000
Income tax expense – current	(194,000)	(90,400)
Net income	$ 291,000	$ 135,600

If Julie Enterprises had used the percentage-of-completion method during 2004 and 2005, income on partially completed contracts would have been $420,000 in 2004 and $380,000 in 2005. To record the change to the percentage-of-completion method in 2006, Julie would prepare the following journal entry:

Construction-in-process	800,000 (420,000 + 380,000)	
Deferred tax liability		320,000*
Retained earnings		480,000

* Changing to the percentage-of-completion method only for financial reporting purposes causes a temporary difference that creates a deferred tax liability (a 40% tax rate is assumed, $168,000 increase for 2004 [420,000 × 40%], and a $152,000 increase for 2005 [380,000 × 40%]).

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EXAMPLE (continued)

If the income statements for 2004 and 2005 were shown in comparison format with the income statement for 2006, retrospective application of the new accounting principle would be reflected in the income statements for 2004 and 2005, as follows:

Julie Enterprises, Inc.
Income Statements
2004 and 2005

Restated

	2004	2005
Sales	$ 3,560,000	$ 4,120,000
Cost of goods sold	(2,130,000)	(3,005,000)
Gross profit	1,430,000	1,115,000
Income on long-term construction contracts	**420,000**	**380,000**
Selling, general & administrative expenses	(860,000)	(810,000)
Operating income	990,000	685,000
Interest expense	(85,000)	(79,000)
Income before tax	905,000	606,000
Income tax expense – current	(194,000)	(90,400)
Income tax expense – deferred	**(168,000)**	**(152,000)**
Net income	$ 543,000	$ 363,600

A summary of the change is:

	2004	2005	Total
Net income restated	$543,000	$363,600	$906,600
Net income as previously reported	(291,000)	(135,600)	(426,600)
Increase	$252,000	$228,000	$480,000

IV. CHANGES IN ACCOUNTING ENTITY (RETROSPECTIVE APPLICATION)

CHANGES IN ACCOUNTING ENTITY

A change in accounting entity occurs when the entity being reported on has changed composition. Examples include consolidated or combined financial statements that are presented in place of statements of the individual companies and changes in the companies included in the consolidated or combined financial statements from year to year.

A. RESTATEMENT TO REFLECT INFORMATION FOR THE NEW ENTITY (IF COMPARATIVE FINANCIAL STATEMENTS ARE PRESENTED)

If a change in accounting entity occurs in the current year, all previous financial statements that are presented in comparative financial statements along with the current year should be restated to reflect the information for the new reporting entity.

B. FULL DISCLOSURE

Full disclosure of the cause and nature of the change should be made, including changes in income before extraordinary items, net income, and retained earnings.

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V. PRIOR PERIOD ADJUSTMENTS (RESTATEMENT)

Prior period adjustments consist of:

(i) Corrections of errors in the financial statements of prior periods,

(ii) Retroactive restatements required by new GAAP pronouncements, and

(iii) Changes from a non-GAAP method of accounting to a GAAP method of accounting (e.g., cash basis to accrual basis), which is a specific correction of an error.

A. ACCOUNTING

1. Comparative Financial Statements Presented

a. Correct the Information, if the Year is Presented

If comparative financial statements are presented and financial statements for the year with the error are presented, merely correct the error in those prior financial statements.

b. Adjust Beginning Retained Earnings of the Earliest Year Presented, if the Year is Not Presented

If comparative financial statements are presented and financial statements for the year with the error are not presented (e.g., because it is too far back in years), adjust (net of tax) the opening retained earnings of the earliest year presented.

2. Comparative Financial Statements Not Presented

If comparative financial statements are not presented, the error correction should be reported as an adjustment to the opening balance of retained earnings (net of tax).

B. EXAMPLE STATEMENT OF RETAINED EARNINGS (WITH RESTATEMENT EFFECTS)

The purpose of the statement of retained earnings is to reconcile the beginning balance of retained earnings with the ending balance. It is usually presented immediately following the income statement.

Jordan Manufacturing
STATEMENT OF RETAINED EARNINGS
For the Year Ended December 31, 20X5

Beginning balance (as previously reported)		$28,000,000
Prior period adjustment (Note 5)	$(4,500,000)	
Add: Income tax benefit	1,800,000	(2,700,000)
Cumulative effect of accounting change	5,000,000	
Less: Income tax effect	(2,000,000)	3,000,000
Beginning balance (restated)		28,300,000
Add: Net income		1,700,000
		30,000,000
Less: Dividends		
Cash dividend declared on preferred stock	500,000	
Cash dividend declared on common stock	350,000	
Property dividend declared on common stock	100,000	
Stock dividend declared on common stock	50,000	(1,000,000)
Ending balance		$29,000,000

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VI. SUMMARY OF ACCOUNTING CHANGES AND PRIOR PERIOD ADJUSTMENTS

Treatment of Accounting Changes

	Estimate	Principle	Entity	Prior Period Adjustment
	Prospectively	Retrospective	Retrospective	Error Correction
Adjust accounts so that only **CURRENT** and **SUBSEQUENT** income statement(s) will be affected.	**YES**	**NO**	**NO**	**NO**
If comparative FS, restate **PRIOR** period FS.	**NO**	**YES**	**YES**	**YES**
If not comparative FS, **restate Retained Earnings** only.	**NO**	**YES**	**N/A**	**YES**
CUMULATIVE EFFECT of "change" of GAAP should be shown in the Retained Earnings Statement of the earliest period presented as an adjustment to beginning retained earnings.	**NO**	**YES**	**NO**	**NO**

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COMPREHENSIVE INCOME

P ension minimum liability adjustments
U nrealized gains and losses (available-for-sale securities)
F oreign currency items
E ffective portion cash flow hedges

I. DEFINITIONS

A. COMPREHENSIVE INCOME

Comprehensive income is the change in equity (net assets) of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

Net income
+ Other comprehensive income
Comprehensive income

B. NET INCOME

Net income includes the following items:

1. Income from continuing operations
2. Discontinued operations
3. Extraordinary items

C. OTHER COMPREHENSIVE INCOME

Other comprehensive income includes those items in comprehensive income that are excluded from net income. Prior to the implementation of SFAS No. 130, these types of items were reported as separate line items (components) of owners' equity. SFAS No. 130 grouped all of these items together and called the changes in them for the period "Other Comprehensive Income."

An entity must classify the specific items by their nature, such as:

1. Pension Changes in Funded Status

Changes in the funded status of a pension plan due to gains or losses, prior service costs, and net transition assets or obligations must be recognized in other comprehensive income in the year the changes occur. All gains or losses, prior service costs, and transition assets or obligations are included in other comprehensive income until recognized as a component of net periodic benefit cost. (Pensions are covered in detail in lecture F-6, later in the course.)

2. Unrealized Gains and Losses

The following types of unrealized gains and losses on certain investments in debt and equity securities (per SFAS No. 115) are reported as components of other comprehensive income. (All are covered in detail in lecture F-3, later in the course.)

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a. Unrealized holding gains and losses on "available-for-sale securities."

b. Unrealized holding gains and losses that result from a debt security being transferred into the "available-for-sale" category from "held-to-maturity."

c. Subsequent decreases or increases in the fair value of "available-for-sale" securities previously written down as impaired.

3. Foreign Currency Items

Foreign currency translation adjustments and gains and losses on foreign currency transactions that are designated as (and are effective as) economic hedges of a net investment in a foreign entity (part of SFAS No. 133 and discussed in the F-7 lecture on derivatives and other financial instruments) are reported as a component of other comprehensive income. (Foreign currency and its related effects are covered in detail in lecture F-2, later in the course.)

4. Effective Portion of Cash Flow Hedges

Cash flow hedges are part of SFAS No. 133 and are discussed in the F-7 lecture on derivatives and other financial instruments, later in the course. The effective portion of a cash flow hedge is reported as a component of other comprehensive income.

D. RECLASSIFICATION ADJUSTMENTS

Adjustments for items that are displayed as part of net income for a period that had previously been displayed as part of other comprehensive income are referred to as reclassification adjustments. These adjustments may be displayed on the face of the financial statement in which comprehensive income is reported or disclosed in the notes to the financial statements.

E. ACCUMULATED OTHER COMPREHENSIVE INCOME

Accumulated other comprehensive income is a component of equity that includes the total of other comprehensive income for the period and previous periods. Other comprehensive income for the current period is "closed" to this account, which is reconciled each period similar to the manner in which retained earnings is reconciled.

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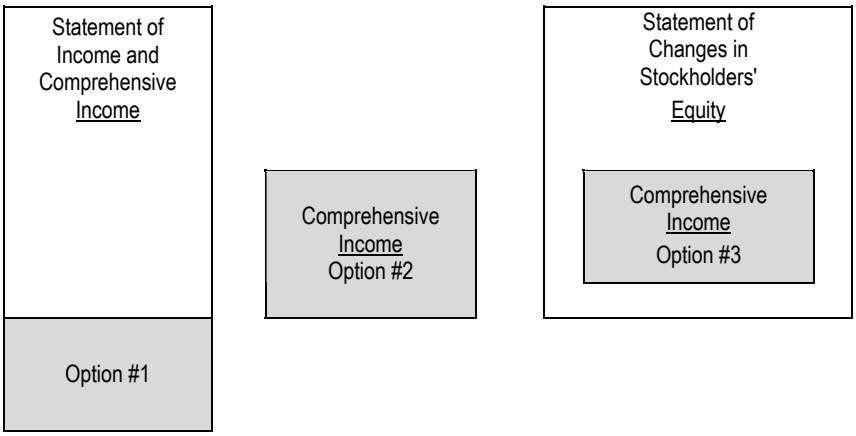
II. FINANCIAL STATEMENT REPORTING

Comprehensive income and its components shall be displayed in a financial statement that is presented with the same prominence as the other financial statements that constitute a full set of financial statements. The requirements to present comprehensive income do not apply to not-for-profit entities or to any company that does not have any item of other comprehensive income. Comprehensive income should not be reported on a per share basis.

One of three formats must be used to present comprehensive income:

1. Below the total for net income in a statement that reports results of operations;
2. In a separate statement of comprehensive income that begins with net income; or
3. In a statement of changes in equity.



A. SINGLE STATEMENT APPROACH

The single statement approach displays other comprehensive income below the income statement and totals them for comprehensive income.

Sydney Technologies, Inc.
Statement of Income and Comprehensive Income
For the Year Ended December 31, 20X5

Summarized	Revenues		$ 20,000,000
	Expenses		(18,400,000)
	Income before income taxes		1,600,000
	Income tax (25%)		(400,000)
	Net income		1,200,000
	Other comprehensive income, net of income tax		
	Pension net loss	$ (25,000)	
	Unrealized holding gains (available-for-sale securities)	300,000	
	Foreign currency items	(75,000)	200,000
	Comprehensive income		$1,400,000

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B. TWO-STATEMENT APPROACH

The two-statement approach displays comprehensive income as a separate statement that begins with net income.

Sydney Technologies, Inc.
Statement of Comprehensive Income
For the Year Ended December 31, 20X5

Net income		$1,200,000
Other comprehensive income, net of income tax		
Pension net loss	$ (25,000)	
Unrealized holding gains	300,000	
Foreign currency items	(75,000)	200,000
Comprehensive income		$1,400,000

C. COMPONENT WITHIN THE STATEMENT OF OWNERS' EQUITY

Comprehensive income may be displayed as a separate column in the statement of owners' equity. Note that the separate presentation of accumulated other comprehensive income is required as part of the statement of owners' equity.

Sydney Technologies, Inc.
Statement of Changes in Stockholders' Equity
For the Year Ended December 31, 20X5

	Total	*Comprehensive income*	*Retained earnings*	*Accumulated other comprehensive income*	*Common stock*
Beginning balance	$30,000,000		$8,500,000	$1,500,000	$20,000,000
Comprehensive income:					
Net income	1,200,000	$1,200,000	1,200,000		
Pension net loss	(25,000)	(25,000)			
Unrealized holding gains	300,000	300,000			
Foreign currency items	(75,000)	(75,000)			
Other comprehensive income		200,000		200,000	
Comprehensive income		$1,400,000			
Common stock issued	1,000,000				1,000,000
Dividends declared on common stock	(700,000)		(700,000)		
Ending balance	$31,700,000		$9,000,000	$1,700,000	$21,000,000

OPTIONAL FORMAT

REQUIRED FORMAT

Total = $31,700,000

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III. OTHER REPORTING ISSUES

A. OTHER COMPREHENSIVE INCOME

Components of other comprehensive income may be reported either (i) net of tax or (ii) before related tax effects with one amount shown for the aggregate income tax expense or benefit related to the total of other comprehensive income items.

B. INCOME TAX EXPENSE OR BENEFIT

The amount of income tax expense or benefit allocated to each component of other comprehensive income is disclosed either on the face of the statement in which those components are displayed or in the notes to the financial statements.

C. INTERIM PERIOD REPORTING

A total for comprehensive income shall be reported in condensed financial statements of interim periods issued to shareholders.

D. REQUIRED DISCLOSURES

All three formats must disclose:

1. The tax effects of each component included in (current) "Other Comprehensive Income," either as part of the statement presentation or in the notes to the financial statements.
2. The accumulated balances of components of "Other Comprehensive Income" (e.g., pension funded status changes, unrealized holding gains/losses on securities, foreign currency items, and the effective portion of cash flow hedges).
   (a) The accumulated balances by component may be shown on the balance sheet, in the statement of changes in equity, or in the notes to the financial statements.
3. Total "Accumulated Other Comprehensive Income" in the balance sheet as an item of "Equity" (see "required format" on above example).
4. The reclassification adjustments, which are made to avoid double counting in "Other Comprehensive Income" items that are displayed in net income for the current year (e.g., previously reported unrealized gains on available-for-sale securities that were realized during the current year).

EXAMPLE

Reclassification Adjustment Disclosure Example

Unrealized holding gains arising during the period	$400,000
Less: Reclassification adjustments for gain included in net income	(100,000)
Net unrealized holding gain	$300,000

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DISCLOSURES

BALANCE SHEET AND DISCLOSURES OVERVIEW

I. BALANCE SHEET OVERVIEW

Below is an example of a classified balance sheet:

Company Name
BALANCE SHEET
As of December 31, 20X5

Assets	*Liabilities and Stockholders' Equity*
Current assets	**Current liabilities**
Cash and cash equivalents	Long-term debt due within one year
Trading securities, at fair value	Accounts payable
Accounts receivable, net of allowance for uncollectible accounts	Notes payable
Notes receivable	Interest payable
Merchandise inventory, at lower of cost or market	Salaries payable
Prepaid expenses	Income tax payable
Investments	Advances from customers (unearned revenue)
Available-for-sale securities, at fair value	Unearned rent revenue
Held to maturity securities	**Long-term liabilities**
Land held for future plant site	Bonds payable (10%, due December 31, 20X9)
Property, plant, and equipment	Plus: Unamortized premium on bonds
Land	or
Building	Less: Unamortized discount on bonds
Equipment	Deferred income tax liability
Less: Accumulated depreciation	Pension and other postretirement benefit liabilities*
Intangible assets	**Total liabilities**
Goodwill	**Stockholders' equity**
Patents, net of amortization	Capital stock
Other assets	Preferred stock, $10 par, 8% cumulative and nonparticipating, 10,000 shares authorized, 5,000 shares issued and outstanding
Bond issue costs	Common stock, $0.01 par, 600,000,000 shares authorized, 57,598,000 shares issued and 57,178,485 shares outstanding
Pension and other postretirement benefit assets*	Paid-in capital in excess of par
Total assets	Total paid-in capital
	Retained earnings
	Accumulated other comprehensive income
	Treasury stock at cost (419,515 shares)
	Total stockholders' equity
	Total liabilities and stockholders' equity

* For balance sheet reporting purposes, all overfunded pension plans are aggregated and reported in total as a noncurrent asset. All underfunded pension plans are also aggregated and reported as a current liability, a noncurrent liability (as shown), or both. See further discussion of pension plan reporting in F-6.

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II. DISCLOSURES (NOTES TO THE FINANCIAL STATEMENTS) OVERVIEW

A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

GAAP requires that a description of all significant policies should be included as an integral part of the financial statements. The preferred presentation is to include the "Summary of Significant Accounting Policies" as the first or second note to the financial statements. Policies presented in other notes should not be duplicated.

1. Identify and describe:
    a. Principles and methods
    b. Criteria
    c. Policies
    d. Pricing
2. Items not included in this footnote:
    a. Composition of accounts
    b. Amounts in dollars of account balances
    c. Details relating to changes in accounting principles
    d. Dates of maturity and amounts of long-term debt
    e. Yearly computation of depreciation, depletion and amortization

B. REMAINING NOTES TO THE FINANCIAL STATEMENTS

The remaining notes contain all other information relevant to decision makers (e.g., investors, creditors, etc.) These notes are used to disclose facts not presented in either the body of the financial statements or in the "Summary of Significant Accounting Policies." Examples of relevant note information include the following:

1. Changes in stockholders' equity including capital stock, paid-in capital, retained earnings, treasury stock, stock dividends and other capital changes;
2. Required marketable securities disclosure including carrying value and gross unrealized gains and losses;
3. Contingency losses;
4. Contractual obligations, including restrictions on specific assets or liabilities;
5. Pension plan description; and
6. Post-balance sheet disclosures of certain events that occurred before the financial statements were issued.

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INTERIM FINANCIAL REPORTING

I. GENERAL

Interim financial reporting is generally concerned with the quarterly reports that public companies must file with the SEC. Generally accepted accounting principles that were used in the most recent annual report of an enterprise should be applied to interim financial statements of the current year, unless a change in accounting principle is adopted in the current year.

II. MATCHING OF REVENUES AND EXPENSES

The general rule in preparing interim financial statements is that costs and expenses that clearly benefit more than one period should be properly allocated to the periods affected. Revenues should be recognized in the period in which they were earned and realized or realizable. Also, a total for comprehensive income in condensed financial statements of interim periods issued to shareholders shall be reported.

III. TIMELINESS OVER RELIABILITY

For interim reporting only, timeliness is emphasized over reliability.

IV. AN INTEGRAL PART OF ANNUAL FINANCIAL STATEMENTS

Interim financial statements must be viewed as an integral part of the annual financial statements. Because interim financial statements generally are not audited, each statement presented should be marked "unaudited."

V. INCOME TAXES

Income tax expense is estimated each quarter, using the estimated average tax rate that will apply for the entire year.

VI. ADDITIONAL INFORMATION

See the enhanced outline for interim financial reporting in the Homework Reading section at the back of this chapter.

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SEGMENT REPORTING

I. GENERAL

SFAS No. 131 significantly increased the items of disclosure that previously existed in segment reporting. The objective of requiring these disclosures was to provide information on the business activities and the economic environment of a company to help users of the financial statements:

(i) Better understand the enterprise's performance,

(ii) Better assess its prospects for future net cash flows, and

(iii) Make more informed judgments about the enterprise as a whole.

In general, an enterprise is required to report a measure of segment profit or loss, segment assets, and certain related items, but is not required to report segment cash flow or segment liabilities.

A. REQUIRED DISCLOSURES FOR ALL PUBLIC ENTERPRISES

In order to conform with GAAP, financial statements for public business enterprises must report segment information about a company's:

1. Operating Segments (Annual and Interim)
2. Products and Services
3. Geographic Areas
4. Major Customers

B. USE SAME ACCOUNTING PRINCIPLES AS MAIN FINANCIAL STATEMENTS

The required financial statement information is essentially a disaggregation of the entity's regular financial statements. The accounting principles used in preparing the financial statements should be used for the segment information. Segment information presented must be reconciled to the related aggregate amounts in the financial statements.

C. INTERCOMPANY TRANSACTIONS NOT ELIMINATED FOR REPORTING

It is important to remember that transactions between the segments of an enterprise are not eliminated as in consolidation between the parent company and subsidiaries.

D. SCOPE (PUBLIC COMPANIES ONLY)

Segment reporting applies to public companies only. It does not apply to not-for-profit organizations, nonpublic companies, or separate financial statements of members of a consolidated group if both the separate company statements and the consolidated or combined financial statements are included in the same financial report.

E. ADDITIONAL INFORMATION

See the Homework Reading at the back of this chapter for an expanded discussion of segment disclosures.

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II. OPERATING SEGMENTS

A. DEFINITION

An operating segment is a component of an enterprise:

(i) That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same enterprise),

(ii) Whose operating results are regularly reviewed by the enterprise's "Chief Operating Decision Maker" to make decisions about resources to be allocated to the segment and assess its performance, and

(iii) For which discrete financial information is available.

The definition of a segment depends on how management uses information, which is called the management approach method. For example, management may report results both by product and service lines and by geographical lines.

B. NOT EVERY ENTERPRISE IS AN OPERATING SEGMENT

Not every part of an enterprise is necessarily an operating segment or part of an operating segment.

1. Corporate Headquarters Not an Operating Segment

A corporate headquarters or certain functional departments may not earn revenues or may earn revenues that are only incidental to the activities of the enterprise and would, therefore, not be operating segments.

2. Pension Plan Not an Operating Segment

An enterprise's pension and other post-retirement benefit plans are not considered to be operating segments.

C. REPORTABLE SEGMENT

Reportable segments are operating segments of an enterprise that meet the criteria for separate reporting.

Those operating segments that exhibit similar long-term financial performance may be aggregated into a single operating segment if (i) aggregation is consistent with the objective and principles of segment reporting, (ii) the segments have similar economic characteristics, and (iii) the segments are similar in:

1. The nature of the products and services,
2. The nature of the production processes,
3. The type or class of customer for their products and services,
4. The methods used to distribute their products or provide their services, and
5. If applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.

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D. QUANTITATIVE THRESHOLDS FOR REPORTABLE SEGMENTS

1. 10% "Size" Test (must only meet one)

a. Revenue

A segment meets the size test if its reported revenue, including both sales to external customers and intersegment sales or transfers (but excluding interest income on advances and loans to other segments), is 10% or more of the combined revenue, internal and external, of all operating segments.

b. Reported Profit or Loss

A segment meets the size test if the absolute amount of its reported profit or loss is 10% or more of the greater, in absolute amount, of

(1) The combined reported profit of all operating segments that did not report a loss, or

(2) The combined reported loss of all operating segments that did report a loss.

c. Assets

A segment meets the size test if its assets are 10% or more of the combined assets of all operating segments. The assets of a segment are those assets included in the measure of the segment's assets that are reviewed by the chief operating decision maker.

2. 75% "Reporting Sufficiency" Test

If the total of external (consolidated) revenue reported by operating segments constitutes less than 75% of external (consolidated) revenue, additional operating segments need to be identified as reportable segments, even if they do not meet the above three tests, until at least 75% of external (consolidated) revenue is included in reportable segments. The practical limit to the number of segments is 10, which is not a precise limit.

3. 90% "Single Industry Dominance" Test

There is no requirement to report any segment if a single segment accounts for 90% or more of the following combined amounts for all segments:

a. Revenue,

b. Reported profit or loss, and

c. Assets.

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E. SEGMENT PROFIT (OR LOSS) DEFINED (see 1.b, above)

1. Formula

Revenues
Less: Directly traceable costs
Less: Reasonably allocated costs
Operating Profit (or loss)

2. Items Normally Excluded from Segment Profit (or Loss)

a. General corporate revenues

b. General corporate expenses

c. Interest expense (except for financial institutions)

d. Income taxes

e. Equity in earnings and losses of an unconsolidated subsidiary (i.e., under the equity method)

f. Gains or losses from discontinued operations

g. Extraordinary items

h. Minority interest

3. Income and Expense Allocation

Income and expenses are not allocated to a segment unless they are included in the determination of segment profit or loss reported to the "Chief Operating Decision Maker."

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DEVELOPMENT-STAGE ENTERPRISES

I. OVERVIEW

A development-stage enterprise is one in which either:

(i) Principal operations have not yet commenced, or

(ii) Principal operations have generated an insignificant amount of revenue (or a loss).

During the development stage, a company devotes most of its activities and resources toward establishing the business.

II. DISCLOSURE

A development-stage enterprise must issue the same financial statements as any other enterprise. These statements should be prepared in conformity with GAAP. The additional required disclosures are as follows:

A. Identify the financial statements as those of a development stage enterprise.

B. In the balance sheet, describe cumulative net losses as "deficit accumulated during the development stage."

C. In the income statement, show revenues and expenses for each period being presented, and present a *cumulative* amount (generally of losses) from the company's inception.

D. In the statement of cash flows, include:

1. Cumulative amounts of cash inflows and cash outflows from the company's inception, and
2. Current amounts of cash inflows and cash outflows for each period presented.

E. In the statement of stockholders' equity, include the following:

1. Number of shares of stock (or other securities) issued,
2. Dates of issuance, and
3. Dollar amounts assigned.
4. If noncash consideration is involved in the issuance, then include:
   a. A description of the nature of the consideration, and
   b. The basis for its valuation.

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FAIR VALUE MEASUREMENTS

I. OVERVIEW

Before SFAS No. 157 was issued, GAAP standards included different definitions of fair value and little information regarding how to use those definitions. SFAS No. 157 standardizes the definition of fair value, establishes a framework for measuring fair value, and expands fair value disclosures. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007, and it applies to all other accounting pronouncements that require or permit fair value measurement, except:

A. SFAS No. 123(R), Share-Based Payment and related interpretative pronouncements,

B. ARB No. 43, Chapter 4, "Inventory Pricing," and

C. Accounting pronouncements that permit measurements based on or using vendor-specific objective evidence of fair value. (Note that these pronouncements are beyond the scope of the CPA Exam.)

II. TERMINOLOGY

A. FAIR VALUE

Fair value is the price to sell an asset or transfer a liability in an orderly transaction between market participants at the measurement date.

1. Fair value is measured for a specific asset or liability, or a group of assets and/or liabilities.
2. Fair value is a market-specific measure, not an entity-specific measure.
3. Fair value is measured in the principal, or most advantageous, market for the asset or liability.
4. Fair value is an exit price (the price to sell an asset or transfer a liability), not an entrance price (the price to acquire an asset or assume a liability).
5. A fair value measure should reflect all of the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk.
6. Fair value does not include transaction costs, but may include transportation costs if location is an attribute of the asset or liability.
7. The fair value of an asset assumes the highest and best use of the asset.
8. The fair value of a liability should include the liability's nonperformance risk, which is the risk that the obligation will not be fulfilled.

B. ORDERLY TRANSACTION

An orderly transaction is one in which the asset or liability is exposed to the market for a period before the measurement date long enough to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities. An orderly transaction cannot be a forced transaction.

C. MARKET PARTICIPANTS

Market participants are buyers and sellers who are independent (not related parties), knowledgeable about the asset or liability, able to transact for the asset or liability, and willing to transact for the asset or liability.

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D. PRINCIPAL MARKET

The principal market is the market with the greatest volume or level of activity for the asset or liability. If there is a principal market for an asset or liability, the price in that market will be the fair value measurement, even if there is a more advantageous price in a different market.

E. MOST ADVANTAGEOUS MARKET

The most advantageous market is the market with the best price for the asset or liability, after considering transaction costs. Note that although transactions costs are used to determine the most advantageous market, transaction costs are not included in the final fair value measurement (see the illustration below). The price in the most advantageous market will be the fair value measurement only if there is no principal market.

ILLUSTRATION

- Gearty holds Foxy Co. stock, which trades on two exchanges (Gearty Inc. can access both the New York and London markets).
- The stock price and transaction costs at the measurement date follow:

Exchange	Quoted Stock Price	Transactions Costs	Net
New York	$52	$(6)	$46
London	$50	$(2)	$48

- ***What is the fair value of Foxy stock?***
  - If New York is the principal market = **$52**
  - If London is the principal market = **$50**
  - If no principal market, with London's price (net of transaction costs) having the most advantageous result = **$50**

F. HIGHEST AND BEST USE

The "highest and best use" is the use that maximizes the value of an asset or group of assets.

1. In-Use

If an asset's highest and best use is when in-use, such as a fixed asset, then the fair value of the asset is based on the price to sell the asset to be used by the buyer with other assets in a group.

2. In-Exchange

If an asset's highest and best use is in-exchange, such as a financial asset, then the fair value of the asset is based on the price to sell the asset standalone.

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III. FAIR VALUE MEASUREMENT FRAMEWORK

SFAS No. 157 establishes a framework for measuring the fair value of an asset or liability. This framework (i) outlines the valuation techniques that can be used to measure fair value and (ii) establishes a hierarchy of the inputs that can be used in these valuation techniques.

A. VALUATION TECHNIQUES

Under SFAS No. 157, entities can use the market approach, the income approach, the cost approach, or a combination of these approaches, as appropriate, when measuring the fair value of an asset or a liability. A change in valuation technique or its application is accounted for as a change in accounting estimate (which is accounted for prospectively).

1. The Market Approach

The market approach uses prices and other relevant information from market transactions involving identical or comparable assets or liabilities to measure fair value.

2. The Income Approach

The income approach converts future amounts, including cash flows or earnings, to a single discounted amount to measure fair value. This method can be applied to assets or liabilities.

3. The Cost Approach

The cost approach uses current replacement cost to measure the fair value of assets.

B. HIERARCHY OF INPUTS

The fair value hierarchy prioritizes the inputs that can be used in the valuation techniques described above. Level 1 inputs have the highest priority, and Level 3 inputs have the lowest priority. The level in the fair value hierarchy in which a fair value measurement falls is determined by the lowest level input that is significant to the fair value measurement.

1. Level 1 Inputs

Level 1 inputs are quoted prices in active markets for identical assets or liabilities that the reporting entity has access to on the measurement date. Level 1 inputs are the most reliable measures of fair value and should be used when available.

2. Level 2 Inputs

Level 2 inputs are inputs other than quoted market prices (Level 1) that are directly or indirectly observable for the asset or liability. Level 2 inputs include:

a. Quoted prices for similar assets or liabilities in active markets.

b. Quoted prices for identical or similar assets in markets that are not active.

c. Inputs other than quoted prices that are observable for the asset or liability.

d. Inputs that are derived from or corroborated by observable market data.

3. Level 3 Inputs

Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs reflect the reporting entity's assumptions and should be based on the best available information. Level 3 inputs should be used only when there are no observable (Level 1 or Level 2) inputs or when undue cost and effort is required to obtain observable inputs.

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IV. FAIR VALUE DISCLOSURES

The SFAS No. 157 disclosure requirements depend on whether the assets and liabilities to be measured at fair value are measured on a recurring basis (e.g., financial instruments) or on a nonrecurring basis (e.g., impaired assets).

A. RECURRING FAIR VALUE MEASUREMENT DISCLOSURES

For assets and liabilities that are measured at fair value on a recurring basis, the reporting entity must disclose the following information for each interim and annual period for each major category of assets and liabilities:

1. Fair value measurements at the reporting date.
2. The level in the fair value hierarchy in which the fair value measurements fall, segregating fair value measurements using Level 1, Level 2 and Level 3 inputs.
3. For fair value measurements based on Level 3 inputs, a reconciliation of beginning and ending balances, showing separately changes due to:
    a. Realized and unrealized gains and losses, segregating gains and losses included in earnings, and describing where gains and losses included in earnings are shown on the income statement,
    b. Purchases, sales, issuances and settlements, and
    c. Transfers in and out of Level 3.
4. The amount of total gains and losses attributable to unrealized gains and losses on assets and liabilities still held on the reporting date and a description of where the unrealized gains and losses are showing on the statement of income.
5. In annual periods, the valuation technique(s) used to measure fair value and a discussion of changes in valuation technique, if any.

B. NONRECURRING FAIR VALUE MEASUREMENT DISCLOSURES

For assets that are measured at fair value on a nonrecurring basis in periods after initial recognition, the reporting entity must disclose the following information for each interim and annual period for each major category of assets and liabilities:

1. The fair value measurements recorded and the reasons for the fair value measurements.
2. The level in the fair value hierarchy in which the fair value measurements fall, segregating fair value measurements using Level 1, Level 2 and Level 3 inputs.
3. For fair value measurements based on Level 3 inputs, a description of the inputs and the information used to develop the inputs.
4. In annual periods, the valuation technique(s) used to measure fair value and a discussion of changes in valuation technique, if any.

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ILLUSTRATION: Disclosure – Recurring[1]				
Fair Value at Reporting Date				
Description	**12/31/XX**	**Level 1:** Quoted prices in active markets for identical assets	**Level 2:** Significant other observable inputs	**Level 3[1]:** Significant unobservable inputs
Trading Securities	$115	$105	$10	-0-
Available-for-Sale Securities	75	75	-0-	-0-
Derivatives	60	25	15[2]	$20[3]
Venture Capital Investments	10	-0-	-0-	$ 10
Total	$260	$205	$25	$ 30

[1] Additional disclosures are required for recurring Level 3 measurements

[2] Standard interest rate swaps

[3] 20-year energy contract

ILLUSTRATION: Level 3 Recurring			
	Level 3: Assets Measured on Recurring Basis Using Significant Unobservable Inputs		
	Derivatives	**Investments by Venture Capitalists**	**Total**
Beginning Balance 01/01/XX	$14	$11	$25
Total gains or losses (realized / unrealized):			
Included in:			
• Income Statement	11	(3)	8
• Included in Other Comprehensive Income	4	-0-	4
• Purchases, issuances, and settlements	(7)	2	(5)
• Transfers in and/or out of Level 3	(2)	-0-	(2)
Ending Balance 12/31/XX	$20	$10	$30
Unrealized gain (loss) in earnings from assets still held at period end	$ 7	$ 2	$ 9

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ILLUSTRATION: Nonrecurring					
	Level 3: Assets Measured on a Recurring Basis Using Significant Unobservable Inputs				
Description	**End of Year 12/31/XX**	**Level 1** Quoted prices in active markets for identical assets	**Level 2** Significant other observable inputs	**Level 3** Significant unobservable inputs	**Total Gains (Losses)**
Long-lived assets held and used	$225	-0-	$225	-0-	($75)
Goodwill	$90	-0-	-0-	$90	($40)
Total					($115)

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HOMEWORK READING
Discontinued Operations Examples

I. DETERMINATION OF WHETHER THE CONDITIONS TO REPORT AS DISCONTINUED OPERATIONS EXIST

A. FACTS AND CIRCUMSTANCES

An entity that manufactures and sells various types of sporting goods determines its product groups by type of sport (e.g., basketball, tennis, golf, swimming, hockey, etc.). The product group is the lowest level of operations at which cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity, so each product group is considered a component of the entity.

B. REPORT AS PART OF DISCONTINUED OPERATIONS

The entity decides to sell its golf sports business and commits to a plan to sell that product group along with its operations. As of the date of the commitment, the golf product group is classified as held for sale. In addition, the operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal and the entity will not have any significant continuing involvement in the operations of the component after the disposal. In this case, the results of operations of the golf product group will be reported as income from discontinued operations, net of related tax effects.

C. REPORT AS PART OF CONTINUING OPERATIONS

The entity decides that it will remain in the golf product business but that it will discontinue its manufacture and sale of giant metal woods, which has been experiencing significant losses due to losing sales to its largest competitor, who specializes in giant metal woods and has brand recognition. Because the giant metal woods manufacture and sale is part of a larger component of the business and is not a component on its own, the conditions for reporting the related losses as part of discontinued operations for the period are not met. The related operations will be reported as part of continuing operations.

II. MEASUREMENT, PRESENTATION, AND DISCLOSURE OF DISCONTINUED OPERATIONS

A. FACTS

The Golf Division is losing $200,000 per month, and management of All Sports Company, which includes the Golf Division as a component, discovers this on March 31, 20X1. The Board of Directors decides on April 30, 20X1 to dispose of the Golf Division. The carrying value of the Golf Division on April 30, 20X1 is $4,000,000, and its fair value is $2,200,000.

After months of negotiations, the division's net assets are sold on June 30, 20X2 for $2,000,000. In the meantime, the Golf Division has continued losing $200,000 per month.

All Sports Company's income tax rate is 40%.

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B. QUESTION

How should the disposal of the Golf Division be reported on All Sports Company's 20X1 and 20X2 financial statements?

C. ANSWER

1. Reporting for 20X1

The Golf Division was not disposed of until 20X2 and would be reported as "held for sale" in the 20X1 financial statements. The decision was made in 20X1 (management committed to a plan to sell the component), and we will assume that all of the other criteria were met.

The Golf Division would be measured at the lower of its carrying amount or fair value less costs to sell. The lower of the two amounts is the fair value of $2,200,000, and the loss of $1,800,000 to recognize this impairment would be included in discontinued operations in 20X1. Because we have no information on "costs to sell", we will assume that the cost to sell is zero.

The continuing loss from the Golf Division would be included in discontinued operations in 20X1 for the number of months in 20X1. The total loss to be included would be the $200,000 per month x 12 months, or $2,400,000, for a total of $4,200,000. (The anticipated continuing losses of $200,000 per month for 20X2 would not be included in the 20X1 discontinued operations but would be included in the 20X2 discontinued operations.)

Reporting for 20X1 would be as follows:

DISCONTINUED OPERATIONS

Loss from operations of held-for-sale Golf Division	
(including impairment loss of $1,800,000)	$(4,200,000)
Income tax benefit	1,680,000
Loss from discontinued operations	$(2,520,000)

2. Reporting for 20X2

For 20X2, discontinued operations would include the continuing losses of $200,000 per month x 6 months, or $1,200,000, and the loss on disposal of $200,000 ($2,200,000-$2,000,000), for a total of $1,400,000.

Reporting for 20X2 would be as follows:

DISCONTINUED OPERATIONS

Loss from operations of held-for-sale Golf Division	
(including disposal loss of $200,000)	$(1,400,000)
Income tax benefit	560,000
Loss from discontinued operations	$ (840,000)

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HOMEWORK READING

Sources of GAAP and Basic Framework and Concepts

I. INTRODUCTION

Generally accepted accounting principles (GAAP) are those accounting principles that have substantial authoritative support. Substantial authoritative support is a question of fact and a matter of judgment. The accounting profession itself determines generally accepted accounting principles.

The development of accounting principles began with the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934. The Securities and Exchange Commission, the body formed to enforce the acts, was given the authority to regulate securities traded on the national exchanges. This, in essence, gave the Securities and Exchange Commission (SEC) the power to establish generally accepted accounting principles and to regulate the accounting profession. However, the SEC has seldom interfered with the accounting profession's practices of establishing generally accepted accounting principles and of self-regulation.

A. THE AICPA

The American Institute of Certified Public Accountants (AICPA) took on the role of the developer of GAAP in 1939 with the formation of the Committee on Accounting Procedures and the Committee on Accounting Terminology.

From 1939 to 1953, the AICPA issued 42 Accounting Research Bulletins (ARBs), of which 8 were on accounting terminology and 34 were on problems that the accounting profession was most concerned with at that time. In June 1953, the AICPA issued ARB 43, "Restatement and Revision of Accounting Research Bulletins," which, excluding the ARBs on terminology, condensed all prior ARBs, eliminating what was no longer applicable, clarifying what continued to be of value, and arranging the retained material by subjects. Subsequently, ARBs 44 to 51 were issued between October 1954 and August 1959. Accounting Research Bulletins that have not been modified are still an important source of generally accepted accounting principles.

In 1959 the AICPA created the Accounting Principles Board (APB). From 1959 to 1972, the APB issued 31 Opinions. Any departure from an APB Opinion must be disclosed in an entity's financial statements. Therefore, CPAs are forced to comply with the APBs or justify the departure with "substantial authoritative support." Statements of the APB that have not been superseded are considered GAAP.

B. FINANCIAL ACCOUNTING STANDARDS BOARD

In 1972 the Accounting Principles Board was abolished and was replaced by the Financial Accounting Standards Board (FASB), a board independent of the AICPA. Since 1973 the FASB has issued numerous pronouncements in the area of financial accounting. These include the following:

1. Statements of Financial Accounting Standards (SFAS)

These statements have the highest level of authority of GAAP. (See II, *Hierarchy of Sources of GAAP*.) They provide accounting principles and procedures on specific accounting issues. Each statement is issued after extensive research, discussion memoranda, exposure drafts, and public comments.

2. Interpretations

These pronouncements provide clarification of previously issued statements, including APB Opinions and Accounting Research Bulletins.

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3. Technical Bulletins

The technical bulletins provide guidance on accounting and reporting problems.

4. Statements of Financial Accounting Concepts

In 1978 the Financial Accounting Standards Board issued the first of a series of Statements of Financial Accounting Concepts. These statements provide a theoretical foundation for generally accepted accounting principles. However, the statements themselves are not considered GAAP.

C. AUTHORITY FOR PROMULGATION OF GAAP

In 1964, the AICPA included in their rules of conduct that a CPA member would not express an opinion on the financial statements if they were not presented in conformity with generally accepted accounting principles. This rule remains part of the Code of Professional Conduct (Rule 203). Through interpretations to Rule 203, the AICPA is authorized to designate a body to establish accounting principles. The FASB has been so designated to promulgate generally accepted accounting principles. FASB statements, and those Accounting Research Bulletins and APB Opinions that have not been superseded, constitute accounting principles. Other pronouncements of the FASB and AICPA also have status of GAAP.

II. HIERARCHY OF SOURCES OF GAAP

In 2007, the Hierarchy of Generally Accepted Accounting Principles was issued. This statement supersedes SAS 69, which had previously established the GAAP hierarchy from the auditor perspective. This statement directs the GAAP hierarchy to enterprises, because enterprises, not their auditors, are responsible for selecting the accounting principles used in their financial statements.

A. CATEGORY A

1. Accounting Research Bulletins (ARBs)
2. Accounting Principles Board Opinions (APBOs)
3. FASB Statements of Financial Accounting Standards
4. FASB Staff Positions
5. FASB Interpretations
6. FASB Statement 133 Implementation Issues

B. CATEGORY B

1. FASB Technical Bulletins
2. AICPA Industry Audit and Accounting Guides (if cleared by the FASB)
3. AICPA Statements of Position (if cleared by the FASB)

C. CATEGORY C

1. AICPA Accounting Standards Executive Committee (AcSEC) Practice Bulletins (if cleared by the FASB)
2. Consensus positions of the FASB Emerging Issues Task Force
3. Topics discussed in Appendix D of EITF-Abstracts (EITF D Topics)

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D. CATEGORY D

1. AICPA Accounting Interpretations
2. FASB Implementation Guides (Q & A)
3. Practices that are widely recognized and prevalent either generally or in the industry
4. AICPA Industry Audit and Accounting Guides (not cleared by the FASB)
5. AICPA Statements of Position (not cleared by the FASB)

III. OBJECTIVES OF FINANCIAL REPORTING BY BUSINESS ENTERPRISES (SFAC NO. 1)

This first concepts statement defines the objectives of general purpose external financial reporting by business enterprises. It concludes that financial statements are intended to provide information that is useful in making business and economic decisions.

A. USERS OF FINANCIAL REPORTING

SFAC No. 1 identifies the potential users of financial reporting as those who base their decisions on their relationships to and knowledge about the business enterprise. This group includes external users such as investors, creditors, and customers, and those who advise these users.

B. OBJECTIVES OF FINANCIAL REPORTING

The objectives of financial reporting are to provide:

1. Information Useful in Investment and Credit Decisions

Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.

2. Information Useful in Assessing Cash Flow Prospects

Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. Since investors' and creditors' cash flows are related to enterprise cash flows, financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise.

3. Information about Enterprise Resources, Claims to Those Resources, and Changes in Them

Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change resources and claims to those resources.

In addition, since management knows more about the enterprise and its affairs than investors, creditors, and other outsiders, they can often increase the usefulness of financial information by identifying certain events and circumstances and explaining their financial effects on the enterprise.

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IV. QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION (SFAC #2)

This second concept statement sets out a hierarchy of characteristics of accounting information. These characteristics make information useful and are to be considered when accounting alternatives are available.

A. THE CENTRAL ROLE OF DECISION MAKING

The central role of decision making leads to the overriding criterion by which accounting choices must be judged, that is, the choice that produces the most useful information.

B. A HIERARCHY OF ACCOUNTING QUALITIES

The characteristics of information that make it a desirable commodity guide the selection of preferred accounting policies from among available alternatives. They can be viewed as a hierarchy of qualities, with usefulness for decision making the most important.

1. Understandability

Understandability is the quality of information that enables users to perceive its significance. SFAC No. 1 states that financial reporting should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence. Thus, understandability is governed by user characteristics and the characteristics inherent in the information. It serves as a link between characteristics of users and decision-specific qualities of information.

2. Decision Usefulness

To be useful in decision making information must possess three qualities:

(i) Relevance,

(ii) Reliability, and

(iii) Comparability.

3. Primary Qualities

a. Relevance

Information is relevant if it has the capacity to make a difference in investors', creditors', or other users' decisions. It is a primary qualitative characteristic. To be relevant, information must have predictive value and/or feedback value and must be timely.

(1) Predictive Value

Predictive value improves the capacity of decision makers to predict or forecast future events.

(2) Feedback Value

Feedback value enables decision makers to confirm prior expectations.

(3) Timeliness

Timeliness is having the information available while it is able to influence decisions.

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b. Reliability

Information is reliable if it is reasonably free from error and bias and faithfully represents what it purports to represent.

(1) Neutrality

Neutrality is freedom from bias toward a predetermined result.

Financial accounting information should not be recorded or reported in accordance with the desires of the users, but should be objectively presented in conformity with GAAP and prepared for the common needs of all users. Financial accounting information that is prepared to satisfy a few users to the detriment of others who may have opposing views is a violation of the concept of neutrality.

(2) Representational Faithfulness

Representational faithfulness is agreement between financial reporting and resources or events represented (validity).

(3) Verifiability

Verifiability secures a high degree of consensus among independent measures. Verifiable information is usually in the form of arm's-length transactions.

4. Secondary Characteristics

Both comparability and consistency are secondary characteristics of both relevance and reliability.

a. Comparability

Comparability is the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena. It allows users to compare the information with similar information for other business enterprises.

b. Consistency

Consistency is conformity from period to period with unchanging policies and procedures. However, consistent use of accounting principles from one accounting period to another, if pushed too far, can inhibit accounting progress. Therefore, it is the representational faithfulness of the measurements used, rather than simply the unchanging nature of the measurement rules or the classification rules, that results in true comparability over time.

5. Constraints

Two pervasive constraints must be considered.

a. Materiality, the Threshold for Recognition

Information should be provided if it is material. The more important a judgment item is, the finer the screen should be that will be used to determine whether it is material. Materiality is the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

b. Costs and Benefits

Benefits derived from disclosing the information must exceed associated costs.

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V. RECOGNITION AND MEASUREMENT IN FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES (SFAC NO. 5)

SFAC No. 3 was issued in 1980 and has been superseded by SFAC No. 6, which is covered in detail in the lecture materials. SFAC No. 4 addresses the objectives of financial reporting by nonbusiness organizations and is discussed in the ARE Not-for-Profit Accounting module.

SFAC No. 5 sets forth the recognition criteria and guidance on what and when information should be incorporated into financial statements.

A. FULL SET OF FINANCIAL STATEMENTS

A full set of financial statements for a period should show:

1. Financial Position

A statement of financial position provides information about an entity's assets, liabilities, and equity and their relationships to each other at a moment in time.

2. Earnings

The concept of earnings is similar to net income for the period. Earnings is a measure of performance for the period. It is revenue minus expenses plus gains minus losses.

3. Comprehensive Income

The concept of comprehensive income is a broad measure of the effects of transactions and other events on the entity. Comprehensive income includes all items of income and loss during a reporting period, including cumulative accounting adjustments and other nonowner changes in equity. Comprehensive income comprises all recognized changes in equity of the entity during a period except those resulting from investments by owners and distributions to owners. It is earnings net of cumulative adjustments and other nonowner changes in equity, such as cumulative accounting adjustments and holding gains and losses.

4. Cash Flows

A statement of cash flows directly or indirectly reflects an entity's cash receipts classified by major sources and its cash payments classified by major uses during a period. It provides useful information about an entity's activities in generating cash through operations, about its financing activities, and about its investing activities.

5. Investments by and Distributions to Owners

A statement of investments by and distributions to owners reflects the extent to which and in what ways the equity of an entity increased or decreased from transactions with owners as owners during a period.

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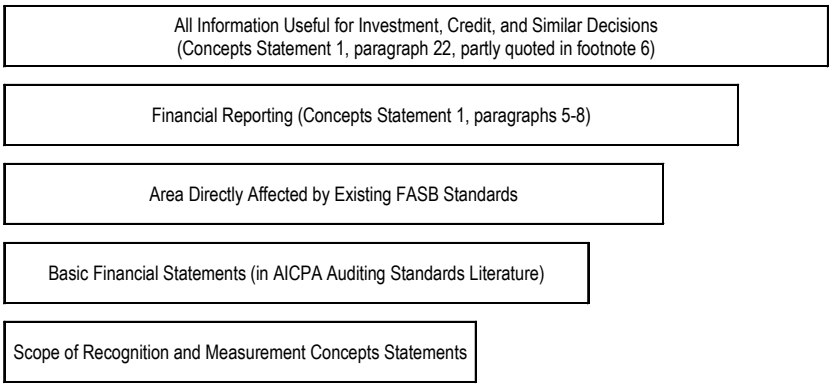
RECOGNITION AND MEASUREMENT IN FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES



Financial Statements	Notes to Financial Statements (and parenthetical disclosures)	Supplementary Information	Other Means of Financial Reporting	Other Information
• Statement of Financial Position • Statements of Earnings and Comprehensive Income • Statement of Cash Flows • Statement of Investments by and Distributions to Owners	• Statement of Financial Position • Statements of Earnings and Comprehensive Income • Statement of Cash Flows • Statement of Investments by and Distributions to Owners	Examples: • Changing Prices Disclosures (SFAS #33 as amended) • Oil and Gas Reserves Information (SFAS #69)	Examples: • Management Discussion and Analysis • Letters to Stockholders	Examples: • Discussion of Competition and Order Backlog in SEC Form 10-K (under SEC Reg. S-K) • Analysts' Reports • Economic Statistics • News Articles about Company

B. RECOGNITION CRITERIA

Recognition is the process of formally recording or incorporating an item into the financial statements of an entity as an asset, liability, equity, revenue, or expense.

1. Measurability

Measurability must be considered together with both relevance and reliability. The item has a relevant attribute measurable with sufficient reliability.

a. Historical Cost

Historical cost is usually acquisition cost, adjusted for depreciation and other allocations. Property, plant, and equipment and most inventories are reported at historical cost.

b. Current Cost

Current cost represents the amount of cash required to purchase an equivalent asset today. Some inventories are reported using current cost.

c. Current Market Value

Current market value represents the amount of cash that could be obtained by selling an asset. Trading and available-for-sale securities (bonds and stock) are reported at current market value.

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d. Net Realizable Value

Net realizable value is the nondiscounted cash into which an asset is expected to be converted in due course of business less direct costs, if necessary, to make that conversion. Some inventories are recorded at net realizable value.

e. Present Value of Future Cash Flows

Long-term receivables and payables are reported at their discounted cash flows, that is the present value of future cash inflows less the present value of any cash outflows to obtain the cash inflows. (See further applications in the SFAC No. 7 outline, below.)

f. Monetary Unit

The monetary unit is the nominal unit of money. All transactions are measured in terms of a single monetary unit. Additionally, the presumption is made that the value of this monetary unit does not change over time. Thus, the effects of inflation are not reflected in the financial statements. However, an increase in inflation might lead the FASB to select another, more stable measurement scale.

2. Relevance

The information about the item is capable of making a difference in user decisions.

3. Reliability

The information is representationally faithful, verifiable, and neutral.

C. GUIDANCE IN APPLYING CRITERIA TO COMPONENTS OF EARNINGS

Guidance for recognizing components of earnings is concerned with identifying which cycles are substantially complete and with associating particular revenues, gains, expenses, and losses with those cycles. This is simply the matching principle. Costs are matched to related revenues in determining earnings for a specific period. Revenues are recognized using the realization principle.

1. Revenue and Gains

a. Realized or Realizable

Revenue and gains are realized when products, merchandise, or other assets are exchanged for cash or claims to cash. Revenues and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash.

b. Earned

Revenues are not recognized until earned. Revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.

2. Expenses and Losses

Expenses and losses are generally recognized when an entity's economic benefits are used up in delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations or when previously recognized assets are expected to provide reduced or no further benefits.

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D. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Financial statements should include a summary of significant accounting policies. The summary is a compilation of the accounting policies of a business entity. It should include, for example, the basis of consolidation of the entity, the basis of profit recognition on long-term construction contracts, the methods of depreciation or amortization, and the methods of inventory costing used by the company. Items such as lists of plant assets or bond maturity dates are not policies and should not be included in the summary.

E. OTHER DISCLOSURES

Besides the informative classifications and segregation of data, financial statements should disclose all additional information that is necessary for a "fair presentation" in conformity with GAAP. Notes that are necessary for adequate disclosure are considered an integral part of the financial statements. Financial statements are restricted to numbers that are usually described in very few words and are essentially summaries of a large quantity of detailed information, usually requiring amplification by the use of notes to make the information more meaningful and provide additional disclosure.

VI. USING CASH FLOW INFORMATION AND PRESENT VALUE IN ACCOUNTING MEASUREMENTS (SFAC NO. 7)

Before February 2000, some of the pronouncements of the FASB included provisions for certain measurements using present value; however, no consistent approach had been provided for in the foundational concepts on which generally accepted accounting principles are based.

(i) SFAC No. 7 provides this much-needed framework for accountants to employ when using future cash flows as a measurement basis for assets and liabilities (either at initial recognition or when using fresh-start measurements), especially when the factors to consider in the measurement are complex.

(ii) SFAC No. 7 also provides a set of principles that govern the use of present value, especially when the timing and/or amount of future cash flows are uncertain.

This SFAC draws on previously issued SFACs by incorporating that a major objective of financial reporting is to provide investors with information regarding the amounts, timing, and uncertainty of future net cash flows of the company SFAC No. 1). It also ensures that the information presented is relevant, reliable, comparable, consistent, and subject to the constraints of materiality and cost-benefit (SFAC No. 2).

A. MEASUREMENTS BASED ON FUTURE CASH FLOWS ONLY

SFAC No. 7 only applies to measurement issues for assets and liabilities that are determined using future cash flows only. It does not apply to measurements based on fair value determined in the marketplace (i.e., cash or other types of assets received or paid or another type of market observation) because if these existed, measurement on future cash flows would not be necessary.

B. FIVE ELEMENTS OF PRESENT VALUE MEASUREMENT

The use of present value helps to identify the economic differences between sets of future cash flows. It helps to ensure that dissimilar assets or liabilities do not appear to be similar (and vice-versa) to the users of the financial statements. Further, present value measurements that consider the element of uncertainty make the presentation of the asset or liability in the financial statements even more relevant than those that do not consider uncertainty. The FASB identified five elements of present value (or economic value) measurement that were used as the basis for determining the measurement objective of SFAC No. 7.

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1. Estimate of Future Cash Flow
2. Expectations about Timing Variations of Future Cash Flows
3. Time Value of Money (the Risk-free Rate of Interest)
4. The Price for Bearing Uncertainty
5. Other Factors (e.g., Liquidity Issues and Market Imperfections)

C. FAIR VALUE OBJECTIVE

Based on the five elements identified above, the FASB determined that the objective of using present value in accounting measurements was to estimate fair value, which is an attribute that includes all of the five elements. As fair value is the measurement objective of assets and liabilities having observable market prices, it reasons that if fair value cannot be determined in the marketplace, an estimate of fair value must be obtained (i.e., a present value of future cash flows).

D. PRESENT VALUE COMPUTATIONS

Prior to SFAC No. 7, most present value computations (if used) were based on fixed (i.e., contractual) cash flows and constant effective interest rates that considered all elements of risk in them. While this is effective for many financial instruments with market interest rates, it is often not the best measure of those assets or liabilities for which cash flows are not certain and for which comparable market interest rates including all inherent risks do no exist. SFAC No. 7 allows the use of two approaches to determine present value (each considering the interest method of allocation), depending on the circumstances.

1. Traditional Approach

The traditional approach (i.e., one discount rate used to take the present value of a future cash flow stream) to present value computations may be used when assets and liabilities have contractual (i.e., fixed) cash flows that are not expected to vary. In this approach, interest rate selection is paramount, as, other than the estimate of future cash flow, all elements of present value measurement (see number 2, above) are included in the discount rate. Therefore, if comparable assets and liabilities can be observed in the marketplace, the traditional method is still acceptable.

2. Expected Cash Flow Approach

When comparable assets and liabilities (including non-financial assets and liabilities) cannot be observed in the marketplace, the traditional approach is not equipped to measure their fair values appropriately. In these more complex cases, the expected cash flow approach is to be used. Rather than focusing on the interest rate selection, this approach uses only the risk-free rate of return as the discount rate and then turns its attention to the expected future cash flows, considering uncertainties (e.g., default risk) as adjustments to the future cash flows.

a. Expected Value vs. Best Estimate

While traditional approaches in accounting have focused on the "most likely" best estimate of cash flows (i.e., the single cash flow with the highest probability of occurring is used), the expected cash flow approach considers a range of possible cash flows. Further, it assigns a (subjective) probability to each cash flow in the range to determine the weighed-average, or "expected," future cash flow.

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b. Risk and Uncertainty Adjustments to Cash Flows

The FASB recognized that cash flows used in the present value measurements are estimates, and, as such, there is an element of uncertainty in them. Companies are exposed to risk when there is uncertainty involved in a transaction. In addition, each company has a price, called the risk premium, for accepting uncertainty. While the traditional approach employs a market discount rate that includes adjustment for risk and uncertainty, the complex measurements that must use the expected value approach are not afforded this luxury. Adjustments to the expected cash flows used in those present value computations (not adjustments to the interest rate) are required for uncertainties (e.g., default risk).

E. LIABILITY MEASUREMENT CONSIDERS ADDITIONAL FACTORS

While all of the above measurement rules apply to both assets and liabilities, the measurement of liabilities must consider certain problems that do not exist with the measurement of assets. Some liabilities are relatively easy to measure (e.g., a bond); however others are significantly more complex (e.g., warranty obligations). The FASB determined that, when using present value, the objective of estimating the fair value of a liability must consider other factors.

1. Measurement Must Include Costs to Settle

The measurement of the liability must include an estimate of the costs (i.e., use of assets) required to settle the liability with the holder or to transfer the liability to a third party of comparable credit risk (i.e., the costs of having a third party assume the liability).

2. Credit Standing of the Company

The credit standing of a company is the most relevant measure of its liabilities and must be included in the measure of fair value. The effect that the credit standing has on the fair value of a liability depends on the provisions that may exist to protect holders of those instruments (e.g., sinking funds, collateral, and government guarantees) and on the ability of the company to pay. When a company's credit standing changes, this must be reflected in the fair value of the company's new and existing liabilities.

F. CHANGES IN ESTIMATED CASH FLOWS USE CATCH-UP APPROACH

The catch-up approach has been chosen by the FASB as the technique to use when reporting changes in estimated cash flows. To use this approach, simply adjust the carrying amount of the asset or liability to the present value determined using the revised estimates and discount using the original effective interest rate.

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HOMEWORK READING
Segment Reporting

I. SEGMENT DISCLOSURES

A. IDENTIFYING FACTORS

Factors used to identify the enterprise's reportable segments, including the basis of organization (e.g., products and services, geographic areas, regulatory environments) should be disclosed. Also disclose whether any operation segments have been aggregated.

B. PRODUCTS AND SERVICES

The types of products and services from which the reportable segment derives its revenues must be disclosed.

C. PROFIT OR LOSS

The following items must be individually disclosed if the amounts are included in the measure of segment profit or loss reviewed by the chief operating decision maker:

1. Revenues from external customers
2. Revenues from transactions with other internal operating segments
3. Interest revenue
4. Interest expense
5. Depreciation, depletion, and amortization
6. Unusual items, including unusual events and transactions
7. Equity in net income of investees accounted for by the equity method
8. Income tax expense or benefit
9. Extraordinary items
10. Significant noncash items other than depreciation, depletion, and amortization expense

D. ASSETS

1. The amount of investment in equity method investees
2. Total expenditures for
    a. Additions to long-lived assets other than financial instruments
    b. Long-term customer relationships of a financial institution
    c. Mortgage and other servicing rights
    d. Deferred policy acquisition costs
    e. Deferred tax assets

E. MEASUREMENT CRITERIA

1. Basis of accounting for any internal transactions
2. Nature of any differences between measurements of the reportable segments' profits or losses and the enterprise's consolidated income
3. Nature of any differences between measurements of the reportable segments' assets and the enterprise's consolidated assets, if not apparent from the reconciliation provided

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4. Nature of any changes from prior periods in the measurement methods used to determine reported segment profit or loss
5. The nature and effect of any asymmetrical allocations to segments

F. RECONCILIATIONS

1. The total of the reportable segments' revenues to the enterprise's consolidated revenues
2. The total of the reportable segments' measures of profit or loss to the enterprise's consolidated income before income taxes, extraordinary items, discontinued operations, and the cumulative effects of changes in accounting principles
3. The total of the reportable segments' assets to the enterprise's consolidated assets
4. The total of the reportable segments' amounts for every other significant item of information disclosed to the corresponding consolidated amount

II. ENTERPRISE-WIDE INFORMATION

The following disclosures apply to enterprises regardless of the number of reportable segments. They are required disclosures for all public enterprises.

A. PRODUCTS AND SERVICES

Revenues from external customers for each product or service or each group of similar products and services must be disclosed unless it is impracticable to do so, and that fact must be disclosed.

B. GEOGRAPHIC AREAS

1. Revenues

Disclose the revenues from external customers that are:

a. Attributable to the enterprise's domicile country.
b. Attributed to all foreign countries if the amount is material.
c. Attributed to individual foreign countries if the amount is material.
d. The basis for attributing revenues from external customers to individual countries.

2. Long-lived Assets

Disclose the long-lived assets that are:

a. Located in the enterprise's domicile country.
b. Located in all foreign countries in total in which the enterprise holds assets.
c. Located in individual foreign countries if the amount is material.

C. MAJOR CUSTOMERS

An enterprise that generates 10% or more of its revenue from sales to a single customer must disclose that fact, the total amount of revenues from each such customer, and the identity of the segment or segments reporting the revenues. The identity of the major customer need not be disclosed.

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HOMEWORK READING

Enhanced Outline for Interim Financial Reporting

I. GENERAL

Generally accepted accounting principles used in the most recent annual report of an enterprise should be applied to interim financial statements of the current year, unless a change in an accounting principle is adopted in the current year.

The general rule in preparing interim period financial statements is that costs and expenses that clearly benefit more than one period should be properly allocated to the periods affected (matching of revenue and cost principle). Revenues should be recognized in the interim period in which they are earned and realized or realizable. In addition, a total for comprehensive income in condensed financial statements of interim periods issued to shareholders shall be reported.

Timeliness is emphasized over reliability for interim reporting only. Interim financial statements must be viewed as an integral part of the annual financial statements.

II. INTERIM INVENTORY VALUATION

A. INVENTORY ESTIMATION METHODS

Companies using the gross profit method or a retail inventory method to determine interim inventory valuation, or other methods different from those used for annual inventory valuation, should disclose the method used at the interim date and any material difference when reconciled with the annual physical inventory.

B. LIQUIDATION OF A LIFO BASE LAYER

A liquidation of a base-period LIFO inventory layer at an interim date that apparently will be corrected by the end of the annual period should be valued at the expected cost of replacement. Cost of sales for the interim period should include the expected cost of replacement and not the cost of the base-period LIFO inventory.

C. PERMANENT AND TEMPORARY DECLINES IN MARKET VALUE

1. Permanent inventory losses from market declines should be reflected in the interim period in which they occur. Market increases in subsequent interim periods should be recognized in the recovery interim period not to exceed the losses included in prior interim periods.
2. Temporary market declines that are expected to reverse before the end of the annual period should not be recognized in interim period statements.

D. MANUFACTURING VARIANCES

Inventory and product costs computed by the use of standard costs should be determined by the same procedures used at the end of a fiscal year. Variances from standard costs that are expected to reverse by the end of the fiscal year should not be reflected in interim period statements.

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III. OTHER COSTS AND EXPENSES

A. SEASONAL REVENUE VARIATIONS

Companies that have material seasonal variations in their businesses should ensure that interim period financial statements do not become misleading. Disclosure of material seasonal variations should be made in interim period financial statements. In addition, if large seasonal changes usually occur, it is desirable to disclose results for the full year, which ends at the interim date.

B. UNUSUAL AND INFREQUENT TRANSACTIONS

Unusual and infrequent transactions that are material and not designated as extraordinary items, such as the effects of a disposal of a segment of business, should be reported separately.

C. INCOME TAXES

Income tax expense is estimated each quarter. The general rule is to multiply the year to date income by the estimated effective tax rate and subtract the result from the provision included in the previous quarter. The estimate of the effective tax rate expected to be applicable for the full fiscal year should reflect all tax planning alternatives including foreign tax rates, percentage depletion, capital gains rate, and anticipated investment tax credits.

D. DISCLOSURE

If the fourth quarter is not reported separately, any significant events and variations for that quarter should be disclosed in the notes.

At a minimum the following needs to be reported:

1. Gross sales or revenues, provision for income taxes, extraordinary items, and net income;
2. Basic and diluted earnings per share;
3. Material seasonal variations of revenues, costs, or expenses;
4. Significant changes in estimates or provisions for income taxes;
5. Disposal of a segment of a business and extraordinary, unusual, or infrequently occurring items;
6. Contingent items;
7. Changes in accounting principles or estimates; and
8. Significant changes in financial position.

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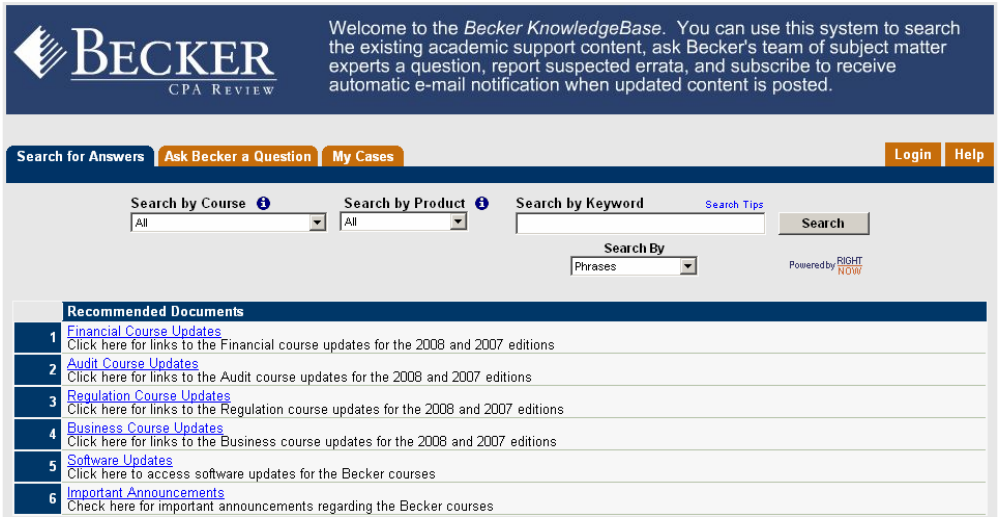
Please check the *Becker KnowledgeBase* (http://www.beckercpa.com/knowledgebase) regularly for supplemental materials, errata postings, software downloads, and other information provided to assist you in the successful preparation for **your** CPA Examination.



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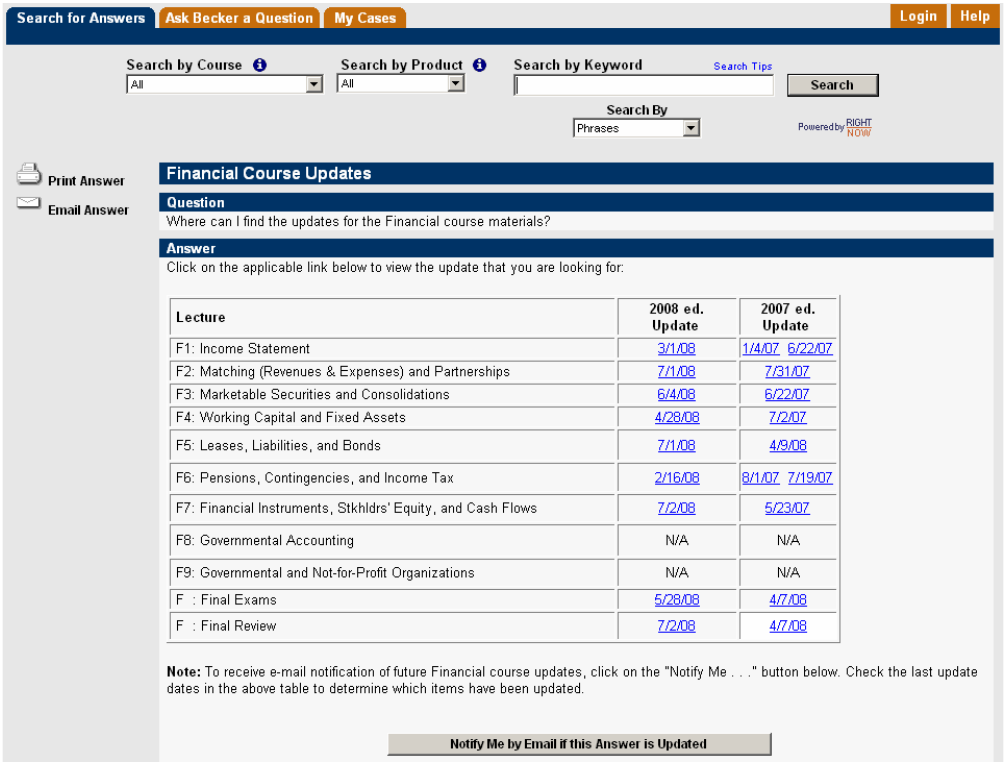

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NOTES

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FINANCIAL ACCOUNTING & REPORTING 1

Class Questions Answer Worksheet

MC Question Number	First Choice Answer	Correct Answer	NOTES
1.			
2.			
3.			
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16.			

Grade:

Multiple-choice Questions Correct / 16 = _____% Correct

Detailed explanations to the class questions are located in the back of this textbook.

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NOTES

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CLASS QUESTIONS

1. CPA-00005

What is the underlying concept governing the generally accepted accounting principles pertaining to recording gain contingencies?

a. Conservatism.
b. Relevance.
c. Consistency.
d. Reliability.

2. CPA-00010

According to Statements of Financial Accounting Concepts, neutrality is an ingredient of:

	Reliability	*Relevance*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

3. CPA-00020

On December 31, 1992, Brooks Co. decided to end operations and dispose of its assets within three months. At December 31, 1992, the net realizable value of the equipment was below historical cost. What is the appropriate measurement basis for equipment included in Brooks' December 31, 1992, balance sheet?

a. Historical cost.
b. Current reproduction cost.
c. Net realizable value.
d. Current replacement cost.

4. CPA-00031

Scott Corporation sold a fixed asset used for operations for greater than its carrying amount. Scott should report the transaction in the income statement using the:

a. Gross concept, showing the proceeds as part of revenues and the carrying amount as part of expenses in the continuing operations section.
b. Net concept, showing the total amount as an extraordinary item, net of income taxes.
c. Net concept, showing the total gain as part of discontinued operations, net of income taxes.
d. Net concept, showing the total gain as part of continuing operations, not net of income taxes.

5. CPA-00052

Which of the following should be included in general and administrative expenses?

	Interest	*Advertising*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

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6. CPA-00045

During January 20X3, Doe Corp. agreed to sell the assets and product line of its Hart division. The sale was completed on January 15, 20X4 and resulted in a gain on disposal of $900,000. Hart's operating losses were $600,000 for 20X3 and $50,000 for the period January 1 through January 15, 20X4. Disregarding income taxes, what amount of net gain (loss) should be reported in Doe's comparative 20X4 and 20X3 income statements?

	20X3	*20X4*
a.	$0	$250,000
b.	$250,000	$0
c.	$(600,000)	$850,000
d.	$(650,000)	$900,000

7. CPA-00055

On October 1, 20X4, Host Co. approved a plan to dispose of one of the company's operating segments. Host expected that the sale would occur on April 1, 20X5 at an estimated gain of $350,000. The segment had actual and estimated operating losses as follows:

1/1/X4 to 9/30/X4	$(300,000)
10/1/X4 to 12/31/X4	(200,000)
1/1/X5 to 3/31/X5	(400,000)

In its 20X4 income statement, what should Host report as a loss from discontinued operations before income taxes?

a. $200,000
b. $550,000
c. $500,000
d. $900,000

8. CPA-00065

On October 1, 20X3, Wand, Inc. committed itself to a formal plan to sell its Kam division's assets early in 20X4. On that date, Wand estimated that the fair value of the component's assets was $25,000 less than the carrying value. Wand also estimated that Kam would incur operating losses of $100,000 for the period of October 1, 20X3 through December 31, 20X3 and $50,000 for the period January 1, 20X4 through February 28, 20X4. All estimates proved to be materially correct. Disregarding income taxes, what should Wand report as loss from discontinued operations in its comparative 20X3 and 20X4 income statements?

	20X3	*20X4*
a.	$175,000	$0
b.	$125,000	$50,000
c.	$100,000	$75,000
d.	$0	$175,000

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9. CPA-00050

During 1994 both Raim Co. and Cane Co. suffered losses due to the flooding of the Mississippi River. Raim is located two miles from the river and sustains flood losses every two to three years. Cane, which has been located fifty miles from the river for the past twenty years, has never before had flood losses. How should the flood losses be reported in each company's 1994 income statement?

	Raim	*Cane*
a.	As a component of income from continuing operations	As an extraordinary item
b.	As a component of income from continuing operations	As a component of income from continuing operations
c.	As an extraordinary item	As a component of income from continuing operations
d.	As an extraordinary item	As an extraordinary item

10. CPA-00098

Midway Co. had the following transactions during 1992:

- $1,200,000 pretax loss on foreign currency exchange due to a major unexpected devaluation by the foreign government.
- $500,000 pretax loss from discontinued operations of a division.
- $800,000 pretax loss on equipment damaged by a hurricane. This was the first hurricane ever to strike in Midway's area. Midway also received $1,000,000 from its insurance company to replace a building, with a carrying value of $300,000 that had been destroyed by the hurricane.

What amount should Midway report in its 1992 income statement as extraordinary loss before income taxes?

a. $100,000
b. $1,300,000
c. $1,800,000
d. $2,500,000

11. CPA-00071

Which of the following statements is correct regarding accounting changes that result in financial statements that are, in effect, the statements of a different reporting entity?

a. Cumulative-effect adjustments should be reported as separate items on the income statement in the year of change.
b. No restatements or adjustments are required if the changes involve consolidated methods of accounting for subsidiaries.
c. No restatements or adjustments are required if the changes involve the cost or equity methods of accounting for investments.
d. The financial statements of all prior periods presented should be restated.

12. CPA-00081

For 1991, Pac Co. estimated its two-year equipment warranty costs based on $100 per unit sold in 1991. Experience during 1992 indicated that the estimate should have been based on $110 per unit. The effect of this $10 difference from the estimate is reported:

a. In 1992 income from continuing operations.
b. As an accounting change, net of tax, below 1992 income from continuing operations.
c. As an accounting change requiring 1991 financial statements to be restated.
d. As a correction of an error requiring 1991 financial statements to be restated.

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13. CPA-00102

One of the elements of a financial statement is comprehensive income. Comprehensive income excludes changes in equity resulting from which of the following?

a. Loss from discontinued operations.
b. Prior period error correction.
c. Dividends paid to stockholders.
d. Unrealized loss on investments in noncurrent marketable equity securities.

14. CPA-00103

Which of the following information should be disclosed in the summary of significant accounting policies?

a. Refinancing of debt subsequent to the balance sheet date.
b. Guarantees of indebtedness of others.
c. Criteria for determining which investments are treated as cash equivalents.
d. Adequacy of pension plan assets relative to vested benefits.

15. CPA-00107

For interim financial reporting, a company's income tax provision for the second quarter of 1992 should be determined using the:

a. Effective tax rate expected to be applicable for the full year of 1992 as estimated at the end of the first quarter of 1992.
b. Effective tax rate expected to be applicable for the full year of 1992 as estimated at the end of the second quarter of 1992.
c. Effective tax rate expected to be applicable for the second quarter of 1992.
d. Statutory tax rate for 1992.

16. CPA-00127

The following information pertains to revenue earned by Timm Co.'s industry segments for the year ended December 31, 1990:

Segment	*Sales to unaffiliated customers*	*Intersegment sales*	*Total revenue*
Alo	$ 5,000	$3,000	$ 8,000
Bix	8,000	4,000	12,000
Cee	4,000	-	4,000
Dil	43,000	16,000	59,000
Combined	60,000	23,000	83,000
Elimination	-	(23,000)	(23,000)
Consolidated	$ 60,000	-	$ 60,000

In conformity with the revenue test, Timm's reportable segments were:

a. Only Dil.
b. Only Bix and Dil.
c. Only Alo, Bix, and Dil.
d. Alo, Bix, Cee, and Dil.

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Financial Accounting & Reporting 2

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Financial Accounting & Reporting 2

TIMING ISSUES: MATCHING OF REVENUE AND EXPENSES, CORRECTING AND ADJUSTING ACCOUNTS

I. TERMINOLOGY AND BASIC CONCEPTS

A. ASSETS

Assets are probable future economic benefits that are obtained or controlled by a particular entity as a result of past events or transactions.

1. Event

An event is something that happens to an entity, and it can occur either externally or internally.

2. Transaction

A transaction is an event that occurs external to the entity and typically involves a transfer of value from one entity (or entities) to another.

B. LIABILITIES

Liabilities are probable future sacrifices of economic benefits that an entity faces for obligations to provide services or transfer assets due to past events or transactions.

C. REVENUES

Revenues are increases of assets or reductions of liabilities (and possibly both) during a period of time. They stem from the rendering of services, delivering of goods, or any other activities that may constitute the major ongoing or central operations of an entity.

1. Revenue is Recognized When a "Sale" Takes Place

a. Requirements

Revenue should be recognized when it is realized (or realizable) and when it is earned.

(1) All four criteria must be met for each element of the contract before any revenue can be recognized:

(a) Persuasive evidence of an arrangement exists,

(b) Delivery has occurred or services have been rendered,

(c) The price is fixed and determinable, and

(d) Collection is reasonably assured.

(2) Revenue from the sales of products or the disposal of other assets is recognized on the date of sale of the product or other asset (i.e., the delivery date).

Generally, the following criteria apply for a sale (exchange) to take place:

(a) Delivery of goods or setting aside goods ordered (which would result in a simultaneous recognition of revenue and expense), and/or

(b) Transfer of legal title.

(3) Revenue that stems from allowing others the use of the entity's assets (e.g., interest revenue, royalty revenue, and rental revenue) is recognized when the assets are used (i.e., as the time passes).

(4) Revenue from the performance of services is recognized in the period the services have been rendered and are able to be billed by the entity.

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b. Objectivity

The reason for waiting for the sale to take place is "objectivity," to minimize tentativeness.

2. Exceptions and Other Special Accounting Treatments

a. Deferred Credits

Certain revenue items are "deferred credits" (unearned revenue) when cash is received in advance. They are recognized as income through the passage of time. For example:

(1) Prepaid interest income

(2) Prepaid rental income

(3) Prepaid royalty income

b. Installment Sales (not GAAP)

Revenue is recognized as collections are made. It is used when ultimate realization of collection is in doubt. (Discussed later in this chapter.)

c. Cost Recovery Method (not GAAP)

No profit is recognized on a sale until all costs have been recovered. (Discussed later in this chapter.)

d. Nonmonetary Exchanges

The recognition of revenue depends upon the type of exchange. (Discussed later in this chapter.)

e. Involuntary Conversions

The involuntary conversion due to fire, theft, etc., of a nonmonetary asset to cash would result in a gain or loss for financial accounting purposes. (Discussed later in this chapter.)

f. Net Method of Accounting for Trade (Sales) Discounts

Sales are recorded net of any discounts; therefore, accounts receivable at year-end does not include the discount offered. If the discount is not earned, the sales discount amount is recorded as "other income," and cash or accounts receivable is debited at that time (discussed in detail in F4).

g. Percentage-of-Completion Contract Accounting

Revenue is recognized as "production takes place" for long-term construction contracts having costs that can be reasonably estimated. If costs cannot be reasonably estimated, then the "completed contract method" must be used. (Discussed later in this chapter.)

D. EXPENSES

Expenses are reductions of assets or increases of liabilities (and possibly both) during a period of time. They stem from the rendering of services, delivering of goods, or any other activities that may constitute the major ongoing or central operations of an entity.

Expenses should be recognized according to the matching principle (see later in this lecture) utilizing association of cause and effect, systematic and rational approach, or expense when no future benefit can be measured.

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E. REALIZATION

Realization occurs when the entity obtains cash or the right to receive cash (i.e., from the sale of assets) or has converted a noncash resource into cash.

F. RECOGNITION

Recognition is the actual recording of transactions and events in the financial statements.

G. MATCHING

One of the most important principles in financial accounting is the matching principle, which indicates that expense must be recognized in the same period in which the related revenue is recognized (when it is practicable to do so). Matching of revenues and costs is the simultaneous or combined recognition of the revenues and expenses that results directly and jointly from the same transactions or events.

For those expenses that do not have a cause and effect relationship to revenue, another systematic and rational approach to expense recognition should be used (e.g., amortization and depreciation of long-lived assets and the immediate expensing of certain administrative costs, referred to as period costs (e.g., no future benefit)).

H. ACCRUAL

Accrual accounting is required by GAAP and is the process of employing the matching principle to the recognition of revenues and expenses. It records the transactions and events as they occur, not when the cash is received or expended. Accrual accounting recognizes revenue when it is earned and expenses when the obligation is incurred (i.e., typically when the expenses relate to the earned revenue).

I. DEFERRAL

Deferral of revenues or expenses will occur when cash is received or expended but is not recognizable for financial statement purposes. Deferral typically results in the recognition of a liability or a prepaid expense.

J. ACCRUED ASSETS AND LIABILITIES

1. Accrued Assets (or Accrued Revenues)

The recognition of an accrued asset (e.g., interest receivable) represents revenue recognized or earned through the passage of time (or other criteria) but not yet paid to the entity.

2. Accrued Liabilities (or Accrued Expenses)

Accrued liabilities and the related recognition of expense represent expenses recognized or incurred through the passage of time (or other criteria) but not yet paid by the entity (e.g., accrued interest payable, accrued wages, etc.).

3. Estimated Liabilities

Estimated liabilities represent the recognition of probable future charges that result from a prior act (e.g., the estimated liability for warranties, trading stamps, or coupons).

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K. COSTS MAY BE APPLICABLE TO PAST, PRESENT, OR FUTURE PERIODS

1. Expired Costs

Expired costs (expenses) are costs that expire during the period and have no future benefit (e.g., the residual value or right to certain future revenues).

a. Insurance expense (e.g., the pro rata portion of a three year policy) is an indirect expense and is systematically allocated to the period for which benefit is received.

b. Costs of goods sold are directly allocated to the periods in which the sales take place, which matches the cause and effect of the transaction.

c. Period costs are costs expiring in the period incurred (e.g., selling, general, and administrative expenses).

2. Unexpired Costs

Unexpired costs (e.g., fixed assets and inventory) should be capitalized and matched against future revenues. If future revenues are not certain or there is no residual value, then those costs should be expensed as expired costs.

L. PREPAID EXPENSES (CURRENT ASSETS)

1. Residual Value

Prepaid expenses relate to expenditures with a residual value (e.g., prepaid insurance with a cancellation value).

2. Future Right to Services

Prepaid expenses may also occur where there exists a future right to services (e.g., a service contract with no cancellation value).

M. DEFERRED CHARGES

1. Not Charges to a Tangible Asset

Deferred charges result from expenditures or accruals that cannot be charged to a tangible asset, but that do pertain to future operations (e.g., bond issue costs).

2. Intangible Assets and Non-Current Prepaid Items

Deferred charges may include intangible assets (covered later in this lecture) and non-current prepaid items.

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II. REVENUE RECOGNITION (MEASUREMENT): DEFERRED CREDITS (DEFERRED INCOME OR UNEARNED REVENUE)

A. BASICS

1. Deferred credits represent future income contracted for and/or collected in advance (e.g., rental income, gift certificates, and magazine subscriptions collected in advance).
2. Deferred credits have not yet been earned by the passing of time or other criteria.
3. Deferred credits are located in the liability section of the balance sheet, just above Shareholders' Equity.

B. ROYALTY INCOME

Royalty revenue is recognized when earned. Royalty revenues can be earned in a variety of ways (e.g., royalties received on patents sold or royalties received from publications sold). In the latter case, a company usually earns royalties based on a stated percentage of sales. Reporting royalty revenue requires accrual of the provision for revenues based on estimated sales.

EXAMPLE

Accrual of Royalty Revenue

TAG Company wrote a textbook and sold it to Fox Company for royalties of 25% of sales. Royalties are payable semiannually on April 30 (for July through December sales of the previous year) and on October 31 (for January through June sales of the same year). During Year 8 and Year 9, TAG Company received the following checks from Fox Company:

	April 30	October 31
Year 8	$14,000	$17,000
Year 9	$12,000	$15,000

TAG estimated that textbook sales would total $80,000 for the last half of Year 9. How much royalty revenue should TAG Company report in its Year 9 income statement for the year ended December 31, Year 9?

October 31, Year 9 check (for January 1 – June 30)	$15,000
Earned July 1 through December 31, Year 9 (25% x $80,000)	20,000
Royalty revenue for Year 9	$35,000

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EXAMPLE

Royalties Received in Advance

TAG Company receives royalties on its patents in two ways. In some cases, advance royalties are received and in other cases royalties are remitted within sixty days after year end. These data are included in TAG Company's December 31 balance sheets:

	Year 8	Year 9	Difference
Royalties receivable	$100,000	$95,000	($ 5,000)
Unearned royalties	70,000	45,000	25,000

During Year 9, TAG Company received royalty remittances of $180,000. In its income statement for the year ended December 31, Year 9, what should TAG Company's royalty income be?

Cash receipts	$180,000
Receipts in Year 9 applied to 12/31/Yr 8 receivables	(100,000)
Cash remaining	80,000
Unearned royalties, 12/31/Yr 9	(45,000)
Preliminary Year 9 royalty income	35,000
Unearned royalties, 12/31/Yr 8	70,000
Receivables balance, 12/31/Yr 9	95,000
Royalty income, Year 9	$200,000

The net method way to calculate royalty income would be:

Royalty collections	$180,000
Plus: Reduction in unearned royalties ($70,000 - $45,000)	25,000
Less: Reduction in royalties receivable ($100,000 - $95,000)	(5,000)
Year 9 royalty income	$200,000

PASS KEY

The examiners frequently test journal entry concepts. The correct journal entries for the collection and recognizing of earned royalties are:

DR	Cash	$XXX	
CR	Unearned royalty		$XXX
DR	Unearned royalty	$XXX	
CR	Earned royalty		$XXX

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C. UNEARNED REVENUE

UNEARNED REVENUES OR ADVANCES

Revenue received in advance is recorded as a liability because it is an obligation to perform a service in the future and is reported as revenue in the period in which it is earned, that is, when no further future service is required. Examples include rent received in advance, interest received in advance on notes receivable, and subscriptions received in advance.

EXAMPLE

Unearned Magazine Subscription Revenue

Kristi Company sells magazine subscriptions for one- to three-year periods. The magazine subscriptions collected in advance account had a balance of $1,200,000 at December 31, Year 8. Information for the Year 9 is:

Cash receipts from subscribers	$1,400,000
Magazines subscription revenue	1,000,000

In its December 31, Year 9 balance sheet, how much should Kristi Company report as the balance for magazine subscriptions collected in advance?

The ending balance in the magazine subscriptions collected in advance is calculated as follows:

Balance at December 31, Year 8	$1,200,000
Cash receipts	1,400,000
	2,600,000
Revenue recognized	(1,000,000)
Balance at December 31, Year 9	$1,600,000

D. REVENUE RECOGNITION WHEN THE RIGHT OF RETURN EXISTS

RIGHT OF RETURN

Revenue from a sales transaction where the buyer has the right to return the product shall be recognized at the time of sale only if all required conditions are met. If the following conditions are not met, then the recognition of revenue shall be deferred (delayed):

1. The sales price is substantially fixed at the date of sale,
2. The buyer assumes all risks of loss (e.g., fire or theft) because the goods are considered in the buyer's possession,
3. The buyer has paid some form of consideration, AND
4. The amount of future returns can be reasonably estimated.

E. FRANCHISES

FRANCHISING

Franchise operations include a franchisee that receives the right to operate one or more units of a franchisor's business for one or both of two types of fees.

1. Initial Franchise Fees

These fees are paid by the franchisee for receiving initial services from the franchisor. Such services might include site selection, supervision of construction, bookkeeping services, and quality control.

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2. Continuing Franchise Fees

These fees are received for ongoing services provided by the franchisor to the franchisee. Usually, such fees are calculated based on a percentage of franchise revenues. Such services might include management training, promotion, and legal assistance. Fees should be reported by the franchisor as revenue when they are earned.

3. Franchisor Accounting (Franchise Fee Revenue)

a. Unearned Revenue

The present value of any contract amounts relating to future services (to be performed by the franchisor) should be recorded as unearned revenue. Unearned revenue is recognized once substantial performance on such future services has occurred.

b. Earned Revenue

The franchisor should report revenue from initial franchise fees when all material conditions of the sale have been "substantially performed." Generally, "substantial performance" means that the following conditions have been met:

(1) Franchisor has no obligation to refund any payment (cash or otherwise) received.

(2) Initial services required of the franchisor have been performed.

(3) All other conditions of the sale have been met.

Generally, the conditions of the sale are not considered to be substantially performed until the franchisee's first day of operations, unless the franchisor can demonstrate otherwise.

c. Other Recognition Methods

(1) Installment or cost recovery percentage methods may be used under certain circumstances.

(2) These methods shall be used for earlier recognition of the initial franchise fee revenue only when:

(a) Revenue is collectible over an extended period of time, and

(b) There is no reasonable basis for estimating collectibility.

EXAMPLE

Franchisor's Fee Revenue

Facts:

On January 1, Year 1, Foxy Enterprises, Inc. authorized Olinto Company to operate as a franchisee over a 12-year period for a nonrefundable initial franchise fee of $50,000 (received on January 1, Year 1). Olinto Company started operations on June 30, Year 1. By this time, Foxy Enterprises had performed all of the required initial services. How much revenue from franchise fees should Foxy Enterprises report in its income statement for the six months ended June 30, Year 1?

Solution:

Since Foxy Enterprises has fulfilled its obligation to Olinto Company, Foxy Enterprises can recognize the full $50,000 as revenue.

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III. EXPENSE RECOGNITION (MEASUREMENT)

A. INTANGIBLES: OVERVIEW, VALUATION, AND CHARACTERISTICS

The term "intangible assets" refers to certain long-lived legal rights and competitive advantages developed or acquired by a business enterprise. They are typically acquired to be used in operations of a business and provide benefits over several accounting periods.

Intangible assets differ considerably in their characteristics, useful lives, and relationship to operations of an enterprise and are classified accordingly.

1. Classification of Intangible Assets

a. Identifiability

(1) Intangible assets may be either specifically identifiable (e.g., patents, copyrights, franchise, etc.) or not specifically identifiable (e.g., goodwill).

(2) Patents, copyrights, franchises, trademarks, and goodwill are the common intangible assets tested on the CPA examination.

b. Manner of Acquisition

(1) Purchased Intangible Assets

(a) Intangible assets acquired from other enterprises or individuals in an "arm's length" transaction should be recorded at cost (otherwise expensed).

(2) Internally Developed Intangible Assets

(a) The cost of intangible assets not acquired from others (i.e., developed internally) and not specifically identifiable (or having indeterminate lives) should be expensed against income when incurred.

(b) Examples

(i) Trademarks (except for the capitalizable costs identified below),

(ii) Goodwill from advertising, and

(iii) The cost of developing, maintaining, or restoring goodwill.

(c) The exception is that certain costs associated with intangibles that are specifically identifiable can be capitalized, such as:

(i) Legal fees and other costs related to a successful defense of the asset,

(ii) Registration or consulting fees,

(iii) Design costs (e.g., of a trademark), and

(iv) Other direct costs to secure the asset.

c. Expected Period of Benefit

Classification of the intangible asset depends upon whether the economic life can be determined or is indeterminable.

d. Separability

The classification of the intangible asset depends upon whether the asset can be separated from the entity (e.g., a patent) or is substantially inseparable from it (e.g., a trade name or goodwill).

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2. Capitalization of Costs

A company should record the cost of intangible assets acquired from other enterprises or individuals in an "arm's length" transaction as assets.

a. Cost is measured by:

(1) The amount of cash disbursed or the fair market value of other assets distributed,

(2) The present value of amounts to be paid for liabilities incurred, and

(3) The fair value of consideration received for stock issued.

b. Cost may be determined either by the fair value of the consideration given or by the fair value of the property acquired, whichever is more clearly evident.

c. The cost of unidentifiable intangible assets is measured as the difference between the cost of the group of assets or enterprise acquired and the sum of the costs assigned to identifiable assets acquired, less liabilities assumed.

d. The cost of identifiable assets should not include goodwill.

3. Expensing of Costs

Costs of developing, maintaining, or restoring intangible assets that are not specifically identifiable, have indeterminate lives, or are inherent in a continuing business and related to an enterprise as a whole (e.g., goodwill) should be deducted from income when incurred.

a. Expenses that increase the useful life of the intangible asset will require an adjustment to the calculation of the annual amortization.

4. Amortization

The value of intangible assets eventually disappears; therefore, the cost of each type of intangible asset (except for goodwill and assets with indefinite lives) should be amortized by systematic charges to income over the period estimated to be benefited. Candidates should be aware that a patent is amortized over the shorter of its estimated life or remaining legal life.

a. Method

The straight-line method of amortization should be applied unless a company demonstrates that another systematic method is more appropriate. The method and estimated useful lives of intangible assets should be adequately disclosed in the notes to the financial statements.

b. Goodwill (impairment approach)

Amortization of purchased goodwill is no longer permitted (effective January 1, 2002, per FASB #142). The required approach is to test goodwill (both previously recorded and newly acquired) under the "impairment" approach.

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c. Miscellaneous Rules

(1) Worthless

Write off the entire remaining cost to expense if an intangible asset becomes worthless during the year (e.g., due to a technological obsolescence or due to an unsuccessful patent defense lawsuit).

(2) Impairment

Write down the intangible asset and recognize an impairment loss if an intangible asset becomes impaired (e.g., due to a change in circumstances that indicate that the full carrying amount of the asset may not be recoverable).

(3) Change in Useful Life

If the life of an existing intangible asset is reduced or extended, the remaining net book value is amortized over the new remaining life ("Change in Estimate," per F1).

(4) Sale

If an intangible asset is sold, simply compare its carrying value at the date of sale with the selling price to determine the gain or loss.

d. Income Tax Effect

Amortization of acquired intangible assets that are not specifically identifiable (e.g., goodwill) is deductible over a 15-year period in computing income taxes payable. This may create a temporary difference, and interperiod allocation of income taxes is appropriate (discussed in detail in F6).

B. FRANCHISEE ACCOUNTING

1. Initial Franchise Fees

The present value of the amount paid (or to be paid) by a franchisee is recorded as an intangible asset on the balance sheet and amortized over the expected period of benefit of the franchise (i.e., the expected life of the franchise).

2. Continuing Franchise Fees

These fees are received for ongoing services provided by the franchisor to the franchisee (often referred to as franchise royalties). Usually, such fees are calculated based on a percentage of franchise revenues. Such services might include management training, promotion, and legal assistance. Fees should be reported by the franchisee as an expense and as revenue by the franchisor, in the period incurred.

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EXAMPLE

Franchisee's Intangible Assets

Peter signed an agreement on July 1, Year 1 with Disco Records to operate as a franchisee in New York City. The initial franchise fee was $75,000 and was paid by a $25,000 down payment with the balance payable in five equal annual payments of $10,000 beginning July 1, Year 2. Peter's borrowing rate is 10% and the present value of an ordinary annuity of $1 for five periods at 10% is 3.7908. Calculate the amount to be capitalized as franchises by Peter on July 1, Year 1.

= $25,000 downpayment + ($10,000 payments x 3.7908)
= $25,000 + $37,908
= $62,908

Franchisee's Journal Entry: To record the franchise at July 1, Year 1		
DR Franchises	$62,908	
DR Discount on notes payable (contra liability)	12,092	
CR Notes payable		$50,000
CR Cash		25,000

The discount will be recognized as interest expense by the franchisee over the payment period on an effective interest basis. The franchise account would appear in the franchisee's intangible assets section of the balance sheet and would be amortized over the expected life of the franchise. If the franchise were expected to exist for 10 years for Peter, the balance in the account at December 31, Year 1, net of accumulated amortization would be:

Yearly amortization = (Franchise balance / Expected life) x Months
= ($62,908 / 10) x 6/12 (July through December, Year 1)
= $3,145

Balance at July 1, Year 1	$62,908
Less: Amortization for Year 1	(3,145)
Balance, net of accumulated amortization	$59,763

Franchisor's Journal Entry: To record fees on July 1, Year 1		
DR Cash	$25,000	
DR Notes receivable	50,000	
CR Discount on notes receivable (contra asset)		$12,092
CR Franchise fee revenue		62,908

The discount will be earned as interest revenue by the franchisor over the payment period on an effective interest basis.

Franchisor's Journal Entry: December 31, Year 1 ($37,908 x .10 x ½ = $1,895)		
DR Discount on notes receivable	$1,895	
CR Interest revenue		$1,895

Franchisee's Journal Entry: December 31, Year 1		
DR Franchise fee amortization (expense)	$3,145	
CR Franchise		$3,145

Franchisee's Journal Entry: December 31, Year 1		
DR Interest expense	$1,895	
CR Discount on notes payable		$1,895

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C. START-UP COSTS

Expenses incurred in the formation of a corporation (e.g., legal fees) are considered organizational costs.

1. For Book Purposes

Start-up costs, including organizational costs, should be expensed when incurred (SOP 98-5).

a. Start-up costs include costs of the one-time activities associated with:

(1) Organizing a new entity (e.g., legal fees for preparing a charter, partnership agreement, bylaws, original stock certifications, filing fees, etc.).

(2) Opening a new facility.

(3) Introducing a new product or service.

(4) Conducting business in a new territory or with a new class of customer.

(5) Initiating a new process in an existing facility.

b. Start-up costs do not include costs associated with:

(1) Routine, ongoing efforts to refine, enrich, or improve the quality of existing products, services, processes, or facilities.

(2) Business mergers or acquisitions.

(3) Ongoing customer acquisition.

2. For Income Tax Purposes

A business may elect to deduct up to $5,000 each of organizational expenditures and start-up costs. Each $5,000 amount is reduced by the amount by which the organizational expenditures or start-up costs exceeds $50,000, respectively. Any excess organizational expenditures or start-up cost is amortized over 180 months (beginning with the month in which the active trade or business begins). This may create a temporary difference, and interperiod allocation of income taxes is appropriate (see F6).

PASS KEY

Remember that organizational expenses are **not** capitalized as an intangible asset. Rather, they are expensed immediately.

D. LEGAL FEES

1. Fees to Obtain Intangible Assets

Capitalize legal and registration fees incurred to obtain an intangible asset because such fees establish the legal rights of the owner.

2. Legal Fees Incurred in Defending an Intangible Asset

a. Successful = Capitalize

Capitalize legal fees incurred in successfully defending an intangible because a future benefit will be derived.

b. Unsuccessful = Expense

Fees incurred in an unsuccessful defense should be expensed as incurred.

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E. GOODWILL

1. Defined

Goodwill is the representation of intangible resources and elements connected with an entity (e.g., management or marketing expertise or technical skill and knowledge that cannot be identified or valued separately). Goodwill means capitalized excess earnings power.

2. Calculation of Goodwill

a. Purchase of Assets

This method compares the cost of the acquired business with the fair value (FV) of the net tangible and identifiable intangible assets. The excess of cost over the FV of the net assets is goodwill.

b. Purchase of Equity

This method involves the purchase of a company's capital stock. Goodwill is the excess of the stock purchase price over the fair market value of the net assets acquired.

3. Maintaining Goodwill

Costs associated with maintaining, developing, or restoring goodwill are not capitalized as goodwill (they are expensed). In addition, goodwill generated internally or *not* purchased in an arm's length transaction also is *not* capitalized as goodwill.

F. RESEARCH AND DEVELOPMENT COSTS

1. General Rule – Expense

Research is the planned efforts of a company to discover new information that will help either create a new product, service, process, or technique or significantly improve the one in current use. Development takes the findings generated by research and formulates a plan to create the desired item or to improve significantly the existing one.

2. Exceptions to General Rule

The only acceptable method for accounting for research and development costs is a direct charge to expense, except for:

a. Materials, equipment, or facilities (i.e., tangible assets) that have alternate future uses.

   (1) Depreciate the assets over their useful lives (not the life of the research and development project).

b. Research and development costs of any nature undertaken on behalf of others under a contractual arrangement.

   (1) The purchaser (buying the R&D) will expense as research and development the amount paid; and the provider (performing the R&D for the purchaser) will expense the costs incurred as cost of sales.

   (2) The conclusion for charging most research and development costs to expense is the high degree of uncertainty of any future benefits.

   (3) Disclosure is required in the financial statements or notes of the amount of research and development charged to expense for the period.

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3. Items Not Considered Research and Development

a. Routine periodic design changes to old products or troubleshooting in production stage (these are manufacturing costs, not research and development expenses)

b. Marketing research

c. Quality control testing

d. Reformulation of a chemical compound

EXAMPLE

Accounting for Research and Development Costs

Facts:

Julile Co. incurred research and development costs in the current year as follows:

Materials used in research and development projects	$ 400,000
Equipment acquired that will have alternate future uses in future research and development projects	2,000,000
Depreciation on above equipment	500,000
Personnel costs of persons involved in research and development projects	1,000,000
Consulting fees paid to outsiders for research and development projects	100,000
Indirect costs reasonably allocable to research and development projects	200,000

Solution:

The following items would qualify as research and development costs and should be expensed in the current year:

Materials used in research and development projects	$ 400,000
Depreciation on equipment used in research and development	500,000
Personnel costs of persons involved in research and development projects	1,000,000
Consulting fees paid to outsiders for research and development projects	100,000
Indirect costs reasonably allocable to research and development projects	200,000
Total	$2,200,000

The equipment is not charged to research and development costs because it has alternative future uses. It should be capitalized as a tangible asset and depreciated over the useful life of the equipment. The depreciation expense should be charged to research and development.

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G. COMPUTER SOFTWARE DEVELOPMENT COSTS

1. Computer Software Developed to be Sold, Leased, or Licensed

a. Technological Feasibility

Technological feasibility is established upon completion of:

(1) A detailed program design, or

(2) Completion of a working model.

b. Accounting for Costs

(1) Expense costs (planning, design, coding, and testing) incurred until technological feasibility has been established for the product.

(2) Capitalize costs (coding, testing, and producing product masters) incurred after technological feasibility has been established.

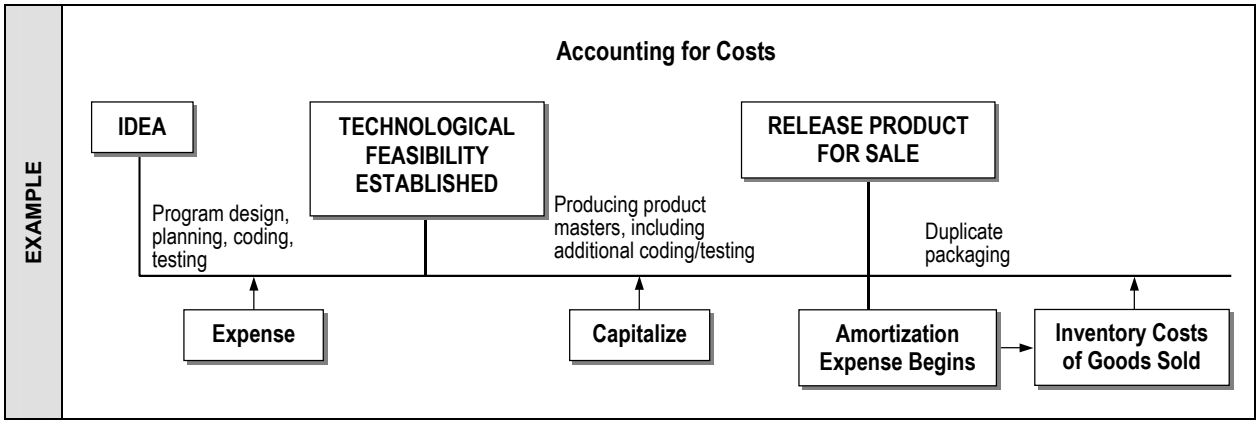
(a) Amortization of Capitalized Software Costs

Annual amortization (on a product by product basis) is the GREATER of:

(a) PERCENTAGE OF REVENUE = Total capitalized amount x $\frac{\text{Current gross revenue for period}}{\text{Total projected gross revenue for product}}$

(b) STRAIGHT LINE = Total capitalized amount x $\frac{1}{\text{Estimate of economic life}}$

(3) Inventory: Costs incurred to actually produce the product are product costs charged to inventory.



c. Balance Sheet

Capitalized software costs are reported at the LOWER OF COST OR MARKET, where

MARKET = NET REALIZABLE VALUE

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2. Computer Software Developed Internally or Obtained for Internal Use Only (SOP 98-1)

a. Expense costs incurred for the preliminary project state and costs incurred for training and maintenance.

b. Capitalize costs incurred after the preliminary project state and for upgrades and enhancements, including:

(1) Direct costs of materials and services,

(2) Costs of employees directly associated with project, and

(3) Interest costs incurred for the project.

c. Capitalized costs should be amortized on a straight-line basis.

d. If software previously developed for internal use is subsequently sold to outsiders, proceeds received (e.g., from the license of computer software, net of incremental costs) should be applied first to the carrying amount of the software, then recognized as revenue (after the carrying amount of the software has reached zero).

IV. IMPAIRMENT (FOR INTANGIBLES AND LONG-LIVED ASSETS)

The carrying amount of intangibles (including goodwill) and fixed assets held for use and to be disposed of needs to be reviewed at least annually or whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The process used to determine impairment depends on the type of asset (i.e., intangible or fixed).

A. SFAS NO. 144 IMPAIRMENT APPLICATION

1. Assets to be Tested for Impairment

SFAS No. 144 applies to all entities and establishes accounting standards for the impairment of:

a. Long-lived assets to be held and used;

b. Long-lived assets slated for disposal;

c. Certain assets of rate-regulated entities.

2. Assets without SFAS No. 144 Application

Impairment does not apply to assets whose valuation is prescribed by other specific provisions of GAAP, such as:

a. Financial instruments

b. Financial institutions' long-term customer relationships (core deposit intangibles, etc.)

c. Mortgage servicing rights

d. Deferred tax assets

e. Deferred policy acquisition costs

f. Assets whose accounting is prescribed by SFAS Nos. 50, 53, 63, 86, or 90 (as amended)

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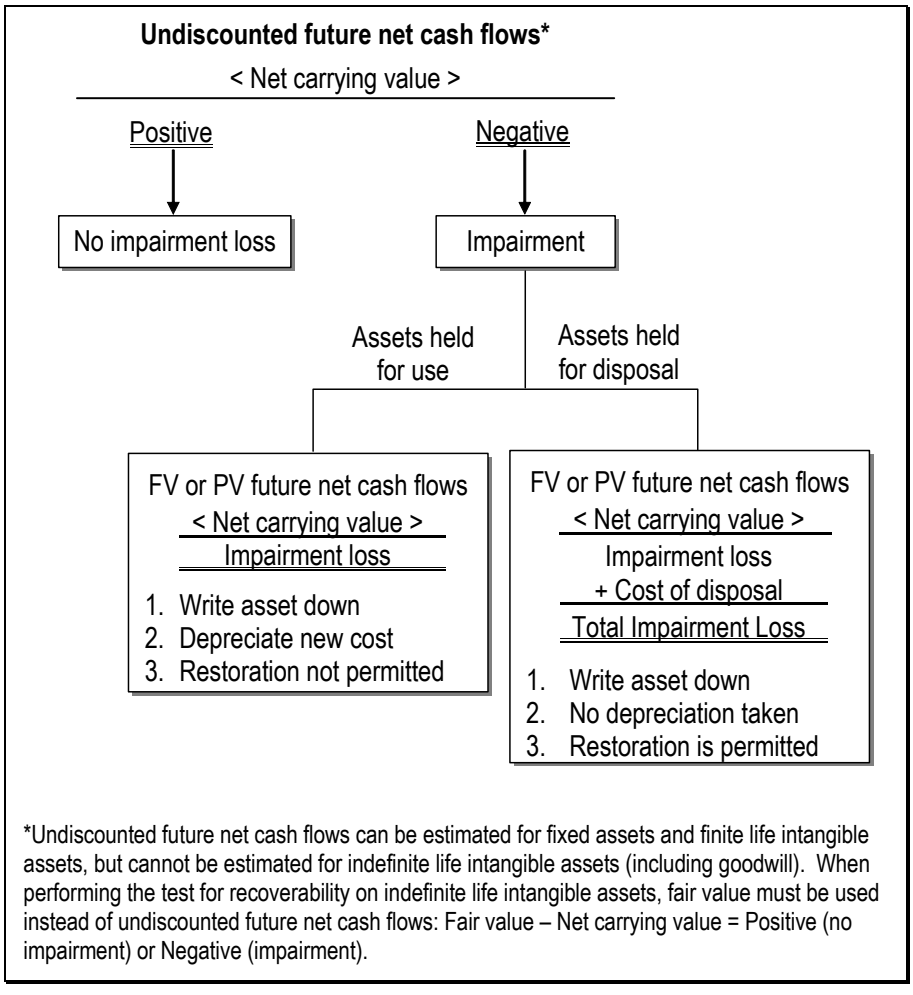
B. TEST FOR RECOVERABILITY

When testing a fixed asset or an intangible asset with a finite life for impairment, the future cash flows expected to result from the use of the asset and its eventual disposition need to be estimated. If the sum of undiscounted expected (future) cash flows is less than the carrying amount, an impairment loss needs to be recognized.

When testing an intangible asset with an indefinite life (including goodwill) for impairment, it is generally not possible to estimated total future cash flows expected to result from the use of the assets and its disposition. As a result, the test for recoverability is performed by comparing the fair value of the asset to its carrying value. If carrying value exceeds fair value, then the asset is impaired.

C. CALCULATION OF THE IMPAIRMENT LOSS

The impairment loss is calculated as the amount by which the carrying amount exceeds the fair value of the asset. The fair value of the asset is determined as outlined in SFAS No. 157—Fair Value Measurements (see lecture F1).



*Undiscounted future net cash flows can be estimated for fixed assets and finite life intangible assets, but cannot be estimated for indefinite life intangible assets (including goodwill). When performing the test for recoverability on indefinite life intangible assets, fair value must be used instead of undiscounted future net cash flows: Fair value – Net carrying value = Positive (no impairment) or Negative (impairment).

PASS KEY

It is important to note the following when testing a fixed asset or an intangible asset with a finite life for impairment:

- Determining the impairment — use undiscounted future net cash flows
- Amount of impairment — use fair value (FV)

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D. IMPAIRMENT DEPENDS ON ASSET TYPE

1. Impairment of Intangible Assets (Other than Goodwill)

The impairment test applied to an intangible asset other than goodwill is determined by the asset's life. An intangible asset has a finite life when it is possible to estimate the useful life of the asset. If it is not possible to determine the useful life of an intangible asset, then the asset has an indefinite (not infinite) life. If an intangible asset has a finite life, it is amortized over that life. If it has an indefinite life, it is not amortized.

a. Intangible Assets with Indefinite Lives

An intangible asset with an indefinite life is tested for impairment by comparing the fair value (determined in accordance with SFAS No. 157) of the intangible asset to its carrying amount. If the asset's fair value is less than its carrying amount, an impairment loss is recognized in an amount equal to the difference. Subsequent reversal of the impairment loss is prohibited.

b. Intangible Assets with Finite Lives

An intangible asset with a finite life is tested for impairment using the two approaches described in the chart above.

Step 1: The carrying amount of the asset is compared to the sum of the undiscounted cash flows expected to result from the use of the asset and its eventual disposition.

Step 2: If the carrying amount exceeds the total undiscounted future cash flows, then the asset is impaired and an impairment loss equal to the difference between the carrying amount of the asset and its fair value (determined in accordance with SFAS No. 157) is recorded.

Note: Subsequent reversal of the impairment loss is prohibited.

2. Impairment of Goodwill (SFAS No. 142)

Goodwill impairment is determined using a different approach. Goodwill impairment is calculated at a reporting unit level. Impairment exists when the carrying amount of the reporting unit goodwill exceeds its fair value (determined in accordance with SFAS No. 157).

a. Definition of Reporting Unit

A reporting unit is an operating segment, or one level below an operating segment. The goodwill of one reporting unit may be impaired, while the goodwill for other reporting units may or may not be impaired.

b. Evaluation of Goodwill Impairment

The evaluation of goodwill impairment involves two major steps.

Step 1: Identify potential impairment by comparing the fair value of each reporting unit with its carrying amount, including goodwill.

(1) Assign assets acquired and liabilities assumed to the various reporting units. Assign goodwill to the reporting units.

(2) Determine the fair values of the reporting units and of the assets and liabilities of those reporting units. Fair value is determined in accordance with SFAS No. 157.

(3) If the fair value of a reporting unit is less than its carrying amount, there is potential goodwill impairment. The impairment is assumed to be due to the reporting unit's goodwill since any impairment in the other assets of the reporting unit will already have been determined and adjusted for (**other impairments are evaluated before goodwill**).

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(4) If the fair value of a reporting unit is more than its carrying amount, there is no goodwill impairment and Step 2 is not necessary.

Step 2: Measure the amount of goodwill impairment loss by comparing the implied fair value of the reporting unit's goodwill with the carrying amount of that goodwill.

(1) Allocate the fair value of the reporting unit to all assets and liabilities of the unit. Any fair value that cannot be assigned to specific assets and liabilities is the implied goodwill of the reporting unit.

(2) Compare the implied fair value of the goodwill to the carrying value of the goodwill. If the implied fair value of the goodwill is less than its carrying amount, recognize a goodwill impairment loss. Once the goodwill impairment loss has been fully recognized, it cannot be reversed.

EXAMPLE

Facts:

Omega Inc. has two reporting units, Alpha and Beta, which have book values including goodwill of $500,000 and $675,000, respectively. Alpha reports goodwill of $50,000 and Beta reports goodwill of $75,000. As part of the company's annual review for goodwill impairment, Omega determined that the fair values of Alpha and Beta were $480,000 and $700,000, respectively, at December 31, 20X8. Determine whether the reporting units' goodwill is potentially impaired.

Alpha: Reporting Unit FV – Reporting Unit BV = $480,000 – 500,000 = $(20,000)
Beta: Reporting Unit FV – Reporting Unit BV = $700,000 – $675,000 = $25,000

Solution:

Because Alpha's fair value is less than its book value, there is potential goodwill impairment. Beta's goodwill is not impaired.

To determine the amount of Alpha's goodwill impairment loss, Omega assigned $460,000 of Alpha's $480,000 fair value to Alpha's assets and liabilities. The $20,000 difference ($480,000 – 460,000) cannot be assigned to specific assets or liabilities and is Alpha's implied goodwill. Calculate Alpha's impairment loss at December 31, 20X8.

Impairment Loss = Goodwill Implied FV – Goodwill BV = $20,000 – 50,000 = $(30,000)

Journal Entry: To record goodwill impairment at December 31, 20X8

DR	Loss due to impairment	$30,000	
CR	Goodwill		$30,000

3. Impairment of Long-Lived Tangible Assets

a. Total Impairment

If there is total impairment, the obsolete asset and related accumulated depreciation are removed from the accounts, and a loss is recognized for the difference. The journal entry follows:

DR	Accumulated depreciation	$XXX	
DR	Loss due to impairment	XXX	
CR	Asset		$XXX

b. Partial Impairment

If there is partial impairment, the asset should be written down to a new cost basis through the accumulated depreciation account. The cost is then depreciated over the remaining life. The journal entry follows:

DR	Loss due to impairment	$XXX	
CR	Accumulated depreciation		$XXX

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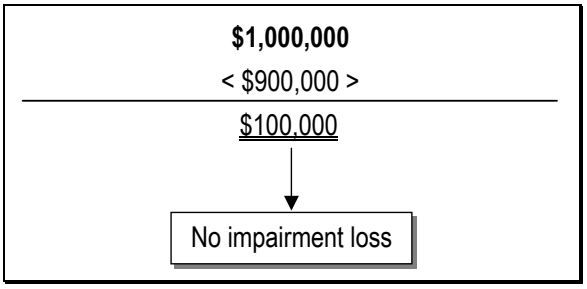
EXAMPLE #1

FACTS:

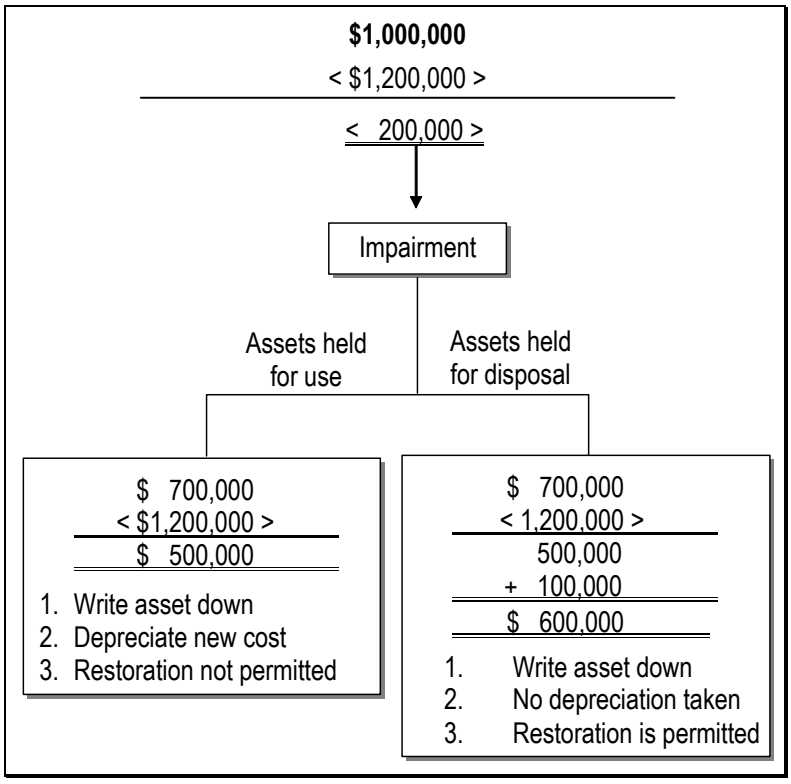
- Assets net carrying value is $900,000
- Net future cash flows are projected as $1,000,000



EXAMPLE #2

FACTS:

- Assets net carrying value is $1,200,000
- Net future cash flows are projected as $1,000,000
- Assumption 1: Asset held for use and
  - FMV/PV net cash flows are $700,000
- Assumption 2: Asset is held for disposal and
  - FMV/PV net cash flows are $700,000
  - Cost of disposal will be $100,000



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E. REPORTING THE IMPAIRMENT LOSS: GENERAL

The impairment loss is reported as a component of income from continuing operations before income taxes or in a statement of activities (not-for-profit entities). The carrying amount of the asset is reduced. Restoration of previously recognized impairment losses is prohibited, unless the asset is held for disposal.

PASS KEY

	Finite Life	Indefinite Life
Characteristics	Useful life is limited	Life extends beyond the foreseeable future, or the useful life cannot be determined
Amortization	Over useful economic life	None
Impairment test	Two-step test • Undiscounted net cash flows • FV or PV net cash flows	One-step test • Fair value

V. CORRECTING AND ADJUSTING ACCOUNTS

A. OBJECTIVE IS TO MATCH EXPENSES AGAINST RELATED REVENUES

The objective of an income statement presentation is to match related expenses with their revenues. This exercise includes typical audit-type adjustments related to the matching of expenses with revenues that the examiners have tested on the CPA exam.

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B. EXERCISE: THREE-YEAR NET INCOME AND ENDING BALANCE SHEET

This exercise is designed to illustrate the effect on income of the following transactions:

	3 Year Income Statement*			Balance Sheet 12-31-X3		
	20X1	20X2	20X3	DR	CR	A/C Title
Net Income Per Books	(5,000)	(8,000)	(10,000)			
1. The company purchased a $300, 3-year insurance policy on 1-1-X2 and expensed it all in 20X2.		(200)	100	100		(Unexpired insurance) prepaid insurance
2. $2,000 of credit sales made in 20X2 were not recorded until collected in 20X3.		(2,000)	2,000			
3. $3,000 of 20X3 sales and related accounts receivable outstanding on 12-31-X3 was not recorded.			(3,000)	3,000		Accounts receivable
4. $1,500 of accounts payable (for expenses incurred) during 20X3 were omitted at 12-31-X3 and expensed when paid in 20X4.			1,500		1,500	Accounts payable
5. $400 was paid in 20X1 and was charged to rent expense. This payment covers rent for Dec. 20X4 in a lease ending 12/31/X4.	(400)			400		Prepaid rent
6. The direct write off method (non-GAAP method) was used to write off a $650 bad debt in 20X3. The original sale was made in 20X1.	650		(650)			
7. Two identical inventory purchases were made by two separate operating divisions - Division A and Division B. Both $1,300 purchases of raw materials were purchased FOB shipping point and were in transit on 12/31/X3. They were not included in the actual 12/31/X3 inventory count (the effect of this correction on the financial statements is the same whether the perpetual or periodic inventory system is used).						
a. Division A: Inventory and liability not recorded.			-0-	1,300	1,300	Inventory Accounts payable
b. Division B: Inventory not recorded, but liability and "cost of sales" were recorded.			(1,300)	1,300		Inventory
Correct Net Income	(4,750)	(10,200)	(11,350)			
Balance Sheet Adjustments				6,100	2,800	
					3,300	**Retained earnings**

* Note: The brackets under the 20X1, 20X2, and 20X3 columns represent income, not losses. Thus in 20X1 net income per books is $5,000 and the subsequent $400 adjustment would increase income by $400.

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Explanations

1. The $300 paid for insurance in 20X2 should have been debited to Prepaid Insurance. At year-end 20X2, two years of insurance coverage are left and one year has expired. The ($200) is a credit to income in 20X2. This combined with the $300 insurance expense already charged in 20X2, results in the proper $100 charge to income. The $100 charge to income for 20X3, represents the correct amount of insurance expense for 20X3, $100 per year. The $100 debit under Balance Sheet 12-31-X3, reflects the correct balance of Prepaid Insurance as of that date. As of 12/31/X3, one year of insurance coverage remains.

2. According to the revenue recognition principle and accrual accounting, sales should be recorded in the period the revenue is earned. The 20X2 ($2,000) credit to income, properly records the credit sales. The 20X3, $2,000 charge to income, removes the revenue recorded in that period.

3. The rationale for the income statement adjustment is the same as in #2. The credit sales should be reflected in the period of sale, 20X3, and the 12-31-X3 Balance Sheet should reflect the correct $3,000 accounts receivable balance.

4. Expenses should be recorded in the period "incurred." The 20X3, $1,500 charge to income, records the correct expense incurred. The 12-31-X3 Balance Sheet will now show the $1,500 as accounts payable.

5. The $400 paid in 20X1 represents Prepaid Rent. The ($400) adjustment to 20X1 removes the incorrect charge to income, and the 12-31-X3 Balance Sheet is adjusted to properly reflect the asset Prepaid Rent.

6. According to the matching principle, expenses should be recorded in the same period as the related revenue. Since the sale was made in 20X1, the related expense of the sale (the bad debt expense) should be recorded in 20X1. The adjustment here ($650) removes the charge from 20X3 income and puts it in the proper year, 20X1.

7. The correct journal entry for either division would have been:

DR	Inventory (perpetual system) or		
DR	Purchases (periodic system)	1,300	
CR	Accounts payable		1,300

Since division A did not make any entry, the correction entry for division A is just the correct original entry. Since division B charged Cost of Sales instead of Inventory or Purchases, the correction here removes the charge to 20X3 income and sets up the proper inventory balance. Accounts payable is already correctly stated.

The final $3,300 increase to Retained Earnings, reflects all cumulative adjustments to income through 20X3. ($200) + 100 (2,000) + 2,000 (3,000) + 1,500 (400) + 650 (650) (1,300) = ($3,300)

Remember: In this schedule ($) are credits or increases to income.

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LONG-TERM CONSTRUCTION CONTRACTS

I. COMPLETED-CONTRACT METHOD

The completed-contract method recognizes income only on completion (or substantial completion) of the contract.

A contract is regarded as substantially complete if the remaining costs are insignificant.

A. REQUIREMENTS

It is acceptable to use the completed-contract method when:

1. It is difficult to estimate the costs of a contract in progress.
2. There are many contracts in progress so that about an equal number are completed in each year and an unequal recognition of income does not result.
3. The projects are of short duration, and collections are not assured.

B. BALANCE SHEET PRESENTATION

The excess of accumulated costs over related billings should be reflected in the balance sheet as a current asset, and the excess of accumulated billings over related costs should be reflected as a current liability. In the case of more than one contract, the accumulated costs or liabilities should be separately stated on the balance sheet.

The preferred terminology for the balance-sheet presentation should be "Costs (billings) of uncompleted contracts in excess of related billings (costs)."

"Progress billings" and "construction in progress" are merely different accounts representing the same contract asset and should be shown net of their related contra accounts.

1. Current Asset Accounts

a. Due on accounts (receivable)

b. Cost of uncompleted contracts in excess of progress billings (sometimes called "Construction in Progress")

OR

2. Current Liability Account

a. Progress billings on uncompleted contracts in excess of cost

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C. ACCOUNTING FOR THE COMPLETED-CONTRACT METHOD

The following are important points to remember in accounting for contracts under the completed-contract method:

1. Applicable overhead and direct costs should be charged to a construction in progress account (an asset).
2. Billings and/or cash received should be credited to advances on construction in progress account (a liability).
3. At completion of the contract, gross profit or loss is recognized as follows:

   Contract price – Total costs = Gross profit or loss

4. At interim balance sheet dates, the excess of either the construction in progress account or the advances account over the other is classified as a current asset or a current liability. It is classified as current because of the current operating cycle concept.
5. Losses should be recognized in full in the year they are discovered.

   An expected loss on the total contract is determined by:

   a. Adding estimated costs to complete to the recorded costs to date to arrive at total contract costs.
   b. Adding to advances any additional revenue expected to arrive at total contract revenue.
   c. Subtracting (b) from (a) to arrive at total estimated loss on contract.

D. ADVANTAGES/DISADVANTAGES

The primary advantage of the completed-contract method is that it is based on final results rather than on estimates.

The primary disadvantage of the completed-contract method is that it does not properly reflect the matching principle when the period of the contract extends over more than one accounting period.

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II. PERCENTAGE-OF-COMPLETION METHOD

A. REQUIREMENTS

It is appropriate to use the percentage-of-completion method when collection is assured and the entity's accounting system can:

1. Reasonably estimate profitability and
2. Provide a reliable measure of progress toward completion.

B. REVENUE RECOGNITION

The realization principle requires that revenue be earned before it is recognized.

1. Revenues are generally recognized when:
   a. The earnings process is complete or virtually complete, and
   b. An exchange has taken place.
2. The percentage-of-completion method recognizes income as work progresses on the contract.
3. Accounting for long-term construction contracts by the percentage-of-completion method is an exception to the basic realization principle. This exception is based on the evidence that the ultimate proceeds are available and the consensus that a better measure of periodic income results (principle of matching revenues and costs).

C. DETERMINATION OF REVENUES RECOGNIZED

Income recognized is the percentage of estimated total income either:

1. That incurred costs to date bear to total estimated costs based on the most recent cost information, or
2. That may be indicated by such other measure of progress toward completion appropriate to the work performed.

D. MATERIAL AND SUBCONTRACT COSTS

During the early stages of a contract, all or a portion of items such as material not used and subcontract costs may be excluded in determining the percentage of completion if it appears that the exclusion would produce a more meaningful allocation of periodic income.

E. LOSSES

A provision for the loss on the entire contract should be made when current estimates of the total contract costs indicate a loss.

1. However, when a loss is indicated on a total contract that is part of a related group of contracts, the group may be treated as a unit in determining the necessity of providing for losses.
2. Income to be recognized under the percentage-of-completion method at various stages should not ordinarily be measured by interim billings.

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F. BALANCE SHEET PRESENTATION

"Progress billings" and "construction-in-progress" are merely different accounts representing the same contract asset and should be shown net of their related contra accounts.

1. Current Asset Accounts

a. Due on accounts (receivable)

b. Costs and estimated earnings of uncompleted contracts in excess of progress billings (sometimes called "construction in progress")

OR

2. Current Liability Account

a. Progress billings in excess of cost and estimated earnings on uncompleted contracts

G. ADVANTAGES/DISADVANTAGES

The principal advantages of the percentage-of-completion method are the accurate reporting of the status of the uncompleted contracts and the periodic recognition of income currently (rather than irregularly) as contracts are completed.

The principal disadvantage of the percentage-of-completion method is the necessity of relying on estimates of the ultimate costs.

H. ACCOUNTING FOR THE PERCENTAGE-OF-COMPLETION METHOD

The following are important points to remember in accounting for contracts under the percentage-of-completion method:

1. Journal entries and interim balance sheet treatment are the same as the completed contract method except that the amount of estimated gross profit earned in each period is recorded by charging the construction in progress account and crediting realized gross profit.
2. Gross profit or loss is recognized in each period by the following steps:

Step 1:	Compute gross profit of completed contract:	Contract price < Estimated total cost > Gross profit
Step 2:	Compute "% of completion":	Total cost to date Total estimated cost of contract
Step 3:	Compute gross profit earned (profit to date):	Step 1 x Step 2 = PTD
Step 4:	Compute gross profit earned for current year:	PTD at current FYE <PTD at beginning of period> Current year-to-date GP

3. An estimated loss on the total contract is recognized immediately in the year it is discovered. However, any previous gross profit or loss reported in prior years must be adjusted for when calculating the total estimated loss.

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I. LONG-TERM CONTRACT GROSS PROFIT COMPUTATION WORKSHEET

1. Class Exercise

Compute the gross profit to be recognized each year from the following facts for contract "A":

FACTS:	YEAR 1	YEAR 2	YEAR 3	YEAR 4
Sales Price	$4,000,000	$4,000,000	$4,000,000	$4,000,000
Total (estimated) cost of contract	3,000,000	3,200,000	4,200,000	4,300,000
Costs incurred to date	1,500,000	2,400,000	3,600,000	4,300,000

PERCENTAGE OF COMPLETION	YEAR 1	YEAR 2	YEAR 3	YEAR 4
STEP 1 – Compute GP of Completed Contract:				
Total contract sales price	$ 4,000	$ 4,000	$	$
Less: Total estimated cost of contract	(3,000)	(3,200)	( )	( )
Total Gross Profit	$ 1,000	$ 800	$	$
STEP 2 – Compute "% of completion":				
Costs incurred to date	$ 1,500	$ 2,400	$ 3,600	$
Total estimated cost of contract	$ 3,000	$ 3,200	$ 4,200	$
Percentage of completion	50%	75%	100% (Loss Rule)	%
STEP 3 – Compute GP earned to date:				
Total Contract GP	$ 1,000	$ 800	$	$
x % of completion	50%	75%	%	%
GP earned to date (cum)	$ 500	$ 600	$	$
STEP 4 – Compute GP earned each year – "% of completion method":				
Previously recognized	$ -0-	$ 500	$	$
Current year gross profit	$ 500	$ 100	$	$

COMPLETED CONTRACT				
Compute GP earned each year – "Completed contract method":				
	$ -0-	$ -0-	$	$
COMPUTATIONS				

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2. Solution

PERCENTAGE OF COMPLETION				
	YEAR 1	YEAR 2	YEAR 3	YEAR 4
STEP 1 – Compute GP of Completed Contract:				
Total contract sales price	$ 4,000	$ 4,000	$ 4,000	$4,000
Less: Total estimated cost of contract	(3,000)	(3,200)	(4,200)	(4,300)
Total Gross Profit	$ 1,000	$ 800	$ (200)	$ (300)
STEP 2 – Compute "% of completion":				
Costs incurred to date	$ 1,500	$ 2,400	$ 3,600	$4,300
Total estimated cost of contract	$ 3,000	$ 3,200	$ 4,200	$4,300
Percentage of completion	50%	75%	100% (Loss Rule)	100%
STEP 3 – Compute GP earned to date:				
Total Contract GP	$ 1,000	$ 800	$ (200)	$ (300)
x % of completion	50%	75%	100%	100%
GP earned to date (cum)	$ 500	$ 600	$ (200)	$ (300)
STEP 4 – Compute GP earned each year – "% of completion method":				
Previously recognized	$ -0-	$ 500	$ 600	$ (200)
Current year gross profit	$ 500	$ 100	$ (800)	$ (100)

COMPLETED CONTRACT				
Compute GP earned each year – "Completed contract method":				
	$ -0-	$ -0-	$ (200)	$ (100)
COMPUTATIONS				

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EXAMPLE

Percentage-of-Completion Method

The following data pertain to a $2,000,000 long-term construction contract.

	Year 1	Year 2	Year 3
Costs incurred during the year	$ 500,000	$700,000	$ 500,000
Year-end estimated costs to complete	1,000,000	300,000	—
Billing during the year	400,000	700,000	900,000
Collections during the year	200,000	500,000	1,200,000

Computation of Realized Gross Profit

Year 1	$\frac{\$500,000}{\$1,500,000^{1}}$	x	$500,000	-	0	=	$166,667
Year 2	$\frac{\$1,200,000}{\$1,500,000^{2}}$	x	$500,000	-	$166,667	=	$233,333
Year 3	$\frac{\$1,700,000}{\$1,700,000^{3}}$	x	$300,000	-	$400,000	=	($100,000)
	Total gross profit						$300,000

Journal Entry: To record the estimated gross profit earned during Year 1 is

DR	Construction in progress	$166,667	
CR	Gross profit on construction in progress		$166,667

[1] Total costs incurred during the year and estimated costs to complete
[2] Total costs incurred during years 1 and 2 and estimated costs to complete
[3] Total costs incurred in years 1, 2, and 3

III. OTHER CONSIDERATIONS

A. CHANGE IN METHOD

A change in the method of accounting for long-term construction-type contracts is a change in accounting principle. The general rule for presenting changes in accounting principle is that changes are reported retrospectively. This type of change is reported retrospectively.

B. DISCLOSURE

Generally, long-term construction contracts require no special disclosure because they are, in fact, the nature of the contractor's business. However, unusual extraordinary commitments should be fully disclosed in the financial statements or footnotes thereto.

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ACCOUNTING FOR INSTALLMENT SALES

I. ACCOUNTING FOR INSTALLMENT SALES

The installment method of accounting is used only when there is no reasonable basis for estimating the degree of collectibility. Under installment accounting, revenue is not recognized at the time a sale is made but rather when cash is actually collected.

A. PROBLEM SOLVING FORMULAS

INSTALLMENT SALES OR INSTALLMENT METHOD

1. Gross Profit = Sale – Cost of Goods Sold
2. Gross Profit Percentage = Gross Profit / Sales Price
3. Earned Revenue = Cash Collections x Gross Profit Percentage
4. Deferred Revenue = Installment Receivable x Gross Profit Percentage

EXAMPLE

Installment Sales Accounting

Assume that TAG Company began operations on January 1, Year 1, had $400,000 in installment sales in Year 1 and a December 31, Year 1, balance in installment accounts receivable of $150,000. If the TAG Company had $300,000 as its cost of goods sold, it would calculate realized profit and deferred profit in Year 1 as follows:

Step 1: Gross Profit

	Year 1
Sale on installment	$ 400,000
Cost of goods sold	(300,000)
Total gross profit	$ 100,000

Step 2: Gross Profit Percentage

$$\text{Gross profit} \div \text{Sale on installment} = \frac{\$100,000}{400,000} = 25\%$$

Step 3: Earned Gross Profit

Sale on installment	$ 400,000
Ending installment accounts receivable	(150,000)
Collections	$ 250,000
Gross profit percentage	25%
Gross profit earned	$ 62,500

Step 4: Deferred Gross Profit

Ending installment accounts receivable	150,000
Gross profit %	25%
Deferred gross profit	$ 37,500

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PASS KEY

Examiners require candidates to determine balance sheet presentation.

Balance Sheet Presentation

Accounts receivable	$150,000
Less: Deferred gross profit*	– 37,500
Balance	$112,500

* The deferred gross profit is a contra asset.

EXAMPLE

Installment Sale

Assume that a company sold $300,000 worth of merchandise (costing $200,000) on account using the installment method of accounting. The first installment of $100,000 was received.

Computations

Sale	$300,000
Cost	(200,000)
Profit	$100,000

1st Installment:

Profit: $100,000 / Sale: $300,000 x $100,000 (received) = $33,333

Journal Entry: To record the installment sale			
DR	Installment sale accounts receivable	$300,000	
CR	Inventory		$200,000
CR	Deferred gross profit (contra-receivable)		100,000

Journal Entry: To recognize cash collection			
DR	Cash	$100,000	
CR	Installment sale accounts receivable		$100,000

Journal Entry: To record profit on collection			
DR	Deferred gross profit	$ 33,333	
CR	Realized gross profit on installments sales		$33,333

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II. COST RECOVERY METHOD

A. GENERAL

COST RECOVERY METHOD

Under the cost recovery method, no profit is recognized on a sale until all costs have been recovered. At the time of sale, the expected profit on the sale is recorded as deferred gross profit. Cash collections are first applied to the recovery of product costs. Collections after all costs have been recovered are recognized as profit.

EXAMPLE

Cost Recovery Method

The following information reflects Foxy Company's real estate sales in Year 1. Foxy Company appropriately uses the cost recovery method.

Sales	$100,000	
Cost of land	70,000	
Cash collections:		
Year 1	35,000	
Year 2	40,000	$100,000
Year 3	25,000	

Journal Entry: To record the sale of land on the cost recovery method

DR	Cost recovery receivable	$100,000	
CR	Land		$70,000
CR	Deferred gross profit (contra-receivable)		30,000

Journal Entry: Year 1 collection

DR	Cash	$35,000	
CR	Cost recovery receivable		$35,000

Year 1: All of the $35,000 collected is treated as recovery of cost of the land.

Journal Entries: Year 2 collection

DR	Cash	$40,000	
CR	Cost recovery receivable		$40,000
and			
DR	Deferred gross profit	$ 5,000	
CR	Realized gross profit on installment sales		$5,000

Year 2: The first $35,000 collected is treated as recovery of cost of the land. The remaining $5,000 collected is gross profit.

Journal Entries: Year 3 collection

DR	Cash	$25,000	
CR	Cost recovery receivable		$25,000
and			
DR	Deferred gross profit	$25,000	
CR	Realized gross profit on installment sales		$25,000

Year 3: The full $25,000 is gross profit.

B. COMPARISON TO OTHER METHODS

The cost recovery method is similar to the installment sales method in that it may only be used when receivables are collected over an extended period and there is no reasonable basis for estimating their collectibility.

Because no profit is recognized until all costs have been recovered, the cost recovery method is the most conservative method of revenue recognition.

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ACCOUNTING FOR NONMONETARY EXCHANGES

I. EXCHANGES HAVING COMMERCIAL SUBSTANCE

SFAS No. 153 now requires that exchanges of nonmonetary assets be categorized into one of two groups:

(1) Those that have "commercial substance," and

(2) Those that lack "commercial substance."

An exchange has commercial substance if the future cash flows change as a result of the transaction. The change can either be in the areas of risk, timing, or amount of cash flows. In other words, if the economic position of the two parties changes because of the exchange, then the exchange has "commercial substance." A fair value approach is used.

PASS KEY

The fair value of assets given up is assumed to be equal to the fair value of assets received, including any cash given or received in the transaction. A simple solution framework for a journal entry is as follows:

DR New asset (FV of consideration given)
DR Accumulated depreciation of asset given up
DR Cash received
DR Loss (if any)
CR Old asset at historical cost
CR Cash given
CR Gain (if any)

A. RECOGNIZING GAINS AND LOSSES

Gains and losses are always recognized in exchanges having commercial substance and are computed as the difference between fair value and book value of the asset given up.

EXAMPLE

Gain on Exchange

Foxy Company exchanged used cars for a building that could possibly become Foxy Company's storage space. Future cash flows will significantly change. The book value of the cars totals $40,000 (cost of $102,000 – accumulated depreciation of $62,000). The cars' fair value is $45,000. In addition, Foxy must pay $20,000 cash as part of the exchange. Calculate the gain to be recognized on the exchange.

Fair value of cars		$ 45,000
Book value of cars:		
Cost of cars	$102,000	
Accumulated depreciation	(62,000)	
Book value		(40,000)
Gain on disposal of cars		$ 5,000

The cash given up does not enter into the calculation of gain on exchange, which is fair value less book value.

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B. CALCULATION OF BASIS OF ACQUIRED ASSET

The cash given up in the exchange is used to calculate the building's basis on Foxy's books.

EXAMPLE

Basis

Given the same facts as in the previous example, what would be the basis of the new building on Foxy Compay's books?

Fair value of cars given up	$45,000
Plus: Cash paid	20,000
Building cost (basis)	$65,000

Journal Entry: To record the exchange and the gain on the exchange			
DR	Building	$65,000	
DR	Accumulated depreciation – cars	62,000	
CR	Cars		$102,000
CR	Gain on disposal of cars		5,000
CR	Cash		20,000

If the FV of the cars in the last example was $38,000 instead of $45,000, a loss of $2,000 (FV $38,000 – BV $40,000) would be recognized and the basis of the building would be $58,000 ($38,000 FV + $20,000 cash).

Journal Entry: To record the exchange and the loss on the exchange			
DR	Building	$58,000	
DR	Accumulated depreciation – cars	62,000	
DR	Loss	2,000	
CR	Cars		$102,000
CR	Cash		20,000

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II. EXCHANGES LACKING COMMERCIAL SUBSTANCE

If projected cash flows after the exchange are not expected to change significantly, then the exchange lacks commercial substance. The following accounting treatment is used (note that this method must also be used in any exchange in which fair values are not determinable, or if the exchange is made to facilitate sales to customers):

A. GAINS

1. No Boot is Received = No Gain

If the exchange lacks commercial substance and no boot is received, no gain is recognized.

2. Boot is Paid = No Gain

If the exchange lacks commercial substance and boot is paid, no gain is recognized.

3. Boot is Received = Recognize Gain

If the exchange lacks commercial substance and boot is received, all of the gain or a proportional part of the gain is recognized.

a. Recognize All of the Gain (≥ 25% Rule)

When the boot received equals or exceeds 25% of the total consideration received (including the boot), the transaction is viewed as a monetary exchange, and all of the gain is recognized (EITF 86-29).

b. Recognize Proportional Gain (< 25% Rule)

When the boot received is less than 25% of the total consideration received, a proportional amount of the gain is recognized (APB No. 29). A ratio (the total boot received / the total consideration received) is calculated, and that proportion of the total gain realized is recognized.

B. LOSSES

If the transaction lacks commercial substance and a loss is indicated, the loss should be recognized.

EXAMPLE

Similar Assets—No Boot Involved

Facts:
- Machine A is exchanged for Machine B
- Machine A, carrying value (BV) = $10,000
- Machine A, fair value (FV) = $12,000
- Machine B, fair value not known

Solution:

Calculate the total gain as follows:

FV of asset(s) received or given up – BV of asset(s) given

$12,000 - $10,000 = $2,000 total gain

The total gain of $2,000 is not recognized because the exchange lacks commercial substance.

Journal Entry: To record the above transaction		
DR Machine B	$10,000	
CR Machine A		$10,000

The asset given up in the exchange should be tested for impairment prior to recording the exchange. (See lecture F4 for a discussion of asset impairment.) See the *homework reading* for additional examples and explanations of exchanges lacking commercial substance.

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III. INVOLUNTARY CONVERSIONS

A. OVERVIEW

Whenever a nonmonetary asset is involuntarily converted (e.g., fire loss, theft, or condemnation) to cash, the entire gain or loss is recognized for financial accounting purposes.

EXAMPLE

Gain on Condemnation

Facts:

On 12/1/Yr 1, Sykes Company received a condemnation award of $100,000 for the forced sale of Sykes Company's factory building. At that time, Sykes Company's building had a book value of $75,000. Compute the gain or loss.

Solution:

Proceeds from condemnation	$100,000
Less: Book value of nonmonetary asset (factory building)	(75,000)
Gain on condemnation	$ 25,000

Journal Entry: To record the above transaction

DR	Cash	$100,000	
CR	Building		$75,000
CR	Gain on involuntary conversion		25,000

B. TAX TREATMENT

The rules for involuntary conversions are different for tax purposes. If a gain is recognized for financial purposes in one period and for tax purposes in another period, a temporary difference will result. Interperiod tax allocation will be necessary. (Interperiod tax allocation is covered in lecture F-6.)

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PARTNERSHIPS

I. ADMISSION OF A PARTNER

A new partner may be admitted by the purchase of an existing partnership interest or by investing additional capital into the partnership.

A. BY PURCHASE OR SALE OF EXISTING PARTNERSHIP INTEREST

A partner, with the consent of all partners, may sell his partnership interest to a new partner. Payment for the partnership interest by the new partner would go directly to the selling partner. The retiring partner could sell his interest in the same manner to the remaining partners.

1. No Journal Entry

No entries are made on the partnership books, except for the change of name on the capital account. Transactions of this type do not affect the assets, liabilities, or total capital of the partnership.

B. FORMATION OF A PARTNERSHIP

Contributions to a partnership are recorded as follows:

1. Assets are valued at fair value.
2. Liabilities assumed are recorded at their present value.
3. Partner's capital account therefore equal the difference between the fair value of the contributed assets less the present value of liabilities assumed.

PASS KEY

It is important to distinguish the tax and GAAP rules relating to the formation of a partnership:

- GAAP Rule = Use FMV of asset contributed
- Tax Rule = Use NBV of assets contributed

C. CREATION OF A NEW PARTNERSHIP INTEREST WITH INVESTMENT OF ADDITIONAL CAPITAL

When a new partnership interest is created by the investment of additional capital into the partnership, the total capital of the partnership does change, and the purchase price can be equal to, more than, or less than book value.

1. Exact Method (Equal to Book Value)

When the purchase price is equal to the book value of the capital account purchased, no goodwill or bonuses are recorded.

a. Rules (problem solving steps)

(1) Determine the exact amount a new partner will have to pay to get his capital account in the exact proportional interest to the new net assets of the partnership.

(2) There is no goodwill or bonus.

(3) Old partners' capital account "dollars" stay the same.

(4) Old partners' "% ownership" changes, but that change is generally not a requirement on the CPA exam.

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PASS KEY

Problems that deal with the exact method will always ask, "How much should the new partner contribute in order to have an x% interest in the new partnership?" and will not include references to goodwill or bonuses in the transaction.

EXAMPLE

New Partner Pays Book Value

Facts:

A, B, and C are partners in a three-person partnership. They have capital accounts of $20,000, $30,000, and $50,000, respectively. A, B, and C decide to admit D as a new partner with a 25% interest in the new partnership. If D pays book value, how much should D contribute in order to have a 25% interest in the partnership?

Solutions:

Equity of new partnership = $20,000 + $30,000 + $50,000 + D's contribution

Since D will contribute an amount equal to 25% of the total book value of the new partnership, D's contribution can be shown as 25% of total new equity.

Total new equity = $100,000 + .25 Total new equity

$$\$100{,}000 = .75 \text{ Total new equity; } \frac{\$100{,}000}{0.75} = \text{Total new equity}$$

Total new equity = $133,333
.25 total new equity = $33,333

Thus, D should pay $33,333 for a 25% interest.

2. Bonus Method

BONUS METHOD

When the purchase price is more or less than the book value of the capital account purchased, bonuses are adjusted between the old and new partners' capital accounts and do not affect partnership assets.

Bonus Method: recognize intercapital transfer

a. Rules (problem-solving steps)

(1) Determine total capital and the interest to the new partner.

(2) If interest less than amount contributed, bonus to old partner(s).

(3) If interest greater than amount contributed, bonus to new partner.

PASS KEY

(B) = **B**onus = **B**alance in total capital accounts controls the capital account allocation

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PASS KEY

Under the bonus method, the bonus will be credited to the following partner:

- Existing partners – when new partner pays more than NBV
- New partner – when new partner pays less than NBV

EXAMPLE

Bonus Method — Bonus to Existing Partners

A and B share profits and losses 60:40, and have capital accounts of $30,000 and $10,000, respectively. C has agreed to invest $35,000 for a one-third interest in the new ABC partnership. Since the partnership has decided not to recognize goodwill, the total capital of the resulting partnership is $75,000 ($30,000 + $10,000 + $35,000). C has purchased a one-third interest, so the balance in C's capital account should equal one-third of $75,000 or $25,000. The extra $10,000 paid by C is recorded as a bonus to the old partners and is shared according to their profit and loss ratio.

Journal Entry: To record the admission of C into the partnership and recognize the bonus to existing partners

DR	Cash	$35,000	
CR	A, Capital ($10,000 x 60%)		$ 6,000
CR	B, Capital ($10,000 x 40%)		4,000
CR	C, Capital (30,000 + 10,000 + 35,000 = 75,000 x 1/3)		25,000

EXAMPLE

Bonus Method — Bonus to New Partner

It is possible for the existing partners to credit a bonus to a new partner. In the example above, if C had invested $14,000 for a one-third interest in the resulting partnership, C would have received a bonus from A and B, because the one-third interest in the partnership is $18,000 [1/3 ($30,000 + $10,000 + $14,000)] and exceeds C's contribution of $14,000. The $4,000 ($18,000 - $14,000) is a bonus credited to C by A and B, and is charged to A's and B's capital accounts according to their profit and loss ratio (60:40).

Journal Entry: To record the partnership and recognize the bonus to new partners

DR	Cash	$14,000	
DR	A, Capital ($4,000 x 60%)	2,400	
DR	B, Capital ($4,000 x 40%)	1,600	
CR	C, Capital (30,000 + 10,000 + 14,000 = 54,000 x 1/3)		$18,000

3. Goodwill Method (Recognized Intangible Asset)

Goodwill is recognized based upon the total value of the partnership implied by the new partner's contribution.

a. Rules (problem-solving steps)

(1) Compute new "net assets before GW" (before goodwill) after admitting new (or paying old) partner.

(2) Memo: Compute new "capitalized" net assets (= total net worth) and compare "Capitalized Net Assets" with "Net Assets before GW," and

(3) "Difference" is "Goodwill" to be allocated to old partners according to their old partnership profit ratios.

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PASS KEY

G = **G**oodwill = **G**oing in investment (dollars) controls capital account allocation & goodwill calculation

EXAMPLE

Goodwill Method —
Goodwill Credited to Capital Accounts of Existing Partners

A and B share profits and losses 60:40, and have capital accounts of $30,000 and $10,000, respectively. On the basis of A and B's present total capital, C has agreed to invest $35,000 for a one-third interest in the new ABC partnership. The partnership decides to recognize goodwill.

C pays $35,000 for a one-third interest in the partnership, goodwill is recognized as the difference between the implied value of the business and the total of the tangible net assets represented by the partners' capital account.

Implied value ($35,000 x 3 = $105,000)	$105,000
Total partner's capital accounts ($35,000 + $10,000 + $30,000 = $75,000)	(75,000)
Goodwill	$ 30,000

Journal Entry: To record the admission of C into the partnership and recognize goodwill

DR	Cash	$35,000	
DR	Goodwill	30,000	
CR	A, Capital (60% x $30,000)		$18,000
CR	B, Capital (40% x $30,000)		12,000
CR	C, Capital (equals amount contributed by C)		35,000

PASS KEY

The following summary will help you remember the differences among the above approaches:

Exact Method:

- Incoming partner's capital account is their actual contribution. (You must calculate.)
- No adjustment to the existing partners capital accounts is required.

Bonus Method:

- Balance in total capital accounts controls the computation.
- Incoming partner's capital account is their percentage of the partnership total NBV (after their contribution).
- Adjust the existing partners capital accounts to balance.

Goodwill Method:

- Going in investment (dollars) controls the computation.
- Incoming partner's capital account is their actual contribution.
- Goodwill (implied) is determined based upon the incoming partners contribution, and shared by the existing partners.

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II. PROFIT AND LOSS DISTRIBUTION

PARTNERSHIP DISTRIBUTION OR DISTRIBUTIONS TO OWNERS

Income or loss is distributed among the partners in accordance with their agreement, and in the absence of an agreement all partners share equally irrespective of what their capital accounts reflect or the amount of time each partner spends on partnership affairs.

Unless the partnership agreement provides otherwise, all payments for interest on capital, salaries, and bonuses are deducted prior to any distribution in the profit and loss ratio. Such payments are provided for in full, even in a loss situation.

PASS KEY

Partnership accounts may be different than their respective profit and loss ratios. The reason for this is that distributions/withdrawals will be at different times and for different reasons.

EXAMPLE

Distribution of Profit and Loss to Individual Partners

A, B, and C, copartners, had capital balances at the end of the year (but before profit distribution) of $30,000, $60,000, and $90,000, respectively. The partnership's profit for the year, excluding any payments to partners, was $200,000. The partnership agreement provided for interest of 8% on ending capital balances, a salary to A of $10,000, and a bonus to C of 15% of partnership profits before any distribution to partners.

The profit and loss ratios were 20% to A, 30% to B, and 50% to C. On the basis of this data, what was the total distribution to each partner?

	Total	*A*	*B*	*C*
Total profit	$200,000			
15% guaranteed bonus to C	(30,000)			$ 30,000
Interest on ending capital balances (8% x capital balance)	(14,400)	$2,400	$ 4,800	7,200
Salary to A	(10,000)	10,000		
Balances	$145,600	$12,400	$ 4,800	$ 37,200
Distribution of balance in P&L ratio 20%; 30%; 50%	(145,600)	29,120	43,680	72,800
Total distribution of P&L	$ 0	$41,520	$48,480	$110,000

Note: All interest, salaries, and bonuses are deducted from total profit to arrive at the amount of profit and loss distributed in the profit and loss ratio. If these items exceed the amount of profit, then the resulting loss is distributed in the profit and loss ratio.

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III. WITHDRAWAL OF A PARTNER

A. BONUS METHOD

PARTNER WITHDRAWAL

The difference between the balance of the withdrawing partner's capital account and the amount that person is paid is the amount of the "bonus." The "bonus" is allocated among the remaining partners' capital accounts in accordance with their remaining profit and loss ratios. Although the partnership's identifiable assets may be revalued to their fair value at the date of withdrawal, any goodwill implied by the excess payment to the retiring partner is NOT recorded.

Step 1:			
Revalue the assets to reflect fair value			
DR	Asset adjustment	$XXX	
CR	A, Capital (%)		$XXX
CR	B, Capital (%)		XXX
CR	X, Capital (%)		XXX
Step 2:			
Pay off withdrawing partner			
DR	A, Capital (%)	$XXX	
DR	B, Capital (%)	XXX	
DR	X, Capital (100%)	XXX	
CR	Cash		$XXX

B. GOODWILL METHOD

The partners may elect to record the implied goodwill in the partnership based on the payment to the withdrawing partner. The amount of the implied goodwill is allocated to ALL of the partners in accordance with their profit and loss ratios. After the allocation of the implied goodwill of the partnership, the balance in the withdrawing partner's capital account should equal the amount that person is to receive in the final settlement of his or her interest.

Step 1:			
Revalue the assets to reflect fair value			
DR	Asset adjustment	$XXX	
CR	A, Capital (%)		$XXX
CR	B, Capital (%)		XXX
CR	X, Capital (%)		XXX
Step 2:			
Record goodwill to make withdrawing partner's capital account equal payoff			
DR	Goodwill	$XXX	
CR	A, Capital (%)		$XXX
CR	B, Capital (%)		XXX
CR	X, Capital (%)		XXX
Step 3:			
Pay off withdrawing partner			
DR	X, Capital (100%)	$XXX	
CR	Cash		$XXX

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IV. LIQUIDATION OF A PARTNERSHIP

The process of winding up the affairs of a partnership after dissolution is generally referred to as liquidation. Liquidation involves the realization of cash from the disposal of partnership assets. Creditors or partners may agree to accept specific partnership assets in full or partial satisfaction of their claims against the partnership.

A. ORDER OF PREFERENCE REGARDING DISTRIBUTION OF ASSETS

Where a solvent partnership is dissolved and its assets are reduced to cash, the cash must be used to pay the partnership's liabilities in the following order:

1. Creditors

Creditors, including partners who are creditors, must be paid before the noncreditor partners receive any payments.

2. Partners' Capital

Right of offset between a partner's loans to and from the partnership and that person's capital balances generally exists in liquidation.

B. LOSSES CONSIDERED IN LIQUIDATION

1. All possible losses must be provided for in a liquidation before any distribution is made to the partners. The rule to follow is not to distribute any cash until maximum potential losses have been taken into consideration.
2. Losses in liquidating a partnership are charged to the partners in accordance with the partnership agreement; in the absence of such an agreement, the losses are shared equally.

C. CONVERT NONCASH ASSETS

The general procedure in a liquidation is that all noncash assets are converted into cash, all liabilities are paid, and the remainder, if any, is distributed to the partners.

D. GAIN OR LOSS ON REALIZATION

The liquidation of partnership assets may result in:

1. A gain on realization,
2. A loss on realization, or
3. A loss on realization resulting in a capital deficiency.

E. CAPITAL DEFICIENCY

A capital deficiency is a debit balance in a partner's capital account and indicates that the partnership has a claim against the partner for the amount of the deficiency.

1. Right of Offset

If a partner with a capital deficiency has a loan account (the partnership has payable to the partner), the partnership has a legal right to offset and may use the loan account to satisfy the capital deficiency.

2. Remaining Partners Charged

If a deficiency still exists, the remaining partners must absorb the deficiency according to their respective (remaining) profit and loss ratios.

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F. THE PARTNERSHIP LIQUIDATION SCHEDULE

The objective of the schedule is to distribute cash, as it becomes available, to the partners.

It is important that no partner is either overpaid or underpaid as the result of any cash distributed by the liquidator because that person could be personally liable for overpayments made to a partner that were not repaid.

PASS KEY

Generally, the "poor" partners do not have any money to repay their shortage; so (generally), the "richest" partners are paid first.

Many multiple-choice exam questions ask for ending partners' balances after liquidation of a partner or the partnership; some questions merely ask for amount of "cash" to be paid upon liquidation. If all "other" assets and all liabilities are liquidated, the answer will be the same: "cash = partners' balances."

LIMITED PARTNERSHIP

V. LIMITED PARTNERSHIPS

Limited partnerships are more similar to corporations than regular partnerships. Limited partners have no personal liability for debts of the partnership and can lose only their actual investment in the firm.

A. GENERAL PARTNER REQUIRED

There is a requirement under the Uniform Limited Partnership Act (ULPA) that limited partnerships must have at least one general partner with unlimited liability.

B. TRANSFER OF INTEREST

Generally, a limited partner's interest is transferable without consent of other partners.

C. DISSOLUTION DOES NOT OCCUR

Dissolution does not result from death, bankruptcy, incapacity, withdrawal, or admission of a limited partner.

D. PRIORITY OVER GENERAL PARTNERS

Limited partners have priority over general partners in the liquidation of a limited partnership.

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FINANCIAL REPORTING AND CHANGING PRICES

I. OVERVIEW

Certain large, publicly held companies may disclose information concerning the effect of changing prices.

A. SIMPLE DEFINITIONS

1. Historic cost—the actual exchange value in the dollars at that time.
2. Current cost—the cost that would be incurred at the present time, the replacement cost. (Use recoverable amount if lower)
3. Nominal dollars—unadjusted for changes in purchasing power.
4. Constant dollars—dollars restated based on calculations of CPI ratios.

II. MEASUREMENT METHODS AND CURRENT COST DETERMINATION

A. There are four methods of measuring prices and the effects of price changes:

1. *Historic Cost/Nominal Dollars (HCND)* is based on historic prices without restatement for changes in the purchasing power of the dollar. This method is the basis for GAAP used in (primary) financial statements.
2. *Historic Cost/Constant Dollars (HCCD)* is based on historic prices adjusted for changes in the general purchasing power of the dollar. This method uses a general price index (e.g., Bureau of Labor Statistics Consumer Price Index—BLS CPI) to adjust historic cost; it retains the historic cost basis.
3. *Current Cost/Nominal Dollars (CCND)* is based on current cost without restatement for (or recognition of) changes in the general purchasing power of the dollar.
4. *Current Cost/Constant Dollars (CCCD)* is based on current cost adjusted for (giving recognition to) changes in the general purchasing power of the dollar. This method may use specific price indexes or direct pricing to determine current cost and will use a general price index to measure general purchasing power effects.

III. MONETARY AND NON-MONETARY ITEMS

A. DEFINITIONS

1. Monetary

Assets and liabilities are "fixed" or denominated in dollars regardless of changes in specific prices or the general price level (e.g., accounts receiveable). Holding monetary assets during periods of inflation will result in a loss of purchasing power, and holding monetary liabilities will result in a gain of purchasing power.

2. Non-Monetary

Assets and liabilities will fluctuate with inflation and deflation. Holders of nonmonetary items may lose or gain with the rise or fall of the CPI-U if the nonmonetary item does not rise or fall in proportion to the change in the CPI-U. In other words, a nonmonetary asset or liability is affected by (1) the rise or fall of the CPI-U and (2) the increase or decrease in the fair value of the nonmonetary item.

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B. CLASSIFICATION: MONETARY AND NON-MONETARY

	Monetary	Non-Monetary
Assets		
Cash	X	
Foreign currency on hand	X	
Marketable common stock (cost method)		X
Bonds—non-convertible	X	
Accounts/notes receivable (and allowance)	X	
Inventory		X
Inventory under a fixed price contract	X	
Advances and pre-paid items	X	
Long term receivables	X	
Investment in subsidiary (equity)		X
Pension funds/bonds held for interest	X	
Pension funds/stock		X
Investment in convertible bonds (speculative)		X
Investment in convertible bonds (for income)	X	
Plant, property, and equipment (and accum. depr.)		X
Cash surrender value of life insurance	X	
Advances paid on purchase commitments		X
Unamortized discount on bonds payable	X	
Intangible assets—patents and trademarks		X
Liabilities		
Accounts and notes payable	X	
Accrued expenses	X	
Cash dividends payable	X	
Obligations payable in foreign currency		X
Advances (if mandatory) to deliver the goods		X
Accrued losses on purchase commitments	X	
Bonds payable	X	
Obligations under warranties		X
Deferred taxes	X	
Accrued pension costs—fixed dollar amount	X	
Accrued pension costs—other		X
Accrued vacation pay—fixed dollars	X	
Accrued vacation pay—fixed number of days		X
Equities		
Preferred stock—nonconvertible	X	
Common stock of your company		X
Retained Earnings is neither. Use as a residual (plug).		

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PASS KEY

A "contra-account" (allowance for doubtful accounts/accumulated depreciation) is classified as monetary or nonmonetary based upon the classification of the related account.

PASS KEY

An important use for this information on the CPA exam relates to its use in foreign currency accounting when the "Remeasurement" method is used (discussed on the following pages).

C. PURCHASING POWER GAINS AND LOSSES

1. Monetary Asset vs. Monetary Liability

	Purchasing Power Gains	Purchasing Power Losses
Holding Monetary Assets	During a period of deflation	During a period of inflation
Holding Monetary Liabilities	During a period of inflation	During a period of deflation

2. Inflation and Appreciation Comparison

	Monetary Purchasing Power Gain/Loss	Non-Monetary Holding Gain/Loss
	Inflation	**Appreciation**
Historical Cost/ Nominal Dollars	No	No
Historical Cost/ Constant Dollars	Yes	No
Current Cost/ Nominal Dollars	No	Yes
Current Cost/ Constant Dollars	Yes	Yes

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FOREIGN CURRENCY

FOREIGN CURRENCY ACCOUNTING (SFAS 52)

I. INTRODUCTION

SFAS 52 provides the standards for converting transactions and financial statements from a foreign currency to the domestic currency (the dollar). Foreign currency accounting is concerned with foreign currency transactions and translations.

A. FOREIGN CURRENCY TRANSACTIONS

Foreign currency transactions are transactions with a foreign entity (e.g., buying from and selling to) denominated in (to be settled in) a foreign currency.

B. FOREIGN CURRENCY TRANSLATION

Foreign currency translation is the conversion of financial statements of a foreign entity into financial statements expressed in the domestic currency (the dollar).

II. PURPOSE OF THE STANDARDS

A. IMPACT OF CASH FLOWS

The standards for foreign currency accounting are designed to:

1. Provide information regarding the effects of exchange rate changes on an enterprise's cash flow and equity.
2. Recognize in income (from continuing operations) the effects (gain or loss) of adjustments for currency exchange rate changes that impact cash flows and exclude from net income those adjustments that do not impact cash flows.

B. PURPOSE

Reflect in consolidated financial statements the financial results and relationships of the affiliated entities as measured in the currency of the primary economic environment in which each entity operates (called the "Functional Currency").

III. TERMINOLOGY

A. EXCHANGE RATE

Exchange rate is the price of one unit of a currency expressed in units of another currency; the rate at which two currencies will be exchanged at equal value. The exchange rate may be expressed as:

1. Direct Method

The direct method is the domestic price of one unit of another currency. For example, one euro costs $0.55.

2. Indirect Method

The indirect method is the foreign price of one unit of the domestic currency. For example, 1.80 euros buys $1.00.

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B. CURRENT EXCHANGE RATE

Current exchange rate is the exchange rate at the current date, or for immediate delivery of currency, often referred to as the "spot" rate.

C. FORWARD EXCHANGE RATE

Forward exchange rate is the exchange rate existing now for exchanging two currencies at a specific future date.

D. HISTORICAL EXCHANGE RATE

The historical exchange rate is the rate in effect at the date of issuance of stock or acquisition of assets.

E. WEIGHTED AVERAGE RATE

The weighted average exchange rate is calculated to take into account the exchange rate fluctuations for the period. It would be impractical to account for the actual exchange rate in effect for numerous, recurring transactions (e.g., sales). The average rate, when applied to a transaction normally assumed to have occurred evenly throughout the period, approximates the effect of separate translations of each item.

F. FORWARD EXCHANGE CONTRACT

A forward exchange contract is an agreement to exchange at a future specified date and rate a fixed amount of currencies of different countries.

G. REPORTING CURRENCY

The reporting currency is the currency of the entity ultimately reporting financial results of the foreign entity, and is always the U.S. dollar for the CPA Exam.

H. FUNCTIONAL CURRENCY

The functional currency is the currency of the primary economic environment in which the entity operates, usually the local currency or the U.S. dollar.

I. FOREIGN CURRENCY REMEASUREMENT

A foreign currency remeasurement is the restatement of financial statements denominated in a foreign currency to the functional currency prior to the translation process. This is required when an entity's books of record are not maintained in its functional currency. Remeasurement is not followed by translation when the functional currency is also the reporting currency.

J. FOREIGN CURRENCY TRANSLATION

A foreign currency translation is the restatement of financial statements denominated in the functional currency to the currency of the reporting entity (assumed to be U.S. dollars) using appropriate rates of exchange.

K. DENOMINATED OR FIXED IN A CURRENCY

A transaction is denominated or fixed in the currency used to negotiate and settle the transaction, either in U.S. dollars or a foreign currency.

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IV. FOREIGN FINANCIAL STATEMENT TRANSLATION

A. INTRODUCTION

The first area to be examined involves foreign currency financial statements that will be consolidated or combined with a parent reporting entity (usually U.S. dollars). In translating foreign currency financial statements to the reporting currency, it is important to retain the financial results and relationships that were present before translation. There are two steps in the foreign currency translation process.

1. Remeasurement (Temporal Method)

REMEASUREMENT: TEMPORAL METHOD

Before translation can be accomplished, the financial statements of the foreign company to be translated must be remeasured to the functional currency of that company and these statements must be in conformity with GAAP.

2. Translation (Current Method)

CURRENT: TRANSLATION METHOD

Once all of the financial statements to be reported on are measured in their functional currencies, it is necessary to translate them to their reporting currency (provided that the functional currency is not the reporting currency).

B. TRANSLATION METHOD (CURRENT METHOD):

Foreign currency = functional currency

1. Income Statement

- Income = Weighted Average
- Expenses = Weighted Average
- Transfer Net Income to Retained Earnings

2. Balance Sheet

- Assets = Current Rate/Year-end
- Liabilities = Current Rate/Year-end
- Common Stock/APIC = Historical Rate
- Retained Earnings = Roll Forward
- Accumulated Translation Adjustment = Plug "Accumulated Translation Adjustment" to Equity to get Balance Sheet to agree
- SFAS 130: "Other comprehensive income" —
  P U Foreign Currency Translation Adjustment **E (PUFE)**

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C. REMEASUREMENT METHOD (TEMPORAL METHOD):

U.S. dollars = functional currency

1. Balance Sheet

- Monetary = Current/Year-end Rate
- Non-Monetary = Historical Rate

2. Income Statement

- Weighted Average
- Historical for Balance Sheet expenses
  - Depreciation/PP&E
  - Cost of Goods Sold/Inventory
  - Amortization/Bonds and Intangibles
- Plug "Currency Gain/Loss" to get net income from continuing operations to the required amount needed for Balance Sheet (and retained earnings)

D. STEPS IN RESTATING FOREIGN FINANCIAL STATEMENTS

1. Prepare in Accordance with GAAP

Before performing any part of the translation process, it is necessary to ensure that the financial statements expressed in the foreign currency were prepared in accordance with U.S. GAAP. If necessary, corrections must be made to comply with GAAP.

2. Determine the Functional Currency

The functional currency of a foreign entity determines the conversion methodology to use. Functional foreign currency can be the entity's local currency, the currency of the reporting entity, or the currency of another country. In order for an entity's local currency to qualify as the foreign entity's functional currency, it must be the currency of the primary economic environment in which the company operates, and all of the following must exist:

a. The foreign operations are relatively self-contained and integrated within the country.

b. The day-to-day operations do not depend on the parent's or investor's functional currency.

c. The local economy of the foreign entity is NOT highly inflationary, which is defined as cumulative inflation of 100% over three years.

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3. Determine Appropriate Exchange Rates

The functional currency of the foreign entity determines the exchange rates to be used in converting account balances and the treatment of the gains or losses associated with the translation process.

4. Remeasure the Financial Statement into the Functional Currency

If the financial statements are not in the company's functional currency, remeasure into the functional currency using:

a. Balance Sheet

(1) Monetary (fixed)

Current/year-end rate is used to convert monetary items.

(2) Nonmonetary (fluctuate/not fixed)

Historical rate is used to convert nonmonetary items.

b. Income Statement

(1) Balance Sheet Related

Income and expense items which directly relate to a specific balance sheet account are converted at the historical exchange rate of the corresponding balance sheet item.

(2) Non-Balance Sheet Related

The weighted average exchange rate is used to convert income and expense items, which are not directly related to a specific balance sheet account.

c. Remeasurement Gain or Loss (Income Statement)

Any resulting remeasurement gains and losses are recognized currently in the income statement. The resulting financial statements are measured as if the financial statements had been initially recorded in the functional currency.

5. Translate the Financial Statements to the Reporting Currency (U.S. Dollars)

Assuming the foreign entity's financial statements are stated in terms of its functional currency, the company is now ready for translation into the reporting currency. This is accomplished using the current method, as is indicated below.

a. Assets and Liabilities: Use Current/Year-End Exchange Rate

Under the current method, assets (including fixed assets) and liabilities are translated from the foreign currency to the reporting currency at current exchange rates.

b. Equity Accounts: Use Historical Rate

The current method translates equity accounts as follows:

(1) Capital stock issued is translated at the rate in effect on the date of issuance.

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(2) Capital accounts and retained earnings acquired are translated at the rate in effect on the date of acquisition.

(3) Retained earnings may also be stated at amounts actually paid by the parent. Retained earnings after the date of acquisition are equal to the beginning translated retained earnings plus translated increases to retained earnings for the current period less translated dividend declared for the current period.

c. Revenues and Expenses: Use Weighted Average Rate

Revenues, expenses (including depreciation), gains, and losses are translated at the weighted average rate under the current method.

d. Translation Gain or Loss (Other Comprehensive Income)

All adjustments resulting from the translation of foreign currency financial statements must be recorded and reported in other comprehensive income. These adjustments are treated as unrealized gains and losses. The translation adjustment is equal to the difference between the debits and credits in the translated trial balance.

EXAMPLE

Financial statements of the Kristi Corporation, a foreign subsidiary of the Dollar Corporation (a U.S. company), are shown below at and for the year ended December 31, 20X1. Two examples follow where the statements are first translated using the LCU (local currency unit) as the functional currency (translation method), then the dollar as the functional currency (remeasurement).

Assumptions:

1. The parent company organized the subsidiary on December 31, 20X0.
2. Exchange rates for the LCU were as follows:

December 31, 20X0 to March 31, 20X1	$ .18
April 1, 20X1 to June 30, 20X1	.13
July 1, 20X1 to September 30, 20X1	.10
October 1, 20X1 to December 31, 20X1	.10
Weighted Average	.1275

3. Inventory was acquired evenly throughout the year and sales were made evenly throughout the year.
4. Fixed assets were acquired by the subsidiary on December 31, 20X0.

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KRISTI CORPORATION
Foreign Currency Financial Statements
Expressed in dollars at and for the year ended December 31, 20X1

			TRANSLATION METHOD		REMEASUREMENT METHOD	
			Exchange Rate	Dollars	Exchange Rate	Dollars
Income Statement						
Sales	LCU	525,000	$.1275	$66,938	$.1275	$66,938
Costs and expenses:						
Cost of goods sold	LCU	400,000	.1275	$51,000	.1275	$51,000
Depreciation expense		22,000	.1275	2,805	.18	3,960
Selling expenses		31,000	.1275	3,953	.1275	3,953
Other operating expenses		11,000	.1275	1,403	.1275	1,403
Income taxes expense		19,000	.1275	2,423	.1275	2,423
Total costs and expenses	LCU	483,000		$61,584		$62,739
Currency exchange (gain)					PLUG #2 →	(6,854)
Net income	LCU	42,000		$5,354		$11,053
Statement of Retained Earnings						
Retained earnings, beginning of year	LCU	-0-		-0-		-0-
Net income		42,000		$5,354		$11,053
Retained earnings, end of year	LCU	42,000		$5,354		$11,053
Balance Sheet – Assets						
Cash	LCU	10,000	.10	$1,000	.10	$1,000
Accounts receivable (net)		50,000	.10	5,000	.10	5,000
Inventories (at cost)		95,000	.10	9,500	.1275	12,113
Fixed assets		275,000	.10	27,500	.18	49,500
Accumulated depreciation		(22,000)	.10	(2,200)		(3,960)
Total assets	LCU	408,000		$40,800		$63,653
Liabilities and Stockholders' Equity						
Accounts payable	LCU	34,000	.10	$3,400	.10	$3,400
Long-term debt		132,000	.10	13,200	.10	13,200
Common stock, 10,000 shares		200,000	.18	36,000	.18	36,000
Retained earnings		42,000		5,354	PLUG #1 →	11,053
Accumulated balance of other comprehensive income			PLUG →	(17,154)		
Total liabilities and stockholders' equity	LCU	408,000		$40,800		$63,653

Note: The superimposed numbers are the order of steps in the two examples and as discussed on pages F2-54 and F2-55.

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PASS KEY

To remember the significant differences in order of steps and conversion rates, the summary chart below should help with the basics:

Method	1st Step	2nd Step	Plug	Reported
Translation	• Income statement • @ Weighted average	• Balance sheet • @ Year-end rate • C/S & APIC @ historical • Roll forward R/E	Equity Accumulated other comprehensive income	PU**F**E
Remeasurement	• Balance sheet • Monetary @ year-end rate • Nonmonetary @ historical	• Income statement • @ Weighted average • Historical for balance sheet related accounts	Gain/loss so I/S is at amount necessary for R.E. plug	**I**DEA

VI. INDIVIDUAL FOREIGN TRANSACTIONS

A. INTRODUCTION

The second area to be examined concerns the accounting and reporting of transactions denominated in a foreign currency. These are usually import or export transactions. Transactions occurring at various dates may experience exchange rate fluctuations. As a result exchange gains and losses will occur when a U.S. company buys or sells to a foreign company with whom it has no ownership interest and agrees to pay or accept payment in a foreign currency. Additional foreign currency transactions occur when subsidiaries engage in transactions denominated in a currency other than their functional currency. However, transactions between subsidiary and parent of a permanent financing nature are not considered foreign currency transactions.

B. TYPES OF FOREIGN CURRENCY TRANSACTIONS

1. Operating Transactions

Operating transactions include import (buying), export (selling), borrowing, lending, and investing transactions.

2. Forward Exchange Contracts

Forward exchange contracts are agreements to exchange two different currencies at a specific future date and at a specific rate.

C. CHANGES IN EXCHANGE RATE

A foreign exchange transaction gain or loss will result if the exchange rate changes between the time a purchase or sale in foreign currency is contracted for and the time actual payment is made.

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D. TRANSACTION NOT SETTLED AT BALANCE SHEET DATE

A foreign exchange transaction gain or loss that is recognized in current net income must be computed at each balance sheet date on all recorded transactions denominated in foreign currencies that have not been settled. The difference between the exchange rate used in recording the transaction in dollars and the exchange rate at the balance sheet date (current exchange rate) is an unrealized gain or loss on the foreign currency transaction.

E. VALUATION OF ASSETS AND LIABILITIES

The assets or liabilities resulting from foreign currency transactions should be recorded in the U.S. company's books using the exchange rate in effect at the date of the transaction.

EXAMPLE

Foreign Currency Transaction

On 12/1/Yr 1 Olinto Company purchased goods on credit for 100,000 pesos. Olinto Company paid for the goods on 2/1/Yr 2. The exchange rates were:

Date	*Rate*
12/1/Yr 1	$0.10
12/31/Yr 1	$0.08
2/1/Yr 2	$0.09

What are the journal entries related to this foreign currency transaction?

12/1/Yr 1

DR	Purchases (100,000 pesos × $0.10 exchange rate)	$10,000	
CR	Accounts payable		$10,000

12/31/Yr 1

DR	Accounts payable (100,000 pesos × $0.10 – $0.08)	$2,000	
CR	Foreign exchange transaction gain		$2,000

The $8,000 can purchase 100,000 pesos at 12/31/Yr 1. The difference between the $8,000 and the original recorded liability of $10,000 is a foreign exchange transaction gain, which would increase net income for Year 1.

2/1/Yr 2

DR	Accounts payable ($10,000 original balance – $2,000 adjustment)	$8,000	
DR	Foreign exchange transaction loss [100,000 × ($0.08 – $0.09)]	1,000	
CR	Cash (100,000 pesos × $0.09)		$9,000

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HOMEWORK READING:
EXPANDED EXAMPLES OF EXCHANGES LACKING COMMERCIAL SUBSTANCE

I. GAIN AND LOSS RECOGNITION

Pg. F2-39 outlines the rules for gain and loss recognition for exchanges lacking commercial substance. In summary, gains are not recognized unless boot is received. All losses are recognized, consistent with the rule of conservatism. The following examples illustrate these rules. The examples assume that the exchanges lack commercial substance.

EXAMPLE

No Boot = No Gain

Assume: - Machine A is exchanged for Machine B
- Machine A, carrying value (BV) = $10,000
- Machine A, fair value (FV) = $12,000
- Machine B, fair value (FV) = $12,000 (FV given = FV received)

Calculate the total gain as follows:

FV of asset given – BV of asset given

$12,000 – 10,000 = $2,000 gain

The gain is not recognized because the exchange lacks commercial substance and boot is not included in the transaction. As a result, the basis of the acquired asset is equal to the basis of the old asset.

Journal Entry: To record the above transaction

DR	Machine B	$10,000	
CR	Machine A		$10,000

EXAMPLE

Boot is Paid = No Gain

Assume: - Machine A and $2,500 is exchanged for Machine B
- Machine A, carrying value (BV) = $10,000
- Machine A, fair value (FV) = $12,000
- Machine B, fair value (FV) = $14,500 (FV given = FV received)

Calculate the total gain as follows:

FV of assets given* – BV of assets given*

$14,500 – 12,500 = $2,000 gain

* Note that the assets given include Machine A plus $2,500.

The gain is not recognized because the exchange lacks commercial substance and boot is paid. As a result, the basis of the acquired asset is equal to the basis of the old asset plus the cash paid.

Journal Entry: To record the above transaction

DR	Machine B	$12,500	
CR	Machine A		$10,000
CR	Cash		2,500

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EXAMPLE

Boot is Received = Proportional Gain Recognized

Assume: - Machine A is exchanged for Machine B and $2,500
- Machine A, carrying value (BV) = $10,000
- Machine A, fair value (FV) = $12,000
- Machine B, fair value (FV) = $9,500 (FV given = FV received)

Calculate the total gain as follows:

FV of asset given – BV of asset given

$12,000 – 10,000 = $2,000 total gain

The $2,500 cash is 21% of the consideration received ($2,500/$12,000 = 21%), so a proportional amount of the gain is recognized:

Recognized gain = Realized gain x (Boot received / FV received) =

$2,000 x ($2,500/$12,000) = $417

Journal Entry: To record the above transaction

DR	Machine B	$7,917 (plug)	
DR	Cash	2,500	
CR	Machine A		$10,000
CR	Gain on exchange		417

EXAMPLE

Boot is Received = All Gain Recognized

Assume: - Machine A is exchanged for Machine B and $6,000
- Machine A, carrying value (BV) = $10,000
- Machine A, fair value (FV) = $12,000
- Machine B, fair value (FV) = $6,000 (FV given = FV received)

Calculate the total gain as follows:

FV of asset given – BV of asset given

$12,000 – 10,000 = $2,000 total gain

The $6,000 cash is 50% of the consideration received ($6,000/$12,000 = 50%), so the entire gain is recognized and the machine acquired is recognized at fair value.

Journal Entry: To record the above transaction

DR	Machine B	$6,000 (plug)	
DR	Cash	6,000	
CR	Machine A		$10,000
CR	Gain on exchange		2,000

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EXAMPLE

Losses Recognized in Full

Assume: - Machine A is exchanged for Machine B

- Machine A, carrying value (BV) = $10,000
- Machine A, fair value (FV) = $8,000
- Machine B, fair value (FV) = $8,000 (FV given = FV received)

Calculate the total loss as follows:

FV of asset given – BV of asset given

$8,000 – 10,000 = $(2,000)

Losses are recognized in full in all exchanges lacking commercial substance.

Journal Entry: To record the above transaction

DR	Machine B	$8,000	
DR	Loss on exchange	2,000	
CR	Machine A		$10,000

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HOMEWORK READING: INSTALLMENT LIQUIDATION

I. INSTALLMENT LIQUIDATION

A long time may pass between the start and finish of a partnership liquidation, and the creditors and partners may request cash distributions before liquidation is complete. A receiver of a bankrupt partnership may want to know exactly how much cash can safely be distributed to the partners without waiting until complete liquidation. These types of situations require:

(i) A schedule of possible losses, and

(ii) A plan for safe distribution of available cash.

EXAMPLE

Comprehensive Example of a Liquidation of a Partnership

After discontinuing the regular business operations and closing the books, A, B, and C decide to liquidate their partnership. The partnership agreement provides for income or loss to be divided 50% to A, 30% to B, and 20% to C. The following is an adjusted trial balance before commencing liquidation:

Cash	$20,000	
Noncash assets	75,000	
Liabilities, creditors		$25,000
Partner advance, A		15,000
Partner advance, C		5,000
Partner's capital, A		10,000
Partner's capital, B		20,000
Partner's capital, C		20,000
	$95,000	$95,000

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A, B, C Partnership — Statement of Liquidation and Realization—Date

	Cash	Noncash Assets	Liabilities Outside Creditors	Liabilities Partner's Advance		Partner's Capital		
				A	C	A	B	C
Assumption 1: Gain on realization (noncash assets sold for $125,000)						50%*	30%*	20%*
Balances – before realization	20,000	75,000	25,000	15,000	5,000	10,000	20,000	20,000
Sale of noncash assets & division of gain	125,000	(75,000)				25,000	15,000	10,000
Balances after realization	145,000	0	25,000	15,000	5,000	35,000	35,000	30,000
Payment of liabilities	(25,000)		(25,000)					
Balances	120,000		0	15,000	5,000	35,000	35,000	30,000
Payment of partners' advances	(20,000)			(15,000)	(5,000)			
Balances	100,000			0	0	35,000	35,000	30,000
Distribution of cash	(100,000)					(35,000)	(35,000)	(30,000)
Assumption 2: Loss on realization (noncash assets sold for $65,000)								
Balances – before realization	20,000	75,000	25,000	15,000	5,000	10,000	20,000	20,000
Sale of noncash assets & division of loss	65,000	(75,000)				(5,000)	(3,000)	(2,000)
Balances – after realization	85,000	0	25,000	15,000	5,000	5,000	17,000	18,000
Payment of liabilities	(25,000)		(25,000)					
Balances	60,000		0	15,000	5,000	5,000	17,000	18,000
Payment of partners' advances	(20,000)			(15,000)	(5,000)			
Balances	40,000			0	0	5,000	17,000	18,000
Distribution of cash	(40,000)					(5,000)	(17,000)	(18,000)
Assumption 3: (see the notes that follow) Loss on realization – capital deficiency (noncash assets sold for $15,000)								
Balances – before realization	20,000	75,000	25,000	15,000	5,000	10,000	20,000	20,000
Sale of noncash assets & division of loss	15,000	(75,000)				(30,000)	(18,000)	(12,000)
Balances – after realization	35,000	0	25,000	15,000	5,000	(20,000)	2,000	8,000
Payment of liabilities	(25,000)		(25,000)					
Balances	10,000		0	15,000	5,000	(20,000)	2,000	8,000
Transfer of A – advance account.				(15,000)		15,000		
Balances	10,000			0	5,000	(5,000)	2,000	8,000
Division of "A's" deficiency						5,000	(3,000)	(2,000)
Balances	10,000				5,000	0	(1,000)	6,000
Division of "B's" deficiency							1,000	(1,000)
Balances	10,000				5,000		0	5,000
Distribution of cash	(10,000)				(5,000)			(5,000)

* Profit and loss ratio

Notes to Assumption 3:

1. It is important to remember that a partnership has a claim against any partner with a capital deficiency. In this example the $15,000 credit balance in A's advance account constitutes a preferred claim once A's capital balance is in a deficiency position. A's advance account is transferred to A's capital account to offset part of the $20,000 capital deficiency balance.
2. All possible losses must be charged to the partners' capital accounts in their income and loss ratios before any distribution is made. A still has a $5,000 capital deficiency that B and C must absorb in their respective income and loss ratios before any cash distribution is made. B and C will have a claim of $3,000 and $2,000, respectively, against A for absorbing the $5,000 capital deficiency that is calculated as follows:
   (B) 3/5 x $5,000 = $3,000
   (C) 2/5 x $5,000 = $2,000
3. Any partner may pay a capital deficiency in cash directly to the partnership.
4. A partnership is not completely liquidated and their affairs wound up until all claims, including those of partners, are settled.

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EXAMPLE

Comprehensive Example of an Installment Distribution to Partners

A, B, and C have capital balances of $40,000, $80,000, and $120,000, respectively. They share profit and losses in the ratio of 40% to A, 20% to B, and 40% to C. Outside creditors are owned $75,000. The partners would like to know the extent of their possible losses and amount of cash that can safely be distributed.

• Schedule 1: Possible Loss Statement

	Eliminating Loss	*A 40%*	*B 20%*	*C 40%*
Beginning capital balance		$40,000	$80,000	$120,000
Loss to eliminate A	$100,000	(40,000)	(20,000)	(40,000)
Capital balances		0	60,000	80,000
Loss to eliminate C (1/3:2/3)	120,000		(40,000)	(80,000)
Capital balance	20,000		20,000	0
Loss to eliminate B			(20,000)	
Total distribution of P&L	$240,000		0	

Notes:

1. The beginning capital balances have been adjusted for any advances to (-) or loans from (+) the partners.
2. The amount of loss necessary to eliminate a partnership is found by dividing the capital account by the partner's profit and loss sharing ratio. The minimum loss to eliminate any partner is used. A's capital balance of $40,000 divided by 40% P/L ratio equals $100,000. [B: $80,000 ÷ 20% = $400,000; C: $120,000 ÷ 40% = $300,000]
3. After A is eliminated, B and C share losses in a ratio of 1/3 to 2/3 respectively. C's remaining capital balance is divided by 2/3 P/L ratio, $80,000 x 3/2 = $120,000, that is less than B's capital divided by 1/3.
4. The schedule indicates that a loss of $240,000 eliminates all capital account balances.
5. In order to prepare a schedule of a safe plan for the distribution of cash when it becomes available, the schedule of possible losses is read backward.

• Schedule 2: Cash Distribution Statement

	Total	*A*	*B*	*C*
First $20,000	$ 20,000		$20,000	
Second $120,000 (1/3:2/3)	120,000		40,000	$ 80,000
Third $100,000 (40:20:40)	100,000	$40,000	20,000	40,000
Capital totals	$240,000	$40,000	$80,000	$120,000

Note: The above schedule applies to any cash that is available for partners, that is, after creditors have been fully paid or provided for.

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HOMEWORK READING: PERSONAL FINANCIAL STATEMENTS

I. DEFINITION

Personal financial statements are financial statements of individuals or groups of related individuals (families) and are generally prepared to organize and plan financial affairs. More specifically, such statement can be used for obtaining credit and for tax, estate, and retirement planning purposes.

II. PRESENTATION

A. STATEMENT OF FINANCIAL CONDITION

The Statement of Financial Condition is the basic personal financial statement and presents assets and liabilities at estimated current values rather than at historical cost. Assets and liabilities are recognized on the accrual basis versus the cash basis, and personal net worth is the difference between total assets and liabilities included in the statement.

1. Assets are reported at "estimated current fair value."
    a. "Present value" of projected cash receipts is appropriate for estimating the current value of a monetary asset (e.g., vested pension benefits).
    b. Life insurance loans payable are netted against cash surrender value.
    c. Business interest that constitutes a large part of an individual's total assets should be presented as a single amount (at "estimated current value").
    d. Pension plan at FV for the portion that has already vested.
2. Liabilities are reported at estimated current amount.
    a. This is generally the GAAP presentation; however, some loans may have a present value less than cost. These would be disclosed at the lower FV.
    b. Deferred tax liability is reported for estimated taxes due, as if all assets were sold at FV and all liabilities were paid at FV.
3. Net Worth at FV is the difference between ASSETS (at estimated current FV) and LIABILITIES (at estimated current amounts).

PASS KEY

Personal Financial Statements: Value assets and liabilities at FV (remember to determine the future taxes on any gains from selling assets).

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B. BASIS OF PRESENTATION

The presentation of assets and liabilities is made in order of liquidity and maturity, with no current and noncurrent classifications. Business interests that make up a significant part of a person's total assets should be shown separately from other investments. Closely held business investments are carried as a single item (Investment in Business) and a current value is estimated for the investments. Assets and liabilities of the business are not reported separately in the statement.

C. STATEMENT OF CHANGES IN NET WORTH

An optional personal financial statement is the Statement of Changes in Net Worth, which shows sources of increases and decreases in net worth. The statement distinguishes between those changes in net worth that have been realized and those unrealized. Presentation of comparative financial statements is optional.

D. DISCLOSURE

Personal financial statements should include sufficient disclosures to make them adequately informative. The nature and type of information disclosed in either the body or notes of the financial statements might include, for example:

1. The individuals covered by the statements.
2. The individuals' assets and liabilities at current estimated values.
3. The methods used in determining estimated current values.
4. Descriptions of intangible assets.
5. The face amount of life insurance policies owned by the individuals.
6. The nature of joint ownership of assets held by these and other individuals.
7. Tax information, including methods and assumptions used to compute estimated income taxes; unused operating loss and capital loss carryforwards; other unused deductions and credits; and the differences between the estimated current values of assets and liabilities and their tax bases.
8. Maturities, interest rates, and other pertinent details relating to receivables and debt.

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FINANCIAL ACCOUNTING & REPORTING 2

Class Questions Answer Worksheet

MC Question Number	First Choice Answer	Correct Answer	NOTES
1.			
2.			
3.			
4.			
5.			
6.			
7.			
8.			
9.			
10.			
11.			
12.			
13.			
14.			
15.			
16.			
17.			

Grade:

Multiple-choice Questions Correct / 17 = _____% Correct

Detailed explanations to the class questions are located in the back of this textbook.

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NOTES

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CLASS QUESTIONS

1. CPA-00555

Hudson Hotel collects 15% in city sales taxes on room rentals, in addition to a $2 per room, per night, occupancy tax. Sales taxes for each month are due at the end of the following month, and occupancy taxes are due 15 days after the end of each calendar quarter. On January 3, 1994, Hudson paid its November 1993 sales taxes and its fourth quarter 1993 occupancy taxes. Additional information pertaining to Hudson's operations is:

1993	*Room Rentals*	*Room Nights*
October	$100,000	1,100
November	110,000	1,200
December	150,000	1,800

What amounts should Hudson report as sales taxes payable and occupancy taxes payable in its December 31, 1993, balance sheet?

	Sales Taxes	*Occupancy Taxes*
a.	$39,000	$6,000
b.	$39,000	$8,200
c.	$54,000	$6,000
d.	$54,000	$8,200

2. CPA-00544

Roro, Inc. paid $7,200 to renew its only insurance policy for three years on March 1, 1995, the effective date of the policy. At March 31, 1995, Roro's unadjusted trial balance showed a balance of $300 for prepaid insurance and $7,200 for insurance expense. What amounts should be reported for prepaid insurance and insurance expense in Roro's financial statements for the three months ended March 31, 1995?

	Prepaid insurance	*Insurance expense*
a.	$7,000	$300
b.	$7,000	$500
c.	$7,200	$300
d.	$7,300	$200

3. CPA-00545

Ward, a consultant, keeps her accounting records on a cash basis. During 1994, Ward collected $200,000 in fees from clients. At December 31, 1993, Ward had accounts receivable of $40,000. At December 31, 1994, Ward had accounts receivable of $60,000, and unearned fees of $5,000. On an accrual basis, what was Ward's service revenue for 1994?

a. $175,000
b. $180,000
c. $215,000
d. $225,000

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4. CPA-00542

Gray Co. was granted a patent on January 2, 1991, and appropriately capitalized $45,000 of related costs. Gray was amortizing the patent over its estimated useful life of fifteen years. During 1994, Gray paid $15,000 in legal costs in successfully defending an attempted infringement of the patent. After the legal action was completed, Gray sold the patent to the plaintiff for $75,000. Gray's policy is to take no amortization in the year of disposal. In its 1994 income statement, what amount should Gray report as gain from sale of patent?

a. $15,000
b. $24,000
c. $27,000
d. $39,000

5. CPA-00548

On January 2, 2001, Paye Co. purchased Shef Co. at a cost that resulted in recognition of goodwill of $200,000. During the first quarter of 2001, Paye spent an additional $80,000 on expenditures designed to maintain goodwill. In its December 31, 2001, balance sheet, what amount should Paye report as goodwill?

a. $180,000
b. $280,000
c. $252,000
d. $200,000

6. CPA-00537

On December 31, 2000, Byte Co. had capitalized software costs of $600,000 with an economic life of four years. Sales for 2001 were 10% of expected total sales of the software. At December 31, 2001, the software had a net realizable value of $480,000. In its December 31, 2001 balance sheet, what amount should Byte report as net capitalized cost of computer software?

a. $432,000
b. $450,000
c. $480,000
d. $540,000

7. CPA-00653

The **next item** is based on the following data pertaining to Pell Co.'s construction jobs, which commenced during 1992:

	Project 1	*Project 2*
Contract price	$420,000	$300,000
Costs incurred during 1992	240,000	280,000
Estimated costs to complete	120,000	40,000
Billed to customers during 1992	150,000	270,000
Received from customers during 1992	90,000	250,000

If Pell used the percentage-of-completion method, what amount of gross profit (loss) would Pell report in its 1992 income statement?

a. $(20,000)
b. $20,000
c. $22,500
d. $40,000

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8. CPA-00647

The **next item** is based on the following data pertaining to Pell Co.'s construction jobs, which commenced during 1992:

	Project 1	*Project 2*
Contract price	$420,000	$300,000
Costs incurred during 1992	240,000	280,000
Estimated costs to complete	120,000	40,000
Billed to customers during 1992	150,000	270,000
Received from customers during 1992	90,000	250,000

If Pell used the completed contract method, what amount of gross profit (loss) would Pell report in its 1992 income statement?

a. $(20,000)
b. $0
c. $340,000
d. $420,000

9. CPA-00691

Lang Co. uses the installment method of revenue recognition. The following data pertain to Lang's installment sales for the years ended December 31, 1993 and 1994:

	1993	*1994*
Installment receivables at year-end on 1993 sales	$60,000	$30,000
Installment receivables at year-end on 1994 sales	-	69,000
Installment sales	80,000	90,000
Cost of sales	40,000	60,000

What amount should Lang report as deferred gross profit in its December 31, 1994, balance sheet?

a. $23,000
b. $33,000
c. $38,000
d. $43,000

10. CPA-00707

Wren Co. sells equipment on installment contracts. Which of the following statements best justifies Wren's use of the cost recovery method of revenue recognition to account for these installment sales?

a. The sales contract provides that title to the equipment only passes to the purchaser when all payments have been made.
b. No cash payments are due until one year from the date of sale.
c. Sales are subject to a high rate of return.
d. There is no reasonable basis for estimating collectibility.

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11. CPA-00720

On July 1, 2000, Balt Co. exchanged a truck for 25 shares of Ace Corp.'s common stock. On that date, the truck's carrying amount was $2,500, and its fair value was $3,000. Also, the book value of Ace's stock was $60 per share. On December 31, 2000, Ace had 250 shares of common stock outstanding and its book value per share was $50. What amount should Balt report in its December 31, 2000, balance sheet as investment in Ace assuming the transaction had commercial substance?

a. $3,000
b. $2,500
c. $1,500
d. $1,250

12. CPA-00721

Eagle and Falk are partners with capital balances of $45,000 and $25,000, respectively. They agree to admit Robb as a partner. After the assets of the partnership are revalued, Robb will have a 25% interest in capital and profits, for an investment of $30,000. What amount should be recorded as goodwill to the original partners?

a. $0
b. $5,000
c. $7,500
d. $20,000

13. CPA-04646

Eagle and Falk are partners with capital balances of $45,000 and $25,000, respectively. They agree to admit Robb as a partner. After the assets of the partnership are revalued, Robb will have a 25% interest in capital and profits, for an investment of $30,000. What amount should be recorded as a bonus to the original partners?

a. $0
b. $5,000
c. $7,500
d. $20,000

14. CPA-00722

During 1994, Young and Zinc maintained average capital balances in their partnership of $160,000 and $100,000, respectively. The partners receive 10% interest on average capital balances, and residual profit or loss is divided equally. Partnership profit before interest was $4,000. By what amount should Zinc's capital account change for the year?

a. $1,000 decrease.
b. $2,000 increase.
c. $11,000 decrease.
d. $12,000 increase.

15. CPA-01258

During a period of inflation in which the amount in an asset account remains constant, which of the following occurs?

a. A purchasing power gain, if the item is a monetary asset.
b. A purchasing power gain, if the item is a nonmonetary asset.
c. A purchasing power loss, if the item is a monetary asset.
d. A purchasing power loss, if the item is a nonmonetary asset.

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16. CPA-01272

Park Co.'s wholly-owned subsidiary, Schnell Corp., maintains its accounting records in German marks. Because all of Schnell's branch offices are in Switzerland, its functional currency is the Swiss franc. Remeasurement of Schnell's 1994 financial statements resulted in a $7,600 gain, and translation of its financial statements resulted in an $8,100 gain. What amount should Park report as a foreign exchange gain in its income statement for the year ended December 31, 1994?

a. $0
b. $7,600
c. $8,100
d. $15,700

17. CPA-01274

On September 22, 1994, Yumi Corp. purchased merchandise from an unaffiliated foreign company for 10,000 units of the foreign company's local currency. On that date, the spot rate was $.55. Yumi paid the bill in full on March 20, 1995, when the spot rate was $.65. The spot rate was $.70 on December 31, 1994. What amount should Yumi report as a foreign currency transaction loss in its income statement for the year ended December 31, 1994?

a. $0
b. $500
c. $1,000
d. $1,500

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NOTES

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Financial Accounting & Reporting 3(A)

Please note that this chapter is to be used for exams prior to June, 2009. If you are planning to sit for the CPA exam after June, 2009, please use the Financial 3(B) chapter, which is also included in this textbook.

1. Marketable securities **3**
2. Business combinations / Consolidations **9**
3. Cost method (external reporting) **11**
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9. Homework reading: Pooling-of-interests method **42**
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MARKETABLE SECURITIES

I. INVESTMENTS IN CERTAIN DEBT AND EQUITY SECURITIES

SFAS No. 115 addresses investments in certain equity securities that have readily determinable fair values. SFAS No. 115 also addresses investments in debt securities, which is covered in the Financial 5 class. Equity securities are defined as securities that represent an ownership interest in an enterprise or the right to acquire or dispose of an ownership interest in an enterprise at fixed or determinable prices.

A. DEFINITION OF EQUITY SECURITIES

MARKETABLE EQUITY SECURITIES

1. Equity securities may be represented by:
   a. Ownership shares (common, preferred, and other forms of capital stock),
   b. Rights to acquire ownership shares (stock warrants, rights, and call options), and
   c. Rights to dispose of ownership shares (put options).
2. Equity securities do *not* include:
   a. Preferred stock redeemable at the option of the investor or stock that must be redeemed by the issuer,
   b. Treasury stock (the company's own stock repurchased and held), and
   c. Convertible bonds.

B. CLASSIFICATION

Securities should be classified into one of three categories, based on the intent of the company.

1. Trading Securities

TRADING SECURITIES

Trading securities are those securities (both debt and equity) that are bought and held principally for the purpose of selling them in the near term. Trading securities generally reflect active and frequent buying and selling with the objective of generating profits on short-term differences in price. Securities classified as trading securities are generally reported as current assets, although they can be reported as noncurrent, if appropriate.

2. Available-for-Sale Securities

AVAILABLE-FOR-SALE SECURITIES

Available-for-sale securities are those securities (both debt and equity) not meeting the definitions of the other two classifications (trading or held-to-maturity). Securities classified as available-for-sale securities are reported as either current assets or noncurrent assets, depending on the intent of the corporation. If the security represents cash available for current operations, it would be appropriate to report the security as a current asset.

3. Held-to-Maturity Securities (Debt Securities Only)

HELD-TO-MATURITY SECURITIES

Investments in debt securities are classified as held-to-maturity securities only if the corporation has the positive intent and ability to hold these securities to maturity. If the intent is to hold the security for an indefinite period of time, but not necessarily to maturity, then the security would be classified as available-for-sale. If a security can be paid or otherwise settled in a manner that the holder may not recover substantially all of its investment, the held-to-maturity category may not be used for the investment. Securities classified as held-to-maturity are reported as current or noncurrent assets, based on their time to maturity.

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II. VALUATION

Both categories of equity securities (trading and available-for-sale) are to be reported at fair value at the end of the current reporting period. Fair value is considered to be the market price of the security or what a willing buyer and seller would pay and accept to exchange the security, consistent with SFAS No. 157 – Fair Value. Changes in the fair value of trading and available-for-sale securities result in unrealized holdings gains or losses. How these gains or losses are reported in the financial statements depends upon the classification of the securities. Note that although two general ledger accounts are normally maintained (i.e., one for the original cost of the security and the other for the valuation account), the presentation on the balance sheet is one *net* amount. Held-to-maturity debt securities are valued at amortized cost.

A. UNREALIZED GAINS AND LOSSES—TRADING SECURITIES

Unrealized holding gains and losses on trading securities are included in earnings. Therefore, the unrealized loss on trading securities is shown in the income statement.

Journal Entry: To record loss on the Income Statement			
DR	Unrealized loss on trading securities	XXX	
CR	Valuation account (fair value adjustment)		XXX

B. UNREALIZED GAINS AND LOSSES—AVAILABLE-FOR-SALE SECURITIES

Unrealized holding gains and losses on available-for-sale securities (including those classified as current assets) are reported in other comprehensive income.

Journal Entry: To record unrealized loss reported in other comprehensive income			
DR	Unrealized loss on available-for-sale securities	XXX	
CR	Valuation account (fair value adjustment)		XXX

In the subsequent period, the security value will again be adjusted from the value it was carried at to the new fair value. For example, assume a stock is purchased on March 1, Year 2, at $24 and is valued at $27 at year-end, December 31, Year 2, and $28 on December 31, Year 3. There would be an unrealized gain in Year 2 of $3 and $1 in Year 3. Realized gains or losses are recognized when a security is disposed of. All realized gains or losses are recognized on the income statement.

SFAS 115 - Investments

Classification	Balance Sheet	Reported	Unrealized Gain/Loss	Cash Flow
Trading	Current or Noncurrent	Fair Value	Income Statement	Operating
Available-for-Sale	Current or Noncurrent	Fair Value	Other Comprehensive Income (PUFE)	Investing
Held-to-Maturity Debt Securities	Current or Noncurrent	Amortized Cost	NONE	Investing

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C. RECLASSIFICATION

Any transfer of a particular security from one group (trading, available-for-sale, or held-to-maturity) to another group (trading, available-for-sale, or held-to-maturity) is accounted for at fair value. Any unrealized holding gain or loss on that security is accounted for as follows:

1. From Trading Category

The unrealized holding gain or loss at the date of transfer is already recognized in earnings and shall not be reversed.

2. To Trading Category

The unrealized holding gain or loss at the date of transfer shall be recognized in earnings immediately.

3. Debt Security Classified as Held-to-Maturity Transferred to Available-for-Sale

The unrealized holding gain or loss at the date of transfer shall be reported in other comprehensive income. Remember that this debt security was valued at amortized cost as a held-to-maturity security and is being transferred to a category valued at fair value.

4. Debt Security Classified as Available-for-Sale Transferred to Held-to-Maturity

The unrealized holding gain or loss at the date of transfer is already reported in other comprehensive income. The unrealized holding gain or loss shall be amortized over the remaining life of the security as an adjustment of yield in a manner consistent with the amortization of any premium or discount.

SUMMARY OF TRANSFERS BETWEEN CATEGORIES

FROM	TO	TRF ACCT FOR	UNREALIZED HOLDING GAIN/LOSS
Trading	Any other	FV	It has already been recognized in income so no adjustment is necessary
Any other	Trading	FV	Recognized in current earnings
Held-to-Maturity (Debt Securities)	Available-for-Sale	FV	Record in Other Comprehensive Income
Available-for-Sale (Debt Securities)	Held-to-Maturity (Debt Securities)	FV	Amortize gain or loss from Other Comprehensive Income with any bond premium/discount amortization

D. IMPAIRMENT OF SECURITIES

The enterprise needs to determine whether the decline in value below the adjusted or amortized cost of any security classified as either available-for-sale or held-to-maturity is other than temporary. If the decline in fair value is other than temporary, the cost basis of the individual security is written down to fair value as the new cost basis and the amount of the write-down is accounted for as a realized loss and included in earnings.

The new cost basis shall not be changed for subsequent recoveries in fair value. If the security is classified as available-for-sale, a subsequent increase in fair value shall be included in other comprehensive income. Subsequent decreases in fair value of available-for-sale securities, if not other than temporary, are also included in other comprehensive income and accounted for as an unrealized loss.

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III. FINANCIAL INSTRUMENTS USED TO HEDGE THE FAIR VALUE OF INVESTMENTS

A. USED TO HEDGE TRADING SECURITIES

Gains and losses on financial instruments that hedge trading securities should be reported in earnings, consistent with the reporting of unrealized gains and losses on the trading securities (covered in detail in class F-7).

B. USED TO HEDGE AVAILABLE-FOR-SALE SECURITIES

Gains and losses on derivative instruments that hedge available-for-sale securities are recognized currently in earnings together with the offsetting losses or gains on the available-for-sale securities attributable to the hedged risk (covered in detail in class F-7).

IV. SALE OF SECURITY

A sale of a security from any category results in a realized gain or loss and is reported on the income statement for the period. The valuation account, if used, would also have to be removed on the sale of a security. For trading securities, the realized gain or loss reported when the security is sold is the difference between the adjusted cost (original cost +/- unrealized gains/losses previously recognized on the income statement) and the selling price. For available-for-sale securities, the realized gain or loss reported when the security is sold is the difference between the selling price and the original cost of the security. Any unrealized gains or losses in accumulated other comprehensive income must be reversed at the time the security is sold.

Trading Securities			
DR	Cash	XXX	
CR	Trading security		XXX
CR	Realized gain on trading security (IDEA)		XXX
Available-for-sale Securities			
DR	Cash	XXX	
DR	Unrealized gain on available-for-sale security (PUFE)	XXX	
CR	Available-for-sale security		XXX
CR	Realized gain on available-for-sale security (IDEA)		XXX

V. INCOME TAX EFFECTS

Tax effects of unrealized gains or losses entering into the determination of net income must be reflected in the computation of deferred income taxes, because unrealized gains and losses are not deductible for tax purposes.

However, the tax effects of unrealized capital losses should only be recognized when it is absolutely certain that the benefit will be realized by the offset of the capital losses against capital gains.

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VI. REQUIRED DISCLOSURES

The following information concerning securities classified as available-for-sale and separately for held-to-maturity securities must be disclosed in the financial statements or appropriate notes thereto:

(i) Aggregate fair value,

(ii) Gross unrealized holding gains and losses,

(iii) Amortized cost basis by major security type, and

(iv) Information about the contractual maturities of debt securities.

COMPREHENSIVE EXAMPLE

Marketable Securities

The following information pertains to Dayle, Inc.'s portfolio of marketable investments for the year ended December 31, 20X2:

	Cost	Fair value at 12/31/X1	20X2 activity Purchases	20X2 activity Sales	Fair value at 12/31/X2
Held-to-maturity securities					
Security ABC			$100,000		$ 95,000
Trading securities					
Security DEF	$150,000	$160,000			155,000
Available-for-sale securities					
Security GHI	190,000	165,000		$175,000	
Security JKL	170,000	175,000			160,000

Security ABC was purchased at par. All declines in fair value are considered to be temporary.

Required:

1. Calculate the carrying amount of each security on the balance sheet at December 31, 20X2.
2. Calculate any realized gain or loss on the 20X2 income statement.
3. Calculate any unrealized gain or loss on the 20X2 income statement.
4. Calculate any unrealized gain or loss to be reported at December 31, 20X2 as other comprehensive income.

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SOLUTION

(1) Carrying amount of each security at December 31, 20X2:

Security ABC $100,000

At year end, held-to-maturity investments are reported at their carrying value (amortized cost), not fair value. Carrying value of security ABC is the purchase price of $100,000.

Security DEF $155,000

The year end carrying amount of trading investments is the fair value at year end. Fair value of security DEF is $155,000.

Security GHI was sold

Security JKL $160,000

The year end carrying amount of available for sale investments is the fair value at year end. Fair value of security JKL is $160,000.

(2) Realized gain or loss on income statement:

Security GHI ($15,000)

The $175,000 sales proceeds less the $190,000 cost yields a realized loss of $15,000.

(3) Unrealized gain or loss on income statement:

Security DEF ($5,000)

Only adjustments to trading securities valuations are reported on the income statement. The $160,000 carrying value of the trading securities must be reduced to the $155,000 fair value and an income statement unrealized loss of $5,000 is recognized.

(4) Unrealized gain or loss (current year change)—other comprehensive income:

Security JKL & GHI (net) $10,000

			Valuation Allowance Account (contra-asset account) DR <CR>	Current Year Unrealized <Gain> Loss OCI DR <CR>	Accumulated OCI (contra-equity account) DR <CR>
Beginning Balance:					
JKL ($175,000 – 170,000)	=	5,000			
GHI ($165,000 – 190,000)	=	<25,000>			
			<20,000>		20,000
Activity:					
JKL ($160,000 – 175,000)	=		<15,000>	15,000	
GHI (Sold / Reverse)	=		25,000	<25,000>	
Subtotal				<10,000>	
Close				$10,000	<10,000>
Ending Balance			<10,000>	—	10,000

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BUSINESS COMBINATIONS/CONSOLIDATIONS

I. PRESUMPTION

The presumption is that consolidated financial statements are more meaningful than parent company financial statements and/or parent company financial statements together with separate subsidiary financial statements.

A. Consolidated financial statements (including segment reporting) are necessary for fair presentation.

B. The equity method is not a valid substitute for consolidation (SFAS 94).

C. Consolidate regardless of method of acquisition (purchase or pooling of interests).

II. CONSOLIDATED FINANCIAL STATEMENTS

Consolidated financial statements ignore important legal relationships and emphasize economic substance over form. Consolidated financial statements are an economic truth but a legal fiction.

III. LIMITATIONS OF CONSOLIDATED FINANCIAL STATEMENTS

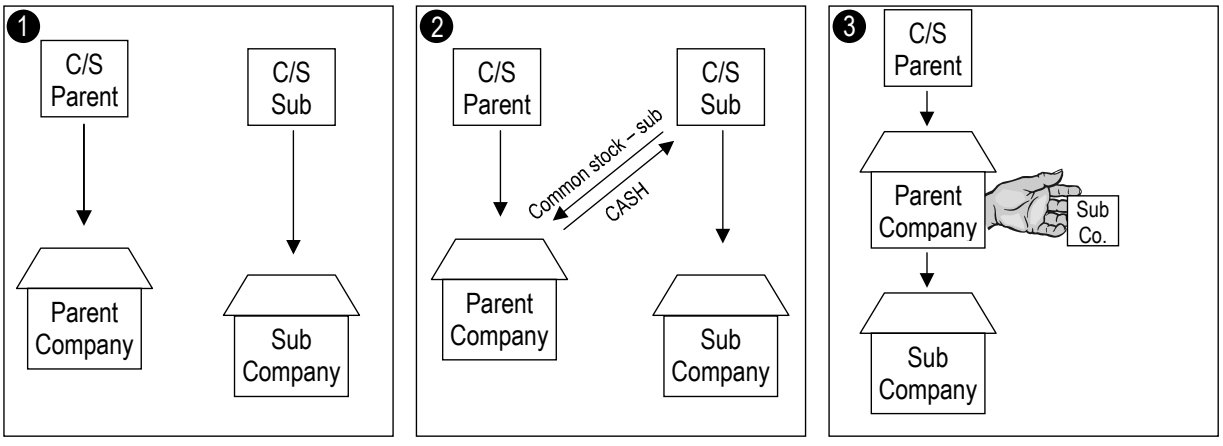
A. Minority shareholders, creditors, and bondholders of the subsidiary remain uninformed regarding the subsidiary's financial statements.

B. Weak performance of one company (entity) may be offset by the strong performance of another company.

C. Ratio analysis of consolidated data is not reliable. For example:

1. Poor income statement results of individual subsidiaries are hidden.
2. Intercompany eliminations affect ratios.

D. Retained earnings available for parent shareholders (the account from which dividends are paid) are not segregated nor otherwise indicated.



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IV. CRITERIA OF WHEN TO AND WHEN NOT TO CONSOLIDATE

A. Consolidate ALL majority-owned subsidiaries (over 50% of the voting interest is owned by parent company) to have one management and one economic entity. Per SFAS 94, this includes domestic, foreign, similar, and dissimilar subsidiaries.

B. DO NOT consolidate when:

Control is not with owners (e.g., under legal reorganization or when control of a subsidiary is with a trustee).

C. It is OK to consolidate companies that have different year ends. The subsidiary merely prepares special financial statements to correspond closely with the parent's fiscal year end. If the year ends differ by three months or less, the parent company can use the subsidiary's regular financial statements of a different period, giving recognition to material intervening events, to expedite the consolidation process.

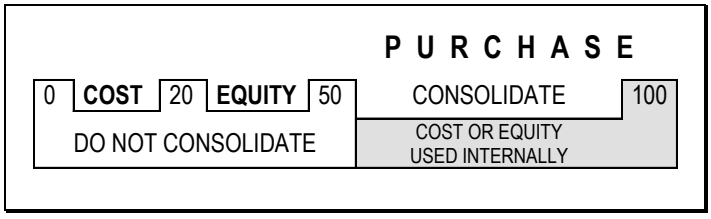
D. In a vertical chain, where parent company owns more than 50% of a subsidiary company and the subsidiary owns more than 50% of a third company, consolidate:

1. Third company into subsidiary company.
2. Subsidiary company (now consolidated with third company) into parent company.

V. DEGREE OF CONTROL

The degree of control the investor has over the investee dictates how the investor accounts for the investment in corporate equity securities.

Consolidation: A combination of the financial statements of two or more entities into a single set of financial statements representing a single economic unit.



A. COST METHOD/DO NOT CONSOLIDATE = NO SIGNIFICANT INFLUENCE (TYPICALLY 0% - 19%)

The investor accounts for the investment using the cost method if the investor does not have the ability to exercise significant influence over the investee. Follow the rules of marketable equity securities and accounts for the investment as either trading or available-for-sale securities.

B. EQUITY METHOD/DO NOT CONSOLIDATE = SIGNIFICANT INFLUENCE BUT 50% OR LESS OWNERSHIP (TYPICALLY 20% - 50%)

The investor accounts for the investment using the equity method of accounting if the investor can exercise significant influence over the investee and holds 50% or less of the voting stock.

C. CONSOLIDATE = CONTROL (GREATER THAN 50% OWNERSHIP)

The investor should prepare consolidated financial statements with its investees when the investor has control (more than 50% ownership) of the subsidiary. Internally, the investor may use either the cost method or the equity method to account for its investments.

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COST METHOD
(External Reporting)

I. COST METHOD (0% - 19% / DOES NOT EXERCISE SIGNIFICANT INFLUENCE)

The cost method should be used when the investor owns less than 20% of the investee's voting stock and does not exercise significant influence. Lacking evidence to the contrary, it is assumed that no significant influence can be exercised from 0%-20%. The original investment under the cost method is accounted for in the same manner as marketable equity securities.

If a company owns less than 20% of the stock of an investee company, but exercises significant influence, the equity method must be used.

A. BALANCE SHEET: "INVESTMENT IN INVESTEE"

1. The carrying amount of the investments account on the investor's (parent's) books is "original cost," measured by the FV of the consideration given, including legal fees. The investment account stays the same from the date of acquisition unless:
   a. Shares of stock in the subsidiary are purchased or sold.
   b. There is an accumulated dividend in excess of accumulated earnings resulting in a return of capital (called a liquidating dividend).
   c. The basis is adjusted to FV as required for marketable equity securities (SFAS 115).
   d. The subsidiary incurs losses that substantially reduce net worth from the date of acquisition.

2. Record at Cost

a. All costs of acquisition. (FV of consideration plus legal fees)

DR	Investment in investee	$XXX	
CR	Cash		$XXX

3. Marketable Securities – Adjust to FV

a. Adjust to FV at year-end. (Decrease in FV)

DR	Unrealized holding losses	$XXX	
CR	Investment in investee (or valuation account)		$XXX

b. Adjust to FV at year-end. (Increase in FV)

DR	Investment in investee (or valuation account)	$XXX	
CR	Unrealized holding gains		$XXX

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4. Reduce Investment in Investee for Return of Capital Distributions

a. Return of capital/liquidating dividend—(dividend in excess of investor's share of retained earnings).

DR	Cash	$XXX	
CR	Investment in investee		$XXX

Note: For tax purposes, a return of capital/liquidating dividend exists when the dividend is in excess of the investor's share of the corporation's earnings and profits. Earnings and profits is a very similar concept to retained earnings, but the two are not always calculated the same way.

B. INCOME STATEMENT:

Record cash dividends from the investee's earnings and profits. Do not recognize stock dividends.

1. Dividends to the Investor/Parent (from Investee) are Income (Earnings) to the Investor/Parent

The cost method does not recognize a pro rata share of the investee's earnings as income to the investor/parent.

DR	Cash	$XXX	
CR	Dividend income		$XXX

2. Distribution that Exceeds Investor's Share of the Investee's Retained Earnings (Reduce Basis / Return of Capital Distribution)

DR	Cash	$XXX	
CR	Investment in investee		$XXX

PASS KEY

The following three issues are the most frequently tested "cost" concepts:

- The "Investment in Investee" is **not** adjusted for investee earnings.
- The "Investment in Investee" is adjusted to FV (per FASB 115).
- Cash dividends from the investee are reported as income by the investor (parent).

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EQUITY METHOD
(External Reporting)

I. EQUITY METHOD (20%–50% / EXERCISES SIGNIFICANT INFLUENCE)

The equity method is used to account for investments if significant influence can be exercised by the investor over the investee. The critical criterion for using the equity method is that the investor exerts significant influence over the operating and financial policies of the investee. If no direct evidence of significant influence exists, ownership of 20% to 50% of the investee's voting stock is deemed to represent significant influence.

Under the equity method the investment is originally recorded at the price paid to acquire the investment. The investment account is subsequently adjusted as the net assets of the investee change through the earning of income and payment of dividends. The investment account increases by the investor's share of the investee's net income with a corresponding credit to the investor's income statement account, Equity in Subsidiary/Investee Income. The distribution of dividends by the investee reduces the investment balance. Continuing losses by a subsidiary/investee may result in a decrease of the investment account to a zero balance. In addition, consolidated statements should be presented when ownership is greater than 50%.

A. EXERCISES SIGNIFICANT INFLUENCE

A company that owns 20%–50% of voting stock of another "investee" company is presumed to be able to exercise "significant influence" over the operating and financial policies of that investee and, therefore, must use the equity method when presenting the investment in that investee in:

1. Consolidated financial statements that include other consolidated entities, but not that investee, or
2. Unconsolidated parent company financial statements.
3. Equity method not appropriate (even if investor owns 20% to 50% of subsidiary):
    a. Bankruptcy of subsidiary.
    b. Investment in subsidiary is temporary.
    c. A lawsuit or complaint is filed.
    d. A "standstill agreement" is signed (under which the investor surrenders significant rights as a shareholder).
    e. Another small group has majority ownership and they operate the company without regard to the investor.
    f. The investor cannot obtain the financial information necessary to apply the equity method.
    g. The investor cannot obtain representation on the Board of Directors.

PASS KEY

The CPA Examination frequently presents questions where the ownership percentage is below 20%, but the "ability to exercise significant influence" exists. The **equity method** is the correct method of accounting for these investments.

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B. BALANCE SHEET – "Investment in investee" using equity.

1. Record at cost (FV of consideration plus legal fees)

DR	Investment in investee	$XXX	
CR	Cash		$XXX

2. Increase by the Investor's/Parent's ownership percentage of earnings of investee

DR	Investment in investee	$XXX	
CR	Equity in earnings/investee income		$XXX

3. Decrease by the Investor's/Parent's ownership percentage of cash dividends from investee (stock dividends reduce unit cost of stock owned in investee)

DR	Cash	$XXX	
CR	Investment in investee		$XXX

C. INCOME STATEMENT – Record the Investor's/Parent's ownership percentage of earnings as income (dividends are not income, treat as bank withdrawals).

1. Investee earnings (Investor's/Parent's percentage ownership of investee)

DR	Investment in investee	$XXX	
CR	Equity in earnings/investee income		$XXX

2. Investee cash dividends (Not income/lower investment like bank withdrawal)

DR	Cash	$XXX	
CR	Investment in investee		$XXX

PASS KEY

An easy way to remember all the GAAP accounting rules for the "equity method" is to think of it like a **bank account** and use your **base** account analysis:

(B) **B**eginning Balance

(A) **A**dd: Investee's earning (like bank interest; it is income when earned, not when taken out).

(S) **S**ubtract: Investee's dividends (like bank withdrawals; and it is not income)

(E) **E**nding Balance

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EXAMPLE

Equity Method

On January 1, Year 1, LKM Corporation acquired a 40% interest in Nerox Company for $300,000. Total stockholders' equity on the date of acquisition consisted of capital stock (common, $1 par) of $500,000 and $250,000 in retained earnings, therefore, no differentiation [$300,000 = .40(500,000 + 250,000)]. During Year 1 Nerox had net income of $90,000 and paid a $40,000 dividend.

Journal Entry: To record the initial investment of 40%

DR	Investment in Nerox (40%)	$300,000	
CR	Cash		$300,000

Journal Entry: To recognize the investee's net income (40% x $90,000)

DR	Investment in Nerox (40% x $90,000)	$36,000	
CR	Equity in investee income		$36,000

Journal Entry: To recognize the dividend paid by the investee (40% x $40,000)

DR	Cash	$16,000	
CR	Investment in Nerox (40% x $40,000)		$16,000

On December 31, Year 1, the investment account on the balance sheet would show $320,000 ($300,000 + $36,000 - $16,000), and the income statement would show $36,000 as LKM's equity in subsidiary income.

AMORTIZATION OF DIFFERENTIAL

D. DIFFERENCES BETWEEN THE PURCHASE PRICE AND BOOK VALUE (NBV) OF THE INVESTEE'S NET ASSETS

Additional adjustments to the investment account under the equity method result from differences between the price paid for the investment and the book value of the investee's net assets. This difference is first attributable to:

1. Asset FV

Differences between the book value and fair value of the net assets acquired.

2. Goodwill

Any remaining difference is goodwill.

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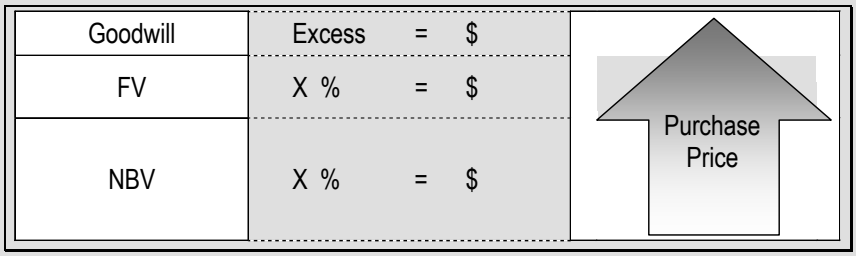
PASS KEY

An easy way to solve this type of question is to set up a building block box and plug in the respective dollar amounts and then compare to the purchase price:



3. Amortize Asset FV Difference (Premium) Over Related Asset Life

The fair value excess (asset FV) would be amortized over the life of the underlying asset (excess caused by land is not amortized). This additional amortization causes the investor's share of the investee's net income to decrease. Amortization of cost (purchase price) over NBV of assets acquired only affects the parent's investment account, "investment in subsidiary," on the books of the parent under the "Equity Method," not under the "Cost Method."

DR	Equity in investee income	$XXX	
CR	Investment in investee		$XXX

4. Goodwill Difference: Not Amortized and No Impairment Test

The fair value excess attributable to goodwill is not subject to the impairment test. Acquired goodwill is no longer amortized.

PASS KEY

To better understand the journal entry and its impact, think of the amortization of excess purchase price (premium) as a bank service charge. The "equity method", which we treat like a bank account, will have the account balance (balance sheet asset) reduced by this "bank service charge" and also will have the **net** earnings from the account reduced by this (service) charge.

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EXAMPLE

Equity Method

On January 1, Year 1, Eva Corporation acquired a 40% interest in Jennrod Company for $500,000 cash. At the date of acquisition, Jennrod's net assets had a book value of $875,000 and a fair value of $1,000,000. The difference between the book value and fair value relates to equipment being depreciated over a remaining useful life of ten years. Jennrod's net income for Year 1 was $320,000. During Year 1, Jennrod declared and paid $120,000 in cash dividends.

1. Investment and Subsidiary Activity:

Journal Entry: To record the initial investment

DR	Investment in Jennrod (40%)	$500,000	
CR	Cash		$500,000

Journal Entry: To recognize the investee's net income

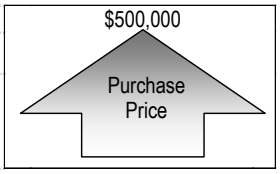
DR	Investment in Jennrod (40% x $320,000)	$128,000	
CR	Equity in investee income		$128,000

Journal Entry: To recognize the dividend paid by the investee

DR	Cash	$48,000	
CR	Investment in Jennrod (40% x $120,000)		$48,000

2. Asset Adjustment and Depreciation:

Goodwill		Excess	=	
FV	$1,000,000	X 40%	=	$400,000
NBV	$875,000	X 40%	=	$350,000



Journal Entry: To record depreciation on undervalued equipment ($50,000 ÷ 10 years)

DR	Equity in investee income	$5,000	
CR	Investment in Jennrod		$5,000

3. Goodwill:

Goodwill, the excess of the purchase price over the fair value of net assets:

Purchase price of the investment in Jennrod	$ 500,000
Less: Fair value of Eva's equity in net assets of Jennrod (40% x 1,000,000)	(400,000)
Goodwill	$ 100,000

On December 31, Year 1, Eva's investment in Jennrod account would show a balance of $575,000 ($500,000 + $128,000 - $48,000 - $5,000), and the income statement would show $123,000 ($128,000 - $5,000) equity in investee income.

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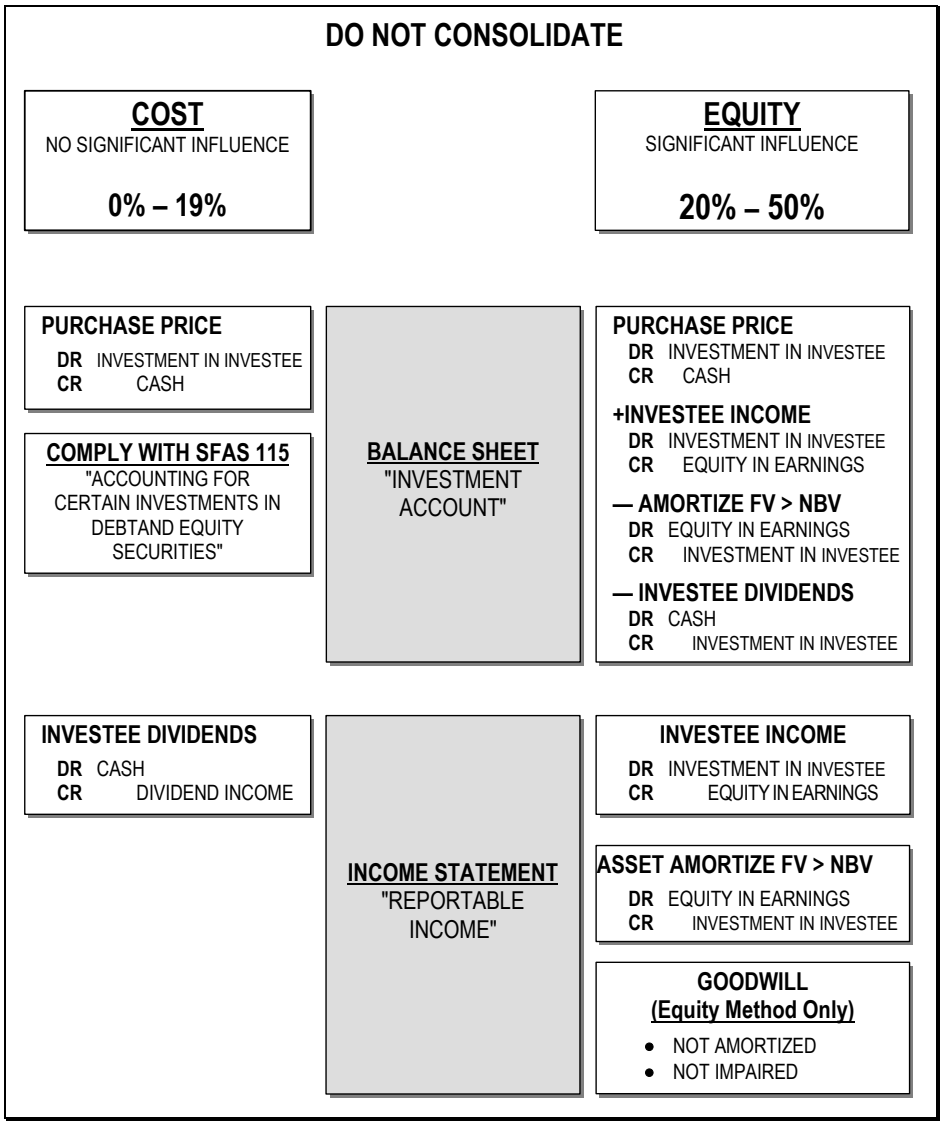
E. UNCONSOLIDATED INVESTMENT OF OVER 50% (EQUITY METHOD REQUIRED)

A parent company that does not consolidate a 50%+ owned subsidiary (e.g., lack of control due to a company being controlled by a bankruptcy trustee, or a subsidiary that is likely to be a temporary investment) must use the equity method when presenting the investment in that sub in:

1. Consolidated financial statements (without that sub being consolidated).
2. Unconsolidated parent company financial statements are NOT allowed to be issued to stockholders as the "primary reporting entity" (SFAS 94). However, they may be presented as a supplemental disclosure.

II. COMPARISON OF COST AND EQUITY METHODS



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III. STEP-BY-STEP ACQUISITION

A corporation may acquire a subsidiary in more than one transaction. In this case, any goodwill must be computed at the time of each transaction.

A. CHANGE FROM COST METHOD TO EQUITY METHOD

ACCOUNTING CHANGES

When significant influence is acquired, it is necessary to record a change from the cost/available-for-sale classification to the equity method. The investment account and the retained earnings account are adjusted retroactively for the difference between the available-for-sale classification/cost method to the equity method.

1. To Equity from Cost

When two or more purchases of stock cause ownership in an investee corporation to go from not having significant influence (< 20%) to having significant influence (≥ 20% but less than 50%):

a. The equity method should be used and the periods during which the cost method (fair value) was used are retroactively adjusted.

b. The year-end ownership percentage is used to make all equity entries.

2. Equity in Investee Income Calculation:

When the additional investment is made sometime during the year, the investor will calculate its share of the investee's income by multiplying the:

a. Investee's income by the fraction of the year that the cost method (available-for-sale) was used and the percentage ownership before the change.

b. This will then be added to the investee's income multiplied by the fraction of the year remaining and the percentage of ownership after the change.

3. Common Stock and Preferred Stock

If an investor company owns both common and preferred stock of an investee company:

a. The "significant influence" test is mostly met by the amount of common stock owned (which is usually the only voting stock).

b. The calculation of equity in earnings of subsidiary / income from subsidiary (or investee) includes:

(1) Preferred stock dividends, and

(2) Share of earnings available to common shareholders (net income reduced by preferred dividends).

PASS KEY

The key to answering questions relating to this issue correctly is to:

- Apply the new method (equity) to the prior period's old percentage (1 - < 20%).
- Do **not** apply the new percentage to the prior period (you did not own that percentage back then!).

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EXAMPLE

Adjustments to Convert from Available-for-Sale Classification to Equity Method

On January 1, Year 1, Party Co. paid $20,000 for a 15% interest in Subston Co. Party Co. does not have significant influence over Subston Co. The book value of net assets was $120,000. Any excess is attributable to a building with a 40-year life. Net income reported by Subston during Year 1 was $35,000. Party's share of dividends declared by Subston amounted to $750. The market value of the investment was $17,000 on December 31, Year 1. Under the cost method (available-for-sale treatment), in Year 1 Party would record dividend income but would not recognize net income reported by Subston nor amortize any asset premium (related to the building).

On January 1, Year 2, Party increased its ownership in Subston to 50%, paying $60,000. The fair value and book value of Subston's net assets at January 1, Year 2 were $108,000.

On January 1, Year 2, Party would record its additional investment and make the following adjustments to retroactively convert from the available-for-sale treatment to the equity method.

Schedule 1: Building (premium) resulting from the investment on January 1, Year 1.

Price paid/Cost of the January 1, Year 1 investment	$20,000
NBV of the net assets acquired ($120,000 x 15%)	(18,000)
Building (premium)	$ 2,000
Building (premium) will be amortized over 40 years (equity method only)	÷ 40 yrs.
$2,000 ÷ 40 = $50 amortization per year (equity method only)	$ 50.00

Schedule 2: Calculation of the retroactive adjustment to the equity method at January 1, Year 2.

	Equity Method:	
B	Year 1 investment (at cost)	$20,000
	Equity method adjustments:	
A	Plus: Share of Subston's net income ($35,000 x 15%)	5,250
S	Less: Dividends received	(750)
E	Less: Amortization of building (premium) ($2,000 ÷ 40)	(50)
	Balance of the investment account under the equity method	$24,450 [1]
	Cost/Available-for-Sale Treatment:	
	Yr 1 Dec. 31, investment balance at market value	$17,000 [2]
	Total adjustment to investment ([1] – [2])	$ 7,450
	Adjustment to unrealized loss on available-for-sale securities	(3,000)
	Retroactive adjustment to Retained Earnings	$ 4,450

Journal Entry: To record the retroactive adjustment to the investment and retained earnings account and write off the unrealized loss on available-for-sale securities

DR	Investment in Subston	$7,450	
CR	Retained earnings		$4,450
CR	Unrealized loss on available-for-sale securities		$3,000

Journal Entry: To record the additional investment at January 1, Year 2

DR	Investment in Subston	$60,000	
CR	Cash		$60,000

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CONSOLIDATED FINANCIAL STATEMENTS

I. CONSOLIDATED FINANCIAL STATEMENTS

A. CONTROL (OVER 50%)

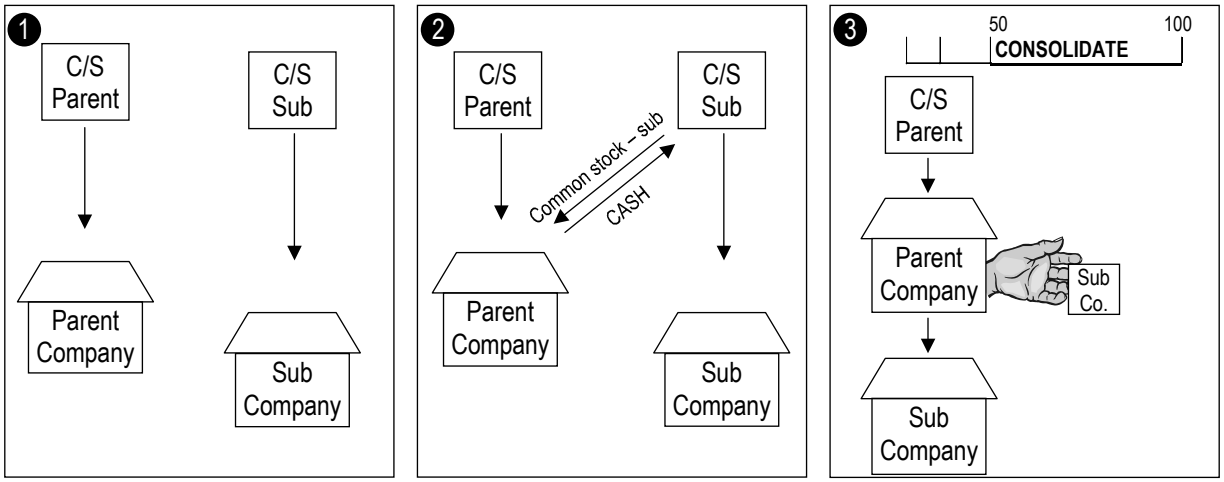
Consolidated financial statements are prepared when a parent-subsidiary relationship has been formed. An investor is considered to have parent status when control over an investee is established or more than 50% of the voting stock of the investee has been acquired.

All majority-owned subsidiaries (domestic and foreign) must be consolidated except when significant doubt exists regarding the parent's ability to control the subsidiary, such as when:

1. The subsidiary is in legal reorganization or
2. Bankruptcy and/or the subsidiary operates under severe foreign restrictions.

B. PURCHASE VS. POOLING OF INTERESTS

Purchase and pooling of interests are methods used to record the acquisition of a subsidiary and are each acceptable in accounting for business combinations under certain circumstances. An investment in the stock or net assets of another corporation is accounted for as a pooling of interests if all of the conditions necessary for a pooling of interests have been met (and it had been completed and/or initiated prior to June 30, 2001).



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PURCHASE METHOD
(External Reporting)

I. PURCHASE METHOD

In a business combination accounted for as a purchase, the subsidiary may be acquired for cash, stock, debt securities, etc. The investment is valued at the fair value of the consideration given or the fair value of the consideration received, whichever is the more clearly evident. The accounting for a purchase begins at the date of acquisition, unlike a pooling, which is accounted for as if the combinor and the combinee(s) had always been together.

(i) Purchase for Cash (at FV) and All Other Direct Costs

DR	Investment in subsidiary	$XXX	
CR	Cash		$XXX

(ii) Purchase for Parent Common Stock (use FV)

DR	Investment in subsidiary	$XXX	
CR	Common stock (Parent at par)		$XXX
CR	A.P.I.C (Parent/FV—par)		$XXX

A. APPLICATION OF THE PURCHASE METHOD

The purchase method has two distinct accounting characteristics: (1) the net assets purchased are recorded at fair value with any unallocable balance remaining creating goodwill, and (2) when the companies are consolidated, any retained earnings (or deficit) of the investee is eliminated (not reported).

PASS KEY

GAAP requires that when an asset is acquired, it is originally recorded at cost. The parent's cost is the purchase price, which is also the fair market value of the subsidiary on the day of purchase. The easy to remember formula is:

FV = Purchase Price = Cost

An acquiring corporation should allocate costs to assets received and liabilities assumed as follows:

1. Paid More than Net Book Value for Subsidiary (Premium)

a. Paid More for Assets (FV > Net Book Value)

All identifiable assets and liabilities should be assigned a portion of the total cost based on fair value at the date of acquisition. Contingencies of the acquired corporation should be included in the assignment of cost using the criteria discussed.

b. Paid More for Assets (at FV) and Paid for Positive Goodwill

Any excess of cost over the amount assigned to identifiable assets and liabilities should be recorded as goodwill (difference between fair value and the amount paid for the net assets acquired).

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2. Paid Less than Net Book Value for Subsidiary (Discount)

a. Paid Less for Assets (FV < Net Book Value)

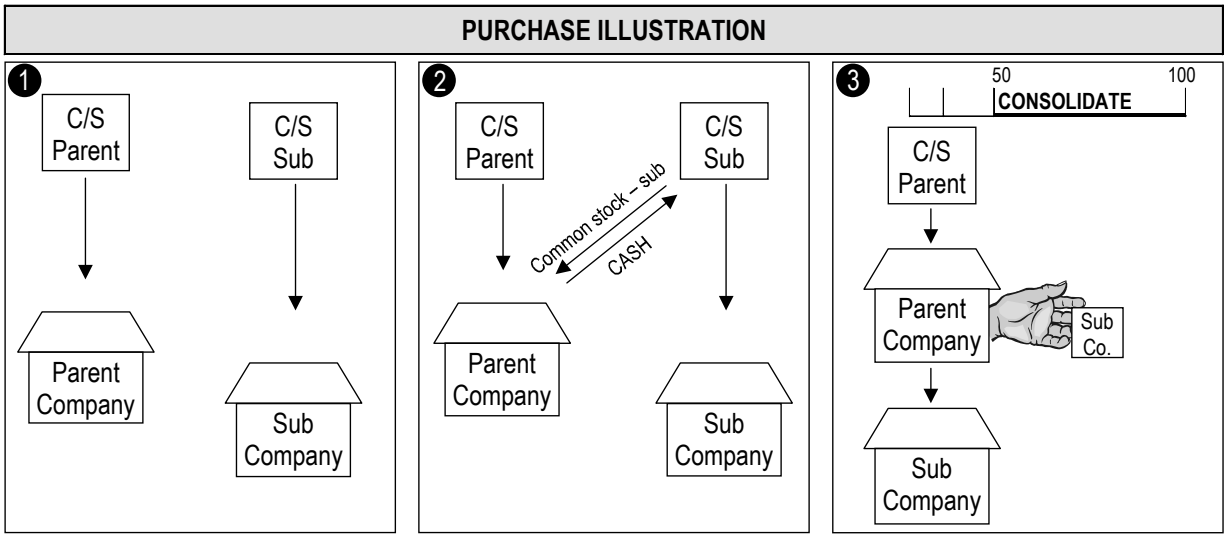
In the event that the assignable fair values of net assets acquired exceed the cost, the noncurrent assets acquired (excluding long-term investments in marketable securities) should be reduced proportionately.

b. Paid Less for Assets and Recognize Gain (Extraordinary)

If after reducing the appropriate noncurrent assets to their maximum extent (written down to zero) an excess remains, the excess (credit) is to be recognized as an extraordinary gain (not as negative goodwill).

3. Eliminate Subsidiary's Old Equity

The pre-acquisition equity (common stock, APIC, and retained earnings) of the subsidiary is not carried forward in a purchase. Consolidated equity will be equal to the parent's equity balance. The subsidiary's equity is eliminated.



4. The Consolidating Workpaper Eliminating Journal Entry

The year end consolidating journal entry known as the consolidating workpaper eliminating journal entry (EJE) is:

CAR I MAG

C	**DR**	Common stock - Sub	$ XXX	
A	**DR**	A.P.I.C. - Sub	XXX	
R	**DR**	Retained earnings - Sub	XXX	
I	**CR**	Investment in Subsidiary		$ XXX
M	**CR**	Minority interest		XXX
A	**DR**	Adjust - Balance sheet (of Sub) to FV (Paid)	XXX	
G	**DR**	Goodwill	XXX	

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PASS KEY

G = Goodwill	Excess	=	$
A = FV	X %	=	$
C A R = NBV	X %	=	$

$$$$$$$$

Purchase Price

B. SUBSIDIARY EQUITY ACQUIRED

1. Formula

The following formula is used to determine the book value of the assets acquired from the subsidiary:

CAR I MAG

- Assets - Liabilities = Equity
- Assets - Liabilities = Net Book Value
- Assets - Liabilities = CAR

2. Purchase Price and Subsidiary Net Book Value Reconciliation

Under the purchase method, the parent's acquisition of the subsidiary is recorded at the fair value of the consideration surrendered. This purchase price must be compared to the respective assets and liabilities of the subsidiary at the date of purchase. The difference between the fair value paid and book value acquired will require an adjustment to the following three areas:

M a. **M**inority interest (if any) for the percentage of the subsidiary's net book value not acquired.

A b. **A**djust balance sheet accounts of subsidiary from book value to fair value paid.

G c. **G**oodwill is recognized for any excess/negative is extraordinary gain.

3. Purchase Date Calculation

The determination of the difference between book value and fair value must be computed as of the purchase date.

When the subsidiary's financial statements are provided for a subsequent period, it is necessary to reverse the activity (income and dividends) in the subsidiary's retained earnings in order to squeeze back into the book value (Assets - Liabilities = CAR) at the purchase date.

Purchase	"Car"	Date
B A S E **Beg. retained earnings** / **Add: income** / **Subtract: dividends** / **End retained earnings**	**C**ommon stock - Sub	Same all year
	A.P.I.C. - Sub	Same all year
	Retained earnings - Sub	Squeeze back purchase date amount
	Investment in Sub	
	Minority Interest	
	Adjust balance sheet to FV (Paid)	
	Goodwill (Plug)	

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CONCEPT EXERCISE

On January 1, 20X1, Duffy Corporation acquired 100% of Gearty Corporation. Duffy issued 100,000 shares of its $15 par common stock, with a market price of $20 a share, for all of Gearty's common stock. The acquisition is a purchase.

On that date the fair value of Gearty's assets and liabilities equaled their respective carrying amounts with the exception of land, which had a fair value that exceeded its book value by $200,000.

For the year ending December 31, 20X1, Gearty reported net income of $350,000 and paid cash dividends of $150,000.

The stockholders' equity section of each company's balance sheet as of December 31, 20X1, was:

	Duffy	Gearty
Common stock	$5,000,000	$1,000,000
Additional paid-in capital	1,000,000	400,000
Retained earnings	3,000,000	500,000
	$9,000,000	$1,900,000

(1) Determine the book value of the acquired subsidiary at date of acquisition.

(2) Determine the amount of the investment at date of acquisition.

(3) Determine the amount of the adjustment to the book value of any assets at date of acquisition.

(4) Determine the amount of goodwill at date of acquisition.

PASS KEY

G = Goodwill	Excess	=	$2,000,000
A = FV	X 100%	= $1,900,000	
C A R = NBV	X 100%	= $1,700,000	

ANSWERS:

Common Stock – Sub	$1,000,000
A.P.I.C. – Sub	400,000
Retained Earnings – Sub (at purchase date)	300,000

B A S E

Beginning	300,000
Add: income	350,000
Subtract: dividends	<150,000>
Ending	500,000

Net Book Value	1,700,000
Investment (100,000 shares x $20 FV)	2,000,000
Difference	300,000
Minority Interest	- 0 -
Difference	300,000
Adjustment to Asset Land	200,000
Goodwill	100,000

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C. INVESTMENT IN SUBSIDIARY

CAR I MAG

The original carrying amount of the investment in subsidiary account on the parent's books is:

1. Original cost – Measured by the FV of the consideration given (Debit: Investment in Sub); and
2. Business combination costs/expenses, in a purchase, are treated as follows:
   a. Direct out-of-pocket costs such as a finder's fee or a legal fee are capitalized to the investment account. (Debit: Investment in Sub)
   b. Stock registration and issuance costs such as SEC filing fees are a direct reduction of the value of the stock issued. (Debit: Additional Paid-in Capital account)
   c. Indirect costs are expensed as incurred. (Debit: Expense)
   d. Bond issue costs are capitalized and amortized. (Debit: Bond Issue Costs)

EXAMPLE

Business Combination Accounted for as a Purchase

On January 1, Year 1, Buygood Company exchanged 10,000 shares of $10 par value common stock with a fair value of $415,000 for 100% of the outstanding stock of Subdue Company in a business combination properly accounted for as a purchase. In addition Buygood paid $35,000 in legal fees. At the date of acquisition, the fair and book value of Subdue's net assets totaled $300,000. Registration fees were $20,000.

Journal Entry: To record the acquisition price and legal fees

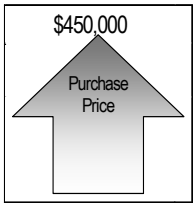
DR	Investment in Sub ($415,000 + $35,000)	$450,000	
CR	Common stock - $10 par value		$100,000
CR	Additional Paid-in capital – Buygood ($315,000 - $20,000)		295,000*
CR	Cash		55,000

*APIC – Buygood = $415,000 - $100,000 = $315,000 - $20,000 = $295,000

Allocation of investment:

C A R	**C**ommon Stock **A**.P.I.C. **R**etained Earnings	($ 300,000)
I	**I**nvestment	450,000
	Difference	150,000
M	**M**inority Interest	- 0 -
	Difference	150,000
A	**A**djustment to Asset	- 0 -
G	**G**oodwill	$ 150,000

G = Goodwill	Excess =	
A = FV	X 100%	= $ -0-
C A R = NBV	X 100%	= $300,000



PASS KEY

When the CPA Examination tests this issue, remember to look carefully for the word "direct" before including it in the "Investment in Sub." Also, all "indirect" costs are expensed.

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D. MINORITY (NON-CONTROLLING) INTEREST

CAR I MAG

1. Overview

MINORITY INTEREST

Business combinations that do not establish 100% ownership of a subsidiary by a parent will result in a portion of the subsidiary's equity being attributed to minority shareholders. This is true whether the business combination was accounted for as a purchase or a pooling. Minority interest must be disclosed in the consolidated balance sheet.

2. Financial Statement Presentation

a. Income Statement

The consolidated income statement will include 100% of the subsidiary's revenues and expenses. However, the minority interest portion of the subsidiary's net income should be included as a line item deduction (like an expense) and is often referred to as the minority interest in net income.

Sub's Income
<Sub's Expenses>
Sub's Net Income
x Minority Interest
Minority Interest in Net Income

b. Balance Sheet

The consolidated balance sheet will include 100% of the subsidiary's assets and liabilities (not the sub's equity / CAR). The minority interest's share of the subsidiary's net assets should be presented on the balance sheet before stockholders' equity, but after long-term debt and is often referred to as the minority interest in net assets.

3. Computation

Compute by multiplying total recorded stockholders' equity of subsidiary times minority interest percentage:

Recorded stockholders' equity $\times$ Minority interest % $=$ Minority Interest

Common Stock	—	Sub
A.P.I.C.	—	Sub
Retained Earnings	—	Sub
Sub's **CAR**		
x Minority Interest %		
Minority Interest		

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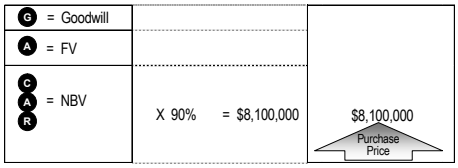
EXAMPLE

Minority Interest

On June 30, P acquired 90% of S for $8,100,000. The stockholders' equities immediately before the combination were:

	P	S
Common stock	$ 6,500,000	$ 2,000,000
Additional paid-in capital	4,400,000	1,600,000
Retained earnings	6,100,000	5,400,000
Total	$ 17,000,000	$ 9,000,000



Net income and dividends for the year were:

	PARENT	SUB
Net Income		
Six months ended 6/30	$ 600,000	$ 200,000
Six months ended 12/31	1,500,000	1,000,000
Dividends paid		
April 5	$ 800,000	
October 12		$ 100,000

BASE

C	A	R		I	M	A	G
2,000,000	1,600,000	5,400,000	Beginning	8,100,000	900,000	-0-	-0-
—	—	1,000,000	Sub—Income	900,000	100,000	—	—
—	—	(100,000)	Sub—Dividend	(90,000)	(10,000)	—	—
2,000,000	1,600,000	6,300,000	Ending	8,910,000	990,000	-0-	-0-

Year-End (Workpaper) Eliminating Journal Entry:

DR	Common stock - Sub	$2,000,000	
DR	A.P.I.C. - Sub	1,600,000	
DR	Retained earnings - Sub	6,300,000	
CR	Investment in Sub		$8,910,000
CR	Minority interest		990,000
DR	Adjustment - Balance sheet	-0-	
DR	Goodwill	-0-	

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E. ASSET ADJUSTMENT AND GOODWILL (EXTRAORDINARY GAIN) COMPUTATION

DIFFERENTIAL ALLOCATION

1. Determining Purchased Positive Goodwill

Rule: When purchasing a corporation for more than its net book value, the excess of cost over net book value of assets acquired, the following three steps are required:

a. Step 1 / Current (FV = NBV)

Allocate the purchase price to current assets and long-term marketable securities and assumed liabilities up to FV (which will be the same as net book value).

b. Step 2 / Noncurrent (Lower of FV or the Remaining Purchase Cost)

Allocate any remaining positive purchase price to noncurrent assets, up to their FV (you paid this price to "purchase" them) plus inventory.

c. Step 3 / Excess Goodwill

Allocate any remaining positive purchase price to create positive goodwill (you paid this price to "purchase it"). This goodwill is not amortized (even if previously amortized in accordance with prior GAAP rules). Purchased goodwill is subject to the impairment test (effective January 1, 2002). Accordingly, in the period it is determined to be impaired, it is written down and charged against income. See the F2 – Impairment for detail on the determination of goodwill impairment.

2. Determining Asset Write Down and Extraordinary Gain

Rule: Where the market or appraised value of identifiable assets less liabilities exceeds the purchase price of the assets or business enterprise being acquired, the following steps should be taken:

a. Step 1 / Current (FV = NBV)

Allocate the purchase price to current assets and long-term marketable securities at full FV (which will be the same as net book value even if you purchase for less).

b. Step 2 / Reduce Noncurrent Assets (Write Assets Down [to -0- if necessary])

The difference between the market value and purchase price should first be used to reduce noncurrent assets (except marketable securities) to zero, if necessary.

c. Step 3 / Resulting Extraordinary Gain

After reducing the noncurrent assets to zero, any difference shall be reported as an extraordinary gain (previously this was treated as negative goodwill and amortized).

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EXAMPLE

Acquisition of 100% Interest in Investee

Example	Sub NBV	Sub FV
Current Assets	$100,000	$100,000
L.T. Investment - Marketable Securities	25,000	25,000
Noncurrent Assets	200,000	250,000
Liabilities	50,000	50,000
Common Stock	100,000	
A.P.I.C.	100,000	
Retained Earnings	75,000	

	PREMIUM			DISCOUNT
	1	2	3	4
Investment in Sub	$350,000	$325,000	$300,000	$ 60,000
Liabilities Assumed	50,000	50,000	50,000	50,000
Cost to be Assigned	$400,000	$375,000	$350,000	$110,000
Step #1:				
Current and L.T. Marketable Securities	<125,000>	<125,000>	<125,000>	<125,000>
	$275,000	$250,000	$225,000	<$15,000>
Step #2:				
Noncurrent (Lower of Cost or Market)	<250,000>	<250,000>	<225,000>	<0>
Step #3:				
Goodwill or <Gain>	$ 25,000	-0-	-0-	<$15,000>

PASS KEY

The trick to properly calculating the allocation is Step #2. The allocation is of (the remaining purchase price) cost or market, whichever is lower.

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PURCHASE: CONSOLIDATING (WORKPAPER) ELIMINATING JOURNAL ENTRIES

Example #1

DR	**C**ommon stock - Sub	$100,000	
DR	**A**.P.I.C. - Sub	100,000	
DR	**R**etained earnings - Sub	75,000	
CR	**I**nvestment in Sub		$350,000
CR	**M**inority interest		0
DR	**A**djust balance sheet (noncurrent)	50,000	
DR	**G**oodwill	25,000	

Example #2

DR	**C**ommon stock - Sub	$100,000	
DR	**A**.P.I.C. - Sub	100,000	
DR	**R**etained earnings - Sub	75,000	
CR	**I**nvestment in Sub		$325,000
CR	**M**inority interest		0
DR	**A**djust balance sheet (noncurrent)	50,000	
DR	**G**oodwill	0	

Example #3

DR	**C**ommon stock - Sub	$100,000	
DR	**A**.P.I.C. - Sub	100,000	
DR	**R**etained earnings - Sub	75,000	
CR	**I**nvestment in Sub		$300,000
CR	**M**inority interest		0
DR	**A**djust balance sheet (noncurrent)	25,000	
DR	**G**oodwill	0	

Example #4

DR	**C**ommon stock - Sub	$100,000	
DR	**A**.P.I.C. - Sub	100,000	
DR	**R**etained earnings - Sub	75,000	
CR	**I**nvestment in Sub		$ 60,000
CR	**M**inority interest		0
CR	**A**djust balance sheet (noncurrent)		200,000
CR	**G**ain (extraordinary)		15,000

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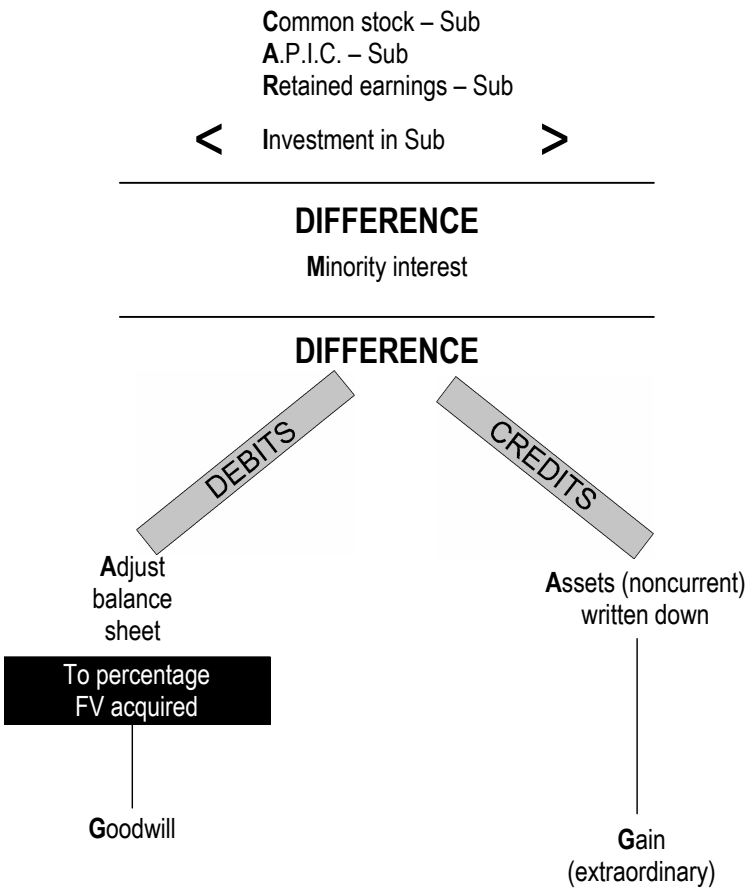
F. JOURNAL ENTRY FLOW CHART—PURCHASE DATE CALCULATION



PASS KEY

It is important to note that if the parent acquired less than 100% of the subsidiary, then the adjustment of the subsidiary's assets to FV (purchase price) cannot exceed the FV × percentage ownership.

CONSOLIDATION DISCLOSURES

G. DISCLOSURE FOR THE PURCHASE METHOD

The following disclosures should be made in the period in which a business combination accounted for by the purchase method occurs.

1. Name, brief description, and total cost of the acquisition.
2. Method of accounting, that is, the purchase method.
3. Period for which results of operations of the acquisition are included in the income statement (usually commences from the date of acquisitions).
4. Other pertinent information such as contingent payments, options, or other commitments.

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The following *supplemental* information should be disclosed in the notes to the financial statements of an acquiring company in the year of acquisition. These disclosures are not required in the financial statements of nonpublic enterprises.

1. Results of operations for the current period combining the acquisition as though it were acquired at the beginning of the period.
2. If comparative statements are presented, results of operations should include the acquisition as though it were acquired at the beginning of the comparative statement period.

C Common Stock	**A** APIC	**R** Retained Earnings		**I** Investment	**M** Minority Interest	**A** Adj. Assets	**G** Goodwill
			Beginning + Income - Dividend				
			End				

BASE

H. PURCHASE SUMMARY

Purchase	
FV	Assets
FV	Liabilities
Parent Only	Retained Earnings
After Purchase	Income
"Investment in Sub"	Acquisition Cost
Yes	Goodwill
Yes (1% - 49%)	Minority Interest
Eliminate	Investment in Sub
Depreciate	Asset Adjustment
Impairment Test	Goodwill Adjustment
Eliminate	Intercompany Transactions

PASS KEY

Purchased goodwill is no longer amortized, it is subject to the impairment test.

Previously recorded negative goodwill is written off and treated as a change in accounting principle.

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INTERCOMPANY TRANSACTIONS

I. INTERCOMPANY TRANSACTIONS

A. ELIMINATE INTERCOMPANY TRANSACTIONS

Intercompany transactions must be eliminated since they lack the criteria of being "arm's length."

1. Balance Sheet

a. Advances Receivable / Advances Payable

b. Accounts Receivable / Accounts Payable

c. Dividends Receivable / Dividends Payable

d. Bonds Receivable / Bonds Payable

2. Income Statement

a. Interest Expense / Interest Income (Bonds)

b. Gain on Sale / Depreciation Expense (Fixed Assets Sold)

c. Sale and Cost of Goods Sold (Inventory - on hand)

B. ELIMINATE 100% (EVEN WHEN MINORITY INTEREST EXISTS)

Eliminate entire amount, even if ownership is less than 100% when you consolidate.

1. Balance Sheet – Eliminate 100%

a. Group I - Eliminate 100% of all Interco Payables and Receivables

(1)	**DR**	Accounts Payable	$XXX	
	CR	Accounts Receivable		$XXX
(2)	**DR**	Bonds Payable (Interco portion only)	$XXX	
	CR	Bonds Investment (in affiliate)		$XXX
(3)	**DR**	Accrued Bond Interest Payable	$XXX	
	CR	Accrued Bond Interest Receivable		$XXX
(4)	**DR**	Dividends Payable (affiliate portion only)	$XXX	
	CR	Dividends Receivable (from affiliate)		$XXX

2. Income Statement – Eliminate 100%

a. Group II–Eliminate All Interco Gross Profit Sitting in Ending Inventory and FA of Parent or Subsidiary

IMPORTANT: The portion eliminated does not depend on who is selling:

1. Parent Was the Seller: Eliminate 100% of the:

a. Balance sheet write-up (or write-down) relating to the inventory or fixed asset that was transferred

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b. Income Statement

(1) Open (Presented): Sale and cost of goods sold

(2) Closed (to Retained Earnings): Profit (or loss) relative to the sale.

2. Subsidiary was the seller: Eliminate 100% of the:

a. Balance Sheet

Gross profit from ending inventory and/or fixed assets.

b. Income Statement

(1) Open (Presented): Sale and cost of goods sold

(2) Closed (to Retained Earnings & Minority Interest): Profit (or loss) relative to the sale.

3. Fixed asset cost and accumulated depreciation are based on original costs from the OUTSIDE world and remains the same on the consolidated financial statements. Only the intercompany gains and losses and their effect on accumulated depreciation are eliminated.

C. NOT CONSOLIDATED = NOT ELIMINATED

Do not eliminate intercompany accounts if you do NOT consolidate.

1. Separate report in financial statements
2. Footnote disclosure

D. INTERCOMPANY INVENTORY / MERCHANDISE TRANSACTIONS

It is common for affiliated companies to sell inventory/merchandise to one another. Often this inventory/merchandise is sold at a profit. The total amount of this intercompany sale and cost of goods sold should be eliminated prior to preparing consolidated financial statements. In addition, the intercompany profit must be eliminated from the ending inventory and the cost of goods sold of the purchasing affiliate. The profit to be eliminated is based upon the gross profit (markup on selling price) recognized by the selling affiliate. 100% of the profit should be eliminated even if the parent's ownership interest is less than 100%. The intercompany profit in beginning inventory that was recognized by the selling affiliate in the previous year must be eliminated by an adjustment (debit) to retained earnings.

Workpaper Elimination Entry for Intercompany Merchandise Transactions

DR	Intercompany sales	$XXX	
DR	Retained earnings (profit in beginning inventory)	$XXX	
CR	Intercompany cost of goods sold		$XXX
CR	Cost of goods sold (intercompany profit included in cost of goods sold of the purchasing affiliate)		$XXX
CR	Ending inventory (intercompany profit in the inventory remaining)		$XXX

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PASS KEY

When inventory has been sold intercompany, and the CPA Examination requires you to correct the accounts, remember to reverse the original intercompany transaction (sale and cost of goods sold, internally) and:

- Inventory sold to outsiders ⟶ correct Cost of Goods Sold
- Inventory still on hand ⟶ correct Ending Inventory

EXAMPLE

Intercompany Profit in Inventories

Potato Company owns 80% of the common stock of Soup Company. Potato sells merchandise to Soup at 10% above its cost. Such sales amounted to $1,100,000 during Year 1. The Year 1 ending inventory of Soup included goods purchased from Potato for $660,000. Potato reported $1,586,000 in net income from its independent operations in Year 1. Soup reported net income of $855,000 in Year 1 and did not declare dividends. Potato records its investment in Soup using the equity method. There were no intercompany sales prior to Year 1.

Year 1 Workpaper Elimination Entry

DR	Intercompany sales – P	$1,100,000	
CR	Intercompany cost of goods sold – P		$1,000,000 **[1]**
CR	Cost of goods sold – S		40,000 **[2]**
CR	Inventory – S		60,000 **[3]**

Step [1]

Sales = Cost + (10% x Cost)

$1,100,000 = 110% x Cost

Intercompany cost of goods sold	$1,000,000 **[1]**

Step [2]

Beginning inventory	$ 0
Purchases	1,100,000
Cost of goods available	1,100,000
Ending inventory	660,000
Cost of goods sold	440,000
Intercompany profit based on Potato's markup on selling price	9.091%*

$$* \text{ Markup on selling price} = \frac{\text{Markup on cost}}{1 + \text{Markup on cost}} = 9.091\%$$

Intercompany profit in Soup's cost of goods sold	$ 40,000 **[2]**

Step [3]

Ending inventory	$ 660,000
Markup	x 9.091%
Intercompany profit in ending inventory	$ 60,000 **[3]**

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E. INTERCOMPANY BOND TRANSACTIONS

If one member of the consolidated group acquires an affiliate's debt from an outsider, the debt is considered to be retired and a gain/loss is recognized. The gain/loss is reported as a gain/loss. This gain/loss on extinguishment of debt is calculated as the difference between the price paid to acquire the debt and the book value of the debt. This gain/loss is not reported on either company's books, but is recorded through an elimination entry. All intercompany account balances are also eliminated.

EXAMPLE

Intercompany Bond Transactions

On December 31, Year 1, Parent Company issued bonds with a carrying value of $300,000, and a face value of $250,000. The premium on bonds payable was recorded as $50,000.

Journal Entry: To record the sale of the bonds on the Parent's books

DR	Cash	$300,000	
CR	Bonds payable		$250,000
CR	Premium on bonds payable		50,000

On December 31, Year 1, before any portion of the premium was amortized, Sub Company acquires all the outstanding bonds from the original purchasers at a price of $275,000.

Journal Entry: To record the purchase of the bonds on the Sub's books

DR	Investment in parent bonds	$275,000	
CR	Cash		$275,000

Workpaper Elimination Entry: Eliminated intercompany balances and recognizes the gain on extinguishment of debt.

DR	Bonds payable	$250,000	
DR	Premium (parent's records)	50,000	
CR	Investment in parent bonds (sub's records)		$275,000
CR	Gain on extinguishment of bonds		25,000

1. Intercompany Interest

Eliminate intercompany accounts such as interest expense, interest income, interest payable, and interest receivable.

2. Amortization of Discount or Premium

Eliminate amortization of the discount or premium, which serves as an increase, or decrease in the amount of interest expense/revenue that is recorded. The unamortized discount or premium on the intercompany bond is eliminated.

3. Subsequent Years

The elimination for realized but unrecorded gain/loss on extinguishment of bonds in subsequent years would be adjusted to retained earnings. Minority interest would be adjusted if the bonds were originally issued by the subsidiary.

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F. INTERCOMPANY SALE OF LAND

The intercompany gain/loss on the sale of land remains unrealized until the land is sold to an outsider. A workpaper elimination entry in the period of sale eliminates the intercompany gain/loss and adjusts the land to its original cost.

EXAMPLE

Intercompany Sale of Land

On January 1, Year 1, Parent Company sold land to Subsidiary Company for $200,000. The initial cost of the land to Parent was $175,000.

Journal Entry: To record the sale by Parent on their books

DR	Cash	$200,000	
CR	Land		$175,000
CR	Intercompany gain on sale of land		25,000

Journal Entry: To record the purchase by Sub on their books

DR	Land	$200,000	
CR	Cash		$200,000

Workpaper Elimination Entry: Elimination of the intercompany gain and adjustment of land to its original cost

DR	Intercompany gain on sale of land	$25,000	
CR	Land ($200,000 - $175,000)		$25,000

In the subsequent year and every year thereafter until the land is sold to a third party, retained earnings (Parent) would be debited and land would be credited to eliminate the intercompany profit. Retained earnings is debited in subsequent years since the gain would have been closed to this account. Since Parent was the seller of the land and Sub was the purchaser, there is no need to divide the intercompany gain between retained earnings and minority interest.

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G. INTERCOMPANY PROFIT ON SALE OF DEPRECIABLE FIXED ASSETS

The gain or loss on the intercompany sale of a depreciable asset is unrealized from a consolidated financial statement perspective until the asset is sold to an outsider. A working paper elimination entry in the period of sale eliminates the intercompany gain/loss and adjusts the asset and accumulated depreciation to their original balance on the date of sale.

EXAMPLE

Intercompany Sale of Equipment

FACTS: Sub Company, a partially owned (90%) subsidiary of Parent Company, sold equipment on Jan.1, 20X1 to Parent for $100,000. The equipment had a net book value of $70,000 (cost of $90,000 and accumulated depreciation of $20,000), and a remaining life of ten years.

Jan. 1, 20X1:	**Journal Entry:** To record the sale by Sub on their books			
	DR	Cash	$100,000	
	DR	Accumulated depreciation	20,000	
	CR	Machinery (original cost)		$90,000
	CR	Intercompany gain on sale of machinery		30,000
Jan. 1, 20X1:	**Journal Entry:** To record the purchase by Parent on their books			
	DR	Machinery	$100,000	
	CR	Cash		$100,000
Dec. 31, 20X1:	**Journal Entry:** To record depreciation by Parent on their books			
	DR	Depreciation expense ($100,000 ÷ 10)	$10,000	
	CR	Accumulated depreciation		$10,000
Dec. 31, 20X1:	**Workpaper Elimination Entry:** Elimination of intercompany gain and adjustment of the machine and accumulated depreciation accounts to their original balance.			
	DR	Intercompany gain on sale of machinery	$30,000	
	CR	Machinery ($100,000 – 90,000)		$10,000
	CR	Accumulated depreciation		$20,000

The depreciation expense recorded by Parent is overstated by the intercompany profit included in the cost of the machinery.

	GAAP Original	Non-GAAP Intercompany	Difference
NBV	$70,000	$100,000	$30,000
Depr. Yrs	÷ 10 Yrs	÷ 10 Yrs	÷ 10 Yrs
Depreciation	$ 7,000	$10,000	$ 3,000

Workpaper Elimination Entry: Elimination of excess depreciation

DR	Accumulated depreciation	$3,000	
CR	Depreciation expense		$3,000

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EXAMPLE CONTINUED

Subsequent Year Work Paper Elimination Journal Entry

In the subsequent years the intercompany gain/loss on the sale of the asset and the excess depreciation have been closed to Retained Earnings. The elimination entries in subsequent years therefore adjusts Retained Earnings, and if appropriate, Minority Interest for the original gain or loss less the excess depreciation previously recorded (Unrealized gain/loss at the beginning of the year). Continuing with the previous example, in Year 2 the workpaper elimination entries would be:

Journal Entry: Adjust fixed asset

DR	Retained Earnings	$24,300		**[1]**
DR	Minority interest in net assets	2,700		**[2]**
CR	Machinery		$10,000	
CR	Accumulated depreciation		17,000	**[3]**

Journal Entry: Adjust depreciation

DR	Accumulated depreciation	$ 3,000		
CR	Depreciation expense		$ 3,000	

[1] Original gain - Excess depreciation previously recorded = Unrealized gain at the beginning of the year. $30,000 - $3,000 = $27,000 x 90% (Parent's ownership percentage) = $24,300

[2] $27,000 x 10% (Minority shareholder's ownership percentage) = $2,700

[3] Original accumulated depreciation difference of $20,000 less excess depreciation of $3,000 previously recorded.

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COMBINED FINANCIAL STATEMENTS / PUSH DOWN ACCOUNTING

I. COMBINED FINANCIAL STATEMENTS

Combined financial statements of a group of related companies (not consolidated because there is no parent company):

A. TYPES:

1. Companies are under common control (e.g., individual owns many companies), or
2. Companies are under common management, or
3. Unconsolidated subsidiaries (e.g., many foreign subs) are combined.

B. REQUIRES:

1. Intercompany transactions and balances among these companies eliminated.
2. Minority interests, etc., be treated like consolidated financial statements.
3. Capital stock and retained earnings be added across, not eliminated.
4. Income statements be added across.

II. PUSH DOWN ACCOUNTING

Push down accounting reports assets and liabilities at fair value in separate financial statements of the subsidiary. In effect, consolidation adjustments are pushed down into the records (and separate financial statements) of each subsidiary.

A. Assets and liabilities are adjusted.

B. Retained earnings of the subsidiary are transferred to paid-in capital (to the extent of parent company's percentage of ownership).

C. Net income of each subsidiary includes depreciation, amortization, and interest expense based on fair values rather than historical cost.

D. The SEC requires push down accounting for each substantially wholly-owned subsidiary.

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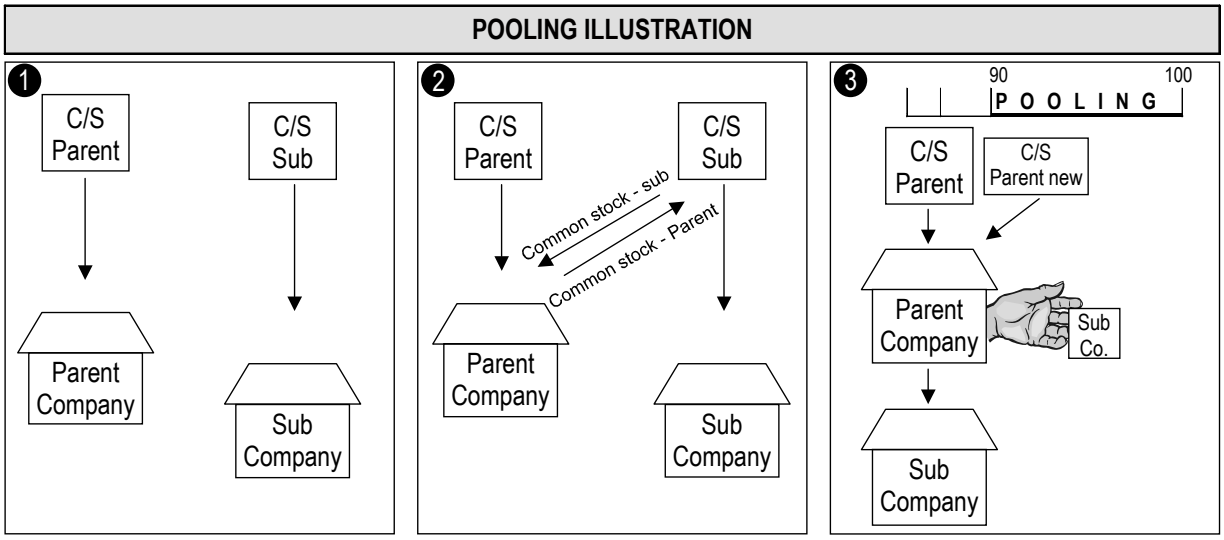
HOMEWORK READING: POOLING-OF-INTERESTS METHOD

I. POOLING-OF-INTERESTS METHOD (90%+ AND ALL OTHER CRITERIA)

For transactions, which had previously qualified, or for transactions initiated before June 30, 2001, that met the following criteria, the pooling of interest method is to be used to account for the acquisition. The following conditions must be met if the pooling-of-interests method is to be used to account for a business combination. If any of the following conditions are not met, the business combination must be accounted for as a purchase. If all of the conditions are met and the transaction was completed and/or initiated before June 30, 2001, the business combination must be accounted for as a pooling of interest. A pooling is accomplished through the issuance, by the acquirer, of voting common stock for 90% or more of the voting common stock or 100% of the net assets of the pooled company. The pooling method never results in goodwill because the investment is recorded at the book value of the subsidiary's net assets.



II. CONDITIONS FOR THE POOLING-OF-INTERESTS METHOD

A. CONDITIONS FOR USE OF THE POOLING OF INTERESTS METHOD (ALL MUST BE MET OR THE BUSINESS COMBINATION IS A PURCHASE)

1. Classifications Pertain To:

a. Attributes of combining companies.

b. Manner of combining interests.

c. Absence of planned transactions.

2. Attributes of Combining Companies Criteria

a. Must be autonomous for two years before the plan is initiated. They cannot have been a subsidiary or division of another corporation within the two years before the plan of combination is initiated.

b. No combining company can own more than 10% of another combining company for two years before the plan of combination is initiated. Each of the combining companies must be independent.

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3. Manner of Combining Interest Criteria

a. The combination must be completed within one year after the plan is initiated.

b. The issuing corporation must issue voting common stock in exchange for at least 90% of the voting common stock of another combining company after the date the plan of combination is initiated,

c. The combining companies

(1) Reacquire their common stock during the combination except for purposes not related to the combination (e.g., employee stock option plans) or

(2) Cannot make equity interest changes for two years before the combination.

d. Following the combination

(1) The ratio of interest of predecessor owners must remain the same, and

(2) The voting rights of all shareholders must be the same.

e. There can be no contingencies related to the exchange of stock (contingent buy-out). For example, additional shares of stock to be issued based on future earnings.

4. Absence of Planned Transactions Criteria

a. No agreements concerning post-combination reacquisition or retirement of stock just acquired are allowed (e.g., a deal with dissident shareholders to reacquire their stock).

b. No agreements offering post-combination benefits are allowed (e.g., an agreement to guarantee loans on stock issued in the combination that would permit shareholders to get cash from their stock, or, in effect, "sell" their stock).

c. No intent or plan to dispose of a significant part of the acquired assets of the combining companies (except duplicate facilities) within two years after the combination can exist.

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B. PROCEDURES FOR RECORDING THE INITIAL INVESTMENT UNDER A POOLING OF INTERESTS

The following basic journal entry is required when the par value of the two companies common stock are equal:

DR Investment in Subsidiary (for NBV of Sub)
CR Common Stock – Parent (shares issued x par value)
CR A.P.I.C. – (for the subsidiary, A.P.I.C.)
CR Retained Earnings – (for the subsidiaries R.E.)

EXAMPLE

I CAR

Recording the Initial Investment under a Pooling of Interests

Poolgood Company merged with Sub-Way Co. in a business combination accounted for as a pooling. Poolgood issued 20,000 shares of its $5 par common stock for all the outstanding capital stock of Sub-Way. In addition, Poolgood paid $10,000 in legal fees and $10,000 in SEC fees.

Sub-Way's stockholders' equity (NBV) at the beginning of the year of the business combination:

Common stock outstanding	$100,000
Additional paid-in capital in excess of par	20,000
Retained earnings	70,000
Total capital	$190,000

The investment is recorded at the book value of Sub-Way's net assets, which equals the parent's share of the subsidiary's stockholders' equity at the beginning of the year.

Par value of parent's shares issued	$100,000
Par value of subsidiary share transferred	100,000
Adjustment to additional paid-in capital (Plug)	$ 0

Journal Entry: To record the initial investment under the pooling-of-interests method

DR	Investment in Sub-Way ($100,000 + $20,000 + $70,000)	$190,000	
CR	Common stock (Poolgood) (20,000 x $5)		$100,000
CR	Additional paid-in capital (Poolgood for Sub-Way) [($100,000 + $20,000) - $100,000]		$ 20,000
CR	Retained earnings (Sub-way's)		$ 70,000

All of the expenses incurred in the pooling are expenses of the combined corporation.

Journal Entry: To record business combination expenses in a pooling

DR	Business combination expense	$20,000	
CR	Cash		$20,000

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C. PROCEDURE FOR RECORDING THE INITIAL INVESTMENT WHEN DIFFERENT PAR VALUE AMOUNTS

ICAR

When preparing the journal entry for recording the initial investment is S Company stock under a pooling of interests, the following steps should be applied in the order given:

1. Debit:

Investment in S Company account for the book value or recorded amount of S Company's net assets (Sub's: Assets – Liabilities = Equity).

2. Credit:

Common stock – Parent: for the par value of the shares issued by the parent company (number of shares issued x the par value of the parent's stock).

3. Plug:

a. Credit: (Increase)

(1) Additional Paid-in Capital to balance

b. Debit: (Decrease)

(1) Parent's A.P.I.C. (to extent it exists), and if necessary,

(2) Parent's retained earnings for any remaining difference.

4. Credit:

Retained Earnings of S Company for an amount equal to the parent's share of S Company's retained earnings at the beginning of the year.

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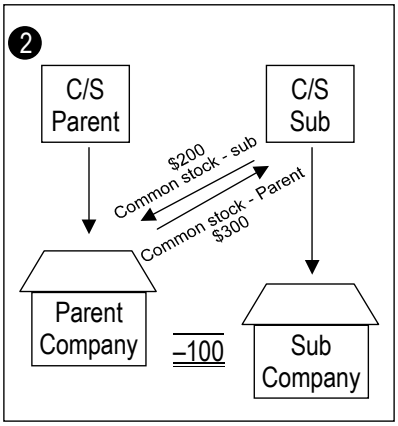
NOTE: EXCHANGE OF STOCK WITH DIFFERENT PAR VALUE AMOUNTS

Plug Additional Paid-in Capital to balance, but if a debit is required, debit paid-in capital of the parent to the extent its exists and if necessary debit the parent's retained earnings for any remaining difference.

NEGATIVE DIFFERENCE

Parent par value issued greater than sub-contributed capital

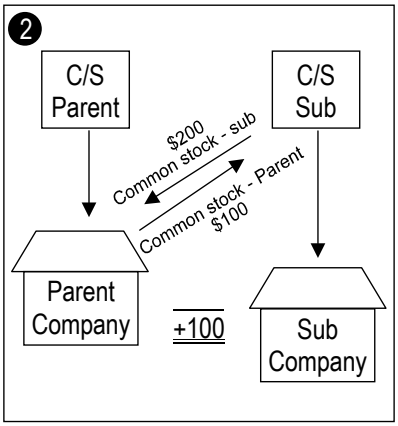


Debits Required

* Debit APIC — Parent (Until zero)
* Remained retained earnings — Parent

POSITIVE DIFFERENCE

Parent par value issued less than sub-contributed capital



Credit Required

* Credit APIC — Parent

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EXAMPLE

Recording the Initial Investment under a Pooling of Interests

The following four assumptions based on information from the previous example will further illustrate the recording of the initial investment under pooling account. Poolgood Company has $40,000 additional paid-in capital on its books.

Shares issued by Poolgood (P) $5 Par	*10,000 Shs*	*20,000 Shs*	*30,000 Shs*	*40,000 Shs*
Par value sub share transferred	$100,000	$100,000	$100,000	$100,000
Par value of parent's shares issued	$ 50,000	$100,000	$150,000	$200,000
Difference	+ $ 50,000	- 0 -	– $ 50,000	– $100,000
Sub's A.P.I.C. forfeited	—	—	20,000	20,000
Difference	+ 50,000	—	– 30,000	– 80,000
Parent A.P.I.C. reduced	—	—	$ 30,000	$ 40,000
Negative: decrease parent R.E.	—	—	—	$ 40,000
Positive: increase A.P.I.C.	$ 50,000	—	—	—
DR Investment account	$190,000	$190,000	$190,000	$190,000
DR Additional paid-in capital (P)			30,000	40,000
DR Retained earnings (P)				40,000
CR Common Stock (P)	$50,000	$100,000	$150,000	$200,000
CR Additional paid-in capital	70,000	20,000	0	0
CR Retained earnings of sub	70,000	70,000	70,000	70,000

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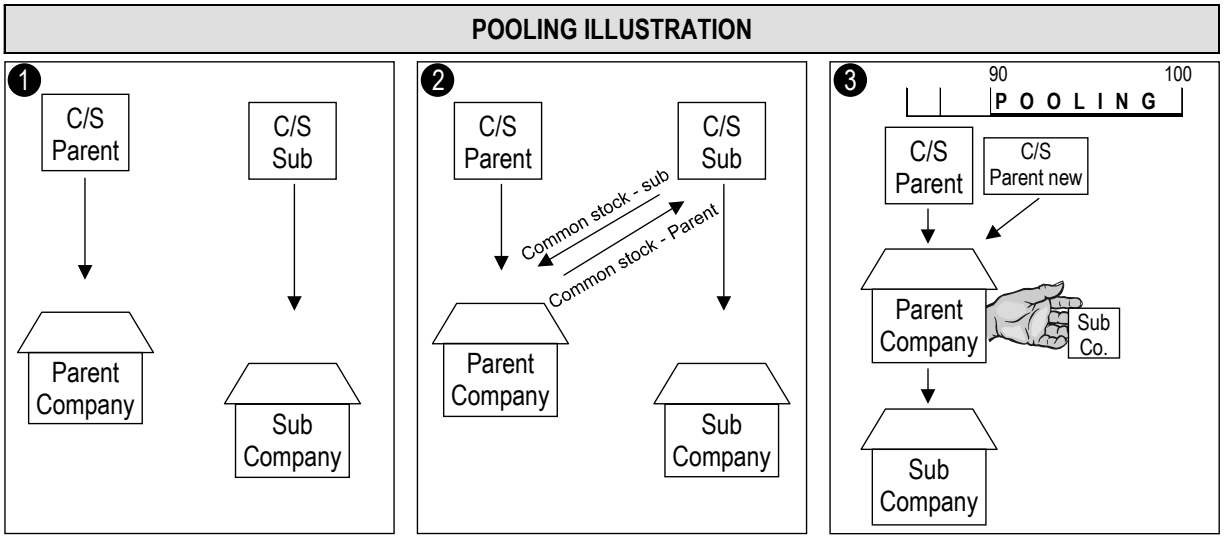
III. POOLING-OF-INTEREST (90%+ AND ALL OTHER CRITERIA)

POOLING-OF INTEREST

For transactions that had previously qualified, or for transaction initiated before June 30, 2001, which met the other criteria for the pooling-of-interest method, this method was, and is, GAAP.

A pooling-of-interest was accomplished through the issuance, by the acquirer, of voting common stock for 90% or more of the voting common stock for 100% of the net assets of the pooled company. The pooling method never results in goodwill because the investment is recorded at the book value of the subsidiary's net assets.



A. APPLICATION OF THE POOLING-OF-INTERESTS METHOD

The pooling-of-interests method is intended to present as a single interest two or more common stockholder interests that were previously independent. A review of the procedures follows:

1. Balance Sheet (NBV)

Assets, liabilities, and stockholders' equity are combined and recorded at historical cost in conformity with GAAP at the date the combination is consummated.

2. Income Statement (Retroactive for Whole Year)

Income statements are retroactively combined for entire year, regardless of when pooling actually occurs.

3. Report as of Beginning of Year

All financial statements for the period in which the combination occurred should be reported as though the combination occurred at the beginning of the period.

4. Restate Prior Financial Statements

Prior-year financial statements should be restated on a consolidated basis.

5. Acquisition Cost (Expensed)

Expenses relating to the combination are expenses of the combined group and should be deducted from combined net income. Examples of such expenses are registration fees, finder's and consultant fees, and costs and losses resulting from combining the separate companies.

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6. No Goodwill Created

Goodwill is not recognized.

7. Minority Interest (Maximum 10%)

Minority interest is recognized (the 10% or less not acquired).

8. Equity Method – Internally Required

The equity method is always used in conjunction with the pooling-of-interests method.

PASS KEY

In a pooling, never use **fair market values**!

B. POOLING-OF-INTERESTS METHOD AT YEAR-END

Under the equity method the parent accrues its proportionate share of the net income reported by the subsidiary. The pooling-of-interests method is accounted for as if the parent and subsidiary had always been combined. Therefore, in the year of acquisition the parent's share of subsidiary's annual net income is included. Dividends declared or paid by the subsidiary are a reduction of the investment in subsidiary account and are not recorded as dividend income. In a pooling all prior financial statements are restated to reflect the combined operations of the pooled companies.

1. Year End Elimination Entry

(C)	**DR:**	Common stock - Sub	$XXX	
(A)	**DR:**	A.P.I.C. - Sub	XXX	
(R)	**DR:**	Retained earnings - Sub	XXX	
(I)	**CR:**	Investment in sub		$XXX
(M)	**CR:**	Minority interest		XXX

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EXAMPLE

Pooling-of-Interests Method at Year-End

PoolGood Company merged with Sub-Way Co. in a business combination accounted for as a pooling-of-interest. PoolGood's investment account at the beginning of the current year is $190,000 (100% ownership). Sub-Way's equity section at the beginning of the year is:

Common Stock	$100,000
A.P.I.C.	20,000
Retained Earnings	70,000
Total	$190,000

Assume Sub-Way has reported $20,000 in net income for the year ended December 31, Year 2001. Sub-Way declared and paid a dividend of $5,000 during Year 2001.

Journal Entry: To recognize Sub-Way net income using the equity method

DR	Investment in Sub-Way	$20,000	
CR	Equity in subsidiary income (Sub-Way)		$20,000

Journal Entry: To recognize dividends received under the equity method

DR	Cash	$5,000	
CR	Investment in Sub-Way		$5,000

CAR I M

C	A	R		I	M
100,000	20,000	70,000	Beginning	190,000	0
—	—	20,000	Sub—Income	20,000	—
—	—	(5,000)	Sub—Dividend	(5,000)	—
100,000	20,000	85,000	Ending	205,000	0

C	**DR**	Common Stock: Sub-Way	$100,000	
A	**DR**	Additional paid-in capital: Sub-Way	20,000	
R	**DR**	Retained Earnings: Sub-Way	85,000	
I	**CR**	Investment in Sub-Way		$205,000
M	**CR**	Minority Interest		- 0-

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C. DISCLOSURE FOR POOLING-OF-INTERESTS COMBINATIONS

CONSOLIDATION DISCLOSURES

Consolidated financial statements should include the following disclosures in the period in which the pooling occurs.

1. Brief description of the companies combined.
2. Method of accounting for the combination, that is, the pooling-of-interests method.
3. Description and amount of shares of stock issued to effect the combination.
4. Details of the results of operations for each separate company, prior to the date of combination, that are included in the current combined net income.
5. Description of the nature of adjustments in net assets of the combining companies necessary to adapt to the same accounting policies.

D. PURCHASE VS. POOLING OF INTEREST COMPARISON

Purchase		Pooling
FV	Assets	NBV
FV	Liabilities	NBV
Parent Only	Retained Earnings	Both
After Purchase	Income	Whole Yr./Retroactive
"Investment in Sub"	Acquisition Cost	Expense
Yes	Goodwill	No
Yes (1% - 49%)	Minority Interest	Yes (1% - 10%)
Eliminate	Investment in Sub	Eliminate
Depreciate	Asset Adjustment	N/A
Impairment Test	Goodwill Adjustment	N/A
Eliminate	Intercompany Transactions	Eliminate

PASS KEY

Many CPA Examination questions have required candidates to distinguish the proper accounting rules between the purchase method and the pooling-of-interests method. The summary chart above will assist in your mastering the differences.

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NOTES

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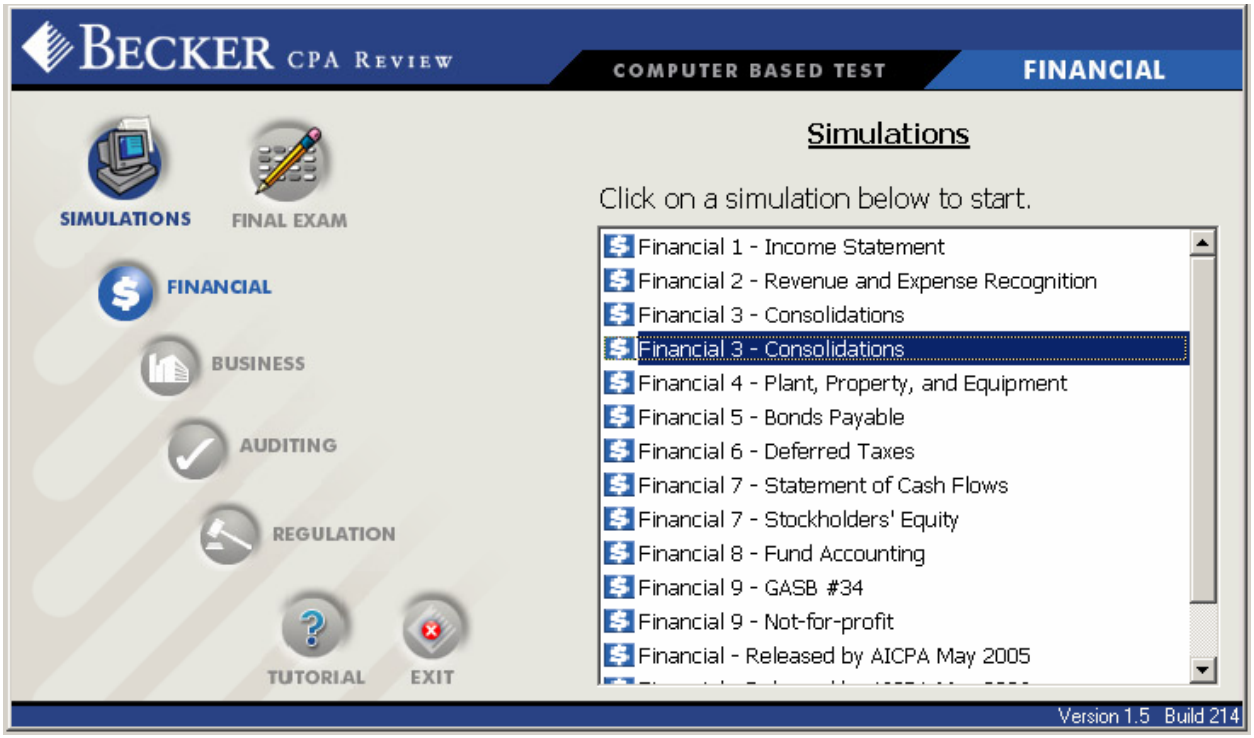
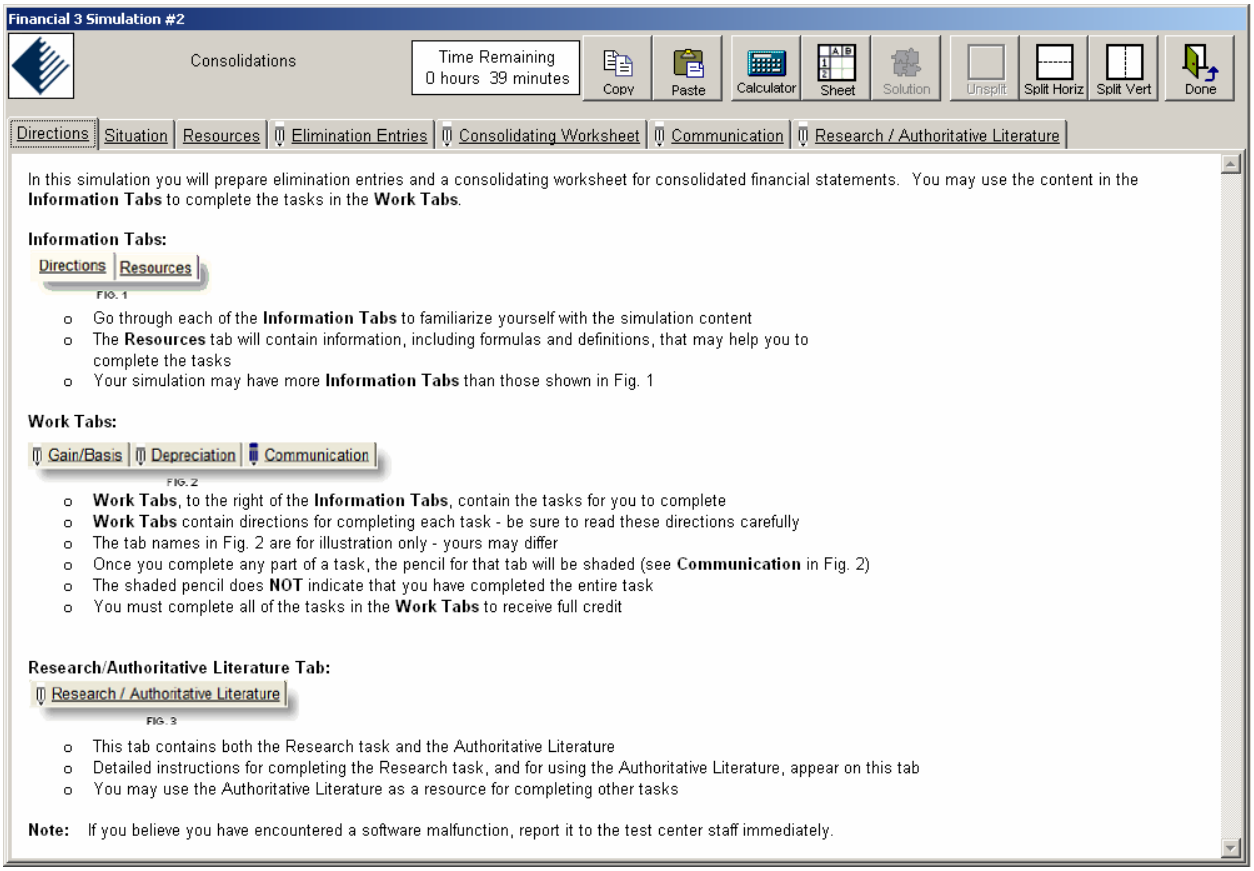
SIMULATION





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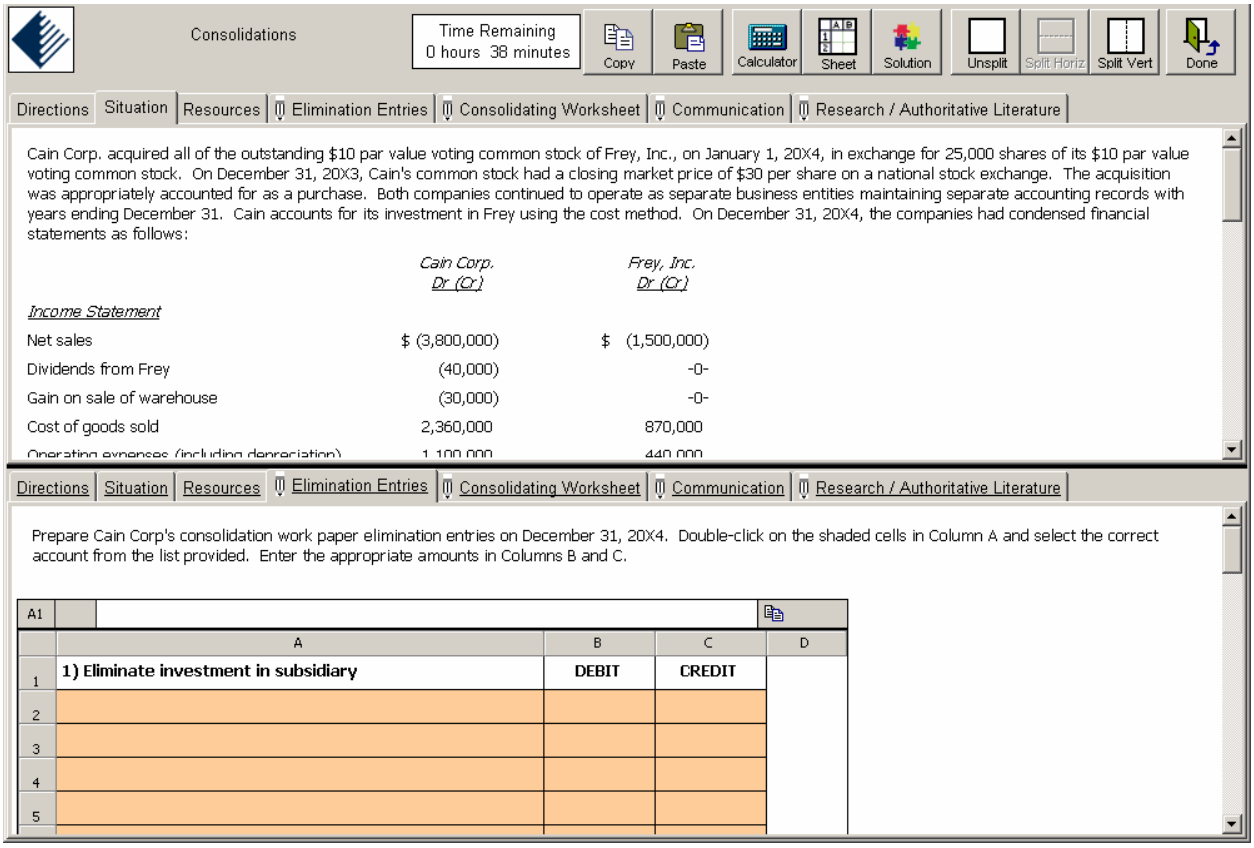

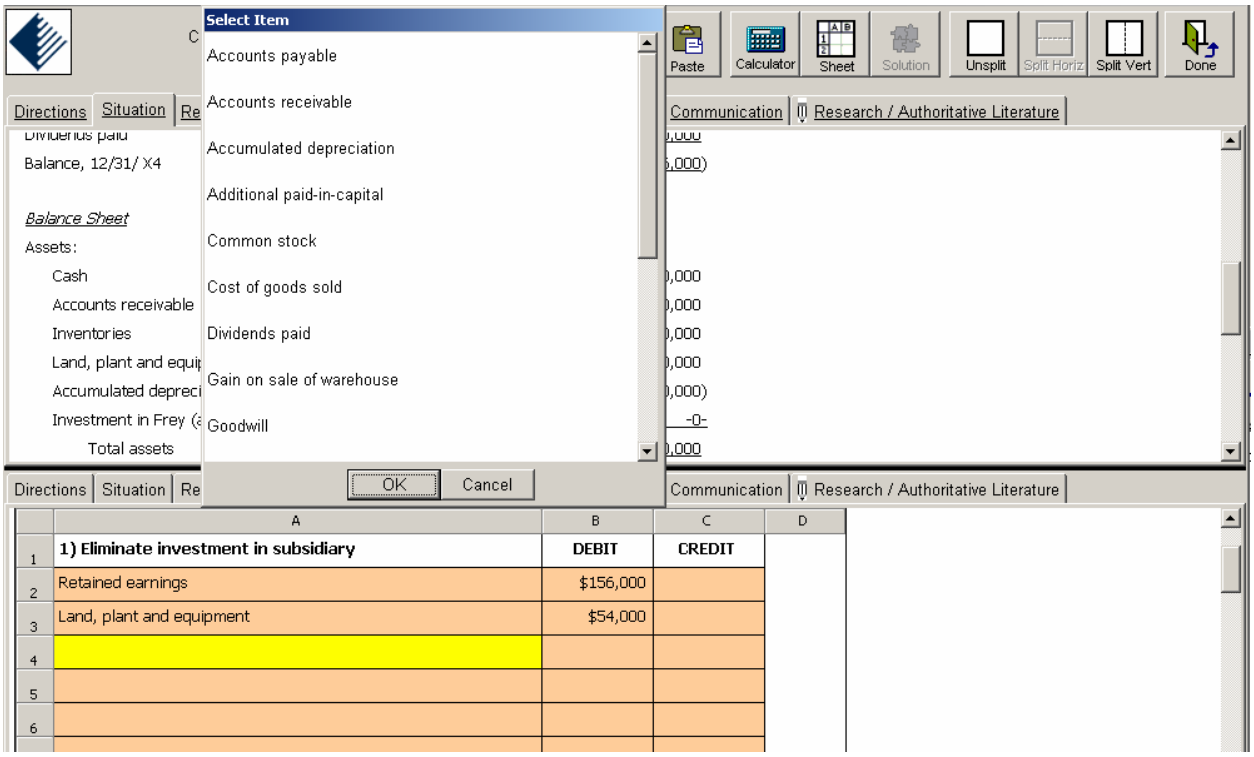

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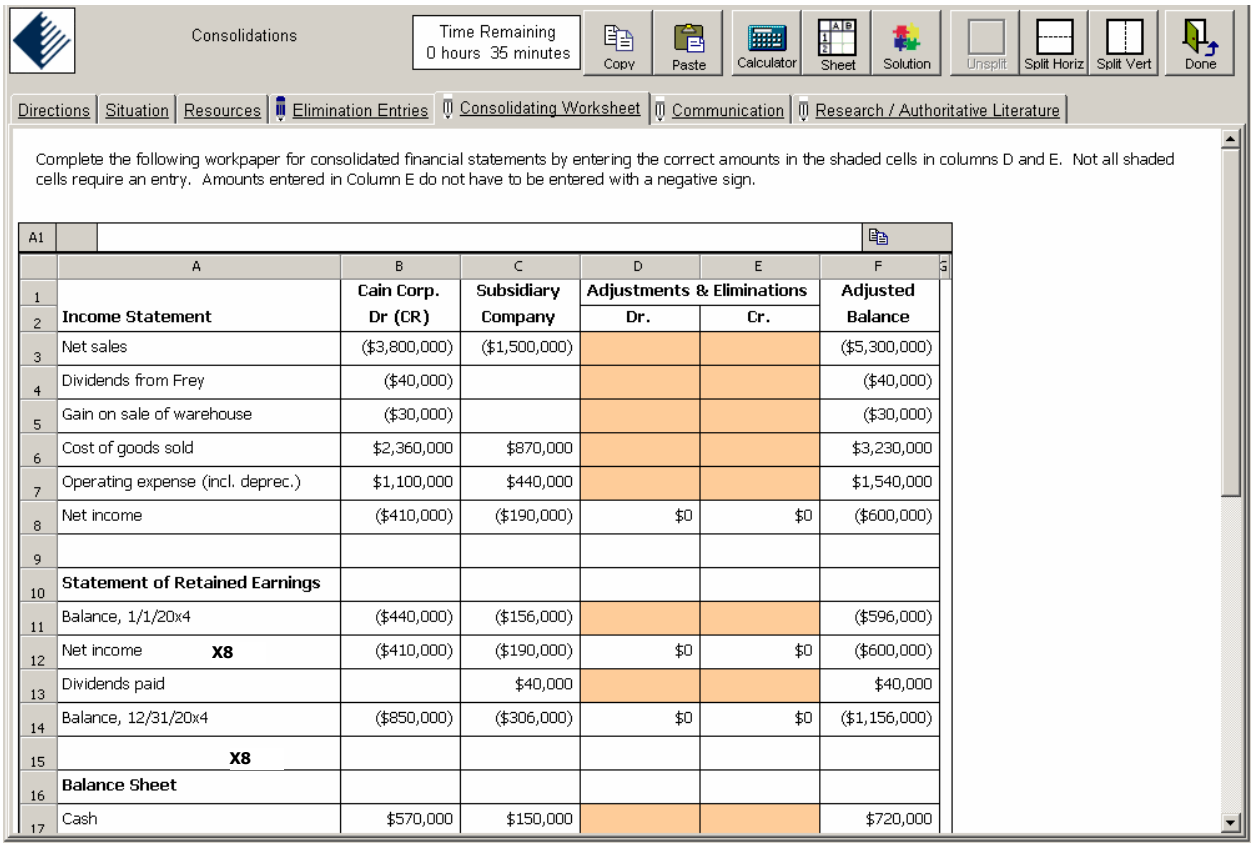
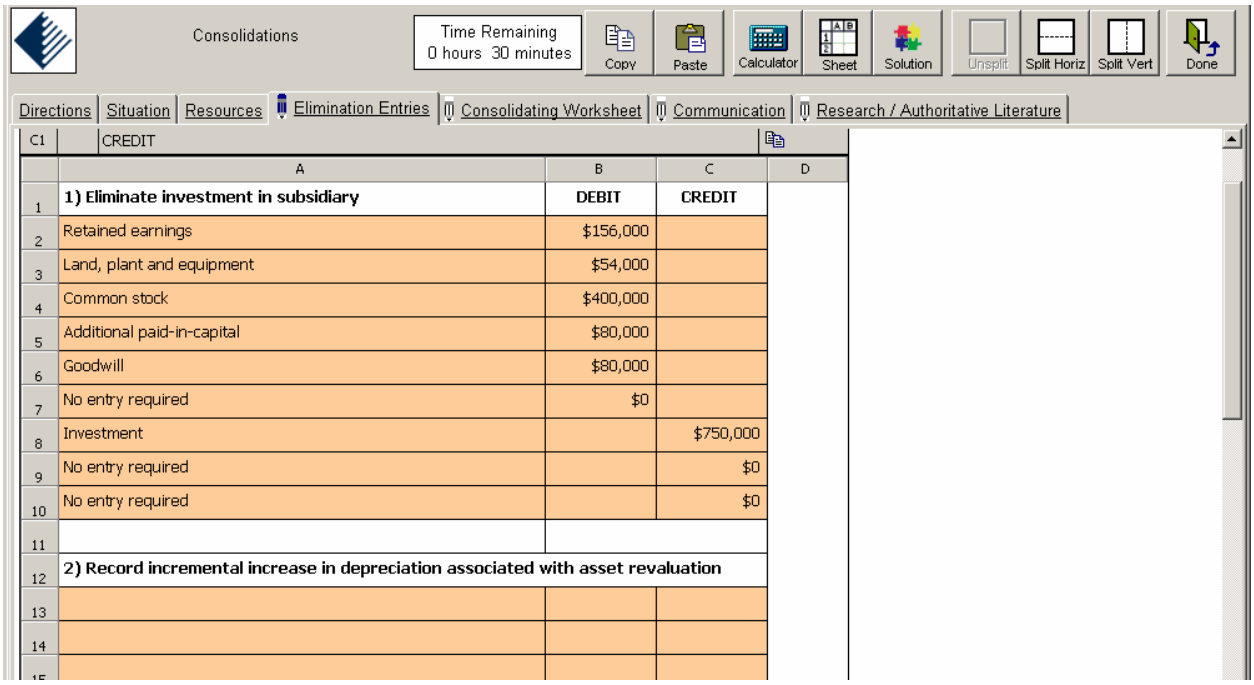


Consolidations | Time Remaining 0 hours 35 minutes | Copy | Paste | Calculator | Sheet | Solution | Unsplit | Split Horiz | Split Vert | Done

Directions | Situation | Resources | Elimination Entries | Consolidating Worksheet | Communication | Research / Authoritative Literature

Complete the following workpaper for consolidated financial statements by entering the correct amounts in the shaded cells in columns D and E. Not all shaded cells require an entry. Amounts entered in Column E do not have to be entered with a negative sign.

	A	B	C	D	E	F
1		Cain Corp.	Subsidiary	Adjustments & Eliminations		Adjusted
2	**Income Statement**	Dr (CR)	Company	Dr.	Cr.	Balance
3	Net sales	($3,800,000)	($1,500,000)			($5,300,000)
4	Dividends from Frey	($40,000)				($40,000)
5	Gain on sale of warehouse	($30,000)				($30,000)
6	Cost of goods sold	$2,360,000	$870,000			$3,230,000
7	Operating expense (incl. deprec.)	$1,100,000	$440,000			$1,540,000
8	Net income	($410,000)	($190,000)	$0	$0	($600,000)
9						
10	**Statement of Retained Earnings**					
11	Balance, 1/1/20x4	($440,000)	($156,000)			($596,000)
12	Net income **X8**	($410,000)	($190,000)	$0	$0	($600,000)
13	Dividends paid		$40,000			$40,000
14	Balance, 12/31/20x4	($850,000)	($306,000)	$0	$0	($1,156,000)
15	**X8**					
16	**Balance Sheet**					
17	Cash	$570,000	$150,000			$720,000



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Directions | Situation | Resources | Elimination Entries | Consolidating Worksheet | Communication | Research / Authoritative Literature

	A	B	C	D
1	**1) Eliminate investment in subsidiary**	**DEBIT**	**CREDIT**	
2	Retained earnings	$156,000		
3	Land, plant and equipment	$54,000		
4	Common stock	$400,000		
5	Additional paid-in-capital	$80,000		
6	Goodwill	$80,000		
7	No entry required	$0		
8	Investment		$750,000	
9	No entry required		$0	
10	No entry required		$0	
11				
12	**2) Record incremental increase in depreciation associated with asset revaluation**			
13				
14				

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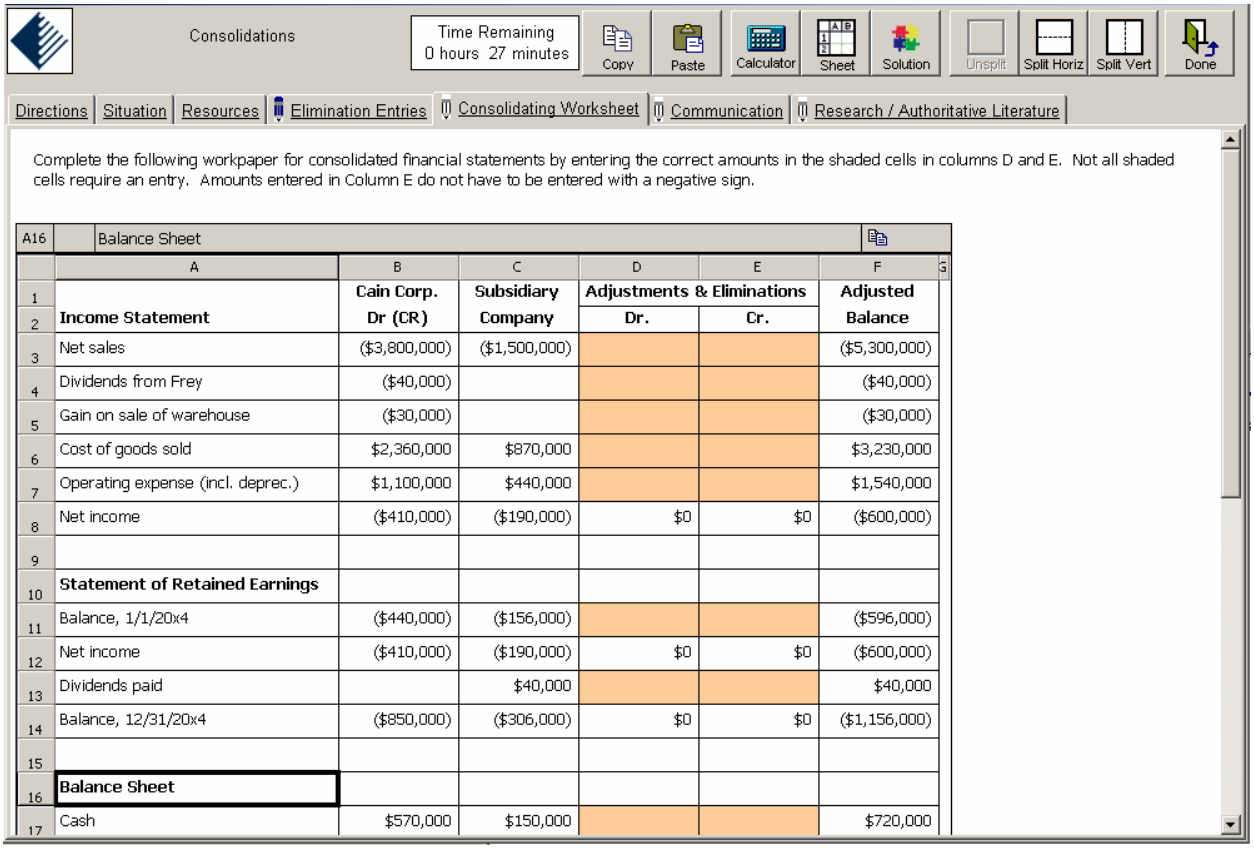

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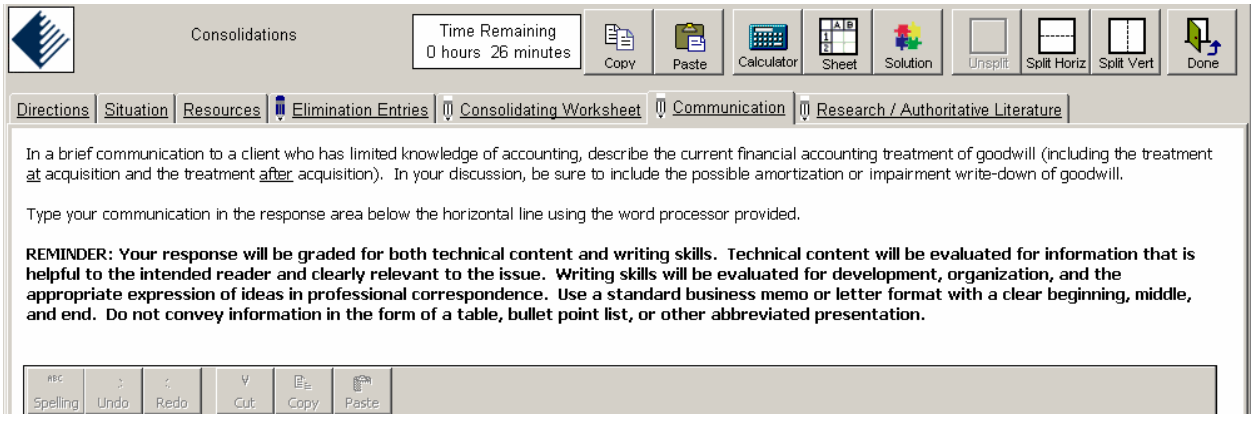
Directions | Situation | Resources | Elimination Entries | Consolidating Worksheet | Communication | Research / Authoritative Literature

Complete the following workpaper for consolidated financial statements by entering the correct amounts in the shaded cells in columns D and E. Not all shaded cells require an entry. Amounts entered in Column E do not have to be entered with a negative sign.

A16 Balance Sheet

	A	B	C	D	E	F
1		Cain Corp.	Subsidiary	Adjustments & Eliminations		Adjusted
2	**Income Statement**	Dr (CR)	Company	Dr.	Cr.	Balance
3	Net sales	($3,800,000)	($1,500,000)			($5,300,000)
4	Dividends from Frey	($40,000)				($40,000)
5	Gain on sale of warehouse	($30,000)				($30,000)
6	Cost of goods sold	$2,360,000	$870,000			$3,230,000
7	Operating expense (incl. deprec.)	$1,100,000	$440,000			$1,540,000
8	Net income	($410,000)	($190,000)	$0	$0	($600,000)
9						
10	**Statement of Retained Earnings**					
11	Balance, 1/1/20x4	($440,000)	($156,000)			($596,000)
12	Net income	($410,000)	($190,000)	$0	$0	($600,000)
13	Dividends paid		$40,000			$40,000
14	Balance, 12/31/20x4	($850,000)	($306,000)	$0	$0	($1,156,000)
15						
16	**Balance Sheet**					
17	Cash	$570,000	$150,000			$720,000



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Directions | Situation | Resources | Elimination Entries | Consolidating Worksheet | Communication | Research / Authoritative Literature

In a brief communication to a client who has limited knowledge of accounting, describe the current financial accounting treatment of goodwill (including the treatment at acquisition and the treatment after acquisition). In your discussion, be sure to include the possible amortization or impairment write-down of goodwill.

Type your communication in the response area below the horizontal line using the word processor provided.

REMINDER: Your response will be graded for both technical content and writing skills. Technical content will be evaluated for information that is helpful to the intended reader and clearly relevant to the issue. Writing skills will be evaluated for development, organization, and the appropriate expression of ideas in professional correspondence. Use a standard business memo or letter format with a clear beginning, middle, and end. Do not convey information in the form of a table, bullet point list, or other abbreviated presentation.

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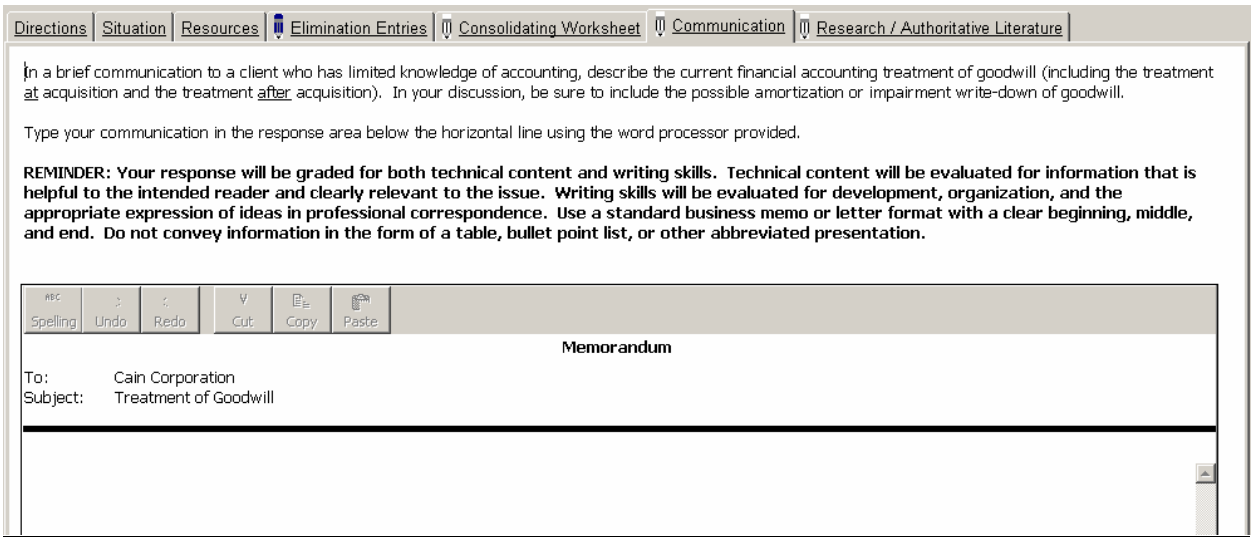

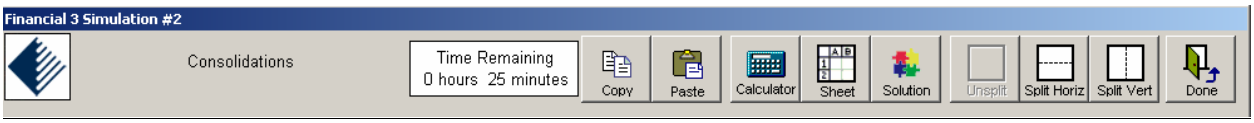

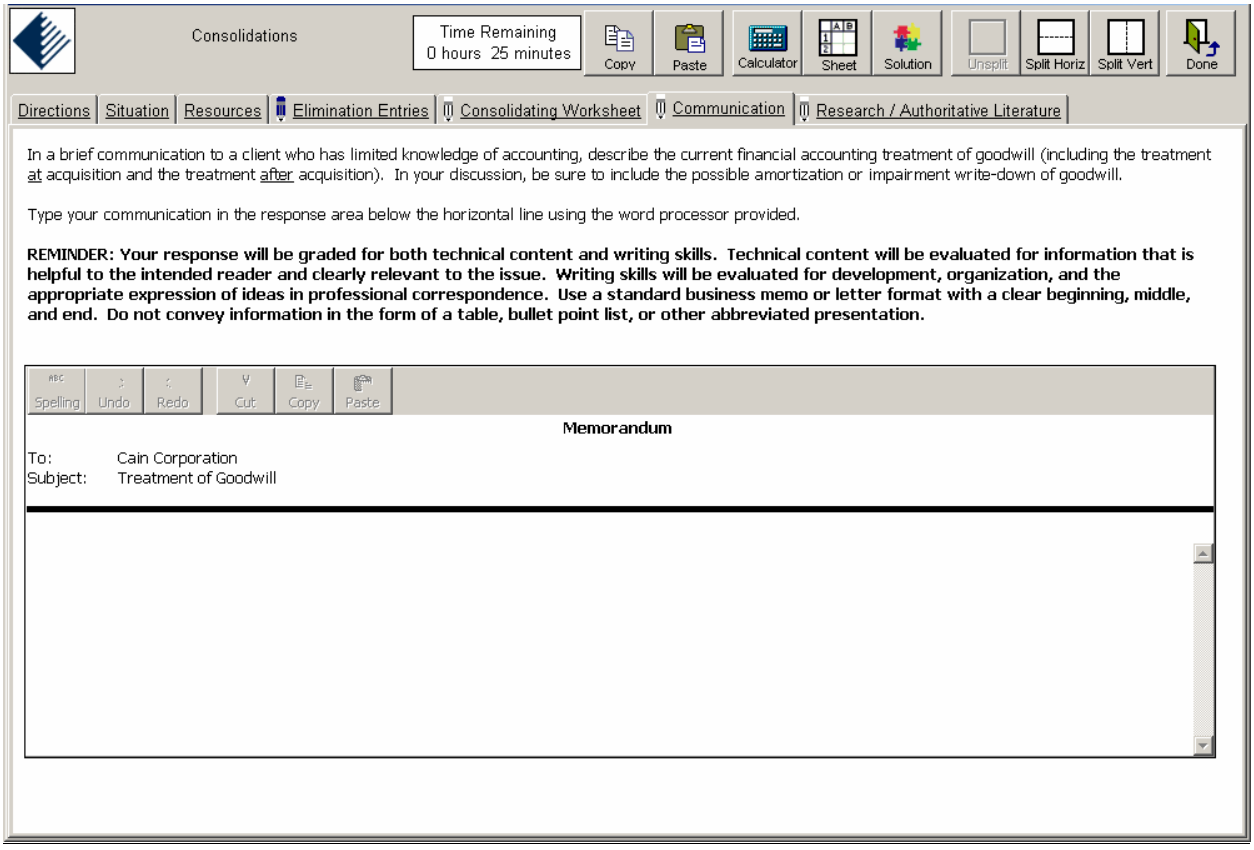

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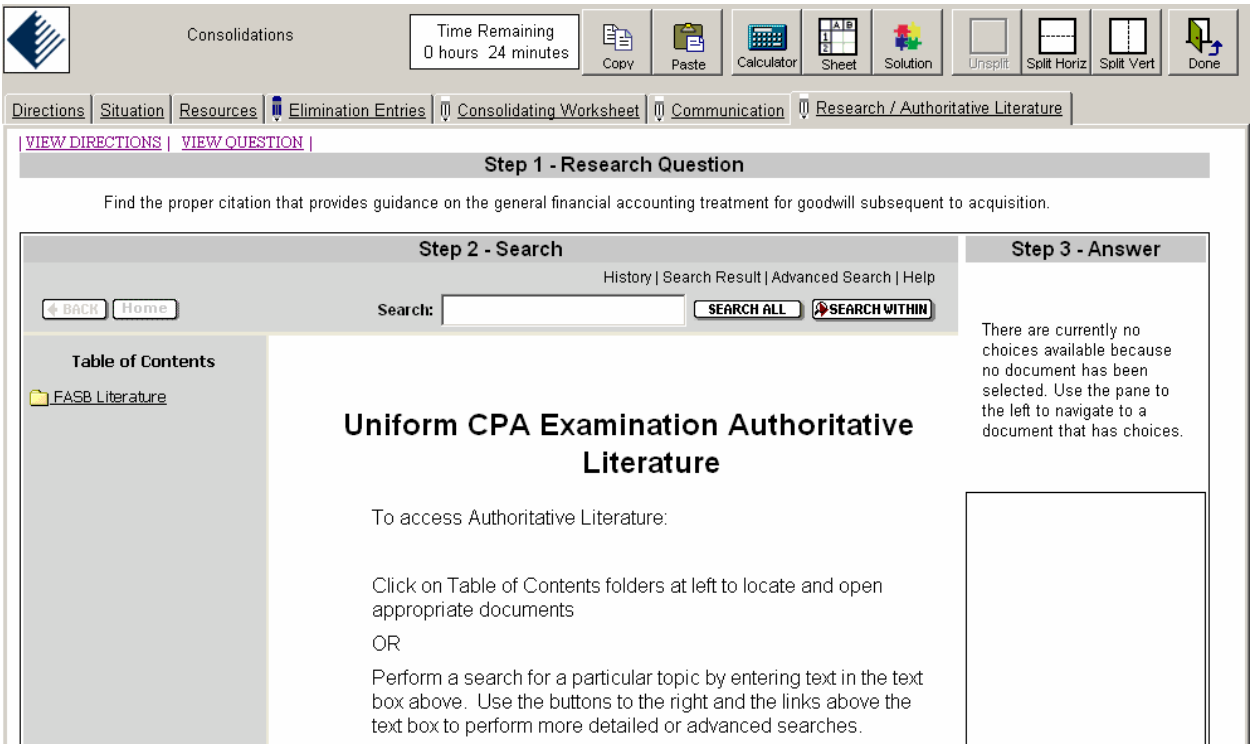

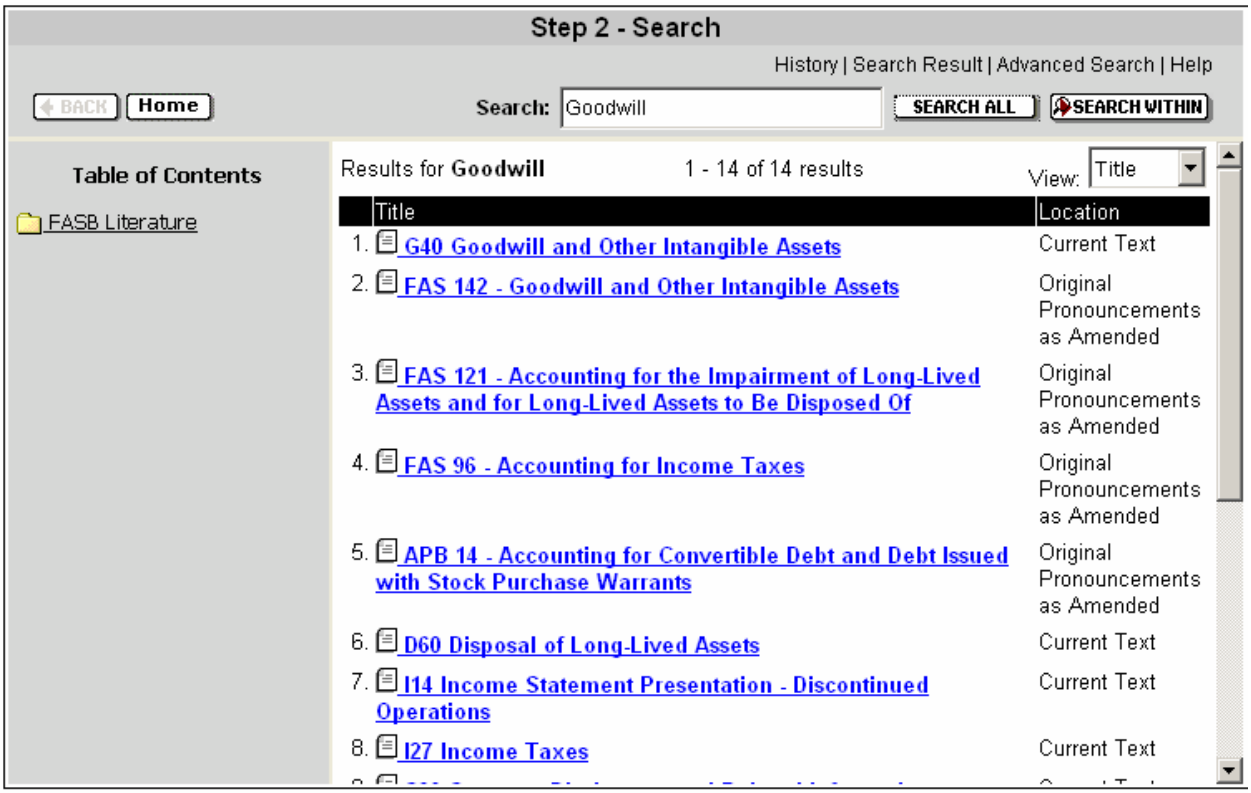

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FINANCIAL ACCOUNTING & REPORTING 3(A)

Class Questions Answer Worksheet

MC Question Number	First Choice Answer	Correct Answer	NOTES
1.			
2.			
3.			
4.			
5.			
6.			
7.			
8.			
9.			
10.			
11.			
12.			
13.			
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16.			
17.			
18.			
19.			
20.			

Grade:

Multiple-choice Questions Correct / 20 = _____% Correct

Detailed explanations to the class questions are located in the back of this textbook.

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NOTES

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CLASS QUESTIONS

1. CPA-00265

A company has adopted Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (as amended by SFAS 130). It should report the marketable equity securities that it has classified as trading at:

a. Lower of cost or market, with holding gains and losses included in earnings.
b. Lower of cost or market, with holding gains included in earnings only to the extent of previously recognized holding losses.
c. Fair value, with holding gains included in earnings only to the extent of previously recognized holding losses.
d. Fair value, with holding gains and losses included in earnings.

2. CPA-00273

Information regarding Stone Co's available-for-sale portfolio of marketable equity securities is as follows:

Aggregate cost as of 12/31/X2	$170,000
Market value as of 12/31/X2	148,000
Net realized gains during 20X2	30,000

At December 31, 20X1, Stone reported an unrealized loss of $1,500 to reduce investments to market value. This was the first such adjustment made by Stone on these types of securities. According to SFAS No. 115, in its 20X2 statement of comprehensive income, what amount of unrealized loss should Stone report?

a. $30,000
b. $20,500
c. $22,000
d. $0

3. CPA-00284

When a parent-subsidiary relationship exists, consolidated financial statements are prepared in recognition of the accounting concept of:

a. Reliability.
b. Materiality.
c. Legal entity.
d. Economic entity.

4. CPA-00283

Consolidated financial statements are typically prepared when one company has a controlling financial interest in another unless:

a. The subsidiary is a finance company.
b. The fiscal year-ends of the two companies are more than three months apart.
c. The subsidiary is in bankruptcy.
d. The two companies are in unrelated industries, such as manufacturing and real estate.

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5. CPA-00287

An investor uses the cost method to account for an investment in common stock. Dividends received this year exceeded the investor's share of investee's undistributed earnings since the date of investment. The amount of dividend revenue that should be reported in the investor's income statement for this year would be:

a. The portion of the dividends received this year that were in excess of the investor's share of investee's undistributed earnings since the date of investment.
b. The portion of the dividends received this year that were not in excess of the investor's share of investee's undistributed earnings since the date of investment.
c. The total amount of dividends received this year.
d. Zero.

6. CPA-00285

Plack Co. purchased 10,000 shares (2% ownership) of Ty Corp. on February 14, 2001. Plack received a stock dividend of 2,000 shares on April 30, 2001, when the market value per share was $35. Ty paid a cash dividend of $2 per share on December 15, 2001. In its 2001 income statement, what amount should Plack report as dividend income?

a. $20,000
b. $24,000
c. $90,000
d. $94,000

7. CPA-00320

On January 2, 1993, Well Co. purchased 10% of Rea, Inc.'s outstanding common shares for $400,000. Well is the largest single shareholder in Rea, and Well's officers are a majority on Rea's board of directors. Rea reported net income of $500,000 for 1993, and paid dividends of $150,000. In its December 31, 1993, balance sheet, what amount should Well report as investment in Rea?

a. $450,000
b. $435,000
c. $400,000
d. $385,000

8. CPA-00303

Band Co. uses the equity method to account for its investment in Guard, Inc. common stock. How should Band record a 2% stock dividend received from Guard?

a. As dividend revenue at Guard's carrying value of the stock.
b. As dividend revenue at the market value of the stock.
c. As a reduction in the total cost of Guard stock owned.
d. As a memorandum entry reducing the unit cost of all Guard stock owned.

9. CPA-00289

Birk Co. purchased 30% of Sled Co.'s outstanding common stock on December 31, 2000, for $200,000. On that date, Sled's stockholders' equity was $500,000, and the fair value of its identifiable net assets was $600,000. On December 31, 2000, what amount of goodwill should Birk attribute to this acquisition?

a. $0
b. $20,000
c. $30,000
d. $50,000

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10. CPA-00348

Park Co. uses the equity method to account for its January 1, 1990, purchase of Tun, Inc.'s common stock. On January 1,1990, the fair values of Tun's FIFO inventory and land exceeded their carrying amounts. How do these excesses of fair values over carrying amounts affect Park's reported equity in Tun's 1990 earnings?

	Inventory excess	*Land excess*
a.	Decrease	Decrease
b.	Decrease	No effect
c.	Increase	Increase
d.	Increase	No effect

11. CPA-00288

Puff Co. acquired 40% of Straw, Inc.'s voting common stock on January 2, 2001 for $400,000. The carrying amount of Straw's net assets at the purchase date totaled $900,000. Fair values equaled carrying amounts for all items except equipment, for which fair values exceeded carrying amounts by $100,000. The equipment has a five-year life. During 2001, Straw reported net income of $150,000. What amount of income from this investment should Puff report in its 2001 income statement?

a. $40,000
b. $52,000
c. $56,000
d. $60,000

12. CPA-00324

On January 1, 1992, Point, Inc. purchased 10% of Iona Co.'s common stock. Point purchased additional shares bringing its ownership up to 40% of Iona's common stock outstanding on August 1, 1992. During October 1992, Iona declared and paid a cash dividend on all of its outstanding common stock. How much income from the Iona investment should Point's 1992 income statement report?

a. 10% of Iona's income for January 1 to July 31, 1992, plus 40% of Iona's income for August 1 to December 31, 1992.
b. 40% of Iona's income for August 1 to December 31, 1992 only.
c. 40% of Iona's 1992 income.
d. Amount equal to dividends received from Iona.

13. CPA-00430

Company J acquired all of the outstanding common stock of Company K in exchange for cash. The acquisition price exceeds the fair value of net assets acquired. How should Company J determine the amounts to be reported for the plant and equipment and long-term debt acquired from Company K?

	Plant and equipment	*Long-term debt*
a.	K's carrying amount	K's carrying amount
b.	K's carrying amount	Fair value
c.	Fair value	K's carrying amount
d.	Fair value	Fair value

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14. CPA-00423

Penn Corp. paid $300,000 for the outstanding common stock of Star Co. At that time, Star had the following condensed balance sheet:

	Carrying amounts
Current assets	$ 40,000
Plant and equipment, net	380,000
Liabilities	200,000
Stockholders' equity	220,000

The fair value of the plant and equipment was $60,000 more than its recorded carrying amount. The fair values and carrying amounts were equal for all other assets and liabilities. What amount of goodwill, related to Star's acquisition, should Penn report in its consolidated balance sheet?

a. $20,000
b. $40,000
c. $60,000
d. $80,000

15. CPA-00389

A business combination is accounted for as a purchase. Which of the following expenses related to the business combination should be included, in total, in the determination of net income of the combined corporation for the period in which the expenses are incurred?

	Fees of finders and consultants	*Registration fees for equity securities issued*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

16. CPA-00391

On September 29, 1995, Wall Co. paid $860,000 for all the issued and outstanding common stock of Hart Corp. On that date, the carrying amounts of Hart's recorded assets and liabilities were $800,000 and $180,000, respectively. Hart's recorded assets and liabilities had fair values of $840,000 and $140,000, respectively. In Wall's September 30, 1995, balance sheet, what amount should be reported as goodwill?

a. $20,000
b. $160,000
c. $180,000
d. $240,000

17. CPA-00418

In a business combination accounted for as a purchase, the appraised values of the identifiable assets acquired exceeded the acquisition price. How should the excess appraised value be reported?

a. As negative goodwill.
b. As an extraordinary gain.
c. As a reduction of the values assigned to noncurrent assets and an extraordinary gain for any unallocated portion.
d. As positive goodwill.

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18. CPA-00455

Wright Corp. has several subsidiaries that are included in its consolidated financial statements. In its December 31, 1992, trial balance, Wright had the following intercompany balances before eliminations:

	Debit	*Credit*
Current receivable due from Main Co.	$ 32,000	
Noncurrent receivable from Main	114,000	
Cash advance to Corn Corp.	6,000	
Cash advance from King Co.		$15,000
Intercompany payable to King		101,000

In its December 31, 1992, consolidated balance sheet, what amount should Wright report as intercompany receivables?

a. $152,000
b. $146,000
c. $36,000
d. $0

19. CPA-00448

Perez, Inc. owns 80% of Senior, Inc. During 1992, Perez sold goods with a 40% gross profit to Senior. Senior sold all of these goods in 1992. For 1992 consolidated financial statements, how should the summation of Perez and Senior income statement items be adjusted?

a. Sales and cost of goods sold should be reduced by the intercompany sales.
b. Sales and cost of goods sold should be reduced by 80% of the intercompany sales.
c. Net income should be reduced by 80% of the gross profit on intercompany sales.
d. No adjustment is necessary.

20. CPA-00484

On January 1, 1990, Poe Corp. sold a machine for $900,000 to Saxe Corp., its wholly-owned subsidiary. Poe paid $1,100,000 for this machine, which had accumulated depreciation of $250,000. Poe estimated a $100,000 salvage value and depreciated the machine on the straight-line method over 20 years, a policy which Saxe continued. In Poe's December 31, 1990, consolidated balance sheet, this machine should be included in cost and accumulated depreciation as:

	Cost	*Accumulated depreciation*
a.	$1,100,000	$300,000
b.	$1,100,000	$290,000
c.	$900,000	$40,000
d.	$850,000	$42,500

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NOTES

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Financial Accounting & Reporting 3(B)

Please note that this chapter is to be used for exams beginning in July, 2009. If you are planning to sit for the CPA exam prior to July, 2009, then you will want to study with the Financial 3(A) chapter, which is also included in this textbook.

1. Marketable securities **3**
2. Business combinations / Consolidations **9**
3. Cost method (external reporting) **11**
4. Equity method (external reporting) **13**
5. Consolidated financial statements **21**
6. Acquisition method (external reporting) **22**
7. Intercompany transactions **46**
8. Combined financial statements / Push down accounting **53**
9. Homework reading: Pooling-of-interests method **54**
10. Simulation **65**
11. Class questions **71**

MARKETABLE SECURITIES

I. INVESTMENTS IN CERTAIN DEBT AND EQUITY SECURITIES

SFAS No. 115 addresses investments in certain equity securities that have readily determinable fair values. SFAS No. 115 also addresses investments in debt securities, which is covered in the Financial 5 class. Equity securities are defined as securities that represent an ownership interest in an enterprise or the right to acquire or dispose of an ownership interest in an enterprise at fixed or determinable prices.

A. DEFINITION OF EQUITY SECURITIES

1. Equity securities may be represented by:
   a. Ownership shares (common, preferred, and other forms of capital stock),
   b. Rights to acquire ownership shares (stock warrants, rights, and call options), and
   c. Rights to dispose of ownership shares (put options).
2. Equity securities do *not* include:
   a. Preferred stock redeemable at the option of the investor or stock that must be redeemed by the issuer,
   b. Treasury stock (the company's own stock repurchased and held), and
   c. Convertible bonds.

B. CLASSIFICATION

Securities should be classified into one of three categories, based on the intent of the company.

1. Trading Securities

Trading securities are those securities (both debt and equity) that are bought and held principally for the purpose of selling them in the near term. Trading securities generally reflect active and frequent buying and selling with the objective of generating profits on short-term differences in price. Securities classified as trading securities are generally reported as current assets, although they can be reported as noncurrent, if appropriate.

2. Available-for-Sale Securities

Available-for-sale securities are those securities (both debt and equity) not meeting the definitions of the other two classifications (trading or held-to-maturity). Securities classified as available-for-sale securities are reported as either current assets or noncurrent assets, depending on the intent of the corporation. If the security represents cash available for current operations, it would be appropriate to report the security as a current asset.

3. Held-to-Maturity Securities (Debt Securities Only)

Investments in debt securities are classified as held-to-maturity securities only if the corporation has the positive intent and ability to hold these securities to maturity. If the intent is to hold the security for an indefinite period of time, but not necessarily to maturity, then the security would be classified as available-for-sale. If a security can be paid or otherwise settled in a manner that the holder may not recover substantially all of its investment, the held-to-maturity category may not be used for the investment. Securities classified as held-to-maturity are reported as current or noncurrent assets, based on their time to maturity.

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II. VALUATION

Both categories of equity securities (trading and available-for-sale) are to be reported at fair value at the end of the current reporting period. Fair value is considered to be the market price of the security or what a willing buyer and seller would pay and accept to exchange the security, consistent with SFAS No. 157 – Fair Value. Changes in the fair value of trading and available-for-sale securities result in unrealized holdings gains or losses. How these gains or losses are reported in the financial statements depends upon the classification of the securities. Note that although two general ledger accounts are normally maintained (i.e., one for the original cost of the security and the other for the valuation account), the presentation on the balance sheet is one *net* amount. Held-to-maturity debt securities are valued at amortized cost.

A. UNREALIZED GAINS AND LOSSES—TRADING SECURITIES

Unrealized holding gains and losses on trading securities are included in earnings. Therefore, the unrealized loss on trading securities is shown in the income statement.

Journal Entry: To record loss on the Income Statement			
DR	Unrealized loss on trading securities	XXX	
CR	Valuation account (fair value adjustment)		XXX

B. UNREALIZED GAINS AND LOSSES—AVAILABLE-FOR-SALE SECURITIES

Unrealized holding gains and losses on available-for-sale securities (including those classified as current assets) are reported in other comprehensive income.

Journal Entry: To record unrealized loss reported in other comprehensive income			
DR	Unrealized loss on available-for-sale securities	XXX	
CR	Valuation account (fair value adjustment)		XXX

In the subsequent period, the security value will again be adjusted from the value it was carried at to the new fair value. For example, assume a stock is purchased on March 1, Year 2, at $24 and is valued at $27 at year-end, December 31, Year 2, and $28 on December 31, Year 3. There would be an unrealized gain in Year 2 of $3 and $1 in Year 3. Realized gains or losses are recognized when a security is disposed of. All realized gains or losses are recognized on the income statement.

SFAS 115 - Investments

Classification	Balance Sheet	Reported	Unrealized Gain/Loss	Cash Flow
Trading	Current or Noncurrent	Fair Value	Income Statement	Operating
Available-for-Sale Securities	Current or Noncurrent	Fair Value	Other Comprehensive Income (PUFE)	Investing
Held-to-Maturity Debt Securities	Current or Noncurrent	Amortized Cost	NONE	Investing

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C. RECLASSIFICATION

Any transfer of a particular security from one group (trading, available-for-sale, or held-to-maturity) to another group (trading, available-for-sale, or held-to-maturity) is accounted for at fair value. Any unrealized holding gain or loss on that security is accounted for as follows:

1. From Trading Category

The unrealized holding gain or loss at the date of transfer is already recognized in earnings and shall not be reversed.

2. To Trading Category

The unrealized holding gain or loss at the date of transfer shall be recognized in earnings immediately.

3. Debt Security Classified as Held-to-Maturity Transferred to Available-for-Sale

The unrealized holding gain or loss at the date of transfer shall be reported in other comprehensive income. Remember that this debt security was valued at amortized cost as a held-to-maturity security and is being transferred to a category valued at fair value.

4. Debt Security Classified as Available-for-Sale Transferred to Held-to-Maturity

The unrealized holding gain or loss at the date of transfer is already reported in other comprehensive income. The unrealized holding gain or loss shall be amortized over the remaining life of the security as an adjustment of yield in a manner consistent with the amortization of any premium or discount.

SUMMARY OF TRANSFERS BETWEEN CATEGORIES

FROM	TO	TRF ACCT FOR	UNREALIZED HOLDING GAIN/LOSS
Trading	Any other	FV	It has already been recognized in income so no adjustment is necessary
Any other	Trading	FV	Recognized in current earnings
Held-to-Maturity (Debt Securities)	Available-for-Sale	FV	Record in Other Comprehensive Income
Available-for-Sale (Debt Securities)	Held-to-Maturity (Debt Securities)	FV	Amortize gain or loss from Other Comprehensive Income with any bond premium/discount amortization

D. IMPAIRMENT OF SECURITIES

The enterprise needs to determine whether the decline in value below the adjusted or amortized cost of any security classified as either available-for-sale or held-to-maturity is other than temporary. If the decline in fair value is other than temporary, the cost basis of the individual security is written down to fair value as the new cost basis and the amount of the write-down is accounted for as a realized loss and included in earnings.

The new cost basis shall not be changed for subsequent recoveries in fair value. If the security is classified as available-for-sale, a subsequent increase in fair value shall be included in other comprehensive income. Subsequent decreases in fair value of available-for-sale securities, if not other than temporary, are also included in other comprehensive income and accounted for as an unrealized loss.

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III. FINANCIAL INSTRUMENTS USED TO HEDGE THE FAIR VALUE OF INVESTMENTS

A. USED TO HEDGE TRADING SECURITIES

Gains and losses on financial instruments that hedge trading securities should be reported in earnings, consistent with the reporting of unrealized gains and losses on the trading securities (covered in detail in class F-7).

B. USED TO HEDGE AVAILABLE-FOR-SALE SECURITIES

Gains and losses on derivative instruments that hedge available-for-sale securities are recognized currently in earnings together with the offsetting losses or gains on the available-for-sale securities attributable to the hedged risk (covered in detail in class F-7).

IV. SALE OF SECURITY

A sale of a security from any category results in a realized gain or loss and is reported on the income statement for the period. The valuation account, if used, would also have to be removed on the sale of a security. For trading securities, the realized gain or loss reported when the security is sold is the difference between the adjusted cost (original cost +/- unrealized gains/losses previously recognized on the income statement) and the selling price. For available-for-sale securities, the realized gain or loss reported when the security is sold is the difference between the selling price and the original cost of the security. Any unrealized gains or losses in accumulated other comprehensive income must be reversed at the time the security is sold.

Trading Securities				
DR	Cash		XXX	
CR		Trading security		XXX
CR		Realized gain on trading security (IDEA)		XXX
Available-for-Sale Securities				
DR	Cash		XXX	
DR	Unrealized gain on available-for-sale security (PUFE)		XXX	
CR		Available-for-sale security		XXX
CR		Realized gain on available-for-sale security (IDEA)		XXX

V. INCOME TAX EFFECTS

Tax effects of unrealized gains or losses entering into the determination of net income must be reflected in the computation of deferred income taxes, because unrealized gains and losses are not deductible for tax purposes.

However, the tax effects of unrealized capital losses should only be recognized when it is absolutely certain that the benefit will be realized by the offset of the capital losses against capital gains.

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VI. REQUIRED DISCLOSURES

The following information concerning securities classified as available-for-sale and separately for held-to-maturity securities must be disclosed in the financial statements or appropriate notes thereto:

(i) Aggregate fair value,

(ii) Gross unrealized holding gains and losses,

(iii) Amortized cost basis by major security type, and

(iv) Information about the contractual maturities of debt securities.

COMPREHENSIVE EXAMPLE

Marketable Securities

The following information pertains to Dayle, Inc.'s portfolio of marketable investments for the year ended December 31, 20X2:

	Cost	Fair value at 12/31/X1	20X2 activity Purchases	20X2 activity Sales	Fair value at 12/31/X2
Held-to-maturity securities					
Security ABC			$100,000		$ 95,000
Trading securities					
Security DEF	$150,000	$160,000			155,000
Available-for-sale securities					
Security GHI	190,000	165,000		$175,000	
Security JKL	170,000	175,000			160,000

Security ABC was purchased at par. All declines in fair value are considered to be temporary.

Required:

1. Calculate the carrying amount of each security on the balance sheet at December 31, 20X2.
2. Calculate any realized gain or loss on the 20X2 income statement.
3. Calculate any unrealized gain or loss on the 20X2 income statement.
4. Calculate any unrealized gain or loss to be reported at December 31, 20X2 as other comprehensive income.

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SOLUTION

(1) Carrying amount of each security at December 31, 20X2:

Security ABC $100,000

At year end, held-to-maturity investments are reported at their carrying value (amortized cost), not fair value. Carrying value of security ABC is the purchase price of $100,000.

Security DEF $155,000

The year end carrying amount of trading investments is the fair value at year end. Fair value of security DEF is $155,000.

Security GHI was sold

Security JKL $160,000

The year end carrying amount of available for sale investments is the fair value at year end. Fair value of security JKL is $160,000.

(2) Realized gain or loss on income statement:

Security GHI ($15,000)

The $175,000 sales proceeds less the $190,000 cost yields a realized loss of $15,000.

(3) Unrealized gain or loss on income statement:

Security DEF ($5,000)

Only adjustments to trading securities valuations are reported on the income statement. The $160,000 carrying value of the trading securities must be reduced to the $155,000 fair value and an income statement unrealized loss of $5,000 is recognized.

(4) Unrealized gain or loss (current year change)—other comprehensive income:

Security JKL & GHI (net) $10,000

			Valuation Allowance Account (contra-asset account) DR <CR>	Current Year Unrealized <Gain> Loss OCI DR <CR>	Accumulated OCI (contra-equity account) DR <CR>
Beginning Balance:					
JKL ($175,000 – 170,000)	=	5,000			
GHI ($165,000 – 190,000)	=	<25,000>			
			<20,000>		20,000
Activity:					
JKL ($160,000 – 175,000)	=		<15,000>	15,000	
GHI (Sold / Reverse)	=		25,000	<25,000>	
Subtotal				<10,000>	
Close				$10,000	<10,000>
Ending Balance			<10,000>	—	10,000

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BUSINESS COMBINATIONS/CONSOLIDATIONS

I. PRESUMPTION

The presumption is that consolidated financial statements are more meaningful than parent company financial statements and/or parent company financial statements together with separate subsidiary financial statements.

A. Consolidated financial statements (including segment reporting) are necessary for fair presentation.

B. The equity method is not a valid substitute for consolidation (SFAS 94).

C. Consolidate regardless of method of acquisition (acquisition or pooling of interests).

II. CONSOLIDATED FINANCIAL STATEMENTS

Consolidated financial statements ignore important legal relationships and emphasize economic substance over form. Consolidated financial statements are an economic truth but a legal fiction.

III. LIMITATIONS OF CONSOLIDATED FINANCIAL STATEMENTS

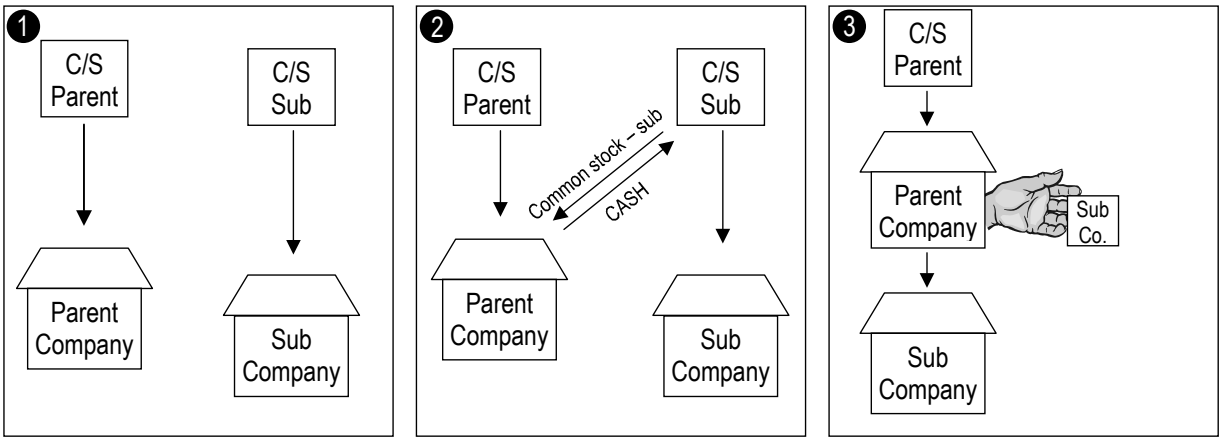
A. Minority shareholders, creditors, and bondholders of the subsidiary remain uninformed regarding the subsidiary's financial statements.

B. Weak performance of one company (entity) may be offset by the strong performance of another company.

C. Ratio analysis of consolidated data is not reliable. For example:

1. Poor income statement results of individual subsidiaries are hidden.
2. Intercompany eliminations affect ratios.

D. Retained earnings available for parent shareholders (the account from which dividends are paid) are not segregated nor otherwise indicated.



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IV. CRITERIA OF WHEN TO AND WHEN NOT TO CONSOLIDATE

A. Consolidate ALL majority-owned subsidiaries (over 50% of the voting interest is owned by parent company) to have one management and one economic entity. This includes domestic, foreign, similar, and dissimilar subsidiaries (per SFAS 94, 141-R, 160).

B. DO NOT consolidate when:

Control is not with owners (e.g., under legal reorganization or when control of a subsidiary is with a trustee).

C. It is OK to consolidate companies that have different year ends. The subsidiary merely prepares special financial statements to correspond closely with the parent's fiscal year end. If the year ends differ by three months or less, the parent company can use the subsidiary's regular financial statements of a different period, giving recognition to material intervening events, to expedite the consolidation process.

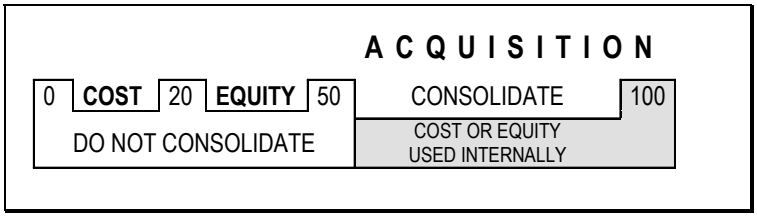
D. In a vertical chain, where parent company owns more than 50% of a subsidiary company and the subsidiary owns more than 50% of a third company, consolidate:

1. Third company into subsidiary company.
2. Subsidiary company (now consolidated with third company) into parent company.

V. DEGREE OF CONTROL

The degree of control the investor has over the investee dictates how the investor accounts for the investment in corporate equity securities.

Consolidation: A combination of the financial statements of two or more entities into a single set of financial statements representing a single economic unit.



A. COST METHOD/DO NOT CONSOLIDATE = NO SIGNIFICANT INFLUENCE (TYPICALLY <20%)

The investor accounts for the investment using the cost method if the investor does not have the ability to exercise significant influence over the investee. Follow the rules of marketable equity securities and account for the investment as either trading or available-for-sale securities.

B. EQUITY METHOD/DO NOT CONSOLIDATE = SIGNIFICANT INFLUENCE BUT 50% OR LESS OWNERSHIP (TYPICALLY 20% - 50%)

The investor accounts for the investment using the equity method of accounting if the investor can exercise significant influence over the investee and holds 50% or less of the voting stock.

C. CONSOLIDATE = CONTROL (GREATER THAN 50% OWNERSHIP)

The investor should prepare consolidated financial statements with its investees when the investor has control (more than 50% ownership) of the subsidiary. Internally, the investor may use either the cost method or the equity method to account for its investments.

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COST METHOD
(External Reporting)

I. COST METHOD (<20% / DOES NOT EXERCISE SIGNIFICANT INFLUENCE)

The cost method should be used when the investor owns less than 20% of the investee's voting stock and does not exercise significant influence. Lacking evidence to the contrary, it is assumed that no significant influence can be exercised from 0%-20%. The original investment under the cost method is accounted for in the same manner as marketable equity securities.

If a company owns less than 20% of the stock of an investee company, but exercises significant influence, the equity method must be used.

A. BALANCE SHEET: "INVESTMENT IN INVESTEE"

1. The carrying amount of the investments account on the investor's (parent's) books is "original cost," measured by the FV of the consideration given, including legal fees. The investment account stays the same from the date of acquisition unless:
   a. Shares of stock in the subsidiary are purchased or sold.
   b. There is an accumulated dividend in excess of accumulated earnings resulting in a return of capital (called a liquidating dividend).
   c. The basis is adjusted to FV as required for marketable equity securities (SFAS 115).
   d. The subsidiary incurs losses that substantially reduce net worth from the date of acquisition.

2. Record at Cost

a. All costs of acquisition. (FV of consideration plus legal fees)

DR	Investment in investee	$XXX	
CR	Cash		$XXX

3. Marketable Securities – Adjust to FV

a. Adjust to FV at year-end. (Decrease in FV)

DR	Unrealized holding losses	$XXX	
CR	Investment in investee (or valuation account)		$XXX

b. Adjust to FV at year-end. (Increase in FV)

DR	Investment in investee (or valuation account)	$XXX	
CR	Unrealized holding gains		$XXX

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4. Reduce Investment in Investee for Return of Capital Distributions

a. Return of capital/liquidating dividend—(dividend in excess of investor's share of retained earnings).

DR	Cash	$XXX	
CR	Investment in investee		$XXX

Note: For tax purposes, a return of capital/liquidating dividend exists when the dividend is in excess of the investor's share of the corporation's earnings and profits. Earnings and profits is a very similar concept to retained earnings, but the two are not always calculated the same way.

B. INCOME STATEMENT

Record cash dividends from the investee's earnings and profits. Do not recognize stock dividends.

1. Dividends to the Investor/Parent (from Investee) are Income (Earnings) to the Investor/Parent

The cost method does not recognize a pro rata share of the investee's earnings as income to the investor/parent.

DR	Cash	$XXX	
CR	Dividend income		$XXX

2. Distribution that Exceeds Investor's Share of the Investee's Retained Earnings (Reduce Basis / Return of Capital Distribution)

DR	Cash	$XXX	
CR	Investment in investee		$XXX

PASS KEY

The following three issues are the most frequently tested "cost" concepts:

- The "Investment in Investee" is **not** adjusted for investee earnings.
- The "Investment in Investee" is adjusted to FV (per FASB 115).
- Cash dividends from the investee are reported as income by the investor (parent).

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EQUITY METHOD
(External Reporting)

I. EQUITY METHOD (20%–50% / EXERCISES SIGNIFICANT INFLUENCE)

The equity method is used to account for investments if significant influence can be exercised by the investor over the investee. The critical criterion for using the equity method is that the investor exerts significant influence over the operating and financial policies of the investee. If no direct evidence of significant influence exists, ownership of 20% to 50% of the investee's voting stock is deemed to represent significant influence.

Under the equity method the investment is originally recorded at the price paid to acquire the investment. The investment account is subsequently adjusted as the net assets of the investee change through the earning of income and payment of dividends. The investment account increases by the investor's share of the investee's net income with a corresponding credit to the investor's income statement account, Equity in Subsidiary/Investee Income. The distribution of dividends by the investee reduces the investment balance. Continuing losses by a subsidiary/investee may result in a decrease of the investment account to a zero balance. In addition, consolidated statements should be presented when ownership is greater than 50%.

A. EXERCISES SIGNIFICANT INFLUENCE

A company that owns 20%–50% of voting stock of another "investee" company is presumed to be able to exercise "significant influence" over the operating and financial policies of that investee and, therefore, must use the equity method when presenting the investment in that investee in:

1. Consolidated financial statements that include other consolidated entities, but not that investee, or
2. Unconsolidated parent company financial statements.
3. Equity method not appropriate (even if investor owns 20% to 50% of subsidiary):
    a. Bankruptcy of subsidiary.
    b. Investment in subsidiary is temporary.
    c. A lawsuit or complaint is filed.
    d. A "standstill agreement" is signed (under which the investor surrenders significant rights as a shareholder).
    e. Another small group has majority ownership and they operate the company without regard to the investor.
    f. The investor cannot obtain the financial information necessary to apply the equity method.
    g. The investor cannot obtain representation on the Board of Directors.

PASS KEY

The CPA Examination frequently presents questions where the ownership percentage is below 20%, but the "ability to exercise significant influence" exists. The **equity method** is the correct method of accounting for these investments.

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B. BALANCE SHEET – "Investment in investee" using equity.

1. Record at cost (FV of consideration plus legal fees)

DR	Investment in investee	$XXX	
CR	Cash		$XXX

2. Increase by the Investor's/Parent's ownership percentage of earnings of investee

DR	Investment in investee	$XXX	
CR	Equity in earnings/investee income		$XXX

3. Decrease by the Investor's/Parent's ownership percentage of cash dividends from investee (stock dividends reduce unit cost of stock owned in investee)

DR	Cash	$XXX	
CR	Investment in investee		$XXX

C. INCOME STATEMENT – Record the Investor's/Parent's ownership percentage of earnings as income (dividends are not income, treat as bank withdrawals).

1. Investee earnings (Investor's/Parent's percentage ownership of investee)

DR	Investment in investee	$XXX	
CR	Equity in earnings/investee income		$XXX

2. Investee cash dividends (Not income/lower investment like bank withdrawal)

DR	Cash	$XXX	
CR	Investment in investee		$XXX

PASS KEY

An easy way to remember all the GAAP accounting rules for the "equity method" is to think of it like a **bank account** and use your **base** account analysis:

(B) **B**eginning Balance

(A) **A**dd: Investee's earning (like bank interest; it is income when earned, not when taken out).

(S) **S**ubtract: Investee's dividends (like bank withdrawals; and it is not income)

(E) **E**nding Balance

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EXAMPLE

Equity Method

On January 1, Year 1, Big Corporation acquired a 40% interest in Small Company for $300,000. Total stockholders' equity on the date of acquisition consisted of capital stock (common, $1 par) of $500,000 and $250,000 in retained earnings, therefore, no differentiation [$300,000 = .40(500,000 + 250,000)]. During Year 1 Small Co. had net income of $90,000 and paid a $40,000 dividend.

Journal Entry: To record the initial investment of 40%

DR	Investment in Small Co. (40%)	$300,000	
CR	Cash		$300,000

Journal Entry: To recognize the investee's net income (40% x $90,000)

DR	Investment in Small Co. (40% x $90,000)	$36,000	
CR	Equity in investee income		$36,000

Journal Entry: To recognize the dividend paid by the investee (40% x $40,000)

DR	Cash	$16,000	
CR	Investment in Small Co. (40% x $40,000)		$16,000

On December 31, Year 1, the investment account on the balance sheet would show $320,000 ($300,000 + $36,000 - $16,000), and the income statement would show $36,000 as Big's equity in subsidiary income.

D. DIFFERENCES BETWEEN THE PURCHASE PRICE AND BOOK VALUE (NBV) OF THE INVESTEE'S NET ASSETS

Additional adjustments to the investment account under the equity method result from differences between the price paid for the investment and the book value of the investee's net assets. This difference is first attributable to:

1. Asset FV

Differences between the book value and fair value of the net assets acquired.

2. Goodwill

Any remaining difference is goodwill.

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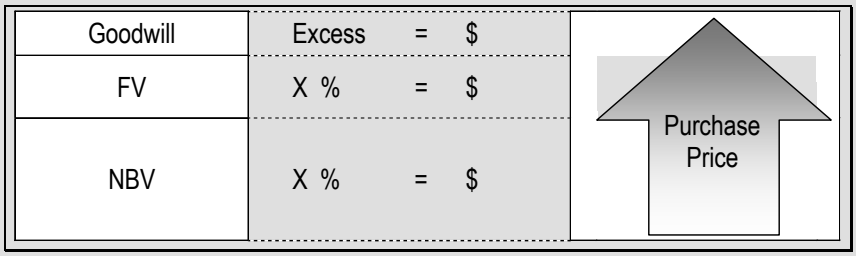
PASS KEY

An easy way to solve this type of question is to set up a building block box and plug in the respective dollar amounts and then compare to the purchase price:



3. Amortize Asset FV Difference (Premium) Over Related Asset Life

The fair value excess (asset FV) would be amortized over the life of the underlying asset (excess caused by land is not amortized). This additional amortization causes the investor's share of the investee's net income to decrease. Amortization of cost (purchase price) over NBV of assets acquired only affects the parent's investment account, "investment in subsidiary," on the books of the parent under the "Equity Method," not under the "Cost Method."

DR	Equity in investee income	$XXX	
CR	Investment in investee		$XXX

4. Goodwill Difference: Not Amortized and No Impairment Test

The fair value excess attributable to goodwill is not subject to the impairment test. Acquired goodwill is no longer amortized.

PASS KEY

To better understand the journal entry and its impact, think of the amortization of excess purchase price (premium) as a bank service charge. The "equity method", which we treat like a bank account, will have the account balance (balance sheet asset) reduced by this "bank service charge" and also will have the **net** earnings from the account reduced by this (service) charge.

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EXAMPLE

Equity Method

On January 1, Year 1, Big Corporation acquired a 40% interest in Small Company for $500,000 cash. At the date of acquisition, Small Co.'s net assets had a book value of $875,000 and a fair value of $1,000,000. The difference between the book value and fair value relates to equipment being depreciated over a remaining useful life of ten years. Small Co.'s net income for Year 1 was $320,000. During Year 1, Small Co. declared and paid $120,000 in cash dividends.

1. Investment and Subsidiary Activity:

Journal Entry: To record the initial investment

DR	Investment in Small Co. (40%)	$500,000	
CR	Cash		$500,000

Journal Entry: To recognize the investee's net income

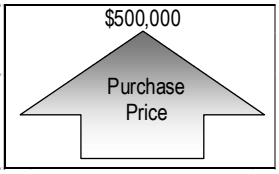
DR	Investment in Small Co. (40% x $320,000)	$128,000	
CR	Equity in investee income		$128,000

Journal Entry: To recognize the dividend paid by the investee

DR	Cash	$48,000	
CR	Investment in Small Co. (40% x $120,000)		$48,000

2. Asset Adjustment and Depreciation:

Goodwill		Excess	=	
FV	$1,000,000	X 40%	=	$400,000
NBV	$875,000	X 40%	=	$350,000



Journal Entry: To record depreciation on undervalued equipment ($50,000 ÷ 10 years)

DR	Equity in investee income	$5,000	
CR	Investment in Small Co.		$5,000

3. Goodwill:

Goodwill, the excess of the purchase price over the fair value of net assets:

Purchase price of the investment in Small Co.	$500,000
Less: Fair value of Big's Co. equity in net assets of Small Co. (40% x 1,000,000)	(400,000)
Goodwill	$100,000

On December 31, Year 1, Big's Co. investment in Small Co. account would show a balance of $575,000 ($500,000 + $128,000 - $48,000 - $5,000), and the income statement would show $123,000 ($128,000 - $5,000) equity in investee income.

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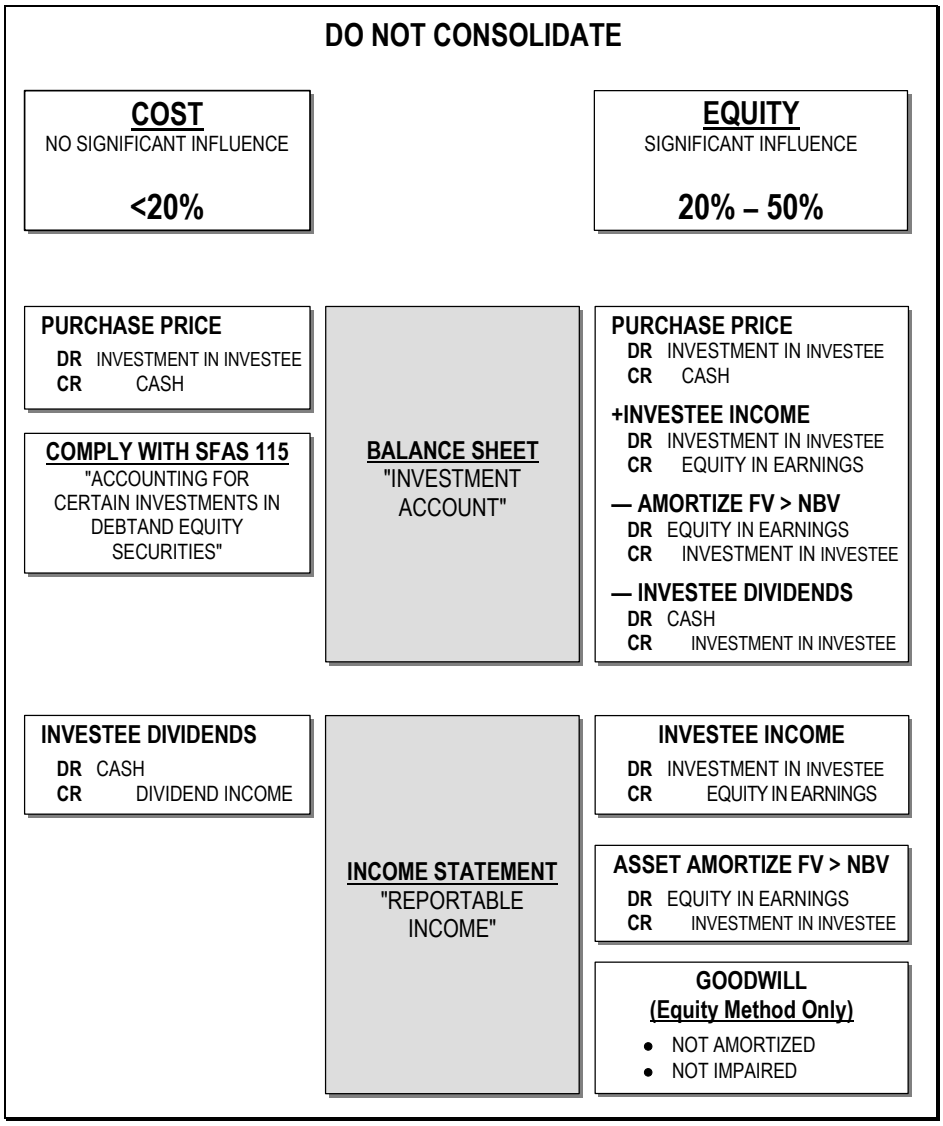
E. UNCONSOLIDATED INVESTMENT OF OVER 50% (EQUITY METHOD REQUIRED)

A parent company that does not consolidate a 50%+ owned subsidiary (e.g., lack of control due to a company being controlled by a bankruptcy trustee, or a subsidiary that is likely to be a temporary investment) must use the equity method when presenting the investment in that sub in:

1. Consolidated financial statements (without that sub being consolidated).
2. Unconsolidated parent company financial statements are NOT allowed to be issued to stockholders as the "primary reporting entity" (SFAS 94). However, they may be presented as a supplemental disclosure.

II. COMPARISON OF COST AND EQUITY METHODS



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III. STEP-BY-STEP ACQUISITION (STILL NOT CONSOLIDATING)

A corporation may acquire an investment in investee in more than one transaction. In this case, any goodwill must be computed at the time of each transaction.

A. CHANGE FROM COST METHOD TO EQUITY METHOD

When significant influence is acquired, it is necessary to record a change from the cost/available-for-sale classification to the equity method. The investment account and the retained earnings account are adjusted retroactively for the difference between the available-for-sale classification/cost method to the equity method.

1. To Equity from Cost

When two or more purchases of stock cause ownership in an investee corporation to go from not having significant influence (< 20%) to having significant influence (≥ 20% but less than 50%):

a. The equity method should be used and the periods during which the cost method (fair value) was used are retrospectively adjusted.

b. The year-end ownership percentage is used to make all equity entries.

2. Equity in Investee Income Calculation:

When the additional investment is made sometime during the year, the investor will calculate its share of the investee's income by multiplying the:

a. Investee's income by the fraction of the year that the cost method (available-for-sale) was used and the percentage ownership before the change.

b. This will then be added to the investee's income multiplied by the fraction of the year remaining and the percentage of ownership after the change.

3. Common Stock and Preferred Stock

If an investor company owns both common and preferred stock of an investee company:

a. The "significant influence" test is mostly met by the amount of common stock owned (which is usually the only voting stock).

b. The calculation of equity in earnings of subsidiary / income from subsidiary (or investee) includes:

(1) Preferred stock dividends, and

(2) Share of earnings available to common shareholders (net income reduced by preferred dividends).

PASS KEY

The key to answering questions relating to this issue correctly is to:

- Apply the new method (equity) to the prior period's old percentage (1 - < 20%).
- Do **not** apply the new percentage to the prior period (you did not own that percentage back then!).

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EXAMPLE

Adjustments to Convert from Available-for-Sale Classification to Equity Method

On January 1, Year 1, Big Co. paid $20,000 for a 15% interest in Small Co. Big Co. does not have significant influence over Small Co. The book value of net assets was $120,000. Any excess is attributable to a building with a 40-year life. Net income reported by Small Co. during Year 1 was $35,000. Big Co.'s share of dividends declared by Small Co. amounted to $750. The market value of the investment was $17,000 on December 31, Year 1. Under the cost method (available-for-sale treatment), in Year 1 Big Co. would record dividend income but would not recognize net income reported by Small Co. nor amortize any asset premium (related to the building).

On January 1, Year 2, Big Co. increased its ownership in Small Co. to 50%, paying $60,000. The fair value and book value of Small Co.'s net assets at January 1, Year 2 were $108,000.

On January 1, Year 2, Big Co. would record its additional investment and make the following adjustments to retroactively convert from the available-for-sale treatment to the equity method.

Schedule 1: Building (premium) resulting from the investment on January 1, Year 1.

Price paid/Cost of the January 1, Year 1 investment	$20,000
NBV of the net assets acquired ($120,000 x 15%)	(18,000)
Building (premium)	$ 2,000
Building (premium) will be amortized over 40 years (equity method only)	÷ 40 yrs.
$2,000 ÷ 40 = $50 amortization per year (equity method only)	$ 50.00

Schedule 2: Calculation of the retroactive adjustment to the equity method at January 1, Year 2.

Equity Method:		
Year 1 investment (at cost)	$20,000	
Equity method adjustments:		
Plus: Share of Small Co.'s net income ($35,000 x 15%)	5,250	
Less: Dividends received	(750)	
Less: Amortization of building (premium) ($2,000 ÷ 40)	(50)	
Balance of the investment account under the equity method	$24,450	[1]
Cost/Available-for-Sale Treatment:		
Yr 1 Dec. 31, investment balance at market value	$17,000	[2]
Total adjustment to investment ([1] – [2])	$ 7,450	
Adjustment to unrealized loss on available-for-sale securities	(3,000)	
Retroactive adjustment to Retained Earnings	$ 4,450	

Journal Entry: To record the retroactive adjustment to the investment and retained earnings account and write off the unrealized loss on available-for-sale securities

DR	Investment in Small Co.	$7,450	
CR	Retained earnings		$4,450
CR	Unrealized loss on available-for-sale securities		$3,000

Journal Entry: To record the additional investment at January 1, Year 2

DR	Investment in Small Co.	$60,000	
CR	Cash		$60,000

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CONSOLIDATED FINANCIAL STATEMENTS

I. CONSOLIDATED FINANCIAL STATEMENTS

A. CONTROL (OVER 50%)

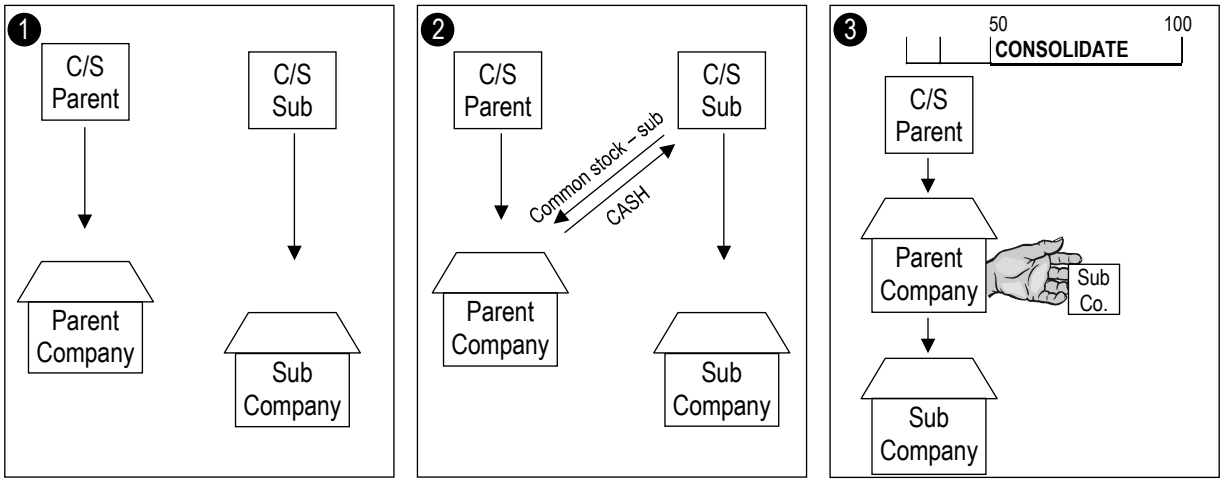
Consolidated financial statements are prepared when a parent-subsidiary relationship has been formed. An investor is considered to have parent status when control over an investee is established or more than 50% of the voting stock of the investee has been acquired.

All majority-owned subsidiaries (domestic and foreign) must be consolidated except when significant doubt exists regarding the parent's ability to control the subsidiary, such as when:

1. The subsidiary is in legal reorganization or
2. Bankruptcy and/or the subsidiary operates under severe foreign restrictions.

B. ACQUISITION METHOD VS. POOLING OF INTERESTS

Acquisition and pooling of interests are methods used to record the acquisition of a subsidiary and are each acceptable in accounting for business combinations under certain circumstances. An investment in the stock or net assets of another corporation is accounted for as a pooling of interests if all of the conditions necessary for a pooling of interests have been met (and it had been completed and/or initiated prior to June 30, 2001).



C. ACQUISITION METHOD: FUNDAMENTAL PRINCIPLES

Main principles for applying the Acquisition Method:

1. Recognition Principle

The acquirer recognizes all of the assets acquired and all of the liabilities assumed.

2. Measurement Principle

The acquirer measures each recognized asset acquired and each liability assumed and any noncontrolling interest at its acquisition date fair value.

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ACQUISITION METHOD
(External Reporting)

I. ACQUISITION METHOD

In a business combination accounted for as an acquisition, the subsidiary may be acquired for cash, stock, debt securities, etc. The investment is valued at the fair value of the consideration given or the fair value of the consideration received, whichever is the more clearly evident. The accounting for an acquisition begins at the date of acquisition.

(i) Acquistion for Cash

DR	Investment in subsidiary	$XXX	
CR	Cash		$XXX

(ii) Acquistion for Parent Common Stock (use FV at Date Transaction Closes)

DR	Investment in subsidiary	$XXX	
CR	Common stock (Parent at par)		$XXX
CR	A.P.I.C. (Parent/FV—par)		$XXX

EXAMPLE 1

Date of Purchase – Stock Price Goes Up

FACTS:

- TAG Inc. announces that it has agreed to buy a Sub Co. on April 1, 200X for 1 million shares of its own common stock.
- Transaction closes on September 30, 200X – 1 million shares issued.

Market Price of Stock	Stock Price Goes Up
4/1/0X (Announced)	$10
9/30/0X (Closed)	$14

Acquisition Price		SFAS 141-R
1,000,000 x $14	=	$14,000,000

EXAMPLE 2

Date of Purchase – Stock Price Goes Down

FACTS:

- TAG Inc. announces that it has agreed to buy a Sub Co. on April 1, 200X for 1 million shares of its own common stock.
- Transaction closes on September 30, 200X – 1 million shares issued.

Market Price of Stock	Stock Price Goes Up
4/1/0X (Announced)	$10
9/30/0X (Closed)	$ 7

Acquisition Price		SFAS 141-R
1,000,000 x $7	=	$7,000,000

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A. APPLICATION OF THE ACQUISITION METHOD

The acquisition method has two distinct accounting characteristics: (1) 100% of the net assets acquired (regardless of percentage acquired) are recorded at fair value with any unallocable balance remaining creating goodwill, and (2) when the companies are consolidated, the subsidiary's entire equity (including its common stock, APIC, and retained earnings) is eliminated (not reported).

PASS KEY

The parent's basis is the acquisition price, which is also the fair market value of the subsidiary on the day of acquisition. The easy to remember formula is:

FV = Acquisition Price = Investment in Sub

An acquiring corporation should adjust the following items during consolidation:

1. Common Stock, A.P.I.C. and Retained Earnings of Subsidiary are Eliminated

The pre-acquisition equity (common stock, APIC and retained earnings) of the subsidiary is not carried forward in an acquisition. Consolidated equity will be equal to the parent's equity balance (plus any Noncontrolling (Minority) Interest). The subsidiary's equity is eliminated by debiting each of the subsidiary's equity accounts in the Eliminating Journal Entry (EJE) on the consolidating workpapers.

2. Investment in Subsidiary is Eliminated

The parent company will eliminate the "Investment in Subsidiary" account on their balance sheet as part of the Eliminating Journal Entry (EJE). This credit will be posted on the consolidating workpapers.

3. Noncontrolling (Minority) Interest is Created

As part of the Eliminating Journal Entry (EJE) on the consolidating workpapers, the fair value of any portion of the subsidiary that is not acquired, must be recorded to an account reported in the equity section of the consolidated financial statements.

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4. Balance Sheet of Subsidiary is Adjusted to Fair Value

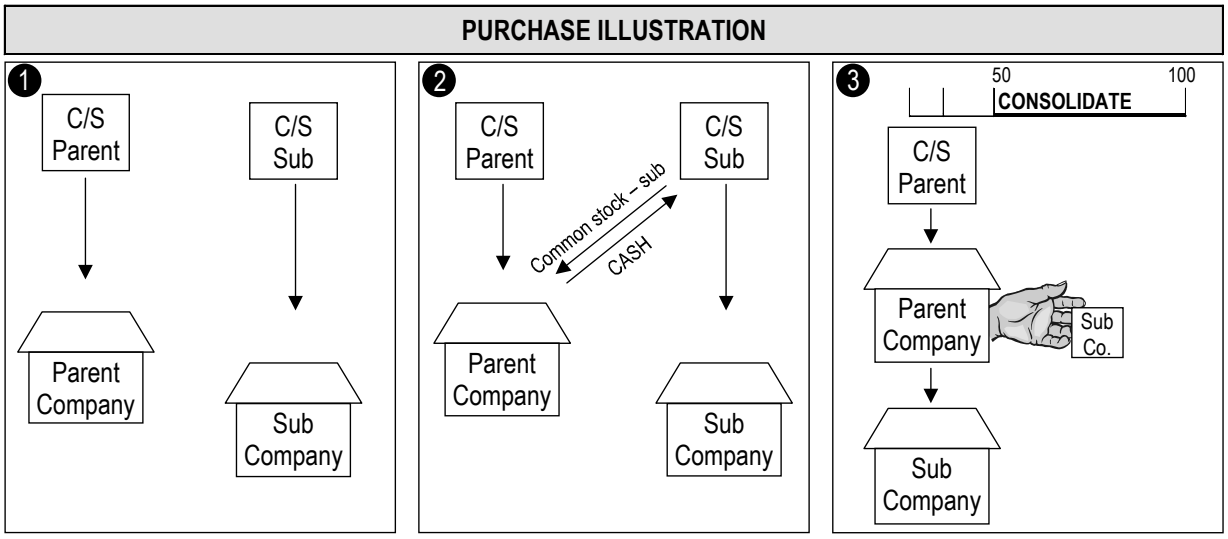
All of the subsidiary's balance sheet accounts are to be adjusted to fair value on the acquisition date. This is accomplished as part of the Eliminating Journal Entry (EJE) on the consolidating workpapers. This adjustment is done, regardless of the amount paid to acquire the subsidiary. The adjustment is for the full (100%) fair value, even if less than the entire subsidiary is acquired.

5. Identifiable Intangible Assets of the Subsidiary are Recorded at their Fair Value

As part of the Eliminating Journal Entry (EJE) on the consolidating workpapers, it is required that the parent record the fair value of all Identifiable Intangible Assets of the subsidiary. This is done, even if no amount was incurred to acquire these items in the acquisition.

6. Goodwill (or Gain) is Required

If there is an excess of the acquisition cost (plus any Noncontrolling (Minority) Interest) over the fair value of the subsidiary, then the remaining/excess is debited to create Goodwill. If there is a deficiency in the acquisition cost compared to the subsidiary's fair value, then the shortage/negative amount is credited to Gain – Extraordinary.



7. The Consolidating Workpaper Eliminating Journal Entry

The year end consolidating journal entry known as the consolidating workpaper eliminating journal entry (EJE) is:

CAR IN BIG

C	**DR**	Common Stock - Sub	$ XXX	
A	**DR**	A.P.I.C. - Sub	XXX	
R	**DR**	Retained Earnings - Sub	XXX	
I	**CR**	Investment in Subsidiary		$ XXX
N	**CR**	Non-Controlling Interest		XXX
B	**DR**	Balance Sheet Adjustments to FV	XXX	
I	**DR**	Identifiable Intangible Assets to FV	XXX	
G	**DR**	Goodwill	XXX	

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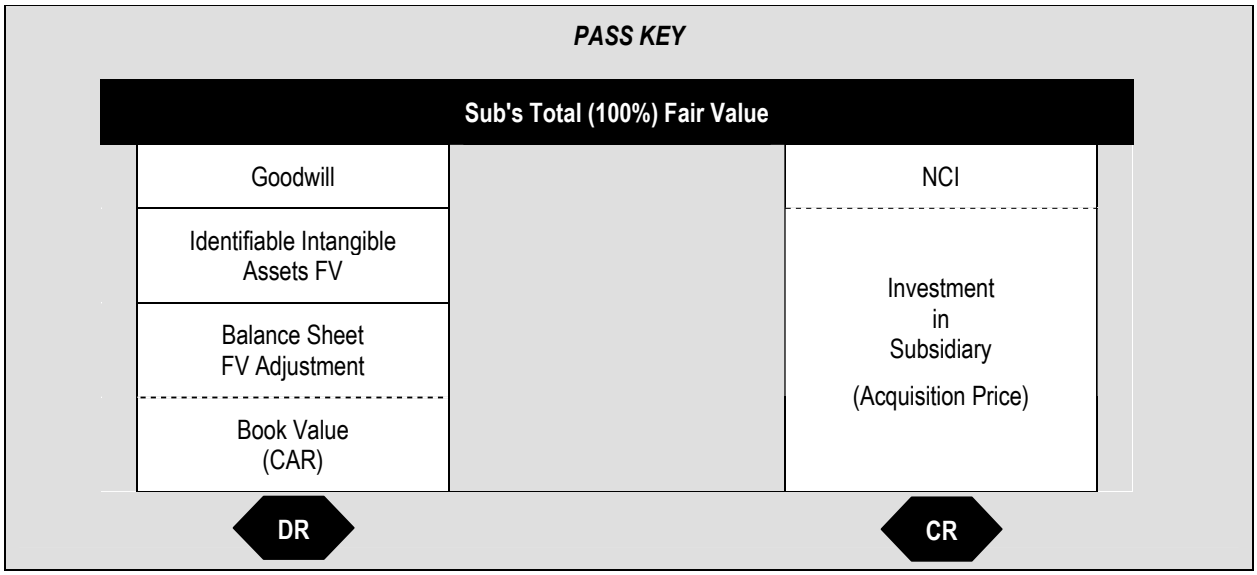

B. "CAR": SUBSIDIARY EQUITY ACQUIRED

1. CAR Formula

The following formula is used to determine the book value of the assets acquired from the subsidiary:

CAR IN BIG

- Assets - Liabilities = Equity
- Assets - Liabilities = Net Book Value
- Assets - Liabilities = CAR

2. Acquisition Date Calculation (of CAR)

The determination of the difference between book value and fair value must be computed as of the acquisition date.

When the subsidiary's financial statements are provided for a subsequent period, it is necessary to reverse the activity (income and dividends) in the subsidiary's retained earnings in order to squeeze back into the book value (Assets - Liabilities = CAR) at the acquisition date.

Acquisition	"Car"	Date
B A S E **Beg. retained earnings** **Add: income** **Subtract: dividends** **End retained earnings**	**C**ommon stock - Sub **A**.P.I.C. - Sub **R**etained earnings - Sub **–** **I**nvestment in Sub **–** **N**oncontrolling Minority Interest **B**alance sheet adjusted to FV **I**dentifiable Intangible Assets FV **G**oodwill	Same all year Same all year Squeeze back to purchase date amount

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C. INVESTMENT IN SUBSIDIARY

CAR IN BIG

The original carrying amount of the investment in subsidiary account on the parent's books is:

1. Original cost – Measured by the FV (on the date the acquisition is completed) of the consideration given (Debit: Investment in Sub);
2. Business combination costs/expenses in an acquisition are treated as follows:
   a. Direct out-of-pocket costs such as a finder's fee or a legal fee are expensed. (Debit: Expense)
   b. Stock registration and issuance costs such as SEC filing fees are a direct reduction of the value of the stock issued. (Debit: Additional Paid-in Capital account)
   c. Indirect costs are expensed as incurred. (Debit: Expense)
   d. Bond issue costs are capitalized and amortized. (Debit: Bond Issue Costs)

EXAMPLE

Business Combination Accounted for as an Acquisition

On January 1, Year 1, Big Company exchanged 10,000 shares of $10 par value common stock with a fair value of $415,000 for 100% of the outstanding stock of Sub Company in a business combination properly accounted for as an acquisition. In addition Big Co. paid $35,000 in legal fees. At the date of acquisition, the fair and book value of Sub Co.'s net assets totaled $300,000. Registration fees were $20,000.

Journal Entry: To record the acquisition price and legal fees

DR	Investment in Sub	$415,000	
DR	Legal Expense	35,000	
CR	Common stock - $10 par value		$100,000
CR	Additional Paid-in capital – Big Co. ($315,000 - $20,000)		295,000*
CR	Cash ($35,000 + $20,000)		55,000

*APIC – Big Co. = $415,000 - $100,000 = $315,000 - $20,000 = $295,000

Sub's Total (100%) Fair Value

Goodwill	$115,000		-0-	NCI
Identifiable Intangible Assets FV	-0-		$415,000	Investment in Subsidiary
Balance Sheet FV Adjustment	-0-			
BV (CAR)	$300,000			
	DR		CR	

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EXAMPLE CONTINUED

CARRYING

DR	Common stock – Sub			
DR	A.P.I.C. – Sub		$300,000	
DR	Retained earnings - Sub			
CR	Investment in Subsidiary			$415,000
CR	Non-controlling interest			-0-
DR	Balance Sheet Adjustments to FV		-0-	
DR	Identifiable Intangible Assets to FV		-0-	
DR	Goodwill		115,000	

PASS KEY

When the CPA Examination tests this issue, remember to look carefully for the acquisition related costs that must be expensed.

3. Step Acquisition – Consolidation and Deconsolidation

Owner Percentage Change	Accounting Treatment
Non-control → control (step transition)	• Remeasure previously held equity interests to fair value • The income statements will reflect this adjustment
Control → "more" or "less" control	• Equity transaction (no gain or loss recognition)
Control → non-control	• Recognize the gain or loss of the sale of the stock • Remeasure the remaining non-consolidating interest to fair value • Recognize the adjustment to fair value on the income statement

PASS KEY

Gaining control/losing control is a remeasurement event.

Concept: The parent exchanges a noncontrolling investment asset for a controlling financial interest in all of the underlying assets and liabilities of the target. (SFAS 153 – "Commercial Substance")

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EXAMPLE

Step Acquisitions with Noncontrolling Interest (Minority Interest)

FACTS:

- On July 1, 2004: Investment in Sub (25% ownership) $ 500,000
- Sub Co.'s FV (100%) on August 1, 2009 $4,000,000
- On August 1, 2009: Purchase extra 50% for $2,000,000

	Original Interest 25%		Acquired Interest 50%		Noncontrolling Interest 25%		Total Fair Value
Original	$ 500,000		$2,000,000		--		
SFAS 141-R Adj.	500,000*		--		$1,000,000		
New Carrying Amount	1,000,000	+	$2,000,000	+	$1,000,000	=	$4,000,000

*$500,000 write up of original interest is a GAIN.

DR:	Investment in Sub	$500,000	
CR:	Gain		$500,000

To record the adjustment to fair value in the previously held 25% ownership in sub.

PASS KEY

If the parent acquires the remaining 25% from the noncontrolling interest (minority interest) shareholders, it is an equity transaction (not an acquisition).

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EXAMPLE

Partial Acquisitions

FACTS:

- In 20X1, TAG Inc. buys 10% of Gearty Co.'s equity for $20,000 when the fair value of Gearty Co.'s net identifiable assets is $180,000. Four years later, in 20X5, TAG Inc. acquires an additional 50% (total now is 60% = 10% + 50%) interest for $400,000 in cash. At the date of this additional acquisition, Gearty Co. had the following:
  - Net identifiable assets FV = $640,000
  - Net identifiable assets NBV = $520,000
  - Minority interest (NCI) FV = $320,000

GAAP SOLUTION:

$	400,000	FV for 50%
X	2	
	800,000	FV for 100%
X	10%	Prior % owned
	80,000	FV – prior 10%
-	20,000	Paid
$	60,000	Gain

DR:	Investment in Sub	$60,000	
CR:	Gain		$60,000

To record the adjustment to fair value in the previously held 10% investment in Gearty Co.

Investment in Sub:						
Beginning Balance	+	FV Adjustment	+	New Acquisition	=	Ending Balance
$20,000	+	$60,000	+	$400,000	=	$480,000

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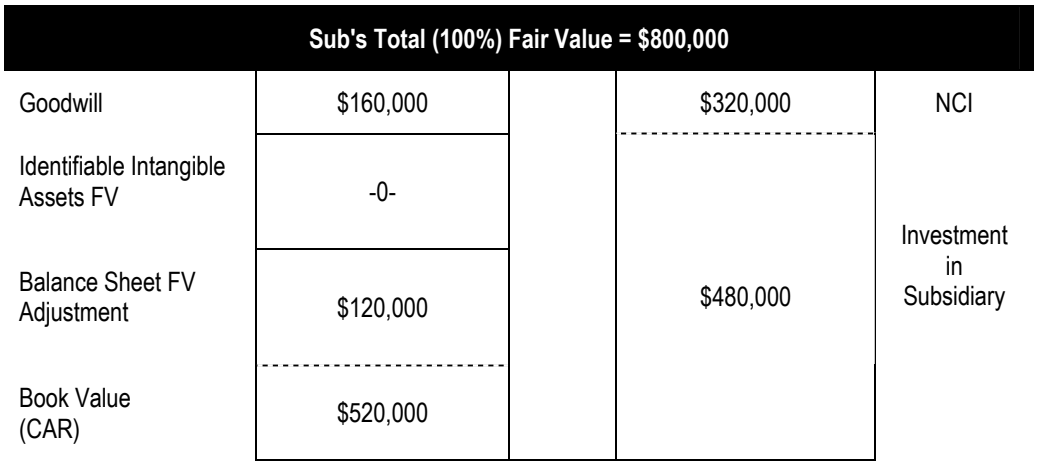
EXAMPLE



C	**DR**	Common stock - Sub			
A	**DR**	A.P.I.C. – Sub		$520,000	
R	**DR**	Retained earnings – Sub			
I	**CR**		Investment in Subsidiary		$480,000
N	**CR**		Non-controlling interest		320,000
B	**DR**	Balance Sheet Adjustments to FV		$120,000	
I	**DR**	Identifiable Intangible Assets to FV		-0-	
G	**DR**	Goodwill		160,000	
				$800,000	**$800,000**

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D. NON-CONTROLLING (MINORITY) INTEREST

CAR IN BIG

1. Overview

NONCONTROLLING MINORITY INTEREST

Business combinations that do not establish 100% ownership of a subsidiary by a parent will result in a portion of the subsidiary's equity being attributed to noncontrolling (minority) interest shareholders. Noncontrolling (minority) interest must be disclosed in the consolidated balance sheet.

If the parent does not acquire 100% of the ownership of the subsidiary, then the percentage of the ownership that is not owned shall be reported at fair value on the consolidated financial statements as Noncontrolling (Minority) Interest. This will include its share of any Goodwill (even though there is no cost basis).

EXAMPLE

Valuation of NCI

FACTS:

- Gearty Co. purchased 600,000 shares (60%) of Foxy, Inc. from Becker Ltd. for $70,000,000 (control premium of $1,000,000 included)
- There is an implied "control premium" in this purchase price over traded market price
- Foxy, Inc.'s remaining 400,000 shares (40%) are publicly traded at $112.50 per share at acquisition date

GAAP Solution:

Estimation of Fair Value of 100% Equity Interest in Foxy, Inc.

• Purchase price for 60% of Foxy, Inc.		$ 70,000,000
• Publicly traded price (fair value) at purchase date	$ 112.50	
• Times: Outstanding shares (40%)	x 400,000	
• Equals: Fair Value		45,000,000
• Fair Value of 100% Equity Interest		$115,000,000

EXAMPLE

Acquisition of less than 100% of the equity interests in the target

FACTS:

- Gearty Co. acquires 60% of Foxy, Inc. for $70,000,000. The purchase price is equal to 60% of the total fair value of Foxy (60% x $115,000,000 = $69,000,000) plus a control premium of $1,000,000

• Fair value of Foxy, Inc. (includes goodwill) =	$115,000,000	$15,000,000
• Fair value of Foxy, Inc. identifiable assets net of liabilities =	$100,000,000	$20,000,000
• Book value of Foxy, Inc. net assets =	$ 80,000,000	

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EXAMPLE CONTINUED

Sub's Total (100%) Fair Value = $115,000,000				
Goodwill	$15,000,000		$45,000,000	NCI
Identifiable Intangible Assets FV	-0-			
Balance Sheet FV Adjustment	$20,000,000		$70,000,000	Investment in Subsidiary
Book Value (CAR)	$80,000,000			

C	**DR**	Common stock - Sub			
A	**DR**	A.P.I.C. – Sub		$ 80,000,000	
R	**DR**	Retained earnings - Sub			
I	**CR**	Investment in Subsidiary			$ 70,000,000
N	**CR**	Non-controlling interest			45,000,000
B	**DR**	Balance Sheet Adjustments to FV		20,000,000	
I	**DR**	Identifiable Intangible Assets to FV		-0-	
G	**DR**	Goodwill		15,000,000	
				$115,000,000	**$115,000,000**

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EXAMPLE

Partial Acquisitions

FACTS:

TAG Inc. purchases 60% of Gearty Co.'s equity for $80,000,000 in cash. Gearty Co.'s net identifiable assets: fair value is $25,000,000; carrying amount is $5,000,000; NCI fair value is $45,000,000.

Sub's Total (100%) Fair Value = $125,000,000				
Goodwill	$100,000,000		$45,000,000	NCI
Identifiable Intangible Assets FV	-0-		$80,000,000	Investment In Subsidiary
Balance Sheet FV Adjustment	$20,000,000			
Book Value (CAR)	$5,000,000			
	DR		CR	

C	**DR**	Common stock - Sub		
A	**DR**	A.P.I.C. – Sub	$ 5,000,000	
R	**DR**	Retained earnings – Sub		
I	**CR**	Investment in Subsidiary		$80,000,000
N	**CR**	Non-controlling interest		45,000,000
B	**DR**	Balance Sheet Adjustments to FV	20,000,000	
I	**DR**	Identifiable Intangible Assets to FV	-0-	
G	**DR**	Goodwill	100,000,000	
			$125,000,000	**$125,000,000**

2. Financial Statement Presentation

a. Income Statement

The consolidated income statement will include 100% of the subsidiary's revenues and expenses (after the date of acquisition). However, the noncontrolling (minority) interest portion of the subsidiary's net income should be allocated to the noncontrolling (minority) interest, within a sub-account of retained earnings.

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(1) Computation

Compute by multiplying the subsidiary's net income times the noncontrolling (minority) interest percentage.

Sub's Income
<Sub's Expenses>
Sub's Net Income
x Noncontrolling (Minority) Interest %
Noncontrolling (Minority) interest in Net Income

b. Balance Sheet

The consolidated balance sheet will include 100% of the subsidiary's assets and liabilities (not the sub's equity / CAR). The noncontrolling (minority) interest's share of the subsidiary's net assets should be presented on the balance sheet as part of stockholders' equity, and is often referred to as the noncontrolling (minority) interest.

(1) Computation

If there is no control premium, compute the noncontrolling (minority) interest by multiplying total subsidiary fair value times the noncontrolling (minority) interest percentage:

Fair Value of Sub
x Noncontrolling (Minority) Interest %
Noncontrolling (Minority) Interest

The noncontrolling interest can also be computed as the difference between the fair value of the subsidiary and the controlling interest in the subsidiary (the purchase price paid by the parent company):

Noncontrolling (Minority) Interest = Fair Value of Sub – Controlling Interest in Sub

This formula works when there is a control premium and when there is no control premium.

(2) Allocation of Subsidiary Net Losses

Allocate to noncontrolling interest (minority interest) even if allocation exceeds the equity attributable to the minority interest/noncontrolling interest (negative carrying balance).

PASS KEY

GAAP Theory: Noncontrolling interest holders participate proportionately in the risks and rewards of the subsidiary.

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EXAMPLE

Noncontrolling (Minority) Interest

On June 30, Parent Co. acquired 90% of Sub Co. for $8,100,000. Sub Co.'s net book value equaled the fair value on the date of acquisition. The stockholders' equities immediately before the combination were:

	P	S
Common stock	$ 6,500,000	$ 2,000,000
Additional paid-in capital	4,400,000	1,600,000
Retained earnings	6,100,000	5,400,000
Total	$17,000,000	$9,000,000

Sub's Total (100%) Fair Value $9,000,000

Goodwill	-0-		$900,000	NCI
Identifiable Intangible Assets FV	-0-			
Balance Sheet FV Adjustment	-0-		$8,100,000	Investment in Subsidiary
Book Value (CAR)	$9,000,000			
	DR		CR	

Net income and dividends for the year were:

	PARENT	SUB
Net Income		
Six months ended 6/30	$ 600,000	$ 200,000
Six months ended 12/31	1,500,000	1,000,000
Dividends paid		
April 5	$ 800,000	
October 12		$ 100,000

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EXAMPLE CONTINUED

	C	A	R		I	N	B	I	G
B	2,000,000	1,600,000	5,400,000	Beginning	8,100,000	900,000	-0-	-0-	-0-
A	—	—	1,000,000	Sub—Income	900,000	100,000	—	—	—
S	—	—	(100,000)	Sub—Dividend	(90,000)	(10,000)	—	—	—
E	2,000,000	1,600,000	6,300,000	Ending	8,910,000	990,000	- 0-	- 0-	-0-

Year-End (Workpaper) Eliminating Journal Entry:

C	**DR**	Common stock – Sub	$2,000,000	
A	**DR**	A.P.I.C. – Sub	1,600,000	
R	**DR**	Retained earnings – Sub	6,300,000	
I	**CR**	Investment in Sub		$8,910,000
N	**CR**	Noncontrolling (Minority) interest		990,000
B	**DR**	Balance sheet adj. To FV	-0-	
I	**DR**	Identifiable intangible assets	-0-	
G	**DR**	Goodwill	-0-	

CAR IN **BIG**

E. BALANCE SHEET ADJUSTMENT TO FAIR VALUE, IDENTIFIABLE INTANGIBLE ASSET ADJUSTMENT TO FAIR VALUE, AND GOODWILL (GAIN)

1. Acquisition Cost + Noncontrolling (Minority) Interest reconciliation to Fair Value of the Subsidiary (Balance Sheet Adjustment, Identifiable Intangible Assets and Goodwill (Gain)

Under the Acquisition Method, the parent's acquisition of the subsidiary is recorded at the fair value of the consideration surrendered. This acquisition price (and any Noncontrolling Interest at fair value) must be compared to the respective assets and liabilities of the subsidiary at the date of acquisition. Any difference between the fair value paid (and fair value of NCI) and the book value acquired will require an adjustment to the following three areas:

a. Balance Sheet Adujstment of the subsidiary's records from book value to fair value.

b. Identifiable Intangible Assets related to the acquisition of the subsidiary are to record at fair value.

c. Goodwill is recognized for any excess/negative in Gain.

PASS KEY

In **P**rocess **R**esearch and **D**evelopment

- Recognize as an intangible asset separately from goodwill at the acquisition date (need valuation)
- Do not immediately write off
- FAC 6 meets the definition of an "asset" – it has probable future economic benefit

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2. Determining Acquisitions with Goodwill

CAR IN BIG

Rule: When acquiring a corporation/subsidiary with an acquisition cost (acquisition price paid + liabilities assumed) that is greater than the fair value of 100% of the underlying assets acquired, the following steps are required:

a. Step 1 / Balance Sheet Adjusted to Fair Value

Allocate the acquisition cost to the fair value of 100% of the Balance Sheet accounts.

b. Step 2 / Identifiable Intangible Assets to Fair Value

- Allocate the remaining acquisition cost to the fair value of 100% of the Identifiable Intangible Assets acquired.

Illustrative List of Identifiable Intangible Assets	
• Agreements & Contracts	• Computer Software & Licenses
• Rights	• Technical Drawings & Manuals
• Permits	• Customer Lists
• Patents	• Unpatented Technology
• Copyrights	• In-Process Research and Development
• Trademarks & Trade Names	
• Franchises	• Noncompetes

- These Identifiable Intangible Assets are separated into two categories. The two categories are:

(1) Finite life

Amortize over the remaining life. Subject to the two step impairment test (see F2 for details).

(2) Indefinite life

Do not amortize. Subject to the one step impairment test (see F2 for details).

c. Step 3 / Goodwill

Allocate any remaining acquisition cost to Goodwill. This Goodwill is not amortized. Acquisition Goodwill is subject to impairment testing. Accordingly, in the period it is determined to be impaired, it is written down and charged as an expense against income on the Income Statement. See the F2 – Impairment for detail on the determination of goodwill impairment.

Intangibles Now Subsumed into Goodwill	
• Assembled Workforce	• Advertising Programs
• Distribution Channels	• Geographic Presence
• Technical Expertise	• Technological Know-How
• Training and Recruiting	• Government Relations
• Product/Service Support	

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3. Determining Acquisition with Gain

Rule: When acquiring a corporation/subsidiary with an acquisition cost (acquisition price paid + liabilities assumed) that is less than the fair value of 100% of the underlying assets acquired, the following steps are required:

a. Step 1 / Balance Sheet Adjusted to Fair Value

Allocate the acquisition cost to the fair value of 100% of the Balance Sheet accounts (even if the acquisition cost is less than the fair value to be assigned). This will create a negative balance in the acquisition cost account.

b. Step 2 / Identifiable Intangible Assets to Fair Value

Allocate any remaining acquisition cost (if any) to the fair value of 100% of the Identifiable Intangible Assets acquired (even if the remaining acquisition cost is less than the fair value to be assigned). This will create or increase the negative balance in the acquisition cost account.

c. Step 3 / Gain

The negative balance in the acquisition cost account (due to the fair value of the Balance Sheet Assets and the Identifiable Intangible Assets have been greater than the acquisition cost) is to be recorded as a Gain.

PASS KEY

	Indefinite Life	Finite Life
Characteristics	Life extends beyond the foreseeable future	Useful life is limited
Amortization	None	Over useful economic life
Impairment Test	One-step test (fair value based)	Two-step test (FASB 121)

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EXAMPLE

Goodwill Allocation

FACTS:

- Gearty Co. purchases 65% of Sub Co. for $1,500,000 (including any control premium).
- Total fair value of Sub Co. is $2,200,000.
- Total net book value of Sub Co. is $1,000,000.
- The purchase price of $1,500,000 is equal to 65% of the total fair value of Sub Co. ($2,200,000 x 65% = $1,430,000) plus a control premium of $70,000.
- Fair value of 100% of Sub Co.'s identifiable net assets is $1,600,000.

Sub's Total (100%) Fair Value = $2,200,000				
Goodwill	$600,000		$700,000	NCI
Identifiable Intangible Assets FV	-0-			
Balance Sheet FV Adjustment	$600,000		$1,500,000	Investment in Subsidiary
Book Value (CAR)	$1,000,000			
	DR		CR	

C	DR	Common stock – Sub		
A	DR	A.P.I.C. – Sub	$1,000,000	
R	DR	Retained earnings – Sub		
I	CR	Investment in Subsidiary		$1,500,000
N	CR	Non-controlling interest		700,000
B	DR	Balance Sheet Adjustments to FV	600,000	
I	DR	Identifiable Intangible Assets to FV	-0-	
G	DR	Goodwill	600,000	
			$2,200,000	**$2,200,000**

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CONCEPT EXERCISE

- On January 1, 20X7, Gearty Corporation (parent) acquired 100% of Olinto Corporation. Gearty Corp. issued 100,000 shares of its $10 par common stock, with a market price of $15 on the date the acquisition was announced and $25 on the date the acquisition was completed, for all of Olinto Corp.'s common stock.
- On that date the fair value of Olinto Corp.'s assets and liabilities equaled their respective carrying amounts with the exception of land, which had a fair value that exceeded its book value by $200,000.
- The fair value of Olinto Corp.'s identifiable intangibles (other than goodwill) is $100,000.
- For the year ending December 31, 20X7, Olinto reported net income of $350,000 and paid cash dividends of $150,000.
- The stockholders' equity section of each company's balance sheet as of December 31, 20X7, was:

	Gearty	Olinto
Common stock	$5,000,000	$1,000,000
Additional paid-in capital	1,000,000	400,000
Retained earnings	3,000,000	500,000
	$9,000,000	$1,900,000

SOLUTION:

REQUIRED: Calculate the acquisition date consolidation workpaper eliminating journal entry

(1) Determine the carrying/book value (CAR) of the subsidiary at the date of acquisition.

(2) Determine the acquisition price (investment in subsidiary).

(3) Determine the fair value of any noncontrolling (minority) interest.

(4) Determine the balance sheet accounts fair value adjustments.

(5) Determine the fair value of any identifiable intangible assets.

(6) Determine the amount of goodwill.

ANSWERS:

Common Stock – Sub		$1,000,000
A.P.I.C. – Sub		400,000
Retained Earnings – Sub (at purchase date)		300,000
B A S E		
Beginning	300,000	
Add: income	350,000	
Subtract: dividends	<150,000>	
Ending	500,000	
Net Book Value		1,700,000
Investment (100,000 shares x $25 FV)		2,500,000
Difference		800,000
Noncontrolling Interest		- 0 -
Difference		800,000
Balance Sheet Adjustment to Asset Land		200,000
Difference		600,000
Identifiable Intangible Assets		100,000
Goodwill		500,000

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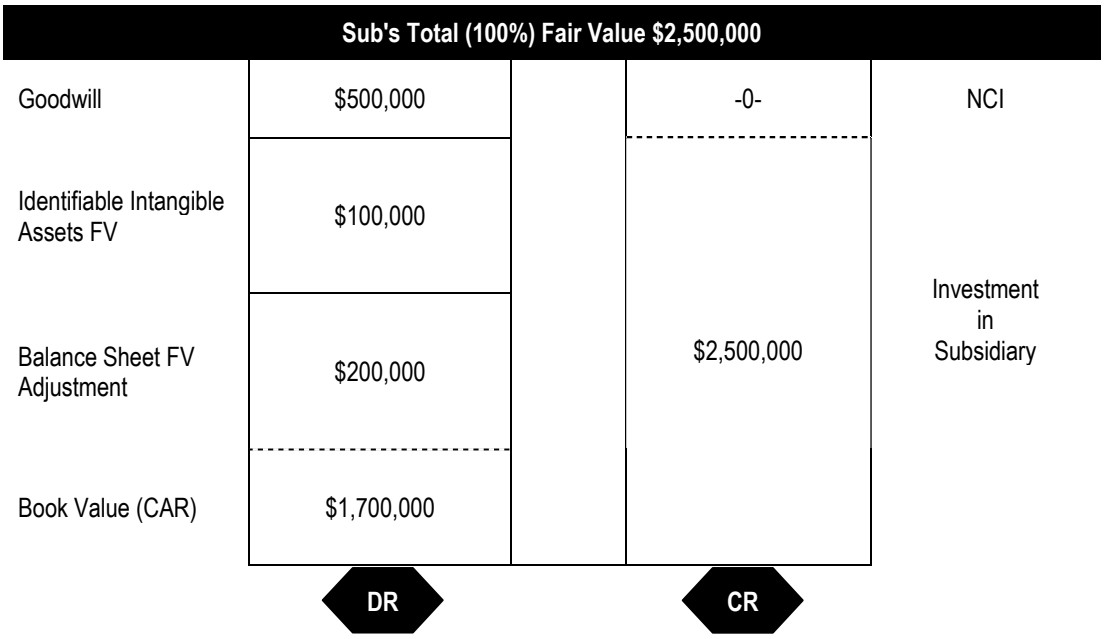

CONSOLIDATING WORKSHEET: ELIMINATING JOURNAL ENTRY			
DR:	Common Stock – Sub	$1,000,000	
DR:	A.P.I.C. – Sub	400,000	
DR:	Retained Earnings – Sub	300,000	
CR:	Investment in Sub		$2,500,000
CR:	Noncontrolling Interest		-0-
DR:	Balance Sheet Adjustment FV	200,000	
DR:	Identifiable Intangible Assets FV	100,000	
DR :	Goodwill	500,000	

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EXAMPLE

Acquisition of 100% Interest in Investee

Example	Sub NBV	Sub FV
Current Assets	$100,000	$100,000
L.T. Investment – Marketable Securities	25,000	25,000
Noncurrent Assets	200,000	250,000
Identifiable Intangible Assets	-0-	100,000
Liabilities	50,000	50,000
Common Stock	100,000	
A.P.I.C.	100,000	
Retained Earnings	75,000	

	PREMIUM		DISCOUNT
	1	2	3
Investment in Sub	$500,000	$425,000	$10,000
Liabilities Assumed	50,000	50,000	50,000
Amount to be Assigned	$550,000	$475,000	$60,000
Step #1:			
Balance Sheet Adjusted Fair Value	<375,000>	<375,000>	<375,000>
Difference	$175,000	$100,000	<$315,000>
Step #2:			
Identifiable Intangibles	<100,000>	<100,000>	<100,000>
Step #3:			
Goodwill <Gain>	$75,000	-0-	<$415,000>

PASS KEY

The trick to properly calculating the proper amounts is to remember to always use fair value of the assets in Steps 1 and 2.

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PURCHASE: CONSOLIDATING (WORKPAPER) ELIMINATING JOURNAL ENTRIES

Example #1

DR	**C**ommon stock – Sub	$100,000	
DR	**A**.P.I.C. – Sub	100,000	
DR	**R**etained earnings – Sub	75,000	
CR	**I**nvestment in Sub		$500,000
CR	**N**oncontrolling (minority) interest		-0-
DR	**B**alance sheet adjust FV	50,000	
DR	**I**dentifiable Intangible Assets	100,000	
DR	**G**oodwill	75,000	

Example #2

DR	**C**ommon stock – Sub	$100,000	
DR	**A**.P.I.C. – Sub	100,000	
DR	**R**etained earnings – Sub	75,000	
CR	**I**nvestment in Sub		$425,000
CR	**N**oncontrolling (minority) interest		-0-
DR	**B**alance sheet adjust FV	50,000	
DR	**I**dentifiable Intangible Assets	100,000	
DR	**G**oodwill	0	

Example #3

DR	**C**ommon stock – Sub	$100,000	
DR	**A**.P.I.C. – Sub	100,000	
DR	**R**etained earnings – Sub	75,000	
CR	**I**nvestment in Sub		$10,000
CR	**N**oncontrolling (minority) interest		-0-
DR	**B**alance sheet adjust FV	50,000	
DR	**I**dentifiable Intangible Assets	100,000	
CR	**G**ain		$415,000

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F. JOURNAL ENTRY FLOW CHART—ACQUISITION DATE CALCULATION

Common stock – Sub
A.P.I.C. – Sub
Retained earnings – Sub

< **I**nvestment in Sub >

DIFFERENCE

+ Noncontrolling (minority) interest

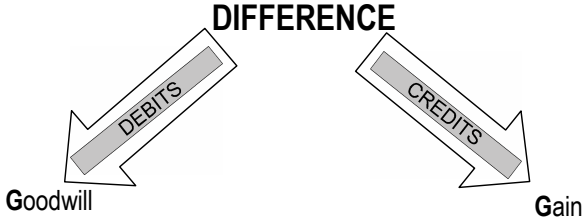
DIFFERENCE

– Balance Sheet FV Adjustment

DIFFERENCE

– Identifiable Intangible Assets

DIFFERENCE



PASS KEY

It is important to note that even if the parent acquired less than 100% of the subsidiary, the adjustment of the subsidiary's assets to FV (purchase price) will always be the FV (100%).

CONSOLIDATION DISCLOSURES

G. DISCLOSURE FOR THE ACQUISITION METHOD

The following disclosures should be made in the period in which a business combination accounted for by the acquisition method occurs.

1. Name, brief description, and total cost of the acquisition.
2. Method of accounting, that is, the acquisition method.
3. Period for which results of operations of the acquisition are included in the income statement (usually commences from the date of acquisitions).
4. Other pertinent information such as contingent payments, options, or other commitments.
5. Amount of subsidiary net income/loss allocated to the noncontrolling interest.
6. Amount of retained earnings applicable to the noncontrolling interest.

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The following *supplemental* information should be disclosed in the notes to the financial statements of an acquiring company in the year of acquisition. These disclosures are not required in the financial statements of nonpublic enterprises.

1. Results of operations for the current period combining the acquisition as though it were acquired at the beginning of the period.
2. If comparative statements are presented, results of operations should include the acquisition as though it were acquired at the beginning of the comparative statement period.

C	A	R		I	N	B	I	G
Common Stock	APIC	Retained Earnings		Investment	Non-controlling Minority Interest	B/S Adj. Assets	Identifiable Intangible Assets	Goodwill
			Beginning + Income - Dividend					
			End					

B A S E

H. ACQUISITION METHOD SUMMARY

Acquisition	
Assets	FV
Liabilities	FV
Retained Earnings	Parent Only
Income	After Acquisition
Acquisition Cost	Expensed
Goodwill	Yes
Noncontrolling (Minority) Interest	Yes (1% - 49%)
Investment in Sub	Eliminate
Asset Adjustment	Depreciate
Identifiable Intangible Assets	Amortization
Goodwill Adjustment	Impairment Test
Intercompany Transactions	Eliminate

PASS KEY

Acquired (purchased) goodwill is not amortized, it is subject to the impairment test.

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INTERCOMPANY TRANSACTIONS

I. INTERCOMPANY TRANSACTIONS

A. ELIMINATE INTERCOMPANY TRANSACTIONS

Intercompany transactions must be eliminated since they lack the criteria of being "arm's length."

1. Balance Sheet

a. Advances Receivable / Advances Payable

b. Accounts Receivable / Accounts Payable

c. Dividends Receivable / Dividends Payable

d. Bonds Receivable / Bonds Payable

2. Income Statement

a. Interest Expense / Interest Income (Bonds)

b. Gain on Sale / Depreciation Expense (Fixed Assets Sold)

c. Sale and Cost of Goods Sold (Inventory - on hand)

B. ELIMINATE 100% (EVEN WHEN NONCONTROLLING (MINORITY) INTEREST EXISTS)

Eliminate entire amount, even if ownership is less than 100% when you consolidate.

1. Balance Sheet – Eliminate 100%

a. Group I – Eliminate 100% of all Interco Payables and Receivables

DR:	Accounts Payable	$XXX	
CR:	Accounts Receivable		$XXX

DR:	Bonds Payable (Interco portion only)	$XXX	
CR:	Bonds Investment (in affiliate)		$XXX

DR:	Accrued Bond Interest Payable	$XXX	
CR:	Accruerd Bond Interest Receivable		$XXX

DR:	Dividends Payable (affiliate portion only)	$XXX	
CR:	Dividends Receivable (from affiliate)		$XXX

2. Income Statement – Eliminate 100%

a. Group II – Eliminate All Interco Gross Profit Sitting in Ending Inventory and Fixed Assets of Parent or Subsidiary

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IMPORTANT: The portion eliminated does not depend on who is selling:

1. Parent Was the Seller: Eliminate 100% of the:
   a. Balance sheet write-up (or write-down) relating to the inventory or fixed asset that was transferred
   b. Income Statement
      (1) Open (Presented): Sale and cost of goods sold
      (2) Closed (to Retained Earnings): Profit (or loss) relative to the sale.
2. Subsidiary was the seller: Eliminate 100% of the:
   a. Balance Sheet
      Gross profit from ending inventory and/or fixed assets.
   b. Income Statement
      (1) Open (Presented): Sale and cost of goods sold
      (2) Closed (to Retained Earnings & Minority Interest): Profit (or loss) relative to the sale.
3. Fixed asset cost and accumulated depreciation are based on original costs from the OUTSIDE world and remains the same on the consolidated financial statements. Only the intercompany gains and losses and their effect on accumulated depreciation are eliminated.

C. NOT CONSOLIDATED = NOT ELIMINATED

Do not eliminate intercompany accounts if you do NOT consolidate.

1. Separate report in financial statements
2. Footnote disclosure

D. INTERCOMPANY INVENTORY / MERCHANDISE TRANSACTIONS

It is common for affiliated companies to sell inventory/merchandise to one another. Often this inventory/merchandise is sold at a profit. The total amount of this intercompany sale and cost of goods sold should be eliminated prior to preparing consolidated financial statements. In addition, the intercompany profit must be eliminated from the ending inventory and the cost of goods sold of the purchasing affiliate. The profit to be eliminated is based upon the gross profit (markup on selling price) recognized by the selling affiliate. 100% of the profit should be eliminated even if the parent's ownership interest is less than 100%. The intercompany profit in beginning inventory that was recognized by the selling affiliate in the previous year must be eliminated by an adjustment (debit) to retained earnings.

Workpaper Elimination Entry for Intercompany Merchandise Transactions			
DR:	Intercompany sales	$XXX	
DR:	Retained earnings (profit in beginning inventory)	$XXX	
CR:	Intercompany cost of goods sold		$XXX
CR:	Cost of goods sold (intercompany profit included in cost of goods sold of the purchasing affiliate)		$XXX
CR:	Ending inventory (intercompany profit in the inventory remaining)		$XXX

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PASS KEY

When inventory has been sold intercompany and the CPA Examination requires you to correct the accounts, remember to reverse the original intercompany transaction (sale and cost of goods sold, internally) and:

- Inventory sold to outsiders ⟶ correct Cost of Goods Sold
- Inventory still on hand ⟶ correct Ending Inventory

EXAMPLE

Intercompany Profit in Inventories

Potato Company owns 80% of the common stock of Soup Company. Potato sells merchandise to Soup at 10% above its cost. Such sales amounted to $1,100,000 during Year 1. The Year 1 ending inventory of Soup included goods purchased from Potato for $660,000. Potato reported $1,586,000 in net income from its independent operations in Year 1. Soup reported net income of $855,000 in Year 1 and did not declare dividends. Potato records its investment in Soup using the equity method. There were no intercompany sales prior to Year 1.

Year 1 Workpaper Elimination Entry

DR	Intercompany sales – P	$1,100,000	
CR	Intercompany cost of goods sold – P		$1,000,000 **[1]**
CR	Cost of goods sold – S		40,000 **[2]**
CR	Inventory – S		60,000 **[3]**

Step [1]

Sales = Cost + (10% x Cost)

$1,100,000 = 110% x Cost

Intercompany cost of goods sold $1,000,000 **[1]**

Step [2]

Beginning inventory	$ 0
Purchases	1,100,000
Cost of goods available	1,100,000
Ending inventory	660,000
Cost of goods sold	440,000
Intercompany profit based on Potato's markup on selling price	9.091%*

$$* \text{ Markup on selling price} = \frac{\text{Markup on cost}}{1 + \text{Markup on cost}} = 9.091\%$$

Intercompany profit in Soup's cost of goods sold $ 40,000 **[2]**

Step [3]

Ending inventory	$ 660,000
Markup	x 9.091%
Intercompany profit in ending inventory	$ 60,000 **[3]**

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E. INTERCOMPANY BOND TRANSACTIONS

If one member of the consolidated group acquires an affiliate's debt from an outsider, the debt is considered to be retired and a gain/loss is recognized. The gain/loss is reported as a gain/loss. This gain/loss on extinguishment of debt is calculated as the difference between the price paid to acquire the debt and the book value of the debt. This gain/loss is not reported on either company's books, but is recorded through an elimination entry. All intercompany account balances are also eliminated.

EXAMPLE

Intercompany Bond Transactions

On December 31, Year 1, Parent Company issued bonds with a carrying value of $300,000, and a face value of $250,000. The premium on bonds payable was recorded as $50,000.

Journal Entry: To record the sale of the bonds on the Parent's books

DR	Cash	$300,000	
CR	Bonds payable		$250,000
CR	Premium on bonds payable		50,000

On December 31, Year 1, before any portion of the premium was amortized, Sub Company acquires all the outstanding bonds from the original purchasers at a price of $275,000.

Journal Entry: To record the purchase of the bonds on the Sub's books

DR	Investment in parent bonds	$275,000	
CR	Cash		$275,000

Workpaper Elimination Entry: Eliminated intercompany balances and recognizes the gain on extinguishment of debt.

DR	Bonds payable	$250,000	
DR	Premium (parent's records)	50,000	
CR	Investment in parent bonds (sub's records)		$275,000
CR	Gain on extinguishment of bonds		25,000

1. Intercompany Interest

Eliminate intercompany accounts such as interest expense, interest income, interest payable, and interest receivable.

2. Amortization of Discount or Premium

Eliminate amortization of the discount or premium, which serves as an increase, or decrease in the amount of interest expense/revenue that is recorded. The unamortized discount or premium on the intercompany bond is eliminated.

3. Subsequent Years

The elimination for realized but unrecorded gain/loss on extinguishment of bonds in subsequent years would be adjusted to retained earnings. Minority interest would be adjusted if the bonds were originally issued by the subsidiary.

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F. INTERCOMPANY SALE OF LAND

The intercompany gain/loss on the sale of land remains unrealized until the land is sold to an outsider. A workpaper elimination entry in the period of sale eliminates the intercompany gain/loss and adjusts the land to its original cost.

EXAMPLE

Intercompany Sale of Land

On January 1, Year 1, Parent Company sold land to Subsidiary Company for $200,000. The initial cost of the land to Parent was $175,000.

Journal Entry: To record the sale by Parent on their books

DR	Cash	$200,000	
CR	Land		$175,000
CR	Intercompany gain on sale of land		25,000

Journal Entry: To record the purchase by Sub on their books

DR	Land	$200,000	
CR	Cash		$200,000

Workpaper Elimination Entry: Elimination of the intercompany gain and adjustment of land to its original cost

DR	Intercompany gain on sale of land	$25,000	
CR	Land ($200,000 - $175,000)		$25,000

In the subsequent year and every year thereafter until the land is sold to a third party, retained earnings (Parent) would be debited and land would be credited to eliminate the intercompany profit. Retained earnings is debited in subsequent years since the gain would have been closed to this account. Since Parent was the seller of the land and Sub was the purchaser, there is no need to divide the intercompany gain between retained earnings and minority interest.

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G. INTERCOMPANY PROFIT ON SALE OF DEPRECIABLE FIXED ASSETS

The gain or loss on the intercompany sale of a depreciable asset is unrealized from a consolidated financial statement perspective until the asset is sold to an outsider. A working paper elimination entry in the period of sale eliminates the intercompany gain/loss and adjusts the asset and accumulated depreciation to their original balance on the date of sale.

EXAMPLE

Intercompany Sale of Equipment

FACTS: Sub Company, a partially owned (90%) subsidiary of Parent Company, sold equipment on Jan.1, 20X1 to Parent for $100,000. The equipment had a net book value of $70,000 (cost of $90,000 and accumulated depreciation of $20,000), and a remaining life of ten years.

Jan. 1, 20X1:	**Journal Entry:** To record the sale by Sub on their books			
	DR	Cash	$100,000	
	DR	Accumulated depreciation	20,000	
	CR	Machinery (original cost)		$90,000
	CR	Intercompany gain on sale of machinery		30,000
Jan. 1, 20X1:	**Journal Entry:** To record the purchase by Parent on their books			
	DR	Machinery	$100,000	
	CR	Cash		$100,000
Dec. 31, 20X1:	**Journal Entry:** To record depreciation by Parent on their books			
	DR	Depreciation expense ($100,000 ÷ 10)	$10,000	
	CR	Accumulated depreciation		$10,000
Dec. 31, 20X1:	**Workpaper Elimination Entry:** Elimination of intercompany gain and adjustment of the machine and accumulated depreciation accounts to their original balance.			
	DR	Intercompany gain on sale of machinery	$30,000	
	CR	Machinery ($100,000 – 90,000)		$10,000
	CR	Accumulated depreciation		$20,000

The depreciation expense recorded by Parent is overstated by the intercompany profit included in the cost of the machinery.

	GAAP Original	Non-GAAP Intercompany	Difference
NBV	$70,000	$100,000	$30,000
Depr. Yrs	÷ 10 Yrs	÷ 10 Yrs	÷ 10 Yrs
Depreciation	$ 7,000	$10,000	$ 3,000

Workpaper Elimination Entry: Elimination of excess depreciation

DR	Accumulated depreciation	$3,000	
CR	Depreciation expense		$3,000

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EXAMPLE CONTINUED

Subsequent Year Work Paper Elimination Journal Entry

In the subsequent years the intercompany gain/loss on the sale of the asset and the excess depreciation have been closed to Retained Earnings. The elimination entries in subsequent years therefore adjusts Retained Earnings, and if appropriate, Minority Interest for the original gain or loss less the excess depreciation previously recorded (Unrealized gain/loss at the beginning of the year). Continuing with the previous example, in Year 2 the workpaper elimination entries would be:

Journal Entry: Adjust fixed asset

DR	Retained Earnings	$24,300		**[1]**
DR	Minority interest in net assets	2,700		**[2]**
CR	Machinery		$10,000	
CR	Accumulated depreciation		17,000	**[3]**

Journal Entry: Adjust depreciation

DR	Accumulated depreciation	$ 3,000		
CR	Depreciation expense		$ 3,000	

[1] Original gain - Excess depreciation previously recorded = Unrealized gain at the beginning of the year. $30,000 - $3,000 = $27,000 x 90% (Parent's ownership percentage) = $24,300

[2] $27,000 x 10% (Minority shareholder's ownership percentage) = $2,700

[3] Original accumulated depreciation difference of $20,000 less excess depreciation of $3,000 previously recorded.

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COMBINED FINANCIAL STATEMENTS / PUSH DOWN ACCOUNTING

I. COMBINED FINANCIAL STATEMENTS

Combined financial statements of a group of related companies (not consolidated because there is no parent company):

A. TYPES:

1. Companies are under common control (e.g., individual owns many companies), or
2. Companies are under common management, or
3. Unconsolidated subsidiaries (e.g., many foreign subs) are combined.

B. REQUIRES:

1. Intercompany transactions and balances among these companies eliminated.
2. Noncontrolling (minority) interests, etc., be treated like consolidated financial statements.
3. Capital stock and retained earnings be added across, not eliminated.
4. Income statements be added across.

II. PUSH DOWN ACCOUNTING

Push down accounting reports assets and liabilities at fair value in separate financial statements of the subsidiary. In effect, consolidation adjustments are pushed down into the records (and separate financial statements) of each subsidiary.

A. Assets and liabilities are adjusted.

B. Retained earnings of the subsidiary are transferred to paid-in capital (to the extent of parent company's percentage of ownership).

C. Net income of each subsidiary includes depreciation, amortization, and interest expense based on fair values rather than historical cost.

D. The SEC requires push down accounting for each substantially wholly-owned subsidiary.

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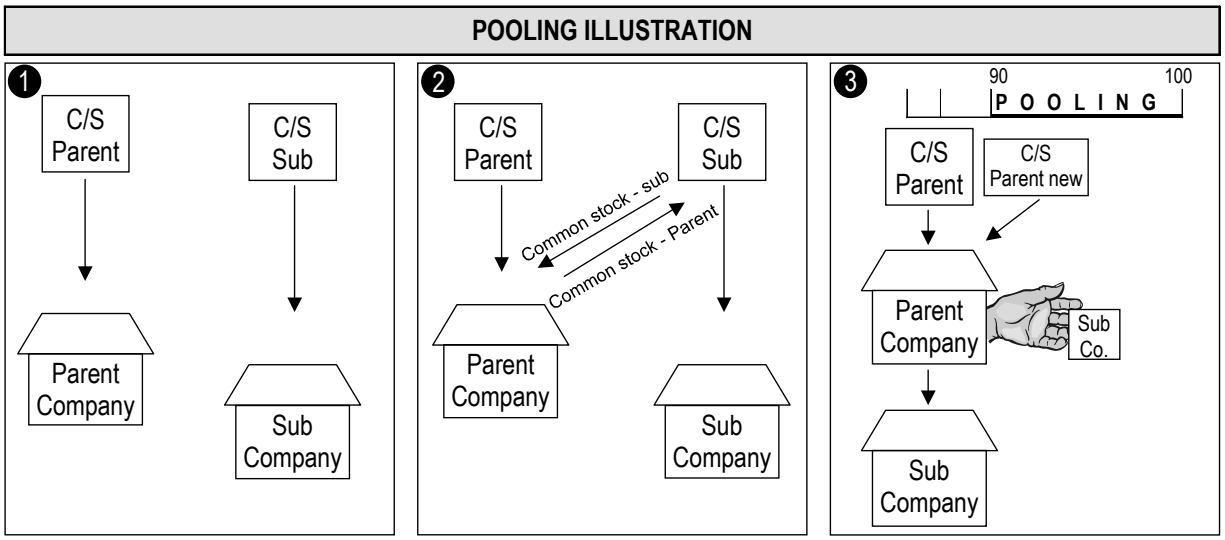
HOMEWORK READING: POOLING-OF-INTERESTS METHOD

I. POOLING-OF-INTERESTS METHOD (90%+ AND ALL OTHER CRITERIA)

For transactions, which had previously qualified, or for transactions initiated before June 30, 2001, that met the following criteria, the pooling of interest method is to be used to account for the acquisition. The following conditions must be met if the pooling-of-interests method is to be used to account for a business combination. If any of the following conditions are not met, the business combination must be accounted for as a purchase. If all of the conditions are met and the transaction was completed and/or initiated before June 30, 2001, the business combination must be accounted for as a pooling of interest. A pooling is accomplished through the issuance, by the acquirer, of voting common stock for 90% or more of the voting common stock or 100% of the net assets of the pooled company. The pooling method never results in goodwill because the investment is recorded at the book value of the subsidiary's net assets.



II. CONDITIONS FOR THE POOLING-OF-INTERESTS METHOD

A. CONDITIONS FOR USE OF THE POOLING OF INTERESTS METHOD (ALL MUST BE MET OR THE BUSINESS COMBINATION IS A PURCHASE)

1. Classifications Pertain To:

a. Attributes of combining companies.

b. Manner of combining interests.

c. Absence of planned transactions.

2. Attributes of Combining Companies Criteria

a. Must be autonomous for two years before the plan is initiated. They cannot have been a subsidiary or division of another corporation within the two years before the plan of combination is initiated.

b. No combining company can own more than 10% of another combining company for two years before the plan of combination is initiated. Each of the combining companies must be independent.

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3. Manner of Combining Interest Criteria

a. The combination must be completed within one year after the plan is initiated.

b. The issuing corporation must issue voting common stock in exchange for at least 90% of the voting common stock of another combining company after the date the plan of combination is initiated,

c. The combining companies

(1) Reacquire their common stock during the combination except for purposes not related to the combination (e.g., employee stock option plans) or

(2) Cannot make equity interest changes for two years before the combination.

d. Following the combination

(1) The ratio of interest of predecessor owners must remain the same, and

(2) The voting rights of all shareholders must be the same.

e. There can be no contingencies related to the exchange of stock (contingent buy-out). For example, additional shares of stock to be issued based on future earnings.

4. Absence of Planned Transactions Criteria

a. No agreements concerning post-combination reacquisition or retirement of stock just acquired are allowed (e.g., a deal with dissident shareholders to reacquire their stock).

b. No agreements offering post-combination benefits are allowed (e.g., an agreement to guarantee loans on stock issued in the combination that would permit shareholders to get cash from their stock, or, in effect, "sell" their stock).

c. No intent or plan to dispose of a significant part of the acquired assets of the combining companies (except duplicate facilities) within two years after the combination can exist.

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B. PROCEDURES FOR RECORDING THE INITIAL INVESTMENT UNDER A POOLING OF INTERESTS

The following basic journal entry is required when the par value of the two companies common stock are equal:

DR Investment in Subsidiary (for NBV of Sub)
CR Common Stock – Parent (shares issued x par value)
CR A.P.I.C. – (for the subsidiary, A.P.I.C.)
CR Retained Earnings – (for the subsidiaries R.E.)

EXAMPLE

I CAR

Recording the Initial Investment under a Pooling of Interests

Poolgood Company merged with Sub-Way Co. in a business combination accounted for as a pooling. Poolgood issued 20,000 shares of its $5 par common stock for all the outstanding capital stock of Sub-Way. In addition, Poolgood paid $10,000 in legal fees and $10,000 in SEC fees.

Sub-Way's stockholders' equity (NBV) at the beginning of the year of the business combination:

Common stock outstanding	$100,000
Additional paid-in capital in excess of par	20,000
Retained earnings	70,000
Total capital	$190,000

The investment is recorded at the book value of Sub-Way's net assets, which equals the parent's share of the subsidiary's stockholders' equity at the beginning of the year.

Par value of parent's shares issued	$100,000
Par value of subsidiary share transferred	100,000
Adjustment to additional paid-in capital (Plug)	$ 0

Journal Entry: To record the initial investment under the pooling-of-interests method

DR	Investment in Sub-Way ($100,000 + $20,000 + $70,000)	$190,000	
CR	Common stock (Poolgood) (20,000 x $5)		$100,000
CR	Additional paid-in capital (Poolgood for Sub-Way) [($100,000 + $20,000) - $100,000]		$ 20,000
CR	Retained earnings (Sub-way's)		$ 70,000

All of the expenses incurred in the pooling are expenses of the combined corporation.

Journal Entry: To record business combination expenses in a pooling

DR	Business combination expense	$20,000	
CR	Cash		$20,000

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C. PROCEDURE FOR RECORDING THE INITIAL INVESTMENT WHEN DIFFERENT PAR VALUE AMOUNTS

I CAR

When preparing the journal entry for recording the initial investment is S Company stock under a pooling of interests, the following steps should be applied in the order given:

1. Debit:

Investment in S Company account for the book value or recorded amount of S Company's net assets (Sub's: Assets – Liabilities = Equity).

2. Credit:

Common stock – Parent: for the par value of the shares issued by the parent company (number of shares issued x the par value of the parent's stock).

3. Plug:

a. Credit: (Increase)

(1) Additional Paid-in Capital to balance

b. Debit: (Decrease)

(1) Parent's A.P.I.C. (to extent it exists), and if necessary,

(2) Parent's retained earnings for any remaining difference.

4. Credit:

Retained Earnings of S Company for an amount equal to the parent's share of S Company's retained earnings at the beginning of the year.

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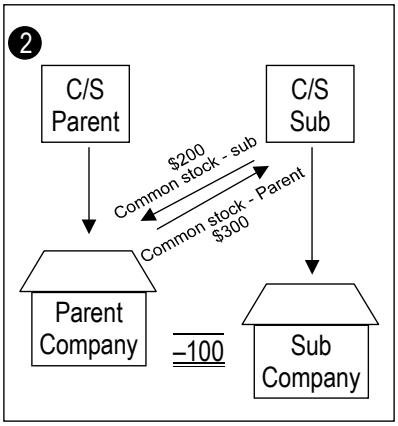
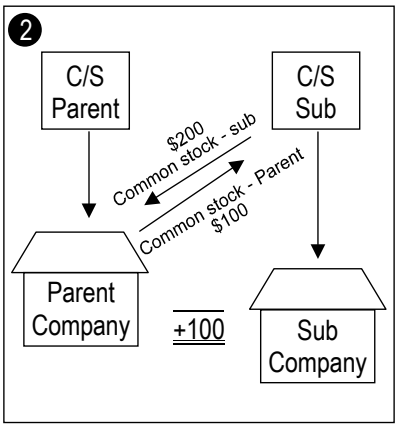
NOTE: EXCHANGE OF STOCK WITH DIFFERENT PAR VALUE AMOUNTS

Plug Additional Paid-in Capital to balance, but if a debit is required, debit paid-in capital of the parent to the extent its exists and if necessary debit the parent's retained earnings for any remaining difference.

NEGATIVE DIFFERENCE

Parent par value issued greater than sub-contributed capital		**Debits Required** * Debit APIC — Parent (Until zero) * Remained retained earnings — Parent

POSITIVE DIFFERENCE

Parent par value issued less than sub-contributed capital		**Credit Required** * Credit APIC — Parent

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EXAMPLE

Recording the Initial Investment under a Pooling of Interests

The following four assumptions based on information from the previous example will further illustrate the recording of the initial investment under pooling account. Poolgood Company has $40,000 additional paid-in capital on its books.

Shares issued by Poolgood (P) $5 Par	*10,000 Shs*	*20,000 Shs*	*30,000 Shs*	*40,000 Shs*
Par value sub share transferred	$100,000	$100,000	$100,000	$100,000
Par value of parent's shares issued	$ 50,000	$100,000	$150,000	$200,000
Difference	+ $ 50,000	- 0 -	– $ 50,000	–$100,000
Sub's A.P.I.C. forfeited	—	—	20,000	20,000
Difference	+ 50,000	—	– 30,000	– 80,000
Parent A.P.I.C. reduced	—	—	$ 30,000	$ 40,000
Negative: decrease parent R.E.	—	—	—	$ 40,000
Positive: increase A.P.I.C.	$ 50,000	—	—	—
DR Investment account	$190,000	$190,000	$190,000	$190,000
DR Additional paid-in capital (P)			30,000	40,000
DR Retained earnings (P)				40,000
CR Common Stock (P)	$50,000	$100,000	$150,000	$200,000
CR Additional paid-in capital	70,000	20,000	0	0
CR Retained earnings of sub	70,000	70,000	70,000	70,000

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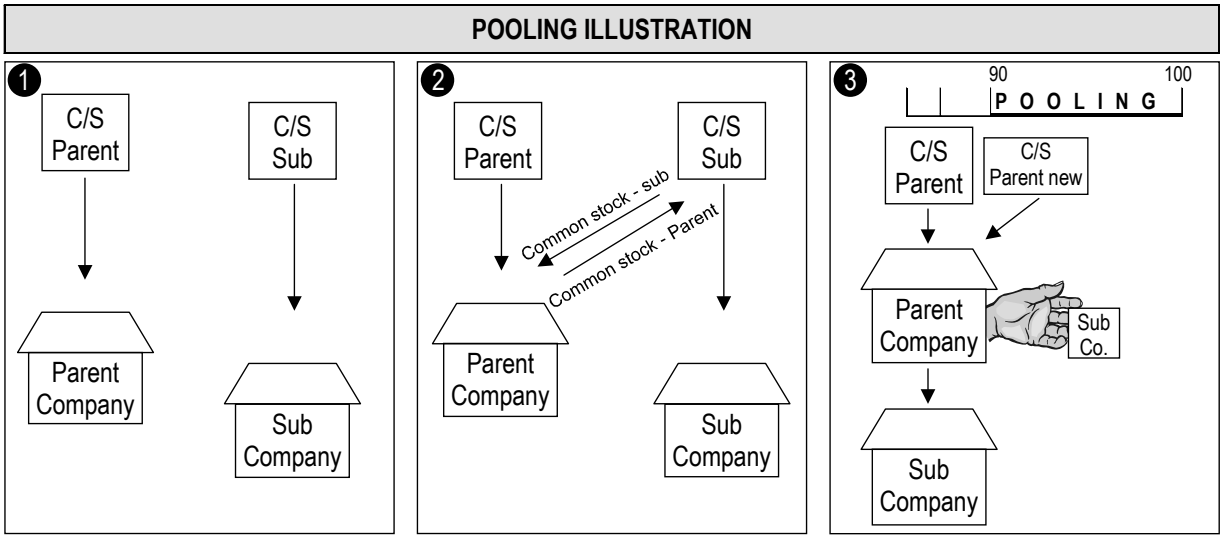
III. POOLING-OF-INTEREST (90%+ AND ALL OTHER CRITERIA)

POOLING-OF INTEREST

For transactions that had previously qualified, or for transaction initiated before June 30, 2001, which met the other criteria for the pooling-of-interest method, this method was, and is, GAAP.

A pooling-of-interest was accomplished through the issuance, by the acquirer, of voting common stock for 90% or more of the voting common stock for 100% of the net assets of the pooled company. The pooling method never results in goodwill because the investment is recorded at the book value of the subsidiary's net assets.



A. APPLICATION OF THE POOLING-OF-INTERESTS METHOD

The pooling-of-interests method is intended to present as a single interest two or more common stockholder interests that were previously independent. A review of the procedures follows:

1. Balance Sheet (NBV)

Assets, liabilities, and stockholders' equity are combined and recorded at historical cost in conformity with GAAP at the date the combination is consummated.

2. Income Statement (Retroactive for Whole Year)

Income statements are retroactively combined for entire year, regardless of when pooling actually occurs.

3. Report as of Beginning of Year

All financial statements for the period in which the combination occurred should be reported as though the combination occurred at the beginning of the period.

4. Restate Prior Financial Statements

Prior-year financial statements should be restated on a consolidated basis.

5. Acquisition Cost (Expensed)

Expenses relating to the combination are expenses of the combined group and should be deducted from combined net income. Examples of such expenses are registration fees, finder's and consultant fees, and costs and losses resulting from combining the separate companies.

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6. No Goodwill Created

Goodwill is not recognized.

7. Minority Interest (Maximum 10%)

Minority interest is recognized (the 10% or less not acquired).

8. Equity Method – Internally Required

The equity method is always used in conjunction with the pooling-of-interests method.

PASS KEY

In a pooling, never use **fair market values**!

B. POOLING-OF-INTERESTS METHOD AT YEAR-END

Under the equity method the parent accrues its proportionate share of the net income reported by the subsidiary. The pooling-of-interests method is accounted for as if the parent and subsidiary had always been combined. Therefore, in the year of acquisition the parent's share of subsidiary's annual net income is included. Dividends declared or paid by the subsidiary are a reduction of the investment in subsidiary account and are not recorded as dividend income. In a pooling all prior financial statements are restated to reflect the combined operations of the pooled companies.

1. Year End Elimination Entry

C	**DR:**	Common stock - Sub	$XXX	
A	**DR:**	A.P.I.C. - Sub	XXX	
R	**DR:**	Retained earnings - Sub	XXX	
I	**CR:**	Investment in sub		$XXX
M	**CR:**	Minority interest		XXX

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EXAMPLE

Pooling-of-Interests Method at Year-End

PoolGood Company merged with Sub-Way Co. in a business combination accounted for as a pooling-of-interest. PoolGood's investment account at the beginning of the current year is $190,000 (100% ownership). Sub-Way's equity section at the beginning of the year is:

Common Stock	$100,000
A.P.I.C.	20,000
Retained Earnings	70,000
Total	$190,000

Assume Sub-Way has reported $20,000 in net income for the year ended December 31, Year 2001. Sub-Way declared and paid a dividend of $5,000 during Year 2001.

Journal Entry: To recognize Sub-Way net income using the equity method

DR	Investment in Sub-Way	$20,000	
CR	Equity in subsidiary income (Sub-Way)		$20,000

Journal Entry: To recognize dividends received under the equity method

DR	Cash	$5,000	
CR	Investment in Sub-Way		$5,000

CAR I M

C	A	R		I	M
100,000	20,000	70,000	Beginning	190,000	0
—	—	20,000	Sub—Income	20,000	—
—	—	(5,000)	Sub—Dividend	(5,000)	—
100,000	20,000	85,000	Ending	205,000	0

C	**DR**	Common Stock: Sub-Way	$100,000	
A	**DR**	Additional paid-in capital: Sub-Way	20,000	
R	**DR**	Retained Earnings: Sub-Way	85,000	
I	**CR**	Investment in Sub-Way		$205,000
M	**CR**	Minority Interest		- 0-

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C. DISCLOSURE FOR POOLING-OF-INTERESTS COMBINATIONS

Consolidated financial statements should include the following disclosures in the period in which the pooling occurs.

1. Brief description of the companies combined.
2. Method of accounting for the combination, that is, the pooling-of-interests method.
3. Description and amount of shares of stock issued to effect the combination.
4. Details of the results of operations for each separate company, prior to the date of combination, that are included in the current combined net income.
5. Description of the nature of adjustments in net assets of the combining companies necessary to adapt to the same accounting policies.

D. ACQUISITING VS. POOLING OF INTEREST COMPARISON

Acquisition		Pooling
FV	Assets	NBV
FV	Liabilities	NBV
Parent Only	Retained Earnings	Both
After Acquisition	Income	Whole Yr./Retroactive
Expense	Acquisition Cost	Expense
Yes	Goodwill	No
Yes (1% - 49%)	Minority Interest	Yes (1% - 10%)
Eliminate	Investment in Sub	Eliminate
Depreciate	Asset Adjustment	N/A
Amortize	Identifiable Intangible Assets	N/A
Impairment Test	Goodwill Adjustment	N/A
Eliminate	Intercompany Transactions	Eliminate

PASS KEY

Many CPA Examination questions have required candidates to distinguish the proper accounting rules between the purchase method and the pooling-of-interests method. The summary chart above will assist in your mastering the differences.

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NOTES

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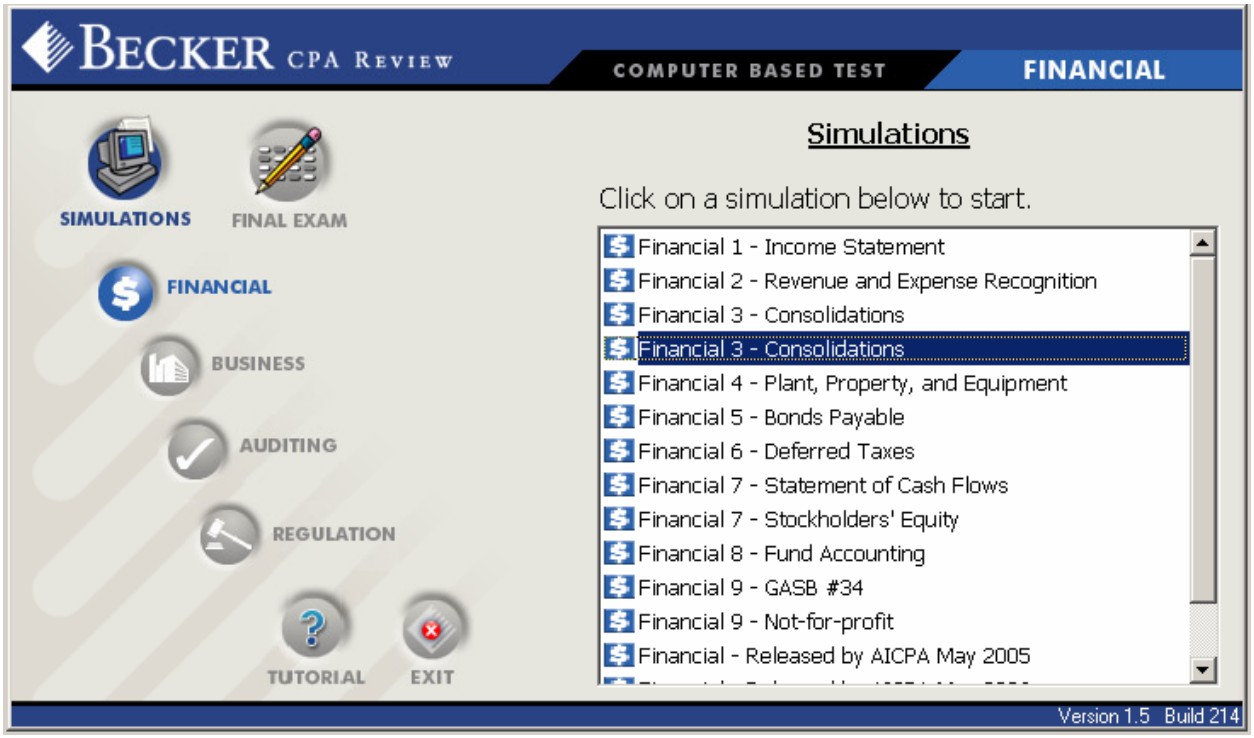
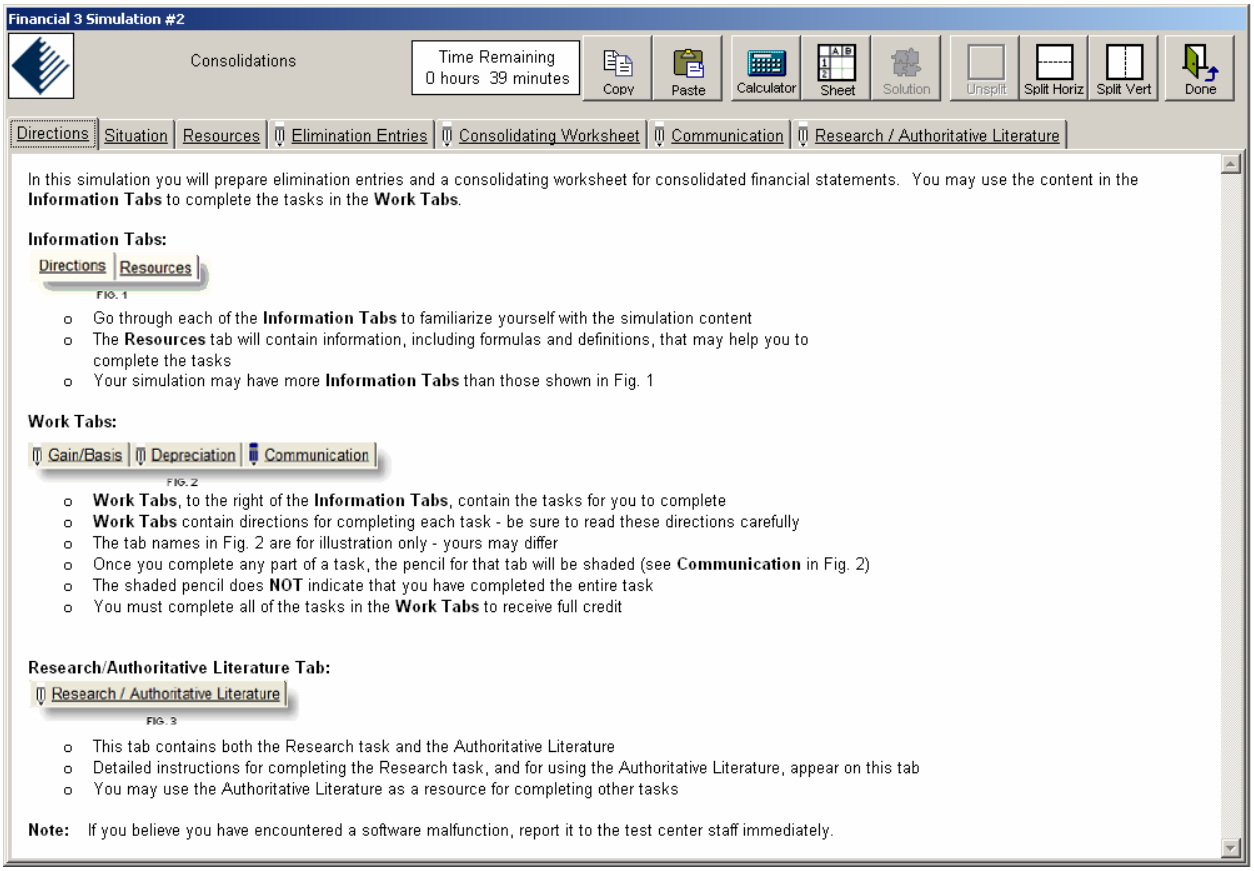
SIMULATION





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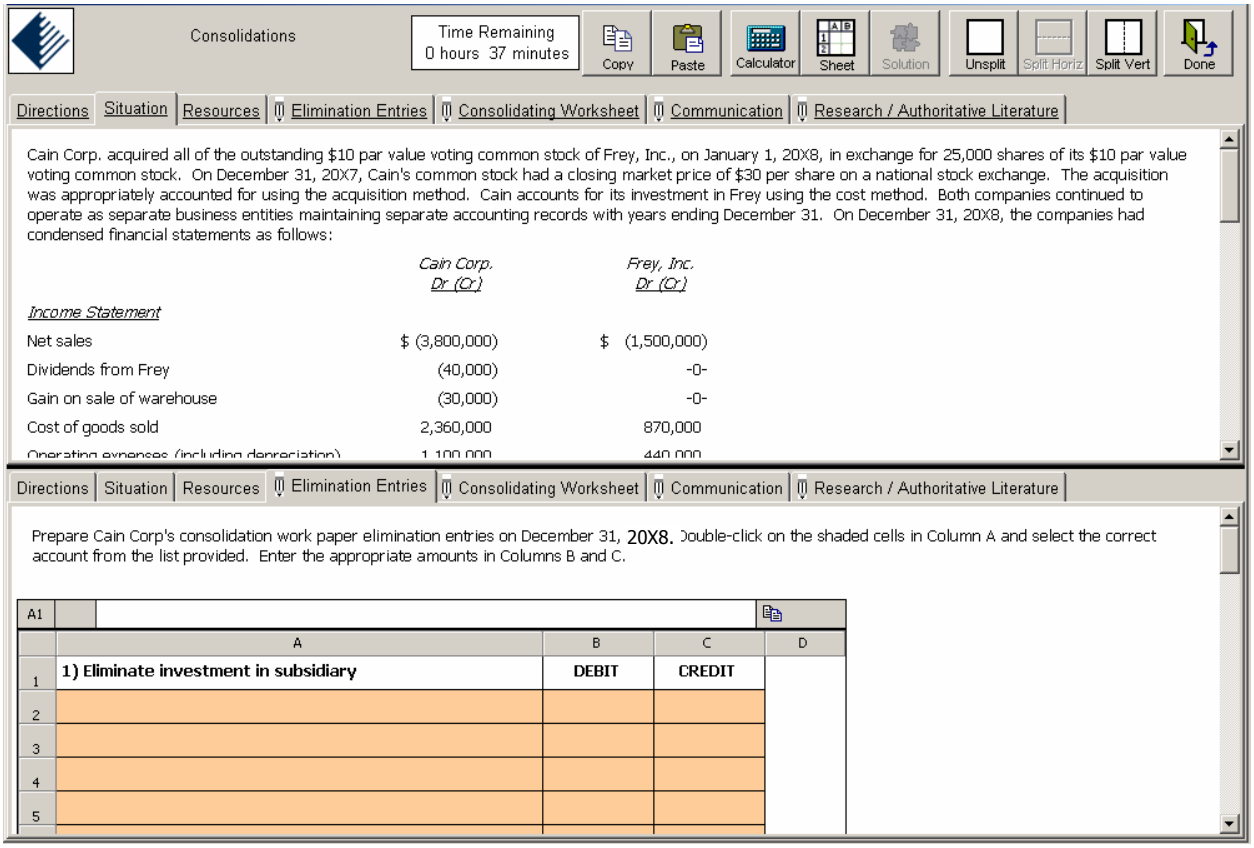

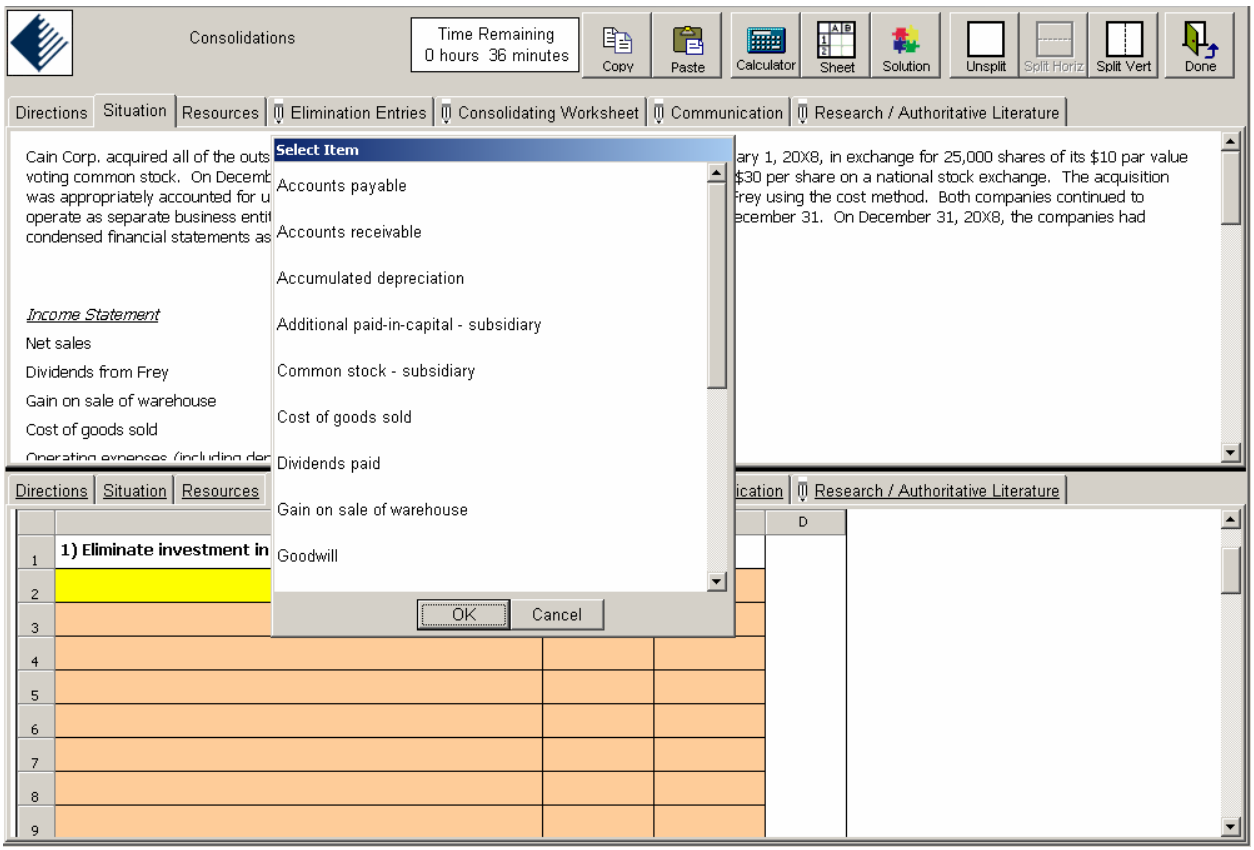

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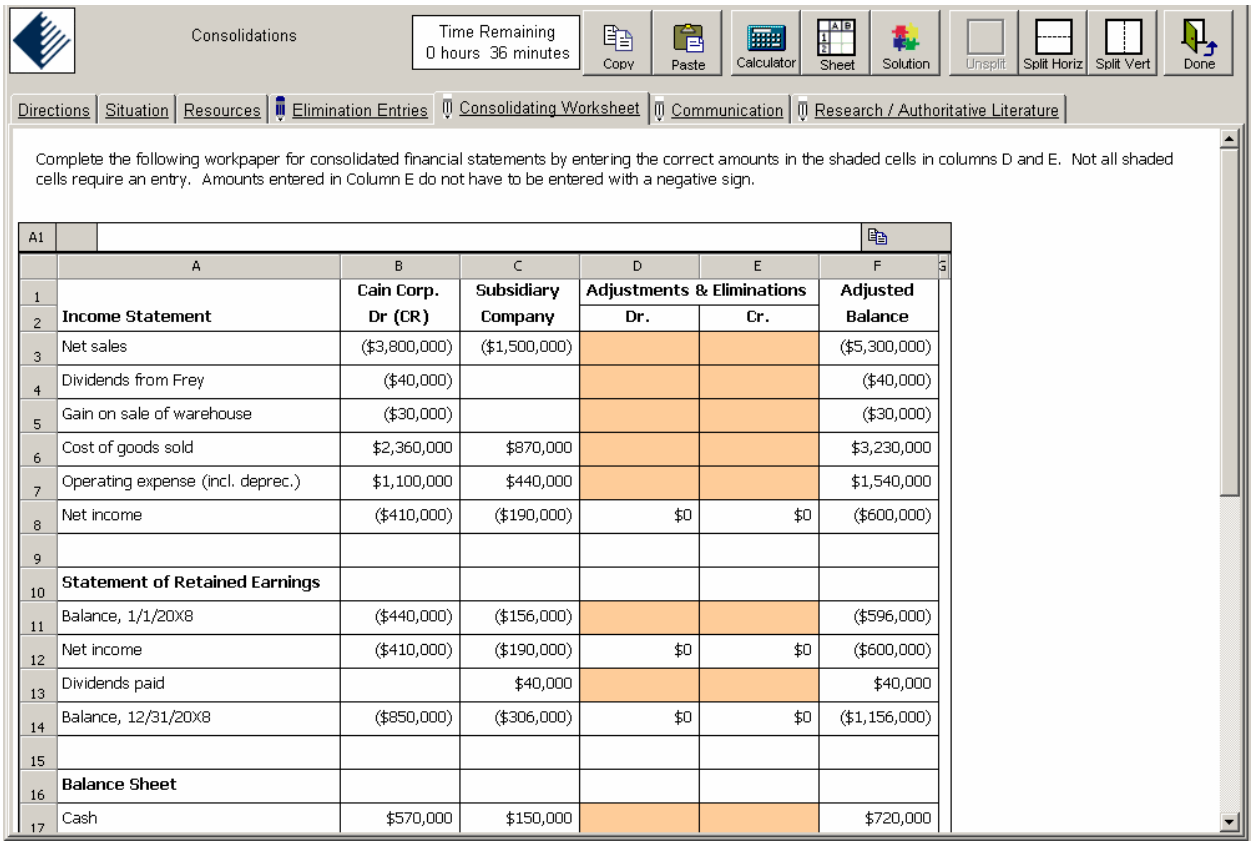

Consolidations

Time Remaining
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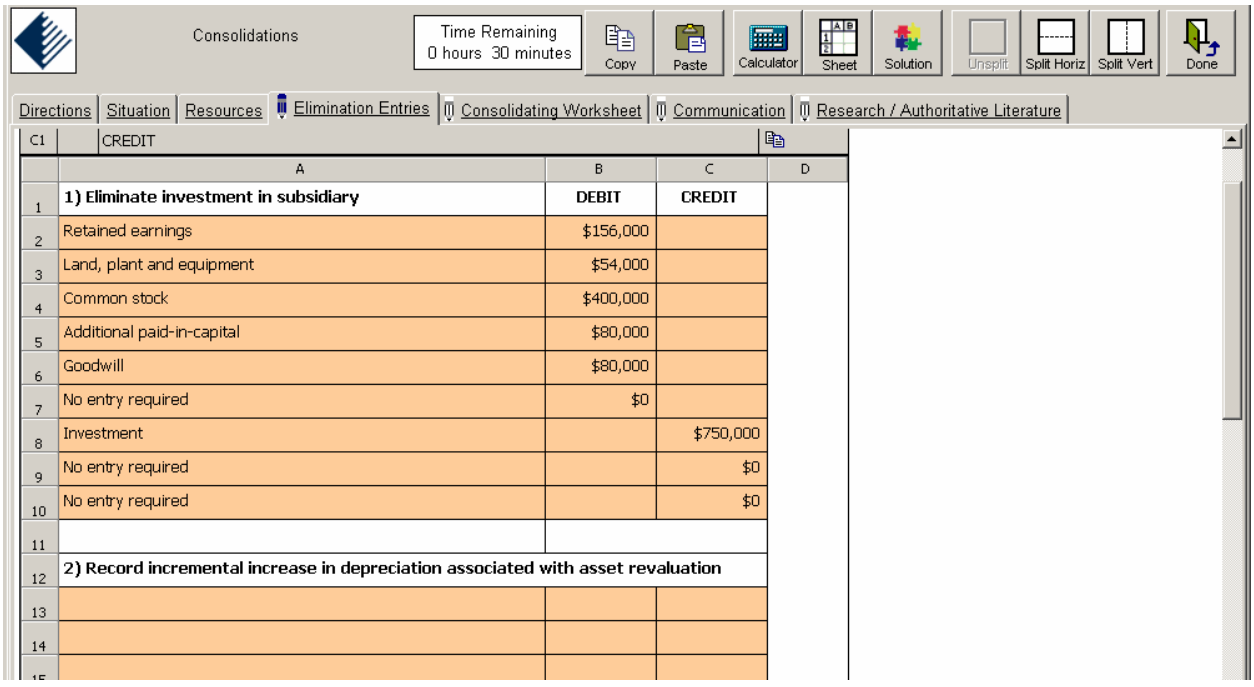
Directions | Situation | Resources | Elimination Entries | Consolidating Worksheet | Communication | Research / Authoritative Literature

Complete the following workpaper for consolidated financial statements by entering the correct amounts in the shaded cells in columns D and E. Not all shaded cells require an entry. Amounts entered in Column E do not have to be entered with a negative sign.

	A	B	C	D	E	F
1		Cain Corp.	Subsidiary	Adjustments & Eliminations		Adjusted
2	**Income Statement**	Dr (CR)	Company	Dr.	Cr.	Balance
3	Net sales	($3,800,000)	($1,500,000)			($5,300,000)
4	Dividends from Frey	($40,000)				($40,000)
5	Gain on sale of warehouse	($30,000)				($30,000)
6	Cost of goods sold	$2,360,000	$870,000			$3,230,000
7	Operating expense (incl. deprec.)	$1,100,000	$440,000			$1,540,000
8	Net income	($410,000)	($190,000)	$0	$0	($600,000)
9						
10	**Statement of Retained Earnings**					
11	Balance, 1/1/20X8	($440,000)	($156,000)			($596,000)
12	Net income	($410,000)	($190,000)	$0	$0	($600,000)
13	Dividends paid		$40,000			$40,000
14	Balance, 12/31/20X8	($850,000)	($306,000)	$0	$0	($1,156,000)
15						
16	**Balance Sheet**					
17	Cash	$570,000	$150,000			$720,000



Consolidations

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Directions | Situation | Resources | Elimination Entries | Consolidating Worksheet | Communication | Research / Authoritative Literature

C1 CREDIT

	A	B	C	D
1	**1) Eliminate investment in subsidiary**	**DEBIT**	**CREDIT**	
2	Retained earnings	$156,000		
3	Land, plant and equipment	$54,000		
4	Common stock	$400,000		
5	Additional paid-in-capital	$80,000		
6	Goodwill	$80,000		
7	No entry required	$0		
8	Investment		$750,000	
9	No entry required		$0	
10	No entry required		$0	
11				
12	**2) Record incremental increase in depreciation associated with asset revaluation**			
13				
14				
15				

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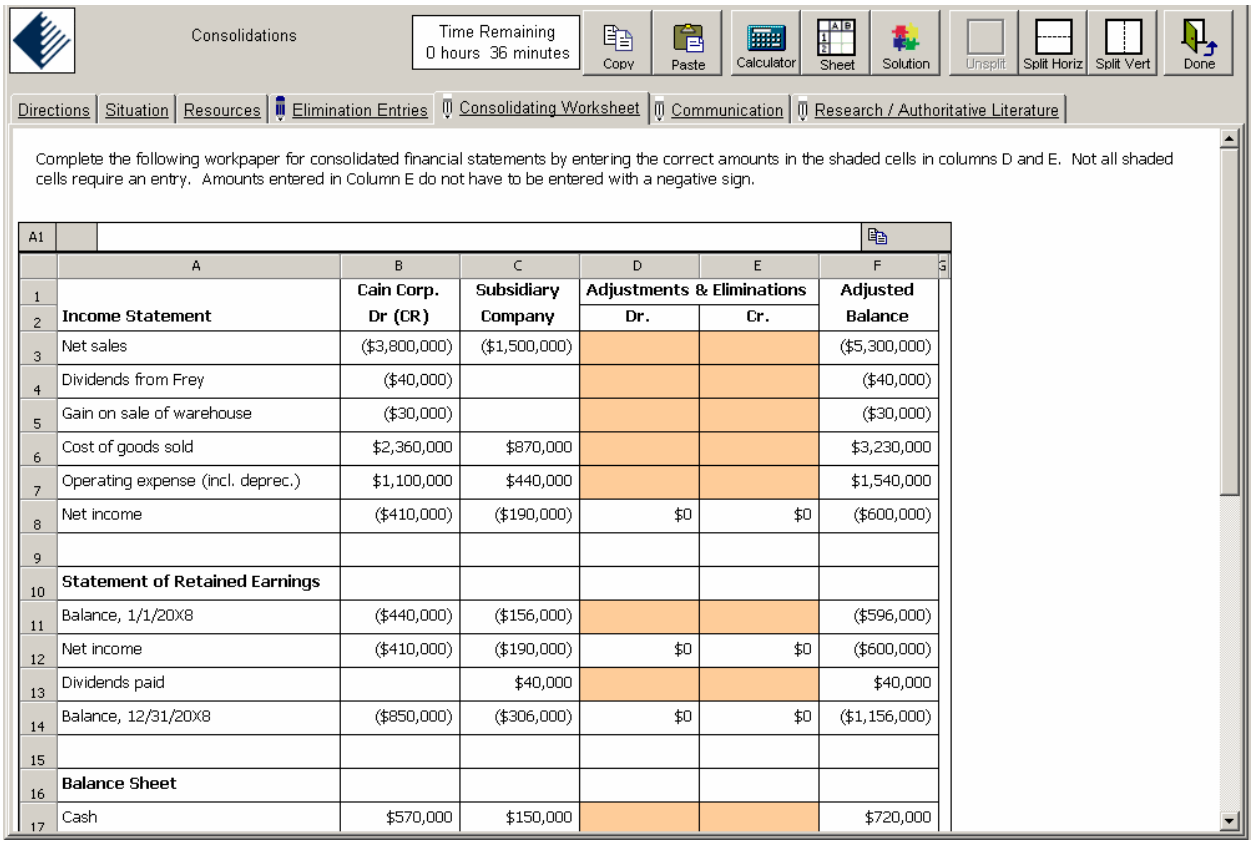

Consolidations

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Directions | Situation | Resources | Elimination Entries | Consolidating Worksheet | Communication | Research / Authoritative Literature

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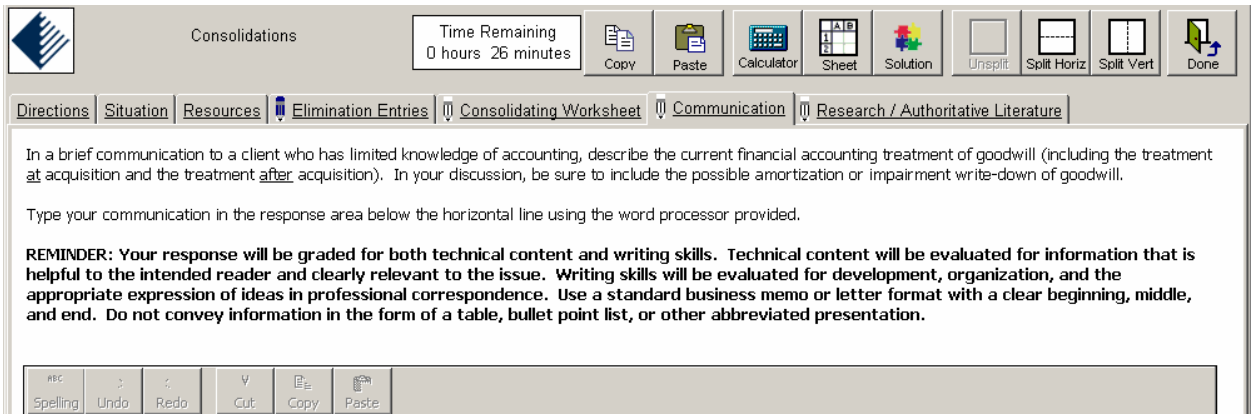
17	Cash	$570,000	$150,000			$720,000



Consolidations

Time Remaining
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Directions | Situation | Resources | Elimination Entries | Consolidating Worksheet | Communication | Research / Authoritative Literature

In a brief communication to a client who has limited knowledge of accounting, describe the current financial accounting treatment of goodwill (including the treatment at acquisition and the treatment after acquisition). In your discussion, be sure to include the possible amortization or impairment write-down of goodwill.

Type your communication in the response area below the horizontal line using the word processor provided.

REMINDER: Your response will be graded for both technical content and writing skills. Technical content will be evaluated for information that is helpful to the intended reader and clearly relevant to the issue. Writing skills will be evaluated for development, organization, and the appropriate expression of ideas in professional correspondence. Use a standard business memo or letter format with a clear beginning, middle, and end. Do not convey information in the form of a table, bullet point list, or other abbreviated presentation.

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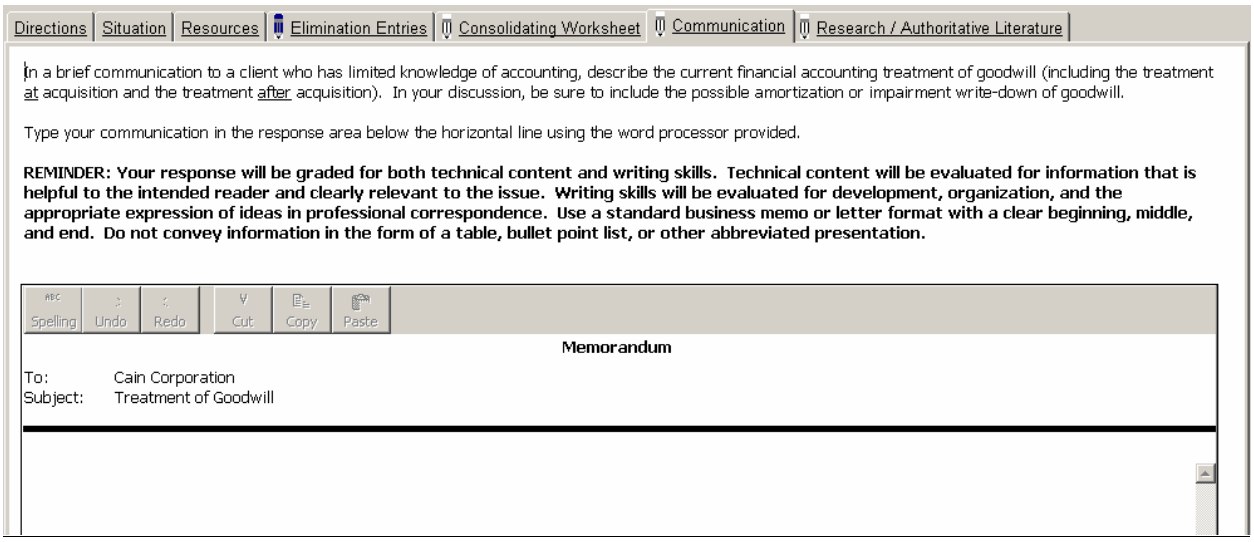

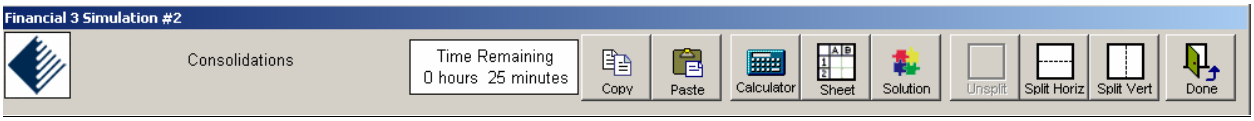

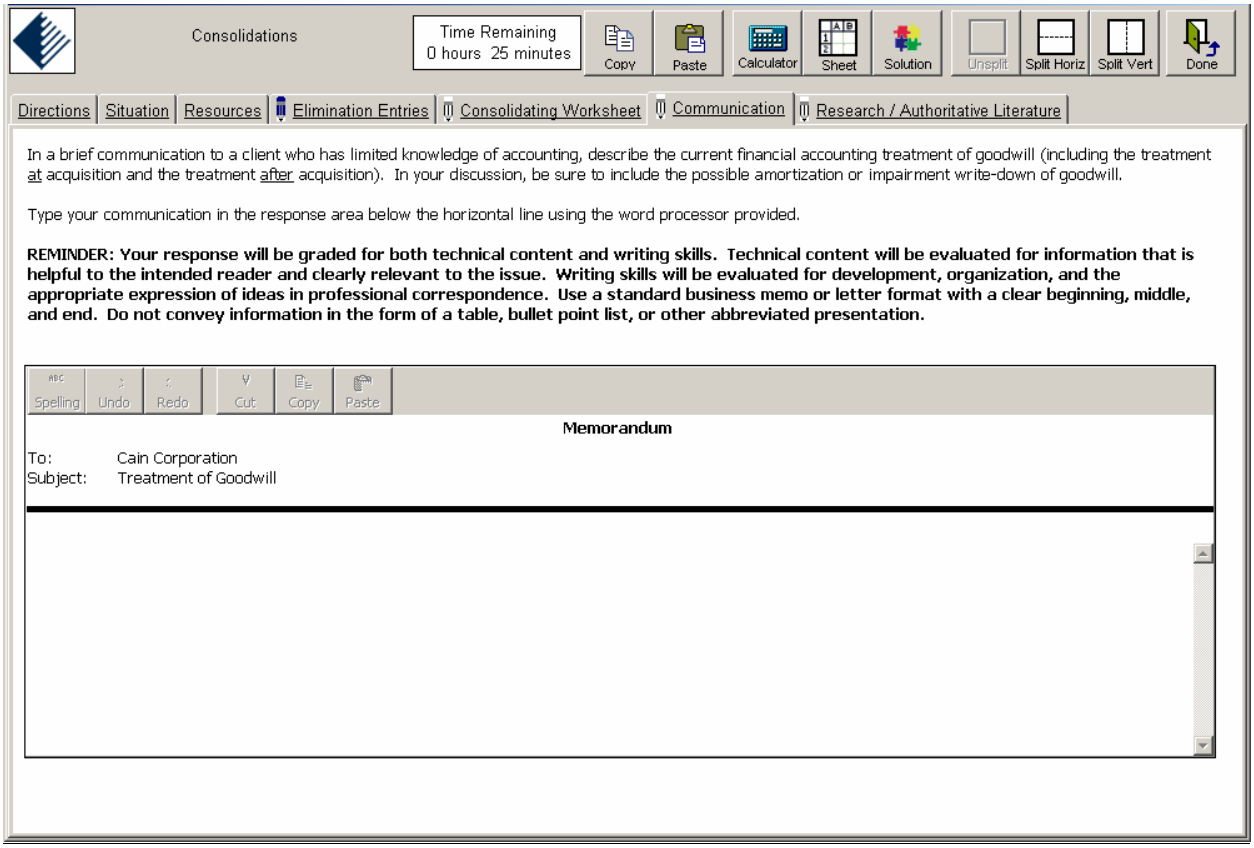

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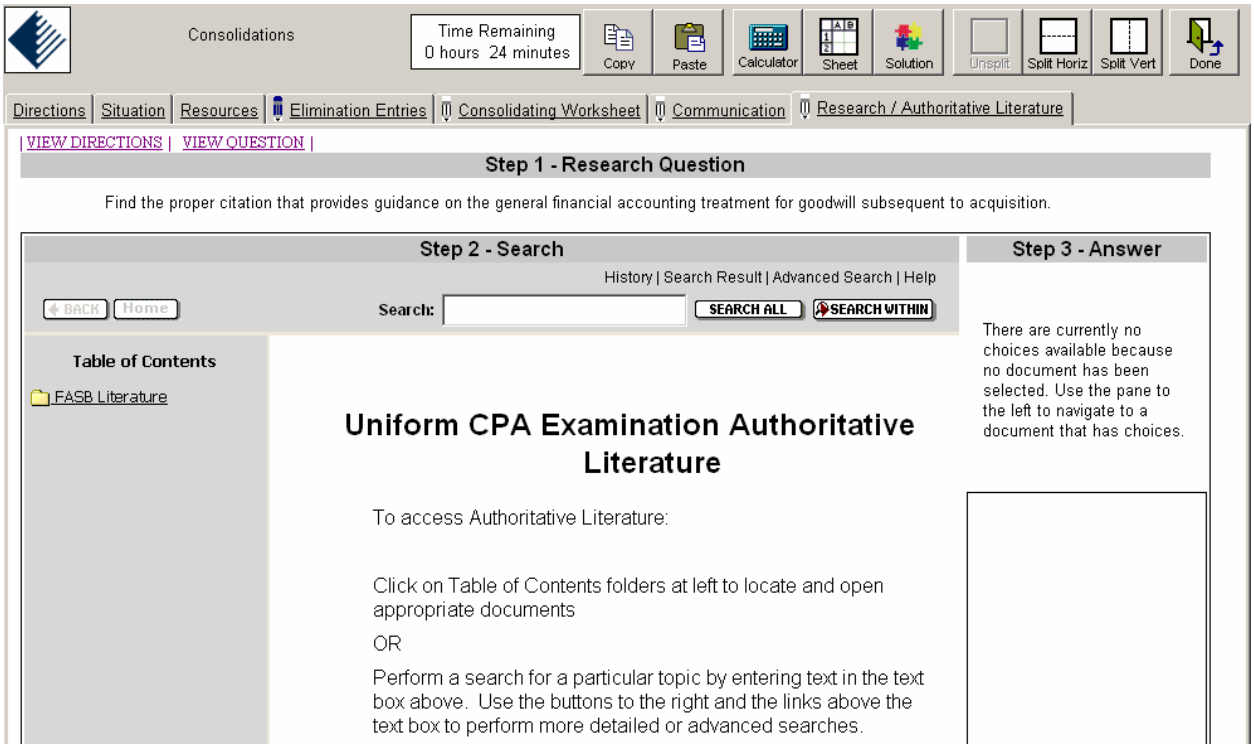

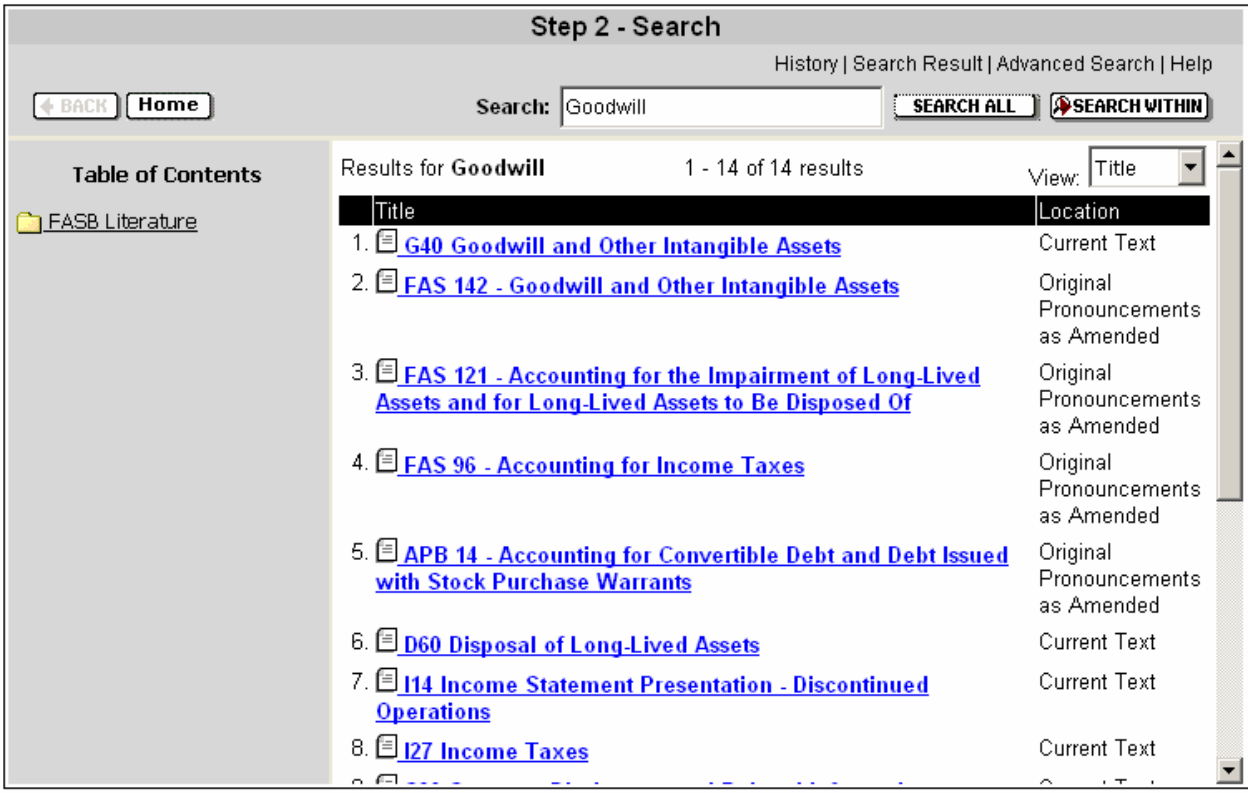

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FINANCIAL ACCOUNTING & REPORTING 3(B)

Class Questions Answer Worksheet

MC Question Number	First Choice Answer	Correct Answer	NOTES
1.			
2.			
3.			
4.			
5.			
6.			
7.			
8.			
9.			
10.			
11.			
12.			
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17.			
18.			
19.			

Grade:

Multiple-choice Questions Correct / 19 = _____% Correct

Detailed explanations to the class questions are located in the back of this textbook.

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NOTES

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CLASS QUESTIONS

1. CPA-00265

A company has adopted Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (as amended by SFAS 130). It should report the marketable equity securities that it has classified as trading at:

a. Lower of cost or market, with holding gains and losses included in earnings.
b. Lower of cost or market, with holding gains included in earnings only to the extent of previously recognized holding losses.
c. Fair value, with holding gains included in earnings only to the extent of previously recognized holding losses.
d. Fair value, with holding gains and losses included in earnings.

2. CPA-00273

Information regarding Stone Co's available-for-sale portfolio of marketable equity securities is as follows:

Aggregate cost as of 12/31/X2	$170,000
Market value as of 12/31/X2	148,000
Net realized gains during 20X2	30,000

At December 31, 20X1, Stone reported an unrealized loss of $1,500 to reduce investments to market value. This was the first such adjustment made by Stone on these types of securities. According to SFAS No. 115, in its 20X2 statement of comprehensive income, what amount of unrealized loss should Stone report?

a. $30,000
b. $20,500
c. $22,000
d. $0

3. CPA-00284

When a parent-subsidiary relationship exists, consolidated financial statements are prepared in recognition of the accounting concept of:

a. Reliability.
b. Materiality.
c. Legal entity.
d. Economic entity.

4. CPA-00283

Consolidated financial statements are typically prepared when one company has a controlling financial interest in another unless:

a. The subsidiary is a finance company.
b. The fiscal year-ends of the two companies are more than three months apart.
c. The subsidiary is in bankruptcy.
d. The two companies are in unrelated industries, such as manufacturing and real estate.

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5. CPA-00287

An investor uses the cost method to account for an investment in common stock. Dividends received this year exceeded the investor's share of investee's undistributed earnings since the date of investment. The amount of dividend revenue that should be reported in the investor's income statement for this year would be:

a. The portion of the dividends received this year that were in excess of the investor's share of investee's undistributed earnings since the date of investment.
b. The portion of the dividends received this year that were not in excess of the investor's share of investee's undistributed earnings since the date of investment.
c. The total amount of dividends received this year.
d. Zero.

6. CPA-00285

Plack Co. purchased 10,000 shares (2% ownership) of Ty Corp. on February 14, 2001. Plack received a stock dividend of 2,000 shares on April 30, 2001, when the market value per share was $35. Ty paid a cash dividend of $2 per share on December 15, 2001. In its 2001 income statement, what amount should Plack report as dividend income?

a. $20,000
b. $24,000
c. $90,000
d. $94,000

7. CPA-00320

On January 2, 1993, Well Co. purchased 10% of Rea, Inc.'s outstanding common shares for $400,000. Well is the largest single shareholder in Rea, and Well's officers are a majority on Rea's board of directors. Rea reported net income of $500,000 for 1993, and paid dividends of $150,000. In its December 31, 1993, balance sheet, what amount should Well report as investment in Rea?

a. $450,000
b. $435,000
c. $400,000
d. $385,000

8. CPA-00303

Band Co. uses the equity method to account for its investment in Guard, Inc. common stock. How should Band record a 2% stock dividend received from Guard?

a. As dividend revenue at Guard's carrying value of the stock.
b. As dividend revenue at the market value of the stock.
c. As a reduction in the total cost of Guard stock owned.
d. As a memorandum entry reducing the unit cost of all Guard stock owned.

9. CPA-00289

Birk Co. purchased 30% of Sled Co.'s outstanding common stock on December 31, 2000, for $200,000. On that date, Sled's stockholders' equity was $500,000, and the fair value of its identifiable net assets was $600,000. On December 31, 2000, what amount of goodwill should Birk attribute to this acquisition?

a. $0
b. $20,000
c. $30,000
d. $50,000

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10. CPA-00348

Park Co. uses the equity method to account for its January 1, 1990, purchase of Tun, Inc.'s common stock. On January 1,1990, the fair values of Tun's FIFO inventory and land exceeded their carrying amounts. How do these excesses of fair values over carrying amounts affect Park's reported equity in Tun's 1990 earnings?

	Inventory excess	*Land excess*
a.	Decrease	Decrease
b.	Decrease	No effect
c.	Increase	Increase
d.	Increase	No effect

11. CPA-00288

Puff Co. acquired 40% of Straw, Inc.'s voting common stock on January 2, 2001 for $400,000. The carrying amount of Straw's net assets at the purchase date totaled $900,000. Fair values equaled carrying amounts for all items except equipment, for which fair values exceeded carrying amounts by $100,000. The equipment has a five-year life. During 2001, Straw reported net income of $150,000. What amount of income from this investment should Puff report in its 2001 income statement?

a. $40,000
b. $52,000
c. $56,000
d. $60,000

12. CPA-00324

On January 1, 1992, Point, Inc. purchased 10% of Iona Co.'s common stock. Point purchased additional shares bringing its ownership up to 40% of Iona's common stock outstanding on August 1, 1992. During October 1992, Iona declared and paid a cash dividend on all of its outstanding common stock. How much income from the Iona investment should Point's 1992 income statement report?

a. 10% of Iona's income for January 1 to July 31, 1992, plus 40% of Iona's income for August 1 to December 31, 1992.
b. 40% of Iona's income for August 1 to December 31, 1992 only.
c. 40% of Iona's 1992 income.
d. Amount equal to dividends received from Iona.

13. CPA-00430

Company J acquired all of the outstanding common stock of Company K in exchange for cash. The acquisition price exceeds the fair value of net assets acquired. How should Company J determine the amounts to be reported for the plant and equipment and long-term debt acquired from Company K?

	Plant and equipment	*Long-term debt*
a.	K's carrying amount	K's carrying amount
b.	K's carrying amount	Fair value
c.	Fair value	K's carrying amount
d.	Fair value	Fair value

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14. CPA-00423

Penn Corp. paid $300,000 for the outstanding common stock of Star Co. At that time, Star had the following condensed balance sheet:

	Carrying amounts
Current assets	$ 40,000
Plant and equipment, net	380,000
Liabilities	200,000
Stockholders' equity	220,000

The fair value of the plant and equipment was $60,000 more than its recorded carrying amount. The fair values and carrying amounts were equal for all other assets and liabilities. What amount of goodwill, related to Star's acquisition, should Penn report in its consolidated balance sheet?

a. $20,000
b. $40,000
c. $60,000
d. $80,000

15. CPA-00389

A business combination is accounted for as an acquisition. Which of the following expenses related to the business combination should be included, in total, in the determination of net income of the combined corporation for the period in which the expenses are incurred?

	Fees of finders and consultants	*Registration fees for equity securities issued*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

16. CPA-00391

On September 29, 1995, Wall Co. paid $860,000 for all the issued and outstanding common stock of Hart Corp. On that date, the carrying amounts of Hart's recorded assets and liabilities were $800,000 and $180,000, respectively. Hart's recorded assets and liabilities had fair values of $840,000 and $140,000, respectively. In Wall's September 30, 1995, balance sheet, what amount should be reported as goodwill?

a. $20,000
b. $160,000
c. $180,000
d. $240,000

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17. CPA-00455

Wright Corp. has several subsidiaries that are included in its consolidated financial statements. In its December 31, 1992, trial balance, Wright had the following intercompany balances before eliminations:

	Debit	*Credit*
Current receivable due from Main Co.	$ 32,000	
Noncurrent receivable from Main	114,000	
Cash advance to Corn Corp.	6,000	
Cash advance from King Co.		$15,000
Intercompany payable to King		101,000

In its December 31, 1992, consolidated balance sheet, what amount should Wright report as intercompany receivables?

a. $152,000
b. $146,000
c. $36,000
d. $0

18. CPA-00448

Perez, Inc. owns 80% of Senior, Inc. During 1992, Perez sold goods with a 40% gross profit to Senior. Senior sold all of these goods in 1992. For 1992 consolidated financial statements, how should the summation of Perez and Senior income statement items be adjusted?

a. Sales and cost of goods sold should be reduced by the intercompany sales.
b. Sales and cost of goods sold should be reduced by 80% of the intercompany sales.
c. Net income should be reduced by 80% of the gross profit on intercompany sales.
d. No adjustment is necessary.

19. CPA-00484

On January 1, 1990, Poe Corp. sold a machine for $900,000 to Saxe Corp., its wholly-owned subsidiary. Poe paid $1,100,000 for this machine, which had accumulated depreciation of $250,000. Poe estimated a $100,000 salvage value and depreciated the machine on the straight-line method over 20 years, a policy which Saxe continued. In Poe's December 31, 1990, consolidated balance sheet, this machine should be included in cost and accumulated depreciation as:

	Cost	*Accumulated depreciation*
a.	$1,100,000	$300,000
b.	$1,100,000	$290,000
c.	$900,000	$40,000
d.	$850,000	$42,500

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NOTES

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Financial Accounting & Reporting 4

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WORKING CAPITAL AND ITS COMPONENTS

I. INTRODUCTION TO WORKING CAPITAL

A. WORKING CAPITAL

Working capital is defined as current assets minus current liabilities. It is often a measure of the solvency of a company and is used in many financial ratios for analysis purposes.

1. Working Capital

Current Assets – Current Liabilities

2. Current Ratio

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

3. Quick Ratio

$$\frac{\text{Cash + Net Receivables + Marketable Securities}}{\text{Current Liabilities}}$$

B. CURRENT ASSETS

Current assets are those resources that are reasonably expected to be realized in cash, sold, or consumed (prepaid items) during the normal operating cycle of a business or one year, whichever is longer. Current assets typically consist of:

1. Cash,
2. Trading securities,
3. Other short-term investments (individual available-for-sale securities if liquidation is anticipated within the operating cycle or one year, whichever is longer),
4. Accounts and notes receivable,
5. Trade installment receivables,
6. Inventories (discussed later in this module),
7. Other short-term receivables,
8. Prepaid expenses, and
9. Cash surrender value of life insurance. Cash surrender value of life insurance can be a current asset or a non-current asset depending on intent. If the policy owner intends to surrender the policy for its cash surrender value during the normal operating cycle, it would be a current asset; if the policy owner does not intend to surrender the policy, as is normal, it would be a non-current asset. If an insurance policy has a cash surrender value, any portion of the premium payment that does not add to that cash surrender value is expensed.

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C. CURRENT LIABILITIES

Current liabilities are obligations whose liquidation is reasonably expected to require the use of current assets or the creation of other current liabilities. Obligations for items that have entered the operating cycle should be classified as current liabilities. The concept of current liabilities includes estimates or accrued amounts that are expected to be required to cover expenditures within the year for known obligations (1) when the amount can be determined only approximately (e.g., provision for accrued bonuses payable), or (2) where the specific person(s) to whom payment will be made is unascertainable (e.g., provision for warranty of a product).

Current liabilities are an important indication of financial strength and solvency. The ability to pay current debts as they mature is analyzed by interested parties both within and outside the company.

1. Sources of Current Liabilities

Current liabilities may arise from regular business operations (as is the case of accounts payable and wages payable) or to meet cash needs through bank borrowings.

2. Types of Current Liabilities

Current liabilities typically consist of:

a. Trade accounts and notes payable,

b. Current portions of long-term debt,

c. Cash dividends payable,

d. Accrued liabilities,

e. Payroll liabilities,

f. Taxes payable, and

g. Advances from customers (deferred revenues if expected to be recognized within one year).

3. Classification of Short-Term Obligations Expected to Be Refinanced

A short-term obligation may be excluded from current liabilities and included in noncurrent debt if the company intends to refinance it on a long-term basis and the intent is supported by the ability to do so as evidenced either by:

a. The actual refinancing prior to the issuance of the financial statements, or

b. The existence of a noncancelable financing agreement from a lender having the financial resources to accomplish the refinancing.

The amount excluded from current liabilities and a full description of the financing agreement shall be fully disclosed in the financial statements or notes thereto.

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II. CASH AND CASH EQUIVALENTS

Cash includes both currency and demand deposits with banks and/or other financial institutions. It also includes deposits that are similar to demand deposits (can be added to or withdrawn at any time without penalty). The term cash equivalents broadens the definition of cash to include short-term, highly liquid investments that are both readily convertible to cash and so near their maturity when acquired by the entity (90 days or less from date of purchase) that they present insignificant risk of changes in value.

A. EXAMPLES OF CASH AND CASH EQUIVALENTS

1. Coin and currency on hand (including petty cash)
2. Checking accounts
3. Savings accounts
4. Money market funds
5. Deposits held as compensating balances against borrowing arrangements with a lending institution that are NOT legally restricted
6. Negotiable paper
   a. Bank checks, money orders, traveler's checks, bank drafts, and cashier's checks
   b. Commercial paper and Treasury bills
   c. Certificates of deposit (having original maturities of 90 days or less)

B. ITEMS NOT CASH OR CASH EQUIVALENTS

1. Time certificates of deposit (if original maturity over 90 days)
2. Legally restricted deposits held as compensating balances against borrowing arrangements with a lending institution

C. RESTRICTED OR UNRESTRICTED

Cash is classified as unrestricted or restricted. Restricted cash is cash that has been set aside for a specific use or purpose (e.g., the purchase of property, plant, and equipment). Unrestricted cash is used for all current operations. The nature, amount, and timing of restrictions should be disclosed in the footnotes.

1. If the restriction is associated with a current asset or current liability, classify as a current asset but separate from unrestricted cash.
2. If the restriction is associated with noncurrent asset or noncurrent liability, classify as a noncurrent asset but separate from either the Investments or Other Assets section.
3. Examples of restrictions
   a. If any portion of cash and cash equivalents is contractually restricted because of financing arrangements with a credit institution (called a compensating balance), that portion should be separately reported as "restricted cash" in the balance sheet.
   b. If any portion of cash and cash equivalents is restricted by management, it should be reported as restricted cash and as a current or long-term asset (depending on the anticipated date of disbursement).
   c. Some industries (such as public utilities) report the amount of cash and cash equivalents as the last asset on the balance sheet because they report assets in inverse order of liquidity.

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EXAMPLE

Items Included in Cash Balance

Smith Corporation's cash ledger balance on December 31, Year 7, was $160,000. On the same date Smith held the following items in its safe:

- A $5,000 check payable to Smith, dated January 2, Year 8 that was not included in the December 31 checkbook balance.
- A $3,500 check payable to Smith, deposited December 22 and included in the December 31 checkbook balance, that was returned NSF. The check was re-deposited January 2, Year 8 and cleared January 7.
- A $25,000 check, payable to a supplier and drawn on Smith's account, that was dated and recorded December 31, but was not mailed until January 15, Year 8.

In its December 31, Year 7 balance sheet, what amount should Smith report for cash?

Smith's cash balance is calculated as follows:

Unadjusted balance of Smith's Cash Ledger Account, December 31, Year 7	$160,000
Add: Check Payable to supplier dated and recorded on December 13, Year 7, but not mailed until January 15, Year 8	25,000
Less: NSF check returned by bank on December 30, Year 7	(3,500)
Adjusted balance, December 31, Year 7	$181,500

D. BANK RECONCILIATIONS

There are two general forms of bank reconciliations. One form is called a simple reconciliation. The other widely used form is entitled reconciliation of cash receipts and disbursements.

1. Simple Reconciliation

Differences between the cash balance reported by the bank and the cash balance per the depositor's records are explained through the preparation of the bank reconciliation. Several factors bring about this differential.

a. Deposits in Transit

Funds sent by the depositor to the bank that have not been recorded by the bank and deposits made after the bank's cutoff date will not be included in the bank statement. In both cases, the balance per the depositor's records will be higher than those of the bank.

b. Outstanding Checks

Checks written for payment by the depositor that have not been presented to the bank will result in a higher balance per bank records than per depositor records.

c. Service Charges

Service charges are deducted by the bank. The depositor will not deduct this amount from its records until it is made aware of the charge, usually in the following month. Balance per books is overstated until this amount is subtracted.

d. Bank Collections

The bank may make collections on the depositor's behalf, increasing the depositor's bank balance. If the depositor is not aware the collection was credited to its balance, the balance per depositor's records will be understated.

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e. Errors

Errors made by either the bank or the depositors are another cause for difference.

f. Nonsufficient Funds (NSF)

The bank may have charged the depositor's account for a dishonored check and the check may not have been redeposited until the following month. This would overstate the depositor's book balance as of the balance sheet date.

g. Interest Income

Usually the depositor does not keep track of average daily cash balances, and so will add this amount to its records once made aware of this revenue. Balance per books is understated until this amount is added.

h. Example of a Simple Bank Reconciliation

Although other methods can be used, the most common procedure is to reconcile both book and bank balances to a common "true" balance. That balance should then appear on the balance sheet under the caption "Cash and Cash Equivalents."

Procedures:

(1) Book balance is adjusted to reflect any corrections reported by the bank (e.g., NSF checks, notes collected by the bank and credited to the account, monthly service charges, and other bank charges such as check printing charges).

(2) After the above adjustments are made,
ADJUSTED BOOK BALANCE = TRUE BALANCE.

(3) The bank balance per the bank statement is reconciled to the "true balance" determined above.

EXAMPLE

Simple Bank Reconciliation

Burbank Company's records reflect a $12,650 cash balance on November 30, Year 3. Burbank's November bank statement reports the following amounts:

Cash balance	$10,050
Bank service charge	10
NSF check	90

Deposits in transit equal $3,000 and outstanding checks are $500.

What is Burbank's November 30, Year 3 adjusted cash balance?

Bank Reconciliation for November Year 3

Balance per books		$12,650
Less: Bank service charge	$10	
NSF check	90	(100)
Adjusted cash balance		$12,550
Balance per bank		$10,050
Add: Deposits in transit		3,000
		$13,050
Less: Outstanding checks		(500)
Adjusted cash balance		$12,550

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2. Reconciliation of Cash Receipts and Disbursements

The reconciliation of cash receipts and disbursements, commonly referred to as the four-column reconciliation or proof of cash, serves as a proof of the proper recording of cash transactions.

Additional information is required in preparing the four-column reconciliation. The bank reconciliation information for the present month and that of the prior month must be obtained.

The object of the four-column approach is to reconcile any differences between the amount the depositor has recorded as cash receipts and the amount the bank has recorded as deposits. Likewise, this approach determines any differences between amounts the depositor has recorded as cash disbursements and amounts the bank has recorded as checks paid.

EXAMPLE

Four-Column Approach

Based on the information in the previous example and additional information for the month of December, Burbank's reconciliation of cash receipts and disbursements follows:

Burbank Company
Reconciliation of Cash Receipts and Cash Disbursements
For the Month of December, Year 3

	Balance November 30, Year 3	*December Receipts*	*December Payments*	*Balance December 31, Year 3*
Balance per depositor's books	$12,550	$12,950	$4,948	$20,552
Note collected by bank		3,050		3,050
Bank service charge			15	(15)
NSF check received from customer		(285)		(285)
Error in recording check #350			54	(54)
Adjusted balances	$12,550	$15,715	$5,017	$23,248
Balance per bank records	$10,050	$15,000	$2,400	$22,650
Deposit in transit:				
November 30	3,000	(3,000)		
December 31		4,000		4,000
Outstanding checks:				
November 30	(500)		(500)	
December 31			3,402	(3,402)
NSF check		(285)	(285)	
Adjusted balances	$12,550	$15,715	$5,017	$23,248

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III. ACCOUNTS RECEIVABLE

Accounts receivable are oral promises to pay debts and are generally classified as current assets. They are classified either as trade receivables (accounts receivable from purchasers of the company's goods and services) or non-trade receivables (accounts receivable from persons other than customers, such as advances to employees, tax refunds, etc.).

A. BLANK ACCOUNT ANALYSIS FORMAT

The preparation of an account analysis may increase your ability to "squeeze" or otherwise derive various answers to CPA exam questions regarding accounts receivable, allowance for doubtful accounts, and many other accounts.

Blank Analysis Format

B	Beginning balance	$_____
A	ADD: _____	_____
	_____	_____
	SUBTOTAL	_____
S	SUBTRACT: _____	_____
	_____	_____
	_____	_____
E	Ending balance	$_____

PASS KEY

The Blank Analysis Format is a tool that is merely an "add-subtract" form of a "T" account, but it often provides a "foolproof" method of obtaining the correct result to many examination questions. You will find that this format will assist you "squeezing" answers in many of the balance sheet items questions on the CPA exam!

1. Accounts Receivable Account Analysis Format

Beginning Balance			$ 90,000
ADD:	Credit sales		800,000
	SUBTOTAL		890,000
SUBTRACT:	Cash collected on account	$810,000	
	Accounts receivable converted to notes receivable	7,000	
	Accounts receivable written off as bad debts	23,000	(840,000)
Ending balance			$ 50,000

The net realizable value of accounts receivable is the balance of the accounts receivable account less receivables that may be uncollectible determined by an aging of year-end receivables.

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B. VALUATION OF ACCOUNTS RECEIVABLE WITH DISCOUNTS AND RETURNS

In general, accounts receivable should be initially valued at the original transaction amount (i.e., historical cost); however, that amount may be adjusted for items of sales or cash discounts and for sales returns (and then further adjusted once information regarding collection is obtained, see item b, below).

1. Discounts

The offer of a cash discount on payments made within a specified period is widely used by many companies. This practice encourages prompt payment and assumes that customers will take advantage of the discount.

a. Sales or Cash Discounts

The discount is generally based on a percentage of the sales price. For example, a discount of 2/10, n/30 offers the purchaser a discount of 2% of the sales price if the payment is made within 10 days. If the discount is not taken, the entire (gross) amount is due in 30 days. The calculation of cash discounts typically follows one of two forms, the determination of which method to use is generally based upon the company's experience with its customers taking discounts.

(1) Gross Method

The gross method records a sale without regard to the available discount. If payment is received within the discount period, a sales discount (contra revenue) account is debited to reflect the sales discount.

(2) Net Method

The net method records sales and accounts receivable net of the available discount. An adjustment is not needed if payment is received within the discount period. However, if payment is received after the discount period, a sales discount not taken account (revenue) must be credited.

EXAMPLE

Sales Discounts

Gearty Company sells $100,000 worth of goods to Smith Company. The terms of the sale are 2/10, n/30. Show the journal entries for the accounts receivable Gearty Company would record using both the gross method and the net method.

		Gross		***Net***	
DR	Accounts Receivable	$100,000		$98,000	
CR	Sales		$100,000		$98,000

Show the journal entries if payment is received within the discount period.

DR	Cash	$98,000		$98,000	
DR	Sales Discounts Taken	2,000			
CR	Accounts Receivable		$100,000		$98,000

b. Trade Discounts

Trade discounts (quantity discounts) are quoted in percentages. Sales revenues and accounts receivable are recorded net of trade discounts.

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EXAMPLE

Trade Discounts

Ann Klein coats have a list price of $1,000. They are sold to stores for list price minus trade discounts of 40% and 10%. Calculate the Ann Klein accounts receivable balance if 100 coats are sold on credit.

List price	$100,000
Less: 40% discount	(40,000)
List price after 40% discount	60,000
Less: 10% discount	(6,000)
Accounts receivable balance	$ 54,000

2. Sales Returns and Allowances

Sales of goods often result in those goods being returned for a variety of reasons. Goods returned represent deductions from accounts receivable and sales.

If past experience shows that a material percentage of receivables are returned, an allowance for sales returns should be established.

EXAMPLE

Sales Returns and Allowances

Aloe Co. estimates 3% of accounts receivable valued at $2,000,000 (end of period) will be returned.

Journal Entry: To record anticipated returns.

Sales returns (contra sales)	$60,000	
Allowance for sales returns (contra accounts receivable)		$60,000

C. ESTIMATING UNCOLLECTIBLE ACCOUNTS RECEIVABLE

ALLOWANCE FOR DOUBTFUL ACCOUNTS

Accounts receivable should be presented on the balance sheet at their net realizable value. Thus, the amount recorded at initial transaction should be reduced by the amount of any uncollectible receivables. Two methods of recognizing uncollectible accounts receivable exist (the direct write-off method and the allowance method); however, only the allowance method is consistent with accrual accounting (and thus acceptable for GAAP).

1. Direct Write-Off Method (Not GAAP)

DIRECT WRITE-OFF METHOD

Under the direct write-off method, the account is written off and the bad debt is recognized when the account becomes uncollectible. The direct write-off method is not GAAP because it does not properly match the bad debt expense with the revenue (note, however, that the direct write-off method is the method used for federal income tax purposes). An additional weakness of this method is that accounts receivable are always overstated because no attempt is made to account for the unknown bad debts included in the balance on the financial statements.

EXAMPLE

Direct Write-Off Method

Roe company estimates that $1,000 of its receivables will be uncollectible.

Journal Entry: To record account balance of $1,000 as uncollectible.

Bad debt expense	$1,000	
Accounts receivable		$1,000

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2. Allowance Method (GAAP)

The allowance for uncollectibles should be based on past experience. A percentage of each period's sales or ending accounts receivable is estimated to be uncollectible. Consequently, the amount determined is charged to bad debts of the period and the credit is made to a valuation account such as "allowance for uncollectible accounts." When specific amounts are written off, they are debited to the allowance account, which is periodically recomputed. There are three generally accepted methods of estimating uncollectible or doubtful accounts under the allowance method.

a. Percentage of Sales Method (Income Statement Approach)

Under the percentage of sales method, a percentage of each sale is debited to the account "bad debt expense" and credited to the account "allowance for doubtful accounts." The applicable percentage is based on the company's experience.

EXAMPLE

Allowance for Uncollectible Accounts Based on Credit Sales

ABC Co. bases estimated uncollectible accounts on total credit sales for the period. ABC Co. estimates that 2% of its $200,000 sales on credit will not be collected. The credit balance in the allowance for uncollectible accounts before adjustment is $1,000.

Journal Entry: To record increase in allowance account

Bad debt expense	$4,000	
Allowance for uncollectible accounts		$4,000

Beginning balance in allowance for uncollectible accounts	$1,000
Additions as a result of new credit sales	4,000
Ending balance in allowance for uncollectible accounts	$5,000

b. Percentage of Accounts Receivable at Year End Method (Balance Sheet Approach)

Uncollectible accounts may also be estimated as a certain percentage of accounts receivable at year-end. Note that under this method, the amount of the estimated allowance calculated is the ending balance that should be in the allowance for doubtful accounts on the balance sheet. Therefore, the difference between the unadjusted balance and the desired ending balance is debited (or credited) to the bad debt expense account.

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EXAMPLE

Allowance for Uncollectible Accounts Based on Accounts Receivable

DEF Co. uses a percentage for uncollectibles based on the year-end balance in accounts receivable. DEF Co. estimates that the balance in the allowance account must be 2% of year-end accounts receivable of $80,000. The balance in the allowance account is $1,000 credit before adjustment.

The amount to be credited to the allowance accounts is calculated below.

Required ending balance ($80,000 x .02)	$1,600
Existing balance before adjustment	(1,000)
Credit to allowance account needed	$ 600

Journal Entry: To record increase in allowance account

Bad debt expense	$600	
Allowance for uncollectible accounts		$600

Note: If the $1,000 balance in the allowance account had been a debit, we would have added it to the required ending balance. The entry would have then been for $2,600.

c. Aging of Receivables Method (Balance Sheet Approach)

Another method that can be used in estimating uncollectible accounts is aging of accounts receivable. A schedule is prepared categorizing accounts by the number of days or months outstanding. Each category's total dollar amount is then multiplied by a percentage representing uncollectibility based on past experience. The sum of the product for each aging category will be the desired ending balance in the allowance account.

EXAMPLE

Aging of Accounts Receivable

The balance in the allowance account before adjustment is $1,000 credit. The analysis of the aging of receivables requires the allowance account to have a net balance of $1,600.

Classification by Due Date	*Balances in Each Category**	*Estimated % Uncollectible*	*Estimated Uncollectible Account*
Current	$10,000	.01	$ 100
31–60 days	6,667	.03	200
61–90 days	5,000	.10	500
Over 90 days	4,000	.20	800
	$25,667		$1,600

* Summarized from an analysis of individual invoices.

The journal entry would be the same as that shown in the previous example.

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D. BAD DEBT EXPENSE

BAD DEBT EXPENSE

The amount charged to earnings for the bad debt expense of the period usually includes these two items:

1. The provision made during the period, and
2. An adjustment made at year-end to increase/decrease the balance in the allowance for uncollectible accounts, if needed.

EXAMPLE

Calculation of Bad Debt Expense

Bost Company, at December 31, Year 5, adopted a new accounting method for estimating the allowance for uncollectible accounts using the percentage of accounts considered uncollectible in the year-end aging of accounts receivable.

The following data are available:

Allowance for uncollectible accounts, 1/1/Yr 5	$20,000
Provision for uncollectible accounts during Year 5 (2% of credit sales of $700,000)	14,000
Bad debts written off, 11/30/Yr 5	12,500
Estimated total of uncollectible accounts, per aging at 12/31/Yr 5	20,500

After year-end adjustments, the Year 5 bad debt expense would be:

Allowance:	
Balance, 1/1/Yr 5	$20,000
Plus: Year 5 provision	14,000
Less: Year 5 write-offs	(12,500)
Preliminary balance	21,500
Desired balance	(20,500)
Decrease needed	$ 1,000

Provision:	
Original provision	$14,000
Less: necessary adjustment	(1,000)
Year 5 bad debt expense	$13,000

Journal Entry: To record the write off of bad debts at November 30, Year 5

Allowance for uncollectible accounts	$12,500	
Accounts receivable		$12,500

Journal Entry: To record the adjustment at December 31, Year 5

Allowance for uncollectible accounts	$1,000	
Bad debt expense		$1,000

E. WRITE-OFF OF A SPECIFIC ACCOUNT RECEIVABLE

When a receivable is formally determined to be uncollectible, the following entry is made:

Allowance for doubtful accounts	XXX	
Accounts receivable		XXX

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F. SUBSEQUENT COLLECTION OF ACCOUNTS RECEIVABLE WRITTEN OFF

If a collection is made on a receivable that was previously written off, the accounting procedure depends upon the method of accounting used.

1. Direct Write-off Method

The journal entry is as follows:

Cash	XXX	
Uncollectible accounts recovered		XXX

The "uncollectible accounts recovered" account is a revenue account.

2. Allowance Method

The journal entries are as follows:

Accounts Receivable	XXX	
Allowance for Uncollectible Accounts		XXX
To restore the account previously written off.		
Cash	XXX	
Account Receivable		XXX
To record the cash collection on the account.		

3. Allowance for Doubtful Accounts Account Analysis Format

(Note the different scenarios with missing information.)

Beginning balance		$100,000	100,000	100,000	?
ADD:	Bad debt expense	3,000	3,000	?	3,000
	Recoveries of bad debts	0	0	0	0
	SUBTOTAL	103,000	103,000	103,000	103,000
LESS:	Accounts receivable written off	2,000	?	2,000	2,000
Ending balance		?	101,000	101,000	101,000

G. PLEDGING (ASSIGNMENT)

PLEDGING OF ACCOUNTS RECEIVABLE

Pledging is the process whereby the company uses existing accounts receivable as collateral for a loan. The company retains title to the receivables but "pledges" that it will use the proceeds to pay the loan. Pledging requires only note disclosure. The accounts receivable account is not adjusted.

H. FACTORING OF ACCOUNTS RECEIVABLE

FACTORING OF ACCOUNTS RECEIVABLE

Factoring is a process by which a company can convert its receivables into cash by assigning them to a "factor" either without or with recourse. Under factoring arrangements, the customer may or may not be notified.

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1. Without Recourse

If a sale is non-recourse, it means that the sale is final and that the assignee (the factor) assumes the risk of any losses on collections. If the buyer is unable to collect all of the accounts receivable, it has no recourse against the seller.

Journal Entry: To factor accounts receivable without recourse

Cash	XXX	
Due from Factor (Factor's Margin)	XXX	
Loss on Sale of Receivable	XXX	
Accounts Receivable		XXX

The entry to the asset account "Due from Factor" reflects the proceeds retained by the factor. This amount protects the factor against sales returns, sales discounts, allowances, and customer disputes.

2. With Recourse

If a sale is on a recourse basis, it means that the factor has an option to re-sell any uncollectible receivables back to the seller.

If accounts receivable are transferred to a factor *with recourse,* two treatments are possible. The transfer may be considered either a sale or a borrowing (with the receivables as mere collateral).

a. In order to be considered a sale, the transfer must meet the following conditions:

   (1) The transferor's (seller's) obligation for uncollectible accounts can reasonably be estimated.

   (2) The transferor surrenders control of the future economic benefits of the receivables to the buyer.

   (3) The transferor cannot be required to repurchase the receivables, but may be required to replace the receivables with other similar receivables.

b. If any of the above conditions are not met, the transfer is treated as a loan.

I. TRANSFERS AND SERVICING OF FINANCIAL ASSETS: SFAS No. 140 (See Enhanced Outline in the Homework Reading).

There are many different forms of transfers of financial assets. More complex types of transactions raise issues regarding whether the transaction should be considered a sale (of all or part of the financial assets) or a secured borrowing. They also raise issues about how they should be accounted for, for both the transferor and the transferee.

1. Objective

The objective of accounting for these transfers of financial assets (per SFAS No. 140) is that each entity involved in the transaction should:

a. **Recognize** only the assets it has control over (and the related liabilities is has incurred in the process) and

b. **Derecognize** (i.e., remove previously recognized items from the balance sheet) those assets only when control over them has been surrendered and those liabilities only when extinguished (covered in class F5).

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2. Financial-Components Approach

The financial-components approach is the basis for the GAAP rules for transfers and servicing of financial assets. Under this approach, which focuses on control, financial assets and liabilities may be divided into many components. These components may have different accounting methods applied to them, depending upon the circumstances.

3. Definition of Surrender of Control

In order to determine the accounting rules to apply to a transaction of this type, one of the first steps is to determine whether control has been surrendered. The following three conditions must all be met before control is deemed to have been surrendered:

a. The transferred assets have been isolated from the transferor,

b. The transferee has the right to pledge or exchange the assets, and

c. The transferor does not maintain control over transferred assets under a repurchase agreement.

4. Control is Surrendered—No Continuing Involvement

If the three conditions for surrender of control are met and there is no continuing involvement, the entire transfer is recorded as a sale, with appropriate reduction in receivables and recognition of any gain or loss.

5. Control is Surrendered—Continuing Involvement

If the three conditions for surrender of control are met and there is continuing involvement, the transfer (i.e., the assets for which there is **no** retained interest) is recorded as a **sale** using the financial-components approach. The transferred assets are divided between those deemed "sold" and those "not sold," and a resulting gain or loss is recorded for the sold items.

Any retained interests in the financial assets are still carried on the books of the transferor (including servicing assets) and are allocated at book value based on the relative fair value of all transferred assets at the date of transfer.

6. No Control is Surrendered

If the three conditions for surrender of control are not met (i.e., the transaction is not deemed a "sale"), the transferee and transferor will account for the transfer as a secured borrowing with pledged collateral and will recognize the appropriate asset/liability amounts and interest revenue/expense amounts. The accounting for the collateral (non-cash) held depends upon whether the debtor has defaulted and whether the secured party has the ability to sell or re-pledge the collateral.

7. Servicing Assets and Liabilities

When an entity is a party to a servicing contract to service financial assets, it should record a servicing asset or liability for the contract (initially measured at the price paid or fair value), with certain exceptions (covered in Homework Reading). The contract (asset or liability) will then be amortized in proportion to the estimated net servicing income (or loss). In addition, the fair value will be determined at regular intervals throughout the life of the contract, and the contract will be then assessed for impairment (or an increase in the liability) based on that fair value.

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IV. NOTES RECEIVABLE

NOTES RECEIVABLE

Notes receivable are written promises to pay a debt, and the writing is called a promissory note. Notes receivable are classified the same as accounts receivable. They are also either a current asset or a long-term asset, depending upon when collection will occur.

A. VALUATION AND PRESENTATION

For financial statement purposes, unearned interest and finance charges are deducted from the face amount of the related promissory note. This is necessary in order to state the receivable at its present value.

Also, if the promissory note is non-interest bearing or the interest rate is below market, the value of the note should be determined by imputing the market rate of interest and determining the value of the promissory note by using the effective interest method. Interest bearing promissory notes issued in an arms-length transaction are presumed to be issued at the market rate of interest.

B. DISCOUNTING NOTES RECEIVABLE

Discounted notes receivable arise when the holder endorses the note (with or without recourse) to a third party and receives a sum of cash. The difference between the amount of cash received by the holder and the maturity value of the note is called the "discount."

1. With Recourse

If the note is discounted with recourse, the holder remains contingently liable for the ultimate payment of the note when it becomes due. Notes receivable that have been discounted with recourse are reported on the balance sheet with a corresponding contra account (Notes Receivable Discounted) indicating that they have been discounted to a third party. Alternatively, the notes receivable may be removed from the balance sheet and the contingent liability disclosed in the notes to the financial statements.

2. Without Recourse

If the note is discounted without recourse, the holder assumes no further liability. Notes receivable that have been discounted without recourse have essentially been sold outright and should, therefore, be removed from the balance sheet.

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EXAMPLE

Discounting a Note at a Bank

Facts and Requirement

1. Jordan Corporation has a $40,000, 90-day note from a customer dated September 30, 20XX, due December 30, 20XX, and bearing interest at 12%.
2. On October 30, 20XX (30 days after issue), Jordan Corporation takes the note to its bank, which is willing to discount it at a 15% rate.
3. The note was paid by Jordan's customer at maturity on December 30, 20XX (60 days later).
4. What amount should Jordan Corporation report as net interest income from the note?

Solution

1. Compute the **maturity value** of the note by **adding the interest to the face** amount of the note, as follows:

Face value of the note	$40,000
Interest on note to maturity	1,200 (90 days at 12%)
Payoff value of note at maturity	$41,200

2. Compute the **bank discount on the payoff value at maturity**, as follows:

$$15\% \text{ discount} \times 60/360 \text{ days} \times \$41,200 = \$1,030$$

3. Determine the amount **paid by the bank** for the note.

Payoff value at maturity	$41,200
Less: Bank's discount	(1,030)
Amount paid by bank for note	$40,170

4. Derive the **interest income** (or expense) by subtracting the face value of the note from the amount paid by the bank for the note, as follows:

Amount paid by bank for the note	$40,170
Less: Face value of the note	(40,000)
Interest income to Jordan Corporation	**$ 170**

3. Dishonored Discounted Notes Receivable

When a discounted note receivable is dishonored, the contingent liability should be removed by a debit to Notes Receivable Discounted and a credit to Notes Receivable. Notes Receivable Dishonored should be recorded to the estimated recoverable amount of the note. A loss is recognized if the estimated recoverable amount is less than the amount required to settle the note and any applicable penalties.

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INVENTORY

INVENTORIES

I. TYPES OF INVENTORIES HELD FOR RE-SALE

Inventories of goods must be periodically counted, valued, and recorded in the books of account of a business. In general, there are four types of inventories that are held for re-sale.

A. RETAIL INVENTORY

Retail inventory is inventory that is re-sold in substantially the same form in which it was purchased.

B. RAW MATERIALS INVENTORY

Raw materials inventory is inventory that is being held for use in the production process.

C. WORK IN PROCESS INVENTORY (WIP)

WIP is inventory that is in production but incomplete.

D. FINISHED GOODS INVENTORY

Finished goods inventory is production inventory that is complete and ready for sale.

II. GOODS AND MATERIALS TO BE INCLUDED IN INVENTORY

The general rule is that any goods and materials in which the company has legal title should be included in inventory, and legal title typically follows possession of the goods. Of course, there are many exceptions and special applications of this general rule.

A. GOODS IN TRANSIT

Title passes from the seller to the buyer in the manner and under the conditions explicitly agreed upon by the parties. If no conditions are explicitly agreed upon ahead of time, title passes from the seller to the buyer at the time and place where the seller's performance regarding delivery of goods is complete.

F.O.B. means "free on board" and requires the seller to deliver the goods to the location indicated as F.O.B. at the seller's expense. The following terminology is most commonly used in passing title from the seller to the buyer:

1. F.O.B. Shipping Point

With F.O.B. shipping point, title passes to the buyer when the seller delivers the goods to a common carrier. Goods shipped in this manner should be included in the buyer's inventory upon shipment.

2. F.O.B. Destination

With F.O.B. destination, title passes to the buyer when the buyer receives the goods from the common carrier.

B. SHIPMENT OF NON-CONFORMING GOODS

If the seller ships the wrong goods, the title reverts to the seller upon rejection by the buyer. Thus, the goods should not be included in the buyer's inventory, even if the buyer possesses the goods prior to their return to the seller.

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C. SALES WITH A RIGHT TO RETURN

If goods are sold but the buyer has the right to return the goods, the goods should be included in the seller's inventory if the amount of the goods likely to be returned **cannot** be estimated.

If the amount of goods likely to be returned **can** be estimated, the transaction will be recorded as a sale with an allowance for estimated returns recorded. Essentially, revenue from a sales transaction where the buyer has the right to return the product shall be recognized at the time of the sale only if all the following conditions are met (also covered in revenue recognition in F2):

1. The sales price is substantially fixed at the date of sale,
2. The buyer assumes all risk of loss because the goods are in the buyer's possession,
3. The buyer has paid some form of consideration,
4. The product sold is substantially complete, and
5. The amount of future returns can be reasonably estimated.

D. CONSIGNED GOODS

In a consignment arrangement, the seller (the "consignor") delivers goods to an agent (the "consignee") to hold and sell on the consignor's behalf. The consignor should include the consigned goods in its inventory because title and risk of loss is retained by the consignor even though the consignee possesses the goods.

If all of the conditions in item C (above) are not met, there is no revenue recognition from a sale. Revenue will be recognized when the goods are sold to a third party. Until the sale, the goods remain in the consignor's inventory. Title passes directly to the third-party buyer (not to the consignee and then to the third-party buyer) at the point of sale.

E. PUBLIC WAREHOUSES

Goods stored in a public warehouse and evidenced by a warehouse receipt should be included in the inventory of the company holding the warehouse receipt. The reason is that the warehouse receipt evidences title even though the owner does not have possession.

F. SALES WITH A MANDATORY BUYBACK

Occasionally, as part of a financing arrangement, a seller has a requirement to repurchase goods from the buyer. If so, the seller should include the goods in inventory even though title has passed to the buyer.

G. INSTALLMENT SALES

If the seller sells goods on an installment basis but retains legal title as security for the loan, the goods should be included in the seller's inventory if the percentage of uncollectible debts cannot be estimated. However, if the percentage of uncollectible debts can be estimated, the transaction would be accounted for as a sale, and an allowance for uncollectible debts would be recorded.

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III. COST COMPONENTS OF PRODUCTION INVENTORY

COST OF GOODS MANUFACTURED

Costs included in inventory are the sum of all expenditures in bringing the goods to the condition and location so that they are ready for sale. Under GAAP, only product costs are included in inventory. There are three types of product costs that must be included in the cost of WIP and finished goods inventory:

(i) Direct materials,

(ii) Direct labor, and

(iii) Manufacturing overhead.

A. DIRECT MATERIALS

Direct materials are raw materials that are placed into production and are directly traceable to the item being produced. Raw materials transferred into work-in-process should include the following product costs:

1. Freight in (not freight out)
2. Insurance for goods in transit
3. Storage (warehousing costs)
4. Import duties
5. Purchasing department costs
6. Receiving department costs

B. DIRECT LABOR

Direct labor is labor that is directly traceable to the item being produced.

C. MANUFACTURING OVERHEAD

Manufacturing overhead includes all indirect costs of production that cannot be directly traced or are uneconomical to trace to the item being produced but are still necessary for production.

1. Indirect labor includes items such as supervision, inspection, and maintenance.
2. Indirect materials include items such as fuel, lubricants, and shop supplies.
3. Overhead includes items such as depreciation of factory equipment, factory insurance, and manufacturing costs.

D. ABSORPTION (FULL) COSTING

FULL ABSORPTION

The method of including product costs as the cost of inventory is called absorption costing, or full costing, and it is required by GAAP.

E. STANDARD COSTING

Inventory valuation by the use of standard costs is acceptable if the standard is adjusted at reasonable intervals to reflect the approximate costs computed under one of the recognized methods. Standard costing is covered in detail and tested in the Business Environment & Concepts section.

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F. PERIOD COSTS

The amount included as production inventory does **not** include period costs. Period costs include non-production costs. Examples of period costs are:

1. Marketing costs
2. Freight out
3. Re-handling costs
4. Abnormal spoilage
5. Idle plant capacity costs

IV. VALUATION OF INVENTORY

GAAP requires that inventory be stated at its **cost**. Where evidence indicates that cost will be recovered with an approximately normal profit on a sale in the ordinary course of business, no loss should be recognized even though replacement or reproduction costs are lower.

A. DEPARTURE FROM THE COST BASIS

1. Lower of Cost or Market

In the ordinary course of business, when the utility of goods is no longer as great as their cost, a departure from the cost basis principle of measuring inventory is required. This is usually accomplished by stating such goods at a lower level designated as market value, or the lower-of-cost-or-market principle (discussed in detail in Item B, below).

2. Precious Metals and Farm Products

Gold, silver, and other precious metals, and meat and some agricultural products are valued at **net realizable value**, which is net selling price less costs of disposal. In some exceptional cases, such as precious metals having a fixed determinable market value with no substantial cost of marketing, inventory may be stated at the higher market value. When inventory is stated at a value in excess of cost, this fact should be fully disclosed in the financial statements. The prerequisites of this exception are:

a. Immediate marketability at quoted prices, and

b. No substantial marketing costs.

B. LOWER OF COST OR MARKET (EXPANDED DISCUSSION)

The purpose of reducing inventory to the lower of cost or market is to show the probable loss sustained (conservatism) in the period in which the loss occurred (matching principle). The lower-of-cost-or-market principle may be applied to a single item, a category, or total inventory, provided that the method most clearly reflects periodic income.

1. Recognize Loss in Current Period

Whatever the cause (e.g., obsolescence, physical deterioration, changes in price levels, etc.), the difference should be recognized as a loss for the current period. In the phrase "lower of cost or market," the term "market" generally means current replacement cost (whether by purchase or reproduction), with certain exceptions (discussed below).

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2. Exceptions

The lower of cost or market rule will not apply if:

a. The subsequent sales price of an end product is not affected by its market value, or

b. The company has a firm sales price contract.

3. Terms

a. Market Value

Under GAAP, market value is the median (middle value) of an inventory item's replacement cost, its market ceiling, and its market floor.

b. Replacement Cost

Replacement cost is the cost to purchase the item of inventory as of the valuation date.

c. Market Ceiling

Market ceiling is item's net selling price less the costs to complete and dispose (called the net realizable value).

d. Market Floor

Market floor is the market ceiling less a normal profit margin.

EXAMPLE

Lower of Cost or Market

Facts and Requirement: Inventory item X has a sales price of $20. Cash discounts of 2.5% are typically taken upon sale. The cost to complete and dispose of item X includes a selling commission of 7.5% and delivery costs of $1.00. Normal profit margin on item X is 25%. The replacement cost is $11. What is the market value of the inventory?

Calculation

Sales price	$20.00	
Cash discount (2.5% x $20)	(.50)	
Net selling price	19.50	
Cost to complete and sell:		
Sales commission (7.5% x $20)	(1.50)	
Delivery costs	(1.00)	
Net realizable value (market ceiling)	**17.00**	
Normal profit margin (25% x 20)	(5.00)	
Market floor		**$12.00 [median]**
Replacement cost		**$11.00**

Solution: The market value is $12.00, the market floor, which is the median of the market ceiling, the market floor, and the replacement cost.

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C. DISCLOSURE

When losses are both substantial and unusual from the application of the lower-of-cost-or-market principle, the amount of the loss is disclosed in income from continuing operations in the income statement and identified separately from the consumed inventory costs described as cost of goods sold. (Small losses from decline in value are included in cost of goods sold.)

The basic principle of consistency must be applied in the valuation of inventory and the method should be disclosed in the financial statements. In the event that a significant change takes place in the measurement of inventory, adequate disclosure of the nature of the change and, if material (materiality principle), the effect on income should be disclosed in the financial statements.

V. PERIODIC INVENTORY SYSTEM VS. PERPETUAL INVENTORY SYSTEM

There are two types of inventory systems used to count inventory.

A. PERIODIC INVENTORY SYSTEM (METHOD)

With a periodic inventory system, the quantity of inventory is determined only by physical count, usually at least annually. Therefore, units of inventory and the associated costs are counted and valued at the end of the accounting period. The actual cost of goods sold for the period is determined after each physical inventory by "squeezing" the difference between beginning inventory plus purchases less ending inventory, based on the physical count.

The periodic method does not keep a running total of the inventory balances. Ending inventory is physically counted and priced. Cost of goods sold is calculated as shown below.

Beginning inventory		$ 70,000
+	Purchases	300,000
=	Cost of goods available for sale	370,000
–	Ending inventory (physical count)	(270,000)
=	Cost of goods sold	$100,000

B. PERPETUAL INVENTORY SYSTEM (METHOD)

With a perpetual inventory system, the inventory record for each item of inventory is updated for each purchase and each sale as they occur. The actual cost of goods sold is determined and recorded with each sale. Therefore, the perpetual inventory system keeps a running total of inventory balances.

C. HYBRID INVENTORY SYSTEMS

1. Units of Inventory on Hand: Quantities Only

Some companies maintain a perpetual record of quantities only. A record of units on hand is maintained on the perpetual basis, and this is often referred to as the "modified perpetual system." Changes in quantities are recorded after each sale and purchase.

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2. Perpetual with Periodic at Year End

Most companies that maintain a perpetual inventory system still perform either complete periodic physical inventories or test count inventories on a random (or cyclical) basis.

EXAMPLE

Comparison of Periodic and Perpetual Inventory Methods

To record sale: ABC Company sold 20,000 units of inventory for $7 per unit. The inventory had originally cost $5 per unit. The journal entries to record the sale using the periodic and perpetual methods appear below.

Journal Entry: To record sale under periodic method

Cash	140,000	
Sales		140,000

Journal Entry: To record sale under perpetual method

Cash	140,000	
Sales		140,000
Cost of Goods Sold	100,000	
Inventory		100,000

To record purchase: ABC Company purchased 50,000 units of merchandise for $6 a unit to be held as inventory.

Journal Entry: To record purchase under periodic method

Purchases	300,000	
Cash		300,000

Journal Entry: To record purchase under perpetual method

Inventory	300,000	
Cash		300,000

VI. GAAP INVENTORY COST FLOW ASSUMPTIONS

Inventory valuation is dependent on the cost flow assumption underlying the computation. The cost flow assumption used by a company is not required to have a rational relationship with the physical inventory flows; however, the primary objective is the selection of the method that will most clearly reflect periodic income.

A. SPECIFIC IDENTIFICATION METHOD

Under the specific identification method, the cost of each item in inventory is uniquely identified to that item. The cost follows the physical flow of the item in and out of inventory to cost of goods sold. Specific identification is usually used for physically large or high value items and allows for greater opportunity for manipulation of income.

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B. FIRST IN, FIRST OUT (FIFO) METHOD

FIFO

Under FIFO, the first costs inventoried are the first costs transferred to cost of goods sold. Ending inventory includes the most recently incurred costs; thus, the ending balance approximates replacement cost. Ending inventory and cost of goods sold are the same whether a periodic or perpetual inventory system is used. In periods of rising prices, income may be overstated because the FIFO method results in the highest ending inventory, the lowest costs of goods sold, and the highest net income (i.e., current costs are not matched with current revenues).

EXAMPLE

FIFO Method

Facts and Requirement: During its first year of operations, Helix Corporation has purchased all of its inventory in 3 separate batches. Batch 1 was for 4,000 units at $4.25 per unit. Batch 2 was for 2,000 units at $4.50 per unit. Batch 3 was for 3,000 units at $4.75 per unit. 4,000 units in total were sold, 3,000 units after the first purchase and 1,000 units after the second purchase. What are the amounts of ending inventory and cost of goods sold using the FIFO method and the periodic and perpetual systems?

FIFO: Periodic Inventory System

Units Bought	Cost/ Unit	Ending Inventory	Goods Available For Sale
4,000	$4.25		$17,000
2,000	4.50	$9,000	9,000
3,000	4.75	14,250	14,250
			$40,250
		$23,250	(23,250)
	Cost of goods sold		**$17,000**

FIFO: Perpetual Inventory System

Units Bought	Units Sold	Cost/ Unit	Change in Inventory	Inventory Balance	COGS
4,000		$4.25	$17,000		
	3,000	4.25	(12,750)	4,250	$12,750
2,000		4.50	9,000	13,250	
	1,000	4.25	(4,250)	9,000	4,250
3,000		4.75	14,250	23,250	
			$23,250		**$17,000**

Solution: Note that the ending inventory under both methods is $23,250 and the amount of cost of goods sold under both methods is $17,000.

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C. WEIGHTED AVERAGE METHOD

WEIGHTED AVERAGE

Under the weighted average method, at the end of the period, the average cost of each item in inventory would be the weighted average of the costs of all items in inventory. The weighted average is determined by dividing the total costs of inventory available by the total number of units of inventory available, remembering that the beginning inventory is included in both totals. This method is particularly suitable for homogeneous products and a *periodic* inventory system.

EXAMPLE

Weighted Average Method

Facts and Requirement: Assume the same information for Helix Corporation as in the example for FIFO (above). What are the amounts of ending inventory and cost of goods sold under the weighted average method?

Solution

Unit Cost	Units Purchased	Total
$4.25	4,000	$17,000
4.50	2,000	9,000
4.75	3,000	14,250
Total	9,000	$40,250

The weighted average cost per unit is $4.4722 ($40,250/9,000).

Cost of goods sold is $17,889 (4,000 units x $4.4722).

Ending inventory is $22,361 (5,000 units x $4.4722).

D. MOVING AVERAGE METHOD

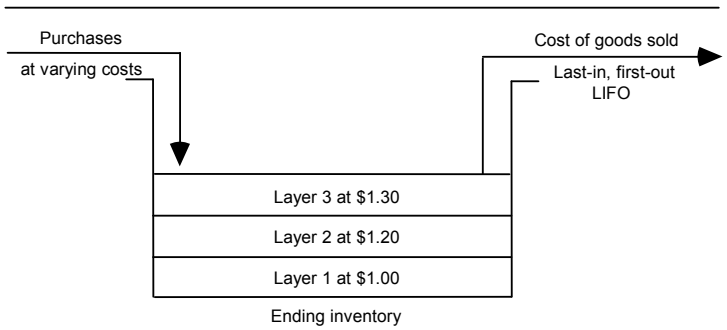
The moving average method computes the weighted average cost after each purchase. The moving average is more current than the weighted average. A *perpetual inventory* system is necessary to use the moving average method.

E. LAST IN, FIRST OUT (LIFO) METHOD

LIFO

Under LIFO, the last costs inventoried are the first costs transferred to cost of goods sold. Ending inventory, thus, includes the oldest costs. The ending balance of inventory will typically not approximate replacement cost. LIFO does not generally relate to actual flow of goods in a company because most companies sell or use their oldest goods first to prevent holding old or obsolete items. If LIFO is used for tax purposes, it must also be used in the GAAP financial statements.

LIFO Layer Container Illustration



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1. LIFO Financial Statement Effects

The use of the LIFO method generally better matches expense against revenues because it matches current costs with current revenues; thus, LIFO eliminates holding gains and reduces net income during times of inflation. If sales exceed production (or purchases) for a given period, LIFO will result in a distortion of net income because old inventory costs (called "LIFO layers") will be matched with current revenue. LIFO is also susceptible to income manipulation by intentionally reducing purchases in order to use old layers at lower costs.

EXAMPLE

LIFO Method

Facts and Requirement: Assume the same facts for Helix Corporation as above. What are the amounts of ending inventory and cost of goods sold using the LIFO method and periodic and the perpetual systems?

LIFO: Periodic Inventory System

Units Bought	Cost/ Unit	Ending Inventory	Goods Available For Sale
4,000	$4.25	$17,000	$17,000
2,000	4.50	4,500	9,000
3,000	4.75		14,250
			$40,250
		$21,500	(21,500)
	Cost of goods sold		**$18,750**

LIFO: Perpetual Inventory System

Units Bought	Units Sold	Cost/ Unit	Inventory Balance	COGS
4,000		$4.25	$17,000	
	3,000	4.25	(12,750)	$12,750
2,000		4.50	9,000	
	1,000	4.50	(4,500)	4,500
3,000		4.75	14,250	
			$23,000	**$17,250**

SOLUTION:

Under the periodic inventory system, ending inventory is $21,500 and cost of goods sold is $18,750.

Under the perpetual inventory system, ending inventory is $23,000 and cost of goods sold is $17,250.

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F. GROSS PROFIT METHOD

The gross profit method is used for interim financial statements as part of a periodic inventory system. Inventory is valued at retail, and the average gross profit percentage is used to determine the inventory cost for the interim financial statements. The gross profit percentage is known and is used to calculate cost of sales.

EXAMPLE

Gross Profit Method

Dahl Co. sells soap at a gross profit percentage of 20%. The following figures apply to the eight months ended August 31, Year 1:

Sales	$ 200,000
Beginning inventory	100,000
Purchases	100,000

On September 1, Year 1, a flood destroys all of Dahl's soap inventory. Estimate the cost of the destroyed inventory.

Sales	$ 200,000
CGS % (1.00 - .20)	x 80%
Cost of goods sold	$ 160,000

Cost of goods sold is deducted from the total goods available to determine ending inventory, as follows:

Beginning inventory	$ 100,000
Add: Purchases	+ 100,000
Cost of goods available	$ 200,000
Less: Cost of goods sold	(160,000)
Estimated cost of inventory destroyed	$ 40,000

G. RETAIL METHOD

The retail method is used by businesses that sell a large volume of items with relatively low unit costs (e.g., department stores). The retail method is a perpetual system that records inventory at the retail price and converts the retail price to GAAP cost through the application of a cost complement percentage. Of course, the cost complement used depends on the cost flow assumption (i.e., FIFO, LIFO, etc.). The retail method tends to highlight deviations from physical counts (i.e., shrinkage).

1. Conventional Retail Inventory Method

The conventional retail inventory method approximates the results that would be obtained by taking a physical inventory count and pricing the goods at the lower of cost or market. Subtracting the markdowns from "total available for sale" results in a lower cost complement percentage, which results in a lower ending inventory. This, in turn, results in an automatic "lower of cost or market" valuation.

	At Cost	At Retail	
Beginning inventory	$ 25,000	$ 39,000	
Purchases	35,000	60,000	
Markups	--	1,000	
Total available for sale	$ 60,000	÷ $100,000	= 60% cost complement
Sales	--	(88,000)	
Markdowns		(2,000)	
Ending inventory at **retail**		**$ 10,000**	
		60%	
Ending inventory at **lower cost or market**		**$ 6,000**	

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2. FIFO / Cost Retail Inventory Method

Under the FIFO cost retail method, the ending inventory comes from the current period purchases, including markups and markdowns.

	At Cost	At Retail	Purchases
Beginning inventory	$ 25,000	$ 39,000	
Purchases	35,000	60,000	$ 60,000
Markups	--	1,000	1,000
Markdowns	--	(2,000)	(2,000)
		98,000	59,000
			$\frac{35,000}{59,000} = 59.32\%$ cost complement
Sales	--	(88,000)	
Ending inventory at FIFO **retail**		**$ 10,000**	
Cost complement		x 59.32%	
Ending inventory at FIFO **cost**		**$ 5,932**	

VII. NON-GAAP INVENTORY COST FLOW ASSUMPTIONS

A. BASE STOCK METHOD

The base stock method replenishes any reduction in LIFO layers with the old cost, not the replacement cost.

B. NEXT IN, FIRST OUT (NIFO) METHOD

The next in, first out (NIFO) method values cost of goods sold at the replacement cost.

VIII. GAAP INVENTORY DISCLOSURES

A. Inventory detail (e.g., raw materials, WIP, and finished goods)

B. Significant finance arrangements

C. Pledged inventory

D. Valuation method

E. Cost flow method

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IX. FIRM PURCHASE COMMITMENTS

PURCHASE COMMITMENTS

A firm purchase commitment is a legally enforceable agreement to purchase a specified amount of goods at some time in the future. All material firm purchase commitments must be disclosed in either the financial statements or the notes thereto.

If the contracted price exceeds the market price and if it is expected that losses will occur when the purchase is actually made, the loss should be recognized at the time of the decline in price. A description of losses recognized on these commitments must be disclosed in the current period's income statement.

EXAMPLE

Loss on Purchase Commitments

J and S Incorporated signed timber-cutting contracts in Year 1 to be executed at $5,000,000 in Year 2. The market price of the rights at December 31, Year 1, is $4,000,000 and it is expected that the loss will occur when the contract is effected in Year 2. What amount should be reported as a loss on purchase commitments at December 31, Year 1?

Price of purchase commitment	$5,000,000
Market price at 12/31/Yr 1	(4,000,000)
Loss on purchase commitments	$1,000,000

Journal Entry: To record the loss

Estimated loss on purchase commitment	1,000,000	
Estimated liability on purchase commitment		1,000,000

Note that the loss is recognized in the period when the price declined. The estimated loss on purchase commitment is reported in the income statement under other expenses and losses.

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FIXED ASSETS

I. CHARACTERISTICS OF FIXED ASSETS

A. Fixed assets are acquired for use in operations and not for resale.

B. They are long term in nature and subject to depreciation.

C. They possess physical substance.

II. CLASSIFICATION OF FIXED ASSETS

The following must be shown separately on the balance sheet (or footnotes) at original cost (historical cost):

A. LAND (PROPERTY)

B. BUILDINGS (PLANT)

C. EQUIPMENT

1. Maybe show machinery, tools, furniture and fixtures separately, if these categories are significant.

D. ACCUMULATED DEPRECIATION ACCOUNT (CONTRA-ASSET)

1. May be combined for two or more asset categories.

E. FIXED ASSETS ARE NONMONETARY ASSETS

1. A monetary asset (or liability) is fixed in dollars regardless of changes in specific prices or changes in the general price level (e.g., cash, accounts and notes receivable, etc.).
2. A nonmonetary asset (or liability) is not fixed in dollars and instead fluctuates with changes in the price level (e.g., inventory, property, plant, equipment, etc.).

III. VALUATION OF FIXED ASSETS

A. PURCHASED

Historical cost is the basis for valuation, which is measured by the cash or cash equivalent price of obtaining the asset and bringing it to the location and condition necessary for its intended use.

B. DONATED FIXED ASSETS

1. Donated fixed assets are recorded at fair market value along with incidental costs incurred.

DR	Fixed asset (FMV)	$XXX	
CR	Contribution revenue		$XXX

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IV. COST OF EQUIPMENT

Equipment is office equipment, machinery, furniture, fixtures, and factory equipment.

A. INCLUDE:

All expenditures related directly to their acquisition or construction

1. Invoice price
2. Less cash discounts and other discounts (if any)
3. Add freight-in (and insurance while in transit and while in construction)
4. Add installation charges (including testing and preparation for use)
5. Add sales and federal excise taxes
6. Possible addition of construction period interest (see section IX)

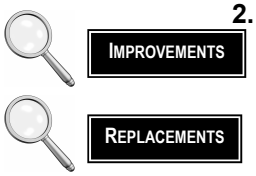
B. CAPITALIZE VS. EXPENSE

Proper accounting is determined based upon the purpose of the disbursement.

1. Additions

Additions increase the quantity of fixed assets.

DR	Asset (machinery, etc.)	$XXX	
CR	Cash/accounts payable		$XXX



2. Improvements and Replacements

Improvements (betterments) improve the quality of fixed assets and are capitalized to the fixed asset account. A better asset is substituted for the old one (e.g., a tile or steel roof is substituted for an old asphalt roof). In a replacement, a new similar asset is substituted for the old asset (e.g., an asphalt shingle roof is replaced with a new roof of similar material).

a. If the carrying value of the old asset is **known**, remove it and recognize any gain or loss. Capitalize the cost of the improvement/replacement to the asset account.

b. If the carrying value of the old asset is **unknown**, and:

(1) The asset's life is extended, debit accumulated depreciation for the cost of the improvement/replacement.

DR	Accumulated depreciation	$XXX	
CR	Cash/accounts payable		$XXX

(2) The usefulness (utility) of the asset is increased, capitalize the cost of the improvement/replacement to the asset account.

3. Repairs

a. Ordinary repairs should be expensed as repair and maintenance.

b. Extraordinary repairs should be capitalized. Treat the repair as an addition, improvement, or replacement as appropriate.

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Summary Chart

		Expense	Capitalize	Reduce Accumulated Depreciation
Additions: Increase quantity			✕	
Improvement/Replacement:	Increase life			✕
	Increase usefulness		✕	
Ordinary repair:		✕		
Extraordinary repair:	Increase life			✕
	Increase usefulness		✕	

V. COST OF LAND

When land has been purchased for the purpose of constructing a building, all costs incurred up to excavation for the new building are considered land costs. All the following expenditures are included:

A. LAND COST INCLUDES:

1. Purchase price
2. Brokers' commissions
3. Title and recording fees
4. Legal fees
5. Draining of swamps
6. Clearing of brush and trees
7. Site development (e.g., grading of mountain tops to make a "pad")
8. Existing obligations assumed by buyer, including mortgages and back taxes
9. Costs of razing (tearing down) an old building (demolition)
10. LESS: Proceeds from sale of existing buildings, standing timber, etc.

B. LAND IMPROVEMENTS (ARE DEPRECIABLE) SUCH AS:

1. Fences
2. Water systems
3. Sidewalks
4. Paving
5. Landscaping
6. Lighting

C. INTEREST COSTS

Interest costs during construction period should be added to cost of land improvement based on weighted average of accumulated expenditures (see IX).

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VI. COST OF BUILDINGS

A. COST INCLUDES:

1. Purchase price, etc.
2. All repair charges neglected by the previous owner ("deferred maintenance")
3. Alterations and improvements
4. Architect's fees
5. Possible addition of construction period interest (see section IX.)

PASS KEY

When preparing the land for the construction of a building:

- Land cost – filling in a hole or leveling.
- Building cost – digging a hole for the foundation.

VII. "BASKET PURCHASE" OF LAND AND BUILDING

A. Allocate the purchase price based on the ratio of appraised values of individual items.

VIII. FIXED ASSETS CONSTRUCTED BY A COMPANY—COST INCLUDES:

A. Direct materials and direct labor.

B. Repairs and maintenance expenses that add value to the fixed asset.

C. Overhead, including direct items of overhead (any "idle plant capacity" expense).

1. Include construction period interest per FASB 34 (see Section IX).

D. Do not include profit.

IX. CAPITALIZATION OF INTEREST COSTS (FASB #34)

A. CONSTRUCTION PERIOD INTEREST

Should be capitalized (based on weighted average of accumulated expenditures) as part of the cost of producing fixed assets, such as:

1. Buildings, machinery, or land improvements, constructed or produced for others or to be used internally.
2. Fixed assets intended for sale or lease and constructed as discrete projects, such as:
   a. Real estate projects.
3. Land improvements
   a. If a structure is placed on the land, charge the interest cost to the structure (and not the land).

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B. INTEREST COST

Interest cost is based on interest obligations having:

1. Stated (explicit) interest rate, or if not stated, use:
   a. Imputed interest rate per APBO #21 (interest on receivables and payables)
   b. Imputed interest rate per FASB #13 (leases)

C. DO NOT CAPITALIZE INTEREST COST

1. On inventory routinely manufactured; however, do capitalize interest on special order goods on hand for sale to customers.
2. On fixed assets held before or after construction period.
3. During intentional delays in construction; however, do capitalize interest cost during ordinary delays in construction.

D. COMPUTING CAPITALIZED COST

1. Weighted Average Amount of Accumulated Expenditures

Capitalized interest costs for a particular period are determined by applying an interest rate to the average amount of accumulated expenditures for the qualifying asset during the period (this is known as the avoidable interest).

2. Interest Rate on Borrowings

The interest rate paid on borrowings (specifically for asset construction) during a particular period should be used to determine the amount of interest cost to be capitalized for the period. Where a qualifying asset is related to a specific new borrowing, the allocated interest cost is equal to the amount of interest incurred on the new borrowing.

3. Interest Rate on Excess Expenditures (Weighted Average)

If the average accumulated expenditures outstanding exceed the amount of the related specific new borrowing, interest cost should be computed on the excess. The interest rate that should be used on the excess is the weighted average interest rate for other borrowings of the company.

4. Not to Exceed Actual Interest Costs

Total capitalized interest costs for any particular period may not exceed the total interest costs actually incurred by an entity during that period. In consolidated financial statements, this limitation should be applied on a consolidated basis.

5. Do Not Reduce Capitalizable Interest

Do not reduce capitalizable interest by income received on the unexpended portion of the loan.

PASS KEY

For the CPA exam, it is important to remember two rules concerning capitalized interest:

Rule 1: Only capitalize interest on money actually spent, not on the total amount borrowed.

Rule 2: The amount of capitalized interest is the lower of:

1. Actual interest cost incurred, or
2. Computed capitalized interest (avoidable interest).

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EXAMPLE

Capitalization of Interest

On January 1, Year 1, Conviser Soup Kitchen, Inc. signed a fixed-price contract to have a new kitchen built for $1,000,000. On the same day, Conviser borrowed $1,000,000 to finance the construction. The loan is payable in ten $100,000 annual payments plus interest at 11%. During Year 1, Conviser had average accumulated expenses of $335,000. What would be Conviser's capitalized interest cost?

Weighted average of accumulated expenditures	x	Applicable interest rate	=	Amount of interest to be capitalized
$335,000	x	11%	=	$36,850

Note that since the capitalized interest ($36,850) is less than the actual interest ($110,000), the full cost of $36,850 is capitalized. The remainder of actual interest is expensed.

E. CAPITALIZATION OF INTEREST PERIOD

1. Begins when three conditions are present:
   a. Expenditures for the asset have been made.
   b. Activities that are necessary to get the asset ready for its intended use are in progress.
   c. Interest cost is being incurred.
2. Continues as long as the three conditions are present.
3. Ends when the asset is (or independent parts of the asset are) substantially complete and ready for the intended use (regardless of whether it is actually used).

F. SUMMARY

SUMMARY	Before Construction	During Construction	After Construction
Borrowed Funds (not used)	Expense	Expense	Expense
Borrowed Funds (weighted average of accumulated expense)	N/A	Capitalize	Expense
Excess (above amount borrowed) Expenditures (weighted average interest rate)	N/A	Capitalize	Expense

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G. DISCLOSE IN FINANCIAL STATEMENTS:

1. Total interest cost incurred during the period.
2. Capitalized interest cost for the period, if any.

EXAMPLE

Construction Period Example

DATE		INTEREST CAP	INTEREST EXP
1-2-X1	Purchased $1,000,000 parcel of land for speculation, paid $600,000 down, borrowed $400,000 at 12% per year.		
3-1	Paid interest cost of $8,000 (2 months)		$8,000
3-2	*Decision made to build condo project on land, and attorneys apply for zoning permits.		
5-1	Paid interest cost of $8,000 (2 months) (charge to building)	$8,000	
5-2	Permits received – architects begin plans		
9-1	Begin grading and developing land and foundation. Paid 4 months interest. (Charge building)	$16,000	
9-2	Incurred expenses to date for attorney, architect, and land development = $300,000 all paid with additional borrowed money.		
12-31-X1	Paid 4 months interest**	$28,000	
	Total interest	$52,000	$8,000
12-31-X1	Required disclosure of interest:		
	Total interest cost incurred during year = $60,000 **Interest cost capitalized = $52,000*** **		
1-2-X2	Wildcat strike stops construction (unintentional delay)	$$$	
2-1	Wildcat strike over – construction continues	$$$	
4-1	Glut on condo market, construction delayed intentionally		$$$
8-1	Construction continued	$$$	
10-1	Floors 1 – 3 of 10-story condo building are completed (except for light fixtures and wall coverings) and ready for sale	Floors 4-10	Floors 1-3
12-15-X2	Building and project completed		$$$

*Construction period begins at point decision is made to build on land, and ends when asset is substantially complete and ready for intended use.

**$400,000 + 300,000 = $700,000 x 12% x 4/12 = $28,000

***Capitalizable interest is based on weighted average of accumulated expenditures to date.

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DEPRECIABLE ASSETS AND DEPRECIATION

I. OVERVIEW

The basic principle of matching revenue and expenses is applied to long-lived assets that are not held for sale in the ordinary course of business. The systematic and rational allocation used to achieve "matching" is usually accomplished by depreciation, amortization, or depletion, according to the type of long-lived asset involved.

A. KINDS OF DEPRECIATION

1. Physical Depreciation

DEPRECIATION

This kind of depreciation is related to an asset's deterioration and wear over a period of time.

2. Functional Depreciation

Functional depreciation arises from obsolescence or inadequacy of the asset to perform efficiently. Obsolescence may result from diminished demand for the product that the depreciable asset produces or from the availability of a new depreciable asset that can perform the same function for substantially less cost.

B. TERMS

1. Salvage Value

Salvage or residual value is an estimate of the amount that will be realized at the end of the useful life of a depreciable asset. Frequently, depreciable assets have little or no salvage value at the end of their estimated useful life and, if immaterial, the amount(s) may be ignored in calculating depreciation.

2. Estimated Useful Life

Estimated useful life is the period of time over which an asset's cost will be depreciated. It may be revised at any time but any revision must be accounted for prospectively, in current and future periods only (change in estimate).

PASS KEY

The CPA exam frequently will have an asset placed in service **during** the year. Therefore, it requires computing depreciation for a part of the year rather than the full year. Candidates must always check the date the asset was placed in service.

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II. DEPRECIATION METHODS

The goal of a depreciation method should be to provide for a reasonable, consistent matching of revenue and expense by systematically allocating the cost of the depreciable asset over its estimated useful life.

The actual accumulation of depreciation in the books is accomplished by using a contra account, such as accumulated depreciation or allowance for depreciation.

The amount subject to depreciation is the difference between the cost and residual or salvage value and is called the depreciable base.

III. COMPOSITE (ENTIRE UNIT) VS. COMPONENT DEPRECIATION

A. ADVANTAGES OF COMPONENT DEPRECIATION OVER COMPOSITE DEPRECIATION:

1. Depreciation expense for the year would be more accurate because each component item would be depreciated over its useful life.
2. Repair and maintenance expense would be more accurate because replacements of components would be excluded.

B. COMPONENT DEPRECIATION

This is not available for MACRS recovery property for tax purposes because depreciation expense under the component method is generally higher and MACRS is already high. However, it does appear to be available when straight-line depreciation is elected.

C. COMPOSITE (DISSIMILAR ASSETS) OR GROUP (SIMILAR ASSETS) DEPRECIATION

This is the process of averaging the economic lives of a number of property units and depreciating the entire class of assets over a single life (e.g., all at five years), thus simplifying record keeping of assets and depreciation calculations.

1. No gain or loss is recognized when one asset in the group is retired.

When a group or composite asset is sold or retired, the accumulated depreciation is treated differently than the accumulated depreciation of a single asset. If the average service life of the group of assets has not been reached when an asset is retired, the gain or loss that results is absorbed in the accumulated depreciation account. The accumulated depreciation account is debited (credited) for the difference between the original cost and the cash received.

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D. THESE METHODS CAN USE SL, SYD, OR DB METHODS OF DEPRECIATION FOR GAAP PURPOSES

EXAMPLE

Composite (Group) Depreciation

A schedule of machinery owned by Lester Manufacturing Company is presented below:

	Total Cost	*Estimated Salvage Value*	*Estimated Life in Years*
Machine A	$550,000	$50,000	20
Machine B	200,000	20,000	15
Machine C	40,000	—	5

Lester computes depreciation on the straight-line method. Based upon the information presented, the composite life of these assets (in years) should be 16 years, computed as follows:

Machine	*Total Cost*		*Estimated Salvage Value*		*Depreciable Cost*	*Estimated Life in Years*	*Annual Depreciation*
A	$550,000		$50,000		$500,000	20	$25,000
B	200,000		20,000		180,000	15	12,000
C	40,000		—		40,000	5	8,000
Totals	$790,000	–	$70,000	=	$720,000		$45,000

Average composite life = $720,000 divided by $45,000 = 16 years

Average composite rate = $45,000 divided by $790,000 = 5.70%

EXAMPLE

Disposal of Group or Composite Asset

Assume the Lester Company sells Machine A in 10 years for $260,000. Since the loss on disposal is not recognized, accumulated depreciation must be reduced or debited.

The journal entry is as follows:

DR	Cash	$260,000	
DR	Accumulated depreciation	290,000	
CR	Asset A		$550,000

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IV. BASIC DEPRECIATION METHODS

A. STRAIGHT-LINE

Straight-line depreciation is determined by the formula:

$$\frac{\text{Cost - Salvage value}}{\text{Estimated useful life}} = \text{Depreciation per period}$$

Estimated useful life is usually stated in periods of time, such as years or months.

EXAMPLE

Straight-Line Method

Assume that an asset cost $11,000, has a salvage value of $1,000 and has an estimated useful life of five years.

$$\frac{\$11,000 - \$1,000}{5 \text{ years}} = \$2,000 \text{ depreciation per year}$$

If the asset was acquired within the year instead of at the beginning of the year, a partial depreciation expense is taken in the first year. Assume the asset above was acquired July 1st.

Depreciation expense in the year of acquisition would be: $2,000 x ½ = $1,000

B. SUM-OF-THE-YEARS'-DIGITS

The sum-of-the-years'-digits method is one of the accelerated methods of depreciation that provides higher depreciation expense in the early years and lower charges in the later years.

1. Calculation

To find the sum-of-the-years'-digits, each year is progressively numbered and then added. For example, the sum-of-the-years'-digits for a five-year life would be:

1 + 2 + 3 + 4 + 5 = 15

For four years:

1 + 2 + 3 + 4 = 10

For three years:

1 + 2 + 3 = 6

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2. Formula

When dealing with an asset with a long life, it is necessary to use the general formula for finding the sum-of-the-years'-digits:

$$S = \frac{N \times (N + 1)}{2}$$

Where N = estimated useful life

To find the sum-of-the-years'-digits for an asset with a 50-year life:

$$S = \frac{50 \times (50 + 1)}{2}$$

$$S = 25 (51)$$

$$S = 1{,}275 \text{ sum-of-the-years'-digits for 50 years}$$

The sum-of-the-years'-digits becomes the denominator. The numerator is the remaining life of the asset at the beginning of the current year. For example, the first year's depreciation for a five-year life would be 5/15 of the depreciable base of the asset.

Note: The CPA exam rarely tests sum-of-the-years'-digits depreciation for asset lives longer than 5 years.

EXAMPLE

Sum-of-the-Years'-Digits Method

Assume that an asset cost $11,000, has a salvage value of $1,000 and has an estimated useful life of four years.

The first step is to determine the depreciable base:

Cost of asset	$11,000
Less: Salvage value	(1,000)
Depreciable base	$10,000

The sum-of-the-years'-digits for four years is:

1 + 2 + 3 + 4 = 10

The first year's depreciation is 4/10, the second year's 3/10, the third year's 2/10, and the fourth year's 1/10, as follows:

1st Year:	4/10 x $10,000 =	$ 4,000
2nd Year:	3/10 x $10,000 =	3,000
3rd Year:	2/10 x $10,000 =	2,000
4th Year:	1/10 x $10,000 =	1,000
	Total depreciation	$10,000

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C. DECLINING-BALANCE

The most common of these accelerated methods is the double-declining-balance method, although other alternative (less than double) methods are acceptable.

1. Calculation

Under double-declining balance, the first year's depreciation rate is double the straight-line rate. In succeeding years, the same percentage is applied to the remaining book value.

2. Salvage Value

No allowance is made for salvage value because the method always leaves a remaining balance, which is treated as salvage value. However, the asset should not be depreciated below the estimated salvage value.

EXAMPLE

Double-Declining-Balance Method

An asset costing $10,000 with a salvage value of $2,000 has an estimated useful life of 10 years. Using the double-declining-balance method, the expense is computed as follows:

First, the regular straight-line method percentage is determined, which in our case is 10% (10-year life). The amount is doubled to 20% and applied each year to the remaining book value, as follows:

Year	(D)ouble Percentage	(N)et Book Value Remaining	(A)mount of Depreciation Expense
1	20	$10,000	$2,000
2	20	8,000	1,600
3	20	6,400	1,280
4	20	5,120	1,024
5	20	4,096	819
6	20	3,277	655
7	20	2,622	524
8	20	2,098	98
Salvage value		2,000	0

Had the preceding illustration been 1½ times declining balance (150%), the rate would have been 15% of the remaining book value.

In the illustration above, if the asset (of a company on a calendar-year basis) had been placed in service on July 1, the first year's depreciation would have been $1,000 (one-half of $2,000), and the second year's depreciation would have been 20% of $9,000 (remaining value after the first year), or $1,800.

Note that in year 8 only $98 depreciation expense is taken because book value cannot drop below salvage value. In addition, no depreciation expense is recorded in years 9 and 10.

PASS KEY

The only methods that ignore salvage value in the annual calculation of depreciation are the declining balance methods. Salvage value is only used as the limitation on total depreciation.

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D. UNITS-OF-PRODUCTION (PRODUCTIVE OUTPUT)

The units-of-production method relates depreciation to the estimated production capability of an asset and is expressed in a rate per unit or hour.

The formula is:

$$\frac{\text{Cost - Salvage value}}{\text{Estimated units or hours}} = \text{Rate per unit or hour}$$

$$\text{Rate per unit (or hour)} \times \text{\# of units produced (or hours worked)} = \text{Depreciation expense}$$

E. PARTIAL YEAR DEPRECIATION

When an asset is placed in service during the year, the depreciation expense is taken only for the portion of the year that the asset is used. For example, if an asset (of a company on a calendar year basis) is placed in service on July 1, only six months' depreciation is taken.

F. DISPOSALS

1. Sale of an asset during its useful life

DR	Cash received from sale	$XXX	
DR	Accumulated depreciation of sold asset	XXX	
CR	Sold asset at cost		$XXX
CR/DR	The difference is gain/loss		XXX

2. Write-off fully depreciated asset

DR	Accumulated depreciation (100%)	$XXX	
CR	Old asset at full cost (100%)		$XXX

3. Total and permanent impairment

DR	Accumulated depreciation per records	$XXX	
DR	Loss due to impairment (the difference)	XXX	
CR	Asset at full cost		$XXX

4. Partial impairment

DR	Loss due to impairment (e.g., technological changes)	$XXX	
CR	Accumulated depreciation		$XXX

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G. DISCLOSURE

Allowances for depreciation and depletion should be deducted from the assets to which they relate.

The following disclosures of depreciable assets and depreciation should be made in the financial statements or notes thereto:

1. Depreciation expense for the period.
2. Balance of major classes of depreciable assets by nature or function.
3. Accumulated depreciation allowances by classes or in total.
4. The methods used, by major classes, in computing depreciation.

H. ADVANTAGES AND DISADVANTAGES OF THE STRAIGHT-LINE METHOD OF DEPRECIATION

1. Advantages

a. Simple to compute.

b. Applies to virtually all assets.

c. Consistent from year to year.

d. Wide acceptability.

e. Similar to treatment of prepaid items.

2. Disadvantages

a. Does not reflect difference in usage of asset from year to year.

b. Does not accurately match costs with revenue.

I. ADVANTAGES AND DISADVANTAGES OF THE MACHINE HOURS AND UNITS-OF-PRODUCTION METHOD

1. Advantages

a. Matches costs with revenues.

b. Reflects activity of the enterprise.

2. Disadvantages

a. If no activity, no depreciation expensed; however, in reality, all assets depreciate.

b. Cannot be used for all assets. EXAMPLE: Buildings.

c. Can be complex because it requires clerical work and records.

J. ADVANTAGES AND DISADVANTAGES OF THE DECLINING-BALANCE METHODS

1. Advantages

a. Matches costs to revenues since greater utility is reflected in greater depreciation during earlier years.

b. As the amount of depreciation decreases, repairs and maintenance charges increase thereby tending to balance out one another.

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2. Disadvantages

a. Does not reflect changes in the activity of the asset.

b. Computation can be complex.

c. Greater disparity in amount of depreciation between earlier years and later years.

d. Possibility that with decreasing depreciation and increasing repairs and maintenance, income is artificially smoothed over the years.

V. DEPLETION

A. DEFINITION

Depletion is the allocation of the cost of wasting natural resources such as oil, gas, timber, and minerals to the production process.

B. TERMS

1. Purchase Cost

Purchase cost includes any expenditures necessary to purchase and then prepare the land for the removal of resources, such as drilling costs or the costs for tunnels or shafts for the oil industry (intangible development costs) or to prepare the asset for harvest, such as in the lumber industry.

2. Residual Value

The residual value is similar to salvage value. It is the monetary worth of a depleted asset after the resources have been removed.

3. Depletion Base (Cost – Residual Value)

The depletion base is the cost to purchase the property minus the estimated net residual value remaining after all resources have been removed from the property.

4. Methods

a. Cost Depletion (GAAP)

Cost depletion is computed by dividing the current estimated recoverable units into unrecovered cost (less salvage) to arrive at a cost depletion rate which is multiplied by units produced to allocate the costs to production.

b. Percentage Depletion (Not GAAP / Tax Only)

(1) It is based on a percentage of sales. It is allowed by Congress as a tax deduction to encourage exploration in very risky businesses.

(2) Percentage depletion can (and usually does) exceed cost depletion.

(3) It is limited to 50% of net income from the depletion property computed before the percentage depletion allowance.

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C. UNIT DEPLETION RATE (DEPLETION PER UNIT)

Unit depletion is the amount of depletion recognized per unit (e.g., ton, barrel, etc.) extracted. It is calculated by dividing the depletion base by estimated removable units.

1. Depletion Base

The depletion base may be calculated as:

a. Cost to purchase property.

b. Plus: Development costs to prepare the land for extraction.

c. Plus: Any estimated restoration costs.

d. Less: Residual value of land after the resources (e.g., mineral ore, oil, etc.) are extracted.

EXAMPLE

Unit Depletion Rate

Lucy Mine Corporation purchased a mineral mine for $9,000,000 with removable ore estimated to be 5,000,000 tons. Lucy is required by the purchase contract to restore the land to a condition suitable for recreational use upon completion of extraction. Estimated residual value of the land after restoration is $1,000,000. Estimated restoration costs are $1,500,000. If Lucy Mine maintains no inventories of extracted material, what should be the charge to depletion expense per ton of ore?

First, calculate the depletion base. The formula is:

Depletion base = Cost of land + Development costs + Restoration costs – Residual value
$9,500,000 = $9,000,000 + 0 + $1,500,000 – $1,000,000

Then, calculate unit depletion rate by dividing the depletion base by estimated removable units.

$$\text{Unit depletion rate} = \frac{\text{Depletion base}}{\text{Estimated removable units}} = \frac{\$9,500,000}{5,000,000} = \$1.90 \text{ per ton}$$

2. Calculation of Depletion

Total depletion is calculated by multiplying the unit depletion rate times the number of units *extracted.*

If all units extracted are not sold, then depletion must be allocated between cost of goods sold and inventory. The amount of depletion to be included in cost of goods sold is calculated by multiplying the unit depletion rate by the number of units *sold.* Depletion applicable to units extracted but not sold is allocated to inventory as direct materials.

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EXAMPLE

Total Depletion and Cost of Goods Sold Depletion (Comprehensive Example)

In Year 1, Happy Mine Corporation purchased a mineral mine for $3,400,000 with removable ore estimated by geological surveys at 4,000,000 tons. The property has an estimated value of $200,000 after the ore has been extracted. The company incurred $800,000 of development costs preparing the mine for production. During Year 1, 400,000 tons were removed and 375,000 tons were sold.

Requirement 1: What is the depletion base?

Requirement 2: What is the amount of depletion Happy Mine should record?

Requirement 3: What is the amount of depletion that Happy Mine should include in its cost of goods sold for Year 1?

1. Calculate depletion base

Depletion base = Cost of land + Development costs + Restoration – Residual value
$4,000,000 = $3,400,000 + $800,000 + 0 – $200,000

Then, calculate unit depletion rate.

$$\text{Unit depletion} = \frac{\text{Depletion base}}{\text{Estimated recoverable units}} = \frac{\$4,000,000}{4,000,000 \text{ tons}} = \$1 \text{ per ton}$$

2. Calculate depletion for Year 1

Depletion for Year 1 = Unit depletion x Units extracted
= $1 per unit x 400,000 units
= $400,000

3. Calculate the amount of depletion to be included in cost of goods sold

CGS depletion = Unit depletion x Units sold
= $1 per unit x 375,000 units
= $375,000

Note that the remaining $25,000* would be included in inventory as direct materials.

*$400,000 – $375,000 = $25,000

PASS KEY

When computing depletion on land, remember it is **REAL** property:

Residual value (subtract)

Extraction/development cost

Anticipated restoration cost

Land purchase price

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FIXED ASSET IMPAIRMENT

I. OVERVIEW

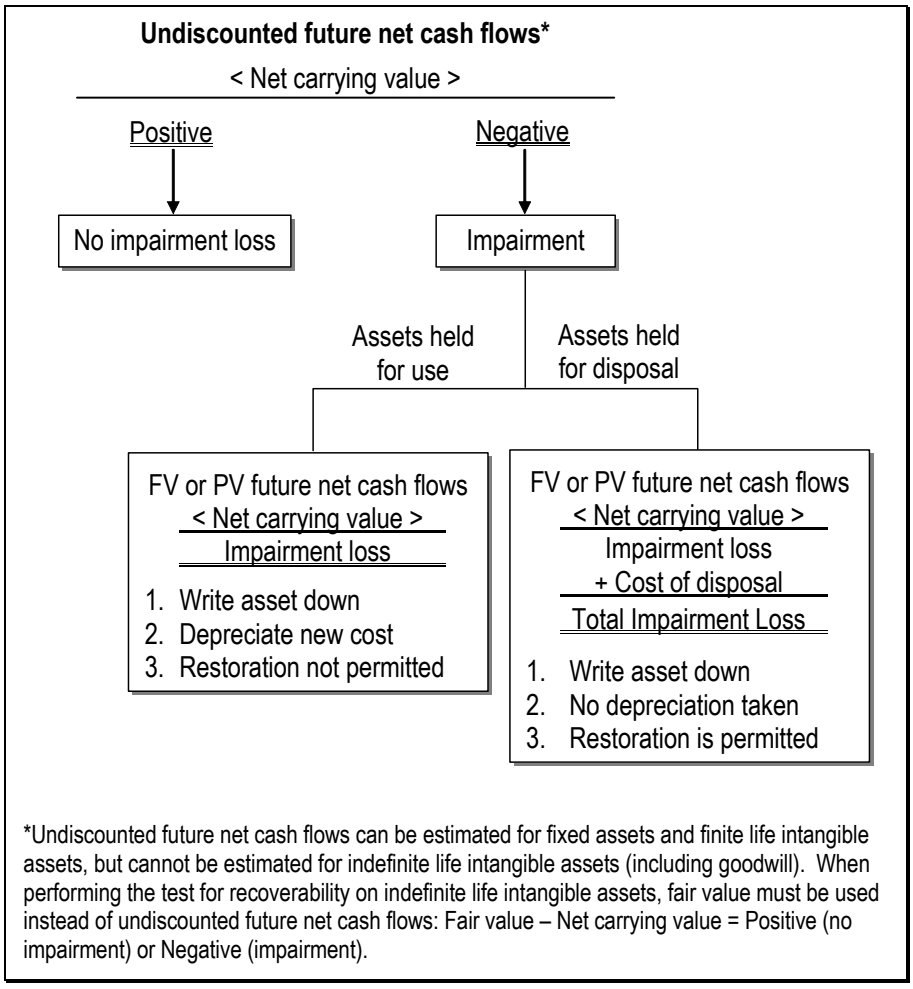
As presented in chapter F2, the carrying amounts of fixed assets held for use and to be disposed of need to be reviewed at least annually or whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

II. TEST FOR RECOVERABILITY

When a fixed asset is tested for impairment, the future cash flows expected to result from the use of the asset and its eventual disposition need to be estimated. If the sum of undiscounted expected (future) cash flows is less than the carrying amount, an impairment loss needs to be recognized.

III. CALCULATION OF THE IMPAIRMENT LOSS: GENERAL

The impairment loss is calculated as the amount by which the carrying amount exceeds the fair value of the asset. The fair value of the asset is determined as outlined in SFAS No. 157—Fair Value Measurements (see chapter F1).



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IV. REPORTING THE IMPAIRMENT LOSS: GENERAL

The impairment loss is reported as a component of income from continuing operations before income taxes or in a statement of activities (related to not-for-profit entities). The carrying amount of the asset is reduced. Restoration of previously recognized impairment losses is prohibited.

PASS KEY

It is important to remember the following rules when performing your calculations:

- Determining the impairment—use undiscounted future net cash flows
- Amount of the impairment—use fair value (FV) or discounted (FV) future net cash flows

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HOMEWORK READING

Enhanced Outlines and Expanded Examples of Inventory

I. EXPANDED EXAMPLE OF LOWER-OF-COST-OR-MARKET CALCULATIONS

EXAMPLE

Lower-of-Cost-or-Market Calculations

		Market			
Item	*Cost*	*Replacement Cost*	*Selling Price*	*Costs of Completion*	*Normal Profit*
1	$20.50	$19.00	$25.00	$1.00	$6.00
2	26.00	20.00	30.00	2.00	7.00
3	10.00	12.00	15.00	1.00	3.00
4	40.00	55.00	60.00	6.00	4.00

Determine the lower of cost or market for the above four items.

Item 1: Determine the maximum ("ceiling") and minimum ("floor") limits for the replacement cost.

Ceiling = $24.00 ($25 - $1)
Floor = $18.00 ($25 - $1) - $6

Since replacement cost falls between the maximum and minimum, market price is $19.00. Market ($19.00) is lower than cost ($20.50), therefore inventory would be valued at market ($19.00).

Item 2: Determine the maximum and minimum limits for the replacement cost.

Ceiling = $28.00
Floor = $21.00

Since replacement cost is less than the minimum, market value is the minimum, or $21.00. Market ($21.00) is lower than cost ($26.00), therefore inventory would be valued at market ($21.00).

Item 3: Determine the maximum and minimum limits for the replacement cost.

Ceiling = $14.00
Floor = $11.00

Replacement costs falls within these limits. Since cost ($10.00) is less than replacement cost ($12.00), the cost of $10.00 is used.

Item 4: Determine the maximum and minimum limits for the replacement cost.

Ceiling = $54.00
Floor = $50.00

Since the replacement cost exceeds the maximum limit, the maximum ($54.00) is compared to cost ($40.00). Inventory is valued at cost ($40.00).

When market is lower than cost, the maximum prevents a loss in future periods by valuing the inventory at its estimated selling price less costs of completion and disposal. The minimum prevents any future periods from realizing any more than a normal profit.

The write-down of inventory to market is usually reflected in cost of goods sold, unless the amount is material, in which case the loss should be identified separately in the income statement.

Journal Entry: To record the write-down to a separate account

DR	Inventory loss due to decline in market value	XXX	
CR	Inventory		XXX

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II. BASIC COST FLOW METHODS

A. GENERAL

Inventories are generally accounted for at cost (basic principle), which has been defined as the price paid or consideration given to acquire an asset. In inventory accounting, cost is the sum of the expenditures and charges, direct and indirect, in bringing goods to their existing condition or location.

The principles of measuring inventory costs can be easily stated, but the application of the principles, particularly to items in work-in-process and finished goods, is difficult because of the problem involved in allocating the various costs and charges between inventory (product costs) and operations (period costs). For example, idle factory expense, excessive spoilage, double freight and rehandling costs can be so abnormal that they may have to be charged to the current period, rather than to inventory costs. Selling expenses should not be considered a part of inventory costs. The exclusion of all fixed overhead from inventory (direct or variable costing) costs is not acceptable under GAAP.

When selecting an inventory cost flow method, the primary objective is the selection of the method that under the circumstances most clearly reflects periodic income. When similar goods are purchased at different times, it may not be possible to identify and match the specific costs of the item sold. Frequently, the identity of goods and their specific related costs are lost between the time of acquisition and the time of sale. This has resulted in the development and general acceptance of several assumptions with respect to the flow of cost factors (FIFO, LIFO, and average cost) to provide practical bases for the measurement of periodic income.

B. SPECIFIC IDENTIFICATION

In some lines of business, specific items or lots of inventory are clearly identifiable from the time of purchase through the time of sale and are costed on this basis.

C. FIRST-IN, FIRST-OUT (FIFO)

The FIFO method of costing inventory is based on the assumption that costs should be charged against revenue in the order in which they were incurred. The inventory remaining on hand is presumed to consist of the *most recent purchases*. In other words, the first goods acquired are the first goods sold, and the last goods acquired are in ending inventory (assuming that there is an ending inventory).

Theoretically, FIFO approximates the results that would be obtained by the specific identification method, if the oldest purchases were sold first. Thus, inventory is valued at approximate current cost and cost of goods sold reflects original acquisition cost. In periods of rising prices, FIFO results in the highest ending inventory and highest net income.

D. LAST-IN, FIRST-OUT (LIFO)

The LIFO method of costing inventory is based on the assumption that the most recent costs should be matched with current revenues. The inventory remaining on hand is presumed to consist of the *goods acquired first*.

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1. LIFO Justification

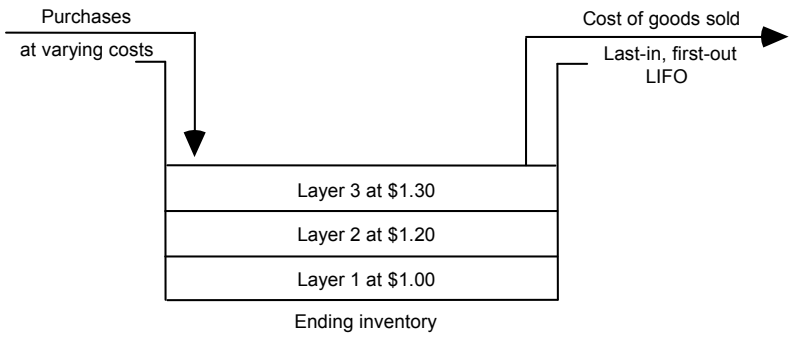
LIFO is often supported on the grounds that it usually produces an amount for cost of goods sold that more closely reflects current cost levels. However, in times of rising prices, the amount reported in the balance sheet of LIFO inventory tends to be understated; in times of falling prices, this amount may be overstated. In periods of rising prices, LIFO results in the lowest ending inventory and lowest net income.

2. LIFO Layers

The last-in, first-out method of determining inventory requires that records be maintained as to the base year inventory amount and additional layers that may be added yearly. After an original LIFO amount is created (base year), it may decrease, or additional layers may be created in each year according to the amount of ending inventory. An additional LIFO layer is created in any year where the ending inventory is greater than the beginning inventory. An additional LIFO layer is priced at the earliest costs of the year in which it was created, because the LIFO method matches the most current costs incurred with current revenues, leaving the first cost incurred to be included in any inventory increase.

It is important to remember that once a LIFO layer is used up because of inventory decreases, any new LIFO layer is priced at the earliest costs of the year in which the new layer is created, and not by reference to a prior LIFO layer.

LIFO Layer Container Illustration



E. AVERAGING METHODS

An averaging method treats goods of a particular category as fungible. Usually, averaging methods will produce results somewhere between the LIFO and FIFO methods.

1. Weighted Average

The weighted average method is based on the assumption that costs should be charged against revenue on the basis of the weighted average price paid for all units purchased. The average price is applied to the ending inventory to find the total ending inventory value. The weighted average is determined by dividing the total costs of inventory available by the total number of units of inventory available, remembering that beginning inventory is included in both totals. This method usually is associated with a *periodic* inventory system.

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2. Moving Average

The moving average method is based on the assumption that average cost should change each time there is a new purchase. The moving average is determined each time there is a purchase by dividing the total cost of inventory available at that time (inventory plus current purchase) by the total units available at that time. Thus, the moving average is more current than the weighted average. Also, since it does not require calculation of the average cost for a particular period, it is available for use currently rather than only at the end of the period. This method does require a *perpetual* inventory system.

EXAMPLE

Comprehensive Example of Methods of Inventory Valuation

To illustrate the application of the FIFO, LIFO, and the averaging methods of inventory valuation, assume the following facts:

Units Purchased During the Year

Date	*Units*	*Cost per Unit*	*Total Cost*
January 15	10,000	$5.10	$ 51,000
March 20	20,000	5.20	104,000
May 10	50,000	5.00	250,000
June 8	30,000	5.40	162,000
October 12	5,000	5.30	26,500
December 21	5,000	5.50	27,500
Totals	120,000		$621,000

Units Sold During the Year

Date	*Units*	*Date*	*Units*
January	9,000	July	8,000
February	6,000	August	10,000
March	14,000	September	4,000
April	4,000	October	6,000
May	15,000	November	8,000
June	20,000	December	12,000
Subtotals	68,000		48,000

Total 68,000 + 48,000 = 116,000 units sold

Beginning inventory consisted of 10,000 units at $5.00.
Ending inventory consisted of 14,000 units.

Note: Remember that the quantities and cost of purchases (or cost of goods manufactured) will always be the same regardless of the cost flow assumption used. The difference between the methods is simply the allocation of costs between ending inventory and cost of goods sold.

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EXAMPLE

Ending Inventory Using FIFO

Under FIFO, the first units in stock are the first units out, which means that the ending inventory is composed of the units purchased last. Since the ending inventory is 14,000 units and the December purchases were only 5,000 units, we must go back to October's purchases for another 5,000 units. In order to make up the 14,000 units in the ending inventory, we also need to take 4,000 units from the June purchases, as follows:

December purchases	5,000 units	@ $5.50	$27,500
October purchases	5,000 units	@ 5.30	26,500
June purchases	4,000 units	@ 5.40	21,600
Ending inventory using FIFO	14,000 units		$75,600

EXAMPLE

Ending Inventory Using LIFO

Under LIFO, the last units in stock are the first units out, which means that the ending inventory is composed of the units purchased first. Here we are assuming a periodic inventory system. Using LIFO, we must go back to the earliest inventory to start our calculations. The earliest inventory available is the beginning inventory of 10,000 units at $5.00, but the ending inventory is 14,000 units. Thus, we must go to the next earliest purchase, which is January, and use 4,000 units at the January price to complete the ending inventory valuation, as follows:

Beginning inventory	10,000 units	@ $5.00	$50,000
January purchases	4,000 units	@ 5.10	20,400
Ending inventory using LIFO	14,000 units		$70,400

Note: The LIFO calculation under the periodic method is an annual calculation and does not consider the actual flow of product during the year. Throughout the year estimates are made to project the year-end inventory balance. At year-end, an adjusting entry is made based on the actual inventory balance.

EXAMPLE

Ending Inventory Using Weighted Average

Under the weighted average method, we must find out what the weighted average cost per unit is and then multiply it by the 14,000 units in the ending inventory, thus:

	Units	Cost per Unit	Total Cost
Beginning inventory	10,000	$5.00	$ 50,000
Purchases:			
January 15	10,000	5.10	51,000
March 20	20,000	5.20	104,000
May 10	50,000	5.00	250,000
June 8	30,000	5.40	162,000
October 12	5,000	5.30	26,500
December 12	5,000	5.50	27,500
Totals	130,000		$671,000

Weighted average = total costs ÷ total units.
Weighted average = $671,000 ÷ 130,000 units.
Weighted average = $5.1615 per unit.
Ending inventory 14,000 units x $5.1615 per unit = $72,261.

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EXAMPLE

Ending Inventory Using Moving Average

Under the moving average method, a new average cost must be calculated each time there is a purchase.

	Purchases/(Sales)			Inventory (Rounded)		
	Units	Unit Cost	Amount	Units	Amount	Unit Cost
Beg. Inven.				10,000	$ 50,000	$5.00
January 15	10,000	$5.10	$51,000	20,000	101,000	5.05
Jan.-Feb.	(15,000)	5.05	(75,750)	5,000	25,250	5.05
March 20	20,000	5.20	104,000	25,000	129,250	5.17
Mar.-April	(18,000)	5.17	(93,060)	7,000	36,190	5.17
May 10	50,000	5.00	250,000	57,000	286,190	5.02
May	(15,000)	5.02	(75,300)	42,000	210,890	5.02
June 8	30,000	5.40	162,000	72,000	372,890	5.18
June-Sept.	(42,000)	5.18	(217,560)	30,000	155,330	5.18
October 12	5,000	5.30	26,500	35,000	181,830	5.20
Oct.-Nov.	(14,000)	5.20	(72,800)	21,000	109,030	5.20
December	5,000	5.50	27,500	26,000	136,530	5.25
December	(12,000)	5.25	(63,000)	14,000	73,530	5.25

Comparison of Methods

Ending inventory, FIFO	$75,600
Ending inventory, LIFO	70,400
Ending inventory, weighted average	72,261
Ending inventory, moving average	73,530

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III. OTHER COST FLOW METHODS

A. LIFO METHOD WITH MULTIPLE POOLS

1. The multiple pools approach to LIFO costing is used to attempt to reduce extensive record keeping inherent in the single goods LIFO approach. Under LIFO with multiple pools, quantities of goods are grouped into natural categories (pools), which then are treated as a unit for costing purposes.

EXAMPLE

Multiple Pools Approach

Assume that Jodi Sue Company has two raw materials in its beginning inventory, products A and B. Beginning inventory includes:

	Quantity	*Price*	*Total*
Product A	10,000 lbs.	$2.00/lb.	$20,000
Product B	15,000 lbs.	$1.00/lb.	15,000
	25,000 lbs.		$35,000

$1.40 average cost/lb.

Assume that raw materials are one pool. Purchases for the period include:

	Beginning Inventory	*Purchases*			*Sales*	*Ending Inventory*
		Quantity	*Price*	*Total*		
Product A	10,000 lbs.	5,000 lbs.	$1.90	$ 9,500	3,000 lbs.	12,000 lbs.
Product B	15,000 lbs.	5,000 lbs.	$1.10	5,500	4,500 lbs.	15,500 lbs.
	25,000 lbs.	10,000 lbs.		$15,000	7,500 lbs.	27,500 lbs.

$1.50 average cost/lb.

Pooled LIFO Cost of Ending Inventory

	Total Quantity	*Price*	*Total*
Beginning inventory	25,000 lbs.	$1.40	$35,000
Increase during year	2,500 lbs.	$1.50	3,750
Ending inventory	27,500 lbs.		$38,750

2. Increases in inventory from period to period form layers. If ending inventory levels are always higher than beginning inventory levels, the costs of the original units remain in inventory. In the case of a decrease in inventory levels, the first layer eliminated is the one that was added most recently.

   Because companies are always changing their product mixes, a company may find dissimilar items replacing items in existing pools with the LIFO multiple pools approach. To overcome this problem of changing pools, the dollar-value LIFO method was created which measures increases and decreases in pools in terms of dollars vs. physical quantities.

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B. DOLLAR-VALUE LIFO

Under the regular LIFO method, inventory is measured in units and is priced at unit prices. Under the dollar-value LIFO method, inventory is measured in dollars and is adjusted for changing price levels. When converting from LIFO inventory to dollar-value LIFO, a price index will be used to adjust the inventory value. In some problems the price index will be internally computed. In other problems, the price index will be supplied.

1. Internally Computed Price Index

When the price index is computed internally by the company, the price index will be ending inventory at current year cost divided by ending inventory at base year cost;

$$\text{Price index} = \frac{\text{Ending inventory at current year cost}}{\text{Ending inventory at base year cost}}$$

To compute the LIFO layer added in the current year at dollar-value LIFO, the LIFO layer at base year cost is multiplied by the internally generated price index.

EXAMPLE

Dollar-value LIFO—Internally Computed Price Index

Brock Co. adopted the dollar-value LIFO inventory method as of January 1, Year 1. A single inventory pool and an internally computed price index are used to compute Brock's LIFO inventory layers. Information about Brock's dollar-value inventory follows:

Date	*At base year cost*	*At current year cost*	*At dollar-value LIFO*
1/1/Year 1	$40,000	$40,000	$40,000
Year 1 layer	5,000	14,000	6,000 [A]
12/31/Year 1	$45,000	$54,000	46,000 [B]
Year 2 layer	15,000	26,000	20,000 [C]
12/31/Year 2	$60,000	$80,000	$66,000 [D]

Compute the LIFO layers added and ending inventory for Years 1 and 2 at dollar-value LIFO.

$$\text{Year 1 price index} = \frac{\$54,000}{\$45,000} = \frac{6}{5}$$

[A] Year 1 LIFO layer added = 6/5 x $5,000 = $6,000

[B] Year 1 ending inventory = $40,000 + $6,000 = $46,000

$$\text{Year 2 price index} = \frac{\$80,000}{\$60,000} = \frac{4}{3}$$

[C] Year 2 LIFO layer added = 4/3 x $15,000 = $20,000

[D] Year 2 ending inventory = $46,000 + $20,000 = $66,000

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2. Price Index Supplied

Where the price index is given in the problem, the year-end price index is multiplied by the LIFO layer at the base year cost to calculate the LIFO layer added at dollar-value LIFO.

EXAMPLE

Dollar-value LIFO—Price Index Supplied

Walt adopted the dollar-value LIFO inventory method as of January 1, Year 1 when its inventory was valued at $500,000. Walt's entire inventory constitutes a single pool. Using a relevant price index of 1.10, Walt determined that its December 31, Year 1 inventory was $577,500 at current year cost, and $525,000 at base year cost. Calculate Walt's dollar-value LIFO inventory at December 31, Year 1.

Although in this problem the data was not presented in tabular form, you should arrange the data in tabular form before computing the answer.

Date	*At base year cost*	*At current year cost*	*At dollar-value LIFO*
1/1/Year 1	$500,000	$500,000	$500,000
Year 1 layer			
12/31/Year 1	$525,000	$577,500	

The Year 1 layer at base year cost is $525,000 − $500,000 = $25,000

The Year 1 layer at current year cost is $577,500 − $500,000 = $77,500

The Year 1 layer at dollar-value LIFO is $25,000 (base year layer) x 1.10 = $27,500

The dollar-value LIFO ending inventory is $500,000 + $27,500 = $527,500

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3. Variations of LIFO

In order to alleviate the effects of using an old LIFO layer, two variations of the LIFO method have been developed: the unit pool approach and the dollar-value approach.

a. Unit Pool Approach

Under the unit pool approach, similar (but not identical) items are grouped together in a pool. Then, if some items in the pool experience a reduction in inventory, they are more likely to be offset by increases in other items in the pool.

EXAMPLE

LIFO Unit Pool Approach

	Total	Year 1	Year 2	Year 3	Year 4	Year 5
Average Acquisition Cost		$1.00/u	$1.20/u	$1.30/u	$1.45/u	$1.60/u
Unit Pools						
Balance 1/1/X1	10,000u	10,000u				
Purchased	33,000	3,000 (net)				
Sold	(30,000)					
Balance 12/31/X1	13,000	13,000				
Purchased	38,000		4,000 (net)			
Sold	(34,000)					
Balance 12/31/X2	17,000	13,000	4,000			
Purchased	41,000			6,000 (net)		
Sold	(35,000)					
Balance 12/31/X3	23,000	13,000	4,000	6,000		
Purchased	24,000				0	
Sold	(32,000)		(2,000)	(6,000)		
Balance 12/31/X4	15,000	13,000	2,000	0	0	
Purchased	43,000					4,000 (net)
Sold	(39,000)					
Balance 12/31/X5	19,000u	13,000	2,000	0	0	4,000

LIFO Layers @ 12/31/X5

	Units		Rate*		LIFO Value
Year 1	13,000u	x	$1.00	=	$13,000
Year 2	2,000	x	$1.20	=	2,400
Year 3	--	x	$1.30	=	--
Year 4	--	x	$1.45	=	--
Year 5	4,000	x	$1.60	=	6,400
	19,000u				$21,800

* This average acquisition cost may be computed using weighted average, FIFO, LIFO, etc.

b. Dollar-Value Approach

Under the "dollar-value" approach, dollar pools of similar items are identified and changes in the pool are determined and measured by total dollars, not the physical quantity of the goods in the pool (as in the unit pool approach).

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C. RELATIVE SALES VALUE COSTING

This method is used when costs cannot be determined individually. Joint products, lump sum purchases of assets (basket purchases), and large assets that are subdivided (real estate tracts) are examples of items that would be costed by their relative sales value.

EXAMPLE

Relative Sales Value Costing

ABC Company purchased four lots of land for $100,000, each containing many parcels. At the time of purchase, an appraisal was made which disclosed the following fair values:

Lot Class	*Number of Parcels*	*Price per Parcel*	*Total*
Lot #1	50	$240	$ 12,000
Lot #2	100	$380	38,000
Lot #3	200	$200	40,000
Lot #4	200	$150	30,000
Total			$120,000

The lots are priced at their relative fair values, as follows:

Lot #1	$\frac{\$12,000}{\$120,000}$	x	$100,000	=	$ 10,000
Lot #2	$\frac{\$38,000}{\$120,000}$	x	$100,000	=	$ 31,667
Lot #3	$\frac{\$40,000}{\$120,000}$	x	$100,000	=	$ 33,333
Lot #4	$\frac{\$30,000}{\$120,000}$	x	$100,000	=	$ 25,000
Total cost allocated					$100,000

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D. GROSS PROFIT METHOD

Under the gross profit method, the gross profit percentage is known and is used to calculate cost of sales.

EXAMPLE

Gross Profit Method

Dahl Co. sells soap at a gross profit percentage of 20%. The following figures apply to the nine months ended August 31, Year 1:

Sales	$200,000
Beginning inventory	100,000
Purchases	100,000

On September 1, Year 1, a flood destroys all of Dahl's soap inventory. Estimate the cost of the destroyed inventory.

Sales	$200,000
CGS % (1.00 - .20)	x 80%
Cost of goods sold	$160,000

Cost of goods sold is deducted from the total goods available to determine ending inventory, as follows:

Beginning inventory	$100,000
Add: Purchases	+100,000
Cost of goods available	$200,000
Less: Cost of goods sold	–160,000
Estimated cost of inventory destroyed	$ 40,000

E. RETAIL INVENTORY METHODS

The retail method requires keeping aggregate records at both cost and retail and the periodic determination of the relationship of one to the other. This allows a business to keep a reasonably accurate inventory balance without the cost inconvenience of a physical count.

1. Basic Calculation for Ending Inventory at Cost

By calculating the amount of goods available for sale at retail and subtracting retail sales, we can determine ending inventory at retail. Multiplying ending inventory at retail by the ratio of aggregate cost to aggregate retail gives us the estimated ending inventory at cost.

It is necessary to maintain records of purchases at both cost and selling price, and of sales at selling price, in order to use the retail inventory method. With the information available, a ratio of cost to retail can be calculated and applied to the estimated ending inventory at retail to compute the approximate cost.

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EXAMPLE

Computation of Cost to Retail Ratio

	Cost	*Retail*
Inventory, at beginning of period	$ 100,000	$ 150,000
Purchases during the period	1,100,000	1,850,000
Totals	1,200,000	2,000,000

Cost-to-Retail Ratio

$1,200,000 / $2,000,000 = 60%

Sales during the period		1,800,000
Estimated ending inventory at retail		$ 200,000
Estimated ending inventory at cost (60% x $200,000)	120,000	
Estimated cost of goods sold	$ 1,080,000	

When the retail inventory method is used, physical inventories should be taken periodically as a check on the accuracy of the estimated inventories.

2. Accounting for Changes in Selling Prices

The illustration above ignores the problem of changes made in selling prices after the original pricing of the goods.

Original selling prices are often revised or modified, which necessitates an understanding of the following terminology:

Original retail:	The first selling price at which the goods are offered for sale.
Markups:	Increases in the selling price above the original selling price.
Markdowns:	Decreases in the selling price below the original selling price.
Markup cancellations:	Decreases in the markup selling price, but not below the original selling price.
Markdown cancellations:	Increases in the markdown selling price, but not above the original selling price.
Net markups:	Markups minus markup cancellations.
Net markdowns:	Markdowns minus markdown cancellations.
Markon:	The difference between the cost and the original selling price.

3. Conventional Retail Inventory Method

This method approximates the results that would be obtained by taking a physical inventory and pricing the goods at the lower of cost or market.

In order to approximate the lower of cost or market in the computations, beginning inventory, markups and markup cancellations are used in calculating the ratio of cost to retail. Markdowns and markdown cancellations are excluded in calculating the ratio of cost to retail and are subtracted from the retail inventory after the ratio is determined.

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4. LIFO Application of the Retail Method

a. Approximates Cost

Unlike the conventional retail method, the LIFO application approximates the original cost of the merchandise.

b. Differences in Calculations Using the LIFO Application

The LIFO method of evaluating inventory can be applied to the retail inventory method by using procedures somewhat different from the conventional retail method. Two differences have to be taken into consideration:

(1) Net markups and net markdowns are included in the cost to retail ratio calculation.

(2) Beginning inventory is excluded from the cost to retail ratio calculation.

EXAMPLE

Calculation of Ending Inventory Using Conventional Retail Inventory Method (LCM) and the LIFO Retail Inventory Method

Assume the following information:

General Data	*Cost*	*Retail*
Inventory, beginning of the period	$200,000	$ 300,000
Purchases	550,000	800,000
Transportation in	50,000	
Markups		120,000
Markup cancellations		20,000
Markdowns		70,000
Markdown cancellations		10,000
Sales		750,000

SOLUTION: Conventional Retail Inventory Method

The calculations would be:

	Cost	*Retail*
Inventory, at beginning of period	$200,000	$ 300,000
Purchases	550,000	800,000
Transportation in	50,000	
Markups		120,000
Markup cancellations		(20,000)
Totals (used to calculate cost to retail ratio)	$800,000	$1,200,000

Cost-to-Retail Ratio

$800,000 / $1,200,000 = 66.67%

Markdowns		(70,000)
Markdown cancellations		10,000
Total goods at retail		1,140,000
Less: Sales during the period		750,000
Inventory, ending (at retail)		$ 390,000
Inventory, ending (66.67% x $390,000)	$260,000 *	

* At estimated lower of cost or market

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SOLUTION

SOLUTION: LIFO Retail Inventory Method (LIFO Layer Added)

	Cost	*Retail*
Inventory, at the beginning of period	omitted	omitted
Purchase	$550,000	$ 800,000
Transportation	50,000	
Markups		120,000
Markup cancellations		(20,000)
Markdowns		(70,000)
Markdown cancellations		10,000
Totals (used to calculate cost to retail ratio)	$600,000	840,000

Cost-to-Retail Ratio

$600,000 / $840,000 = 71.4%

Add: Inventory, at the beginning of period	300,000
Total goods at retail	1,140,000
Less: Sales during the period	750,000
Inventory, ending (at retail)	$ 390,000

In this example, the computation is as follows:

	Retail
Ending inventory	$390,000
Less: beginning inventory	300,000
LIFO layer added	$ 90,000

Due to the nature of LIFO inventory valuation, the LIFO layer added represents additions to the inventory made after the beginning of the period. Therefore, to determine the cost of the LIFO layer added, the LIFO layer added at retail, $90,000, is multiplied by the new cost to retail ratio. In this example, the ratio is 71.4% ($600,000/$840,000).

Thus, the LIFO layer has a value, at cost, of $64,260 ($90,000 x 71.4%).

To calculate the ending inventory at cost, the LIFO layer added is combined with the beginning inventory at cost. In this example, the computation is as follows:

Beginning inventory at cost	$200,000
Plus: LIFO layer added, at cost	64,260
Ending inventory, at cost	$264,260

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EXAMPLE

Calculation of Ending Inventory Using LIFO Retail (LIFO layer depleted)

For this example, assume sales of $860,000.

	Cost	*Retail*
Inventory, at the beginning of period	omitted	omitted
Purchases	$ 550,000	$ 800,000
Transportation	50,000	
Markups		120,000
Markup cancellations		(20,000)
Markdowns		(70,000)
Markdown cancellations		10,000
Totals	$ 600,000	840,000
Add: Inventory, at the beginning of period		300,000
Total goods at retail		1,140,000
Less: Sales during the period		860,000
Inventory, ending (at retail)		$ 280,000

When the ending LIFO inventory (at retail) is less than the beginning inventory (at retail), part or all of a LIFO layer has been used. To determine the LIFO layer depleted, the ending inventory at retail is subtracted from the beginning inventory at retail.

In this example, the computation is as follows:

	Retail
Beginning inventory	$ 300,000
Less: Ending inventory	280,000
LIFO layer depleted	$ 20,000

Due to the nature of LIFO inventory valuation, the LIFO layer depleted represents additions to the inventory made prior to the beginning of the period. Therefore, to determine the cost of the LIFO layer depleted, the LIFO layer depleted at retail ($20,000) is multiplied by the inventory cost to retail ratio applicable to the layer depleted. In this example, assuming the beginning inventory consists of only one layer, this ratio is:

$$\frac{\$200{,}000 \text{ cost}}{\$300{,}000 \text{ retail}} = 66.67\%$$

Thus, the LIFO layer at cost is $13,334 ($20,000 x 66.67%).

To calculate the ending inventory at cost, the LIFO layer depleted at cost is subtracted from the beginning inventory at cost. In this example, the computation is as follows:

Beginning inventory, at cost	$200,000
Less: LIFO layer depleted, at cost	(13,334)
Ending inventory, at cost	$186,666

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5. Cost Retail Inventory Method

Under the cost retail inventory method, the markdowns go above the "total available for sale" line. Therefore, the result must be adjusted to "lower of cost or market."

	At Cost		At Retail
Beginning inventory	$ 25,000		$ 39,000
Purchases	35,000		60,000
Markups	--		1,000
Markdowns	--		(2,000)
Total available for sale	$ 60,000	÷	$ 98,000 = 61.22% cost complement
Sales	--		(88,000)
Ending inventory at **retail**			**$ 10,000**
Ending inventory at **cost** ($10,000 x 61.22%)	**$ 6,122**		

6. LIFO / Cost Retail Inventory Method

Under the LIFO cost retail inventory method, ending inventory comes from beginning inventory plus an incremental increase for the period.

	At Cost		At Retail
Beginning inventory	$ 25,000	÷	$ 39,000 = 64.10% cost complement
Purchases	35,000		60,000
Markups	--		1,000
Markdowns	--		(2,000)
Sales			(88,000)
Ending inventory at retail	--		**$ 10,000**
Ending inventory at LIFO **cost** ($10,000 x 64.10%)	**$ 6,410**		

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7. Dollar Value LIFO / Cost Retail Inventory Method

In general, dollar value LIFO can also be used in a retail environment. The dollar value LIFO cost retail process requires five steps:

a. Count the inventory at year-end at retail.

b. Convert the year-end balance to base year amounts via price indices.

c. Compute the yearly increment (increase or decrease).

d. Convert each yearly increment from base year amounts to year-end prices.

e. Convert retail prices to cost.

December 31	Ending Inventory at End of Year Prices	Price Index at December 31	Yearly Cost Complement %
20X1	$100,000	100	63%
20X2	121,000	110	65%
20X3	138,000	120	62%

Calculated Yearly Increments

Dec. 31	Base Year Amounts	Increments
20X1	100,000 x 100/100 = $100,000	100,000
20X2	121,000 x 100/110 = 110,000	10,000
20X3	138,000 x 100/120 = 115,000	5,000

Convert to Year-end Prices/Convert to Cost

Dec. 31	Increments	Year-end Amounts	Cost %	Cost
20X1	$100,000 x 100/100	= $100,000	x 63%	$63,000
20X2	10,000 x 110/100	= 11,000	x 65%	7,150
20X3	5,000 x 120/100	= 6,000	x 62%	3,720
		$117,000		$73,870

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8. Retail Method: Additional Rules

Certain additional rules apply to the retail method.

a. Freight costs are added to the cost (not retail) of purchases.

b. Purchase returns and allowances are reductions of both the cost and retail amounts.

c. Sales returns and allowances are subtracted from sales.

d. Employee discounts are deducted from retail in a manner similar to sales discounts.

e. Shrinkage is the difference between book ending inventory and the amount per physical count.

	Cost		Retail	
Beginning inventory	$ 20,000		$ 45,000	
Purchases	100,000		210,000	
Purchase returns	(2,000)		(6,000)	
Freight-in	3,000		n/a	
Markups	n/a		3,000	
Total available for sale	$ 121,000	÷	$ 252,000	= 48%
Sales, net of $2,000 returns			(204,000)	
Net markdowns			(4,000)	
Employee discounts			(2,000)	
Ending inventory per books			42,000	
Shrinkage (a "squeeze")			(2,000)	
Ending inventory at **retail**			**$ 40,000**	
Ending inventory at **cost** ($40,000 x 48%)	**$ 19,200**			

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HOMEWORK READING

Transfers and Servicing of Financial Assets (SFAS No. 140)

I. INTRODUCTION

There are many different forms of transfers of financial assets. When the transferor has no continuing involvement with the transferred financial assets or with the transferee, the accounting is fairly simple; however, it becomes more complex when there is some sort of continuing involvement. These more complex types of transactions raise issues regarding whether the transaction should be considered a sale (of all of part of the financial assets) or a secured borrowing. They also raise issues about how they should be accounted for, both on the side of the transferor and the transferee. Continuing involvement is present in the following types of transactions (partial list):

(i) Servicing of financial assets,

(ii) Recourse transactions,

(iii) Pledges of collateral, and

(iv) Agreements to reacquire collateral.

II. OBJECTIVE

The objective of accounting for these transfers of financial assets (per SFAS No. 140) is that each entity that is involved in the transaction should:

A. **Recognize** only the assets it has control over (and the related liabilities is has incurred in the process) and

B. **Derecognize** (i.e., remove previously recognized items from the balance sheet) those assets only when control over them has been surrendered and those liabilities only when extinguished (covered in class F5).

III. FINANCIAL-COMPONENTS APPROACH

The financial-components approach is the basis for the GAAP rules for transfers and servicing of financial assets. Under this approach, which focuses on control, financial assets and liabilities may be divided into many components. These components may have different accounting methods applied to them, depending upon the circumstances.

A. DEFINITION OF SURRENDER OF CONTROL

In order to determine the accounting rules to apply to a transaction of this type, one of the first steps is to determine whether control has been surrendered. The following three conditions must all be met before control is deemed to have been surrendered:

1. The transferred assets have been isolated from the transferor,
2. The transferee has the right to pledge or exchange the assets, and
3. The transferor does not maintain control over transferred assets under a repurchase agreement.

B. CONTROL IS SURRENDERED—NO CONTINUING INVOLVEMENT

If the three conditions for surrender of control are met and there is no continuing involvement, the entire transfer is recorded as a sale, with appropriate reduction in receivables and recognition of any gain or loss.

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C. CONTROL IS SURRENDERED—CONTINUING INVOLVEMENT

If the three conditions for surrender of control are met and there is continuing involvement, the transfer (i.e., the assets for which there is **no** retained interest) is recorded as a **sale** using the financial-components approach. The transferred assets are divided between those deemed "sold" and those "not sold." Any retained interests in the financial assets are still carried on the books of the transferor (including servicing assets) and are not considered "sold."

1. All assets that have been sold by the transferor are derecognized (i.e., the previous carrying amount of the sold assets and those with retained interests are allocated based on relative fair market values at the date of transfer).
2. All assets and liabilities received by the transferor as consideration for the sale are considered proceeds of the sale and should be recognized by the transferor.
3. The assets obtained and the liabilities incurred in the sale are initially measured by the transferor at fair value (if practicable to estimate).
4. A gain or loss is recognized in earnings.

D. NO CONTROL IS SURRENDERED

If the three conditions for surrender of control are not met (i.e., the transaction is not deemed a "sale"), the transferee and transferor will account for the transfer as a secured borrowing with pledged collateral and will recognize the appropriate asset/liability amounts and interest revenue/expense amounts. The accounting for the collateral (non-cash) held depends upon whether the debtor has defaulted and whether the secured party has the ability to sell or re-pledge the collateral.

1. No Default by the Transferor

If the transferor has not defaulted, the transferor will still carry the pledged collateral as an asset on its books, and the transferee will not report the collateral as an asset on its books.

a. However, if the transferee has the ability to sell or re-pledge that collateral, the transferor will report the collateral separately from other unencumbered assets on its balance sheet (i.e., as "pledged security").

b. If the transferor actually does sell the pledged collateral, the transferor will record a sale and also a liability for return of the same amount of collateral to the transferee.

2. Default by the Transferor

If the transferor defaults on the secured borrowing and is no longer entitled to the pledged collateral, then the transferor must derecognize the collateral as an asset on its books, and the transferee will recognize the assets (initially at fair value). If the transferee has already sold the collateral (as in a(2), above), the transferee will simply remove the liability to return the collateral from its books.

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IV. SERVICING ASSETS AND LIABILITIES

When an entity is a party to a servicing contract to service financial assets, it should record a servicing asset or liability for the contract (initially measured at the price paid or fair value). The contract (asset or liability) will then be amortized in proportion to the estimated net servicing income (or loss). In addition, the fair value will be determined at regular intervals throughout the life of the contract, and the contract will be then assessed for impairment (or an increase in the liability) based on that fair value.

No recognition of a servicing asset or liability will be made if:

(i) There is a guaranteed mortgage securitization with a transfer to a qualifying special-purpose entity (SPE),

(ii) All of the resulting securities are retained, and

(iii) The classification is as a debt security that is of the held-to-maturity type.

V. DISCLOSURES

SFAS No. 140 increased the amount of disclosures required for transfers and servicing of financial assets compared to those pronouncements that previously governed the same. The following is a condensed listing of certain of those disclosures:

A. Details regarding the collateral pledged in a secured borrowing

B. A description of the nature and restrictions on assets set aside for payment of an obligation

C. Details surrounding the determination of why the fair value of assets obtained or liabilities incurred in a transfer of financial assets could not be estimated and a description of the items

D. The amount of servicing assets and liabilities recognized and amortized in the period

E. Details regarding the determination of fair value of servicing assets and liabilities and the impairment measurements used

F. Details regarding the sale of financial assets during the period (including policies for measurement of fair value of both the sold interests and the retained interests, the measurement of gain or loss, and certain related cash flows)

G. Policies and assumptions related to retained interests in securitized financial assets

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FINANCIAL ACCOUNTING & REPORTING 4

Class Questions Answer Worksheet

MC Question Number	First Choice Answer	Correct Answer	NOTES
1.			
2.			
3.			
4.			
5.			
6.			
7.			
8.			
9.			
10.			
11.			
12.			
13.			
14.			
15.			

Grade:

Multiple-choice Questions Correct / 15 = _____% Correct

Detailed explanations to the class questions are located in the back of this textbook.

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NOTES

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CLASS QUESTIONS

1. CPA-00067

On Merf's April 30, 1993, balance sheet a note receivable was reported as a noncurrent asset and its accrued interest for eight months was reported as a current asset. Which of the following terms would fit Merf's note receivable?

a. Both principal and interest amounts are payable on August 31, 1993, and August 31, 1994.
b. Principal and interest are due December 31, 1993.
c. Both principal and interest amounts are payable on December 31, 1993, and December 31, 1994.
d. Principal is due August 31, 1994, and interest is due August 31, 1993, and August 31, 1994.

2. CPA-00061

Cook Co. had the following balances at December 31, 1992:

Cash in checking account	$350,000
Cash in money-market account	250,000
U.S. Treasury bill, purchased 12/1/92, maturing 2/28/93	800,000
U.S. Treasury bond, purchased 3/1/92, maturing 2/28/93	500,000

Cook's policy is to treat as cash equivalents all highly liquid investments with a maturity of three months or less when purchased. What amount should Cook report as cash and cash equivalents in its December 31, 1992, balance sheet?

a. $600,000
b. $1,150,000
c. $1,400,000
d. $1,900,000

3. CPA-00049

Inge Co. determined that the net value of its accounts receivable at December 31, 1993, based on an aging of the receivables, was $325,000. Additional information is as follows:

Allowance for uncollectible accounts, 1/1/93	$30,000
Uncollectible accounts written off during 1993	18,000
Uncollectible accounts recovered during 1993	2,000
Accounts receivable at 12/31/93	350,000

For 1993, what would be Inge's uncollectible accounts expense?

a. $5,000
b. $11,000
c. $15,000
d. $21,000

4. CPA-00036

At January 1, 1994, Jamin Co. had a credit balance of $260,000 in its allowance for uncollectible accounts. Based on past experience, 2% of Jamin's credit sales have been uncollectible. During 1994, Jamin wrote off $325,000 of uncollectible accounts. Credit sales for 1994 were $9,000,000. In its December 31, 1994, balance sheet, what amount should Jamin report as allowance for uncollectible accounts?

a. $115,000
b. $180,000
c. $245,000
d. $440,000

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5. CPA-00034

Gar Co. factored its receivables without recourse with Ross Bank. Gar received cash as a result of this transaction, which is best described as a:

a. Loan from Ross collateralized by Gar's accounts receivable.
b. Loan from Ross to be repaid by the proceeds from Gar's accounts receivable.
c. Sale of Gar's accounts receivable to Ross, with the risk of uncollectible accounts retained by Gar.
d. Sale of Gar's accounts receivable to Ross, with the risk of uncollectible accounts transferred to Ross.

6. CPA-00059

Roth, Inc. received from a customer a one-year, $500,000 note bearing annual interest of 8%. After holding the note for six months, Roth discounted the note at Regional Bank at an effective interest rate of 10%. What amount of cash did Roth receive from the bank?

a. $540,000
b. $523,810
c. $513,000
d. $495,238

7. CPA-00114

Bren Co.'s beginning inventory at January 1, 1993, was understated by $26,000, and its ending inventory was overstated by $52,000. As a result, Bren's cost of goods sold for 1993 was:

a. Understated by $26,000.
b. Overstated by $26,000.
c. Understated by $78,000.
d. Overstated by $78,000.

8. CPA-00112

Herc Co.'s inventory at December 31, 1993, was $1,500,000 based on a physical count priced at cost, and before any necessary adjustment for the following:

- Merchandise costing $90,000, shipped FOB shipping point from a vendor on December 30, 1993, was received and recorded on January 5, 1994.
- Goods in the shipping area were excluded from inventory although shipment was not made until January 4, 1994. The goods, billed to the customer FOB shipping point on December 30, 1993, had a cost of $120,000.

What amount should Herc report as inventory in its December 31,1993, balance sheet?

a. $1,500,000
b. $1,590,000
c. $1,620,000
d. $1,710,000

9. CPA-00132

On December 1, 1992, Alt Department Store received 505 sweaters on consignment from Todd. Todd's cost for the sweaters was $80 each, and they were priced to sell at $100. Alt's commission on consigned goods is 10%. At December 31, 1992, 5 sweaters remained. In its December 31, 1992, balance sheet, what amount should Alt report as payable for consigned goods?

a. $49,000
b. $45,400
c. $45,000
d. $40,400

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10. CPA-00092

A company decided to change its inventory valuation method from FIFO to LIFO in a period of rising prices. What was the result of the change on ending inventory and net income in the year of the change?

	Ending inventory	*Net income*
a.	Increase	Increase
b.	Increase	Decrease
c.	Decrease	Decrease
d.	Decrease	Increase

11. CPA-00134

Samm Corp. purchased a plot of land for $100,000. The cost to raze a building on the property amounted to $50,000 and Samm received $10,000 from the sale of scrap materials. Samm built a new plant on the site at a total cost of $800,000 including excavation costs of $30,000. What amount should Samm capitalize in its land account?

a. $150,000
b. $140,000
c. $130,000
d. $100,000

12. CPA-00139

On December 1, 1991, Boyd Co. purchased a $400,000 tract of land for a factory site. Boyd razed an old building on the property and sold the materials it salvaged from the demolition. Boyd incurred additional costs and realized salvage proceeds during December 1991 as follows:

Demolition of old building	$50,000
Legal fees for purchase contract and recording ownership	10,000
Title guarantee insurance	12,000
Proceeds from sale of salvaged materials	8,000

In its December 31, 1991, balance sheet, Boyd should report a balance in the land account of:

a. $464,000
b. $460,000
c. $442,000
d. $422,000

13. CPA-00142

Spiro Corp. uses the sum-of-the-years'-digits method to depreciate equipment purchased in January 1996 for $20,000. The estimated salvage value of the equipment is $2,000 and the estimated useful life is four years. What should Spiro report as the asset's carrying amount as of December 31, 1998?

a. $1,800
b. $2,000
c. $3,800
d. $4,500

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14. CPA-00144

Rye Co. purchased a machine with a four-year estimated useful life and an estimated 10% salvage value for $80,000 on January 1, 1992. In its income statement, what would Rye report as the depreciation expense for 1994 using the double-declining-balance method?

a. $9,000
b. $10,000
c. $18,000
d. $20,000

15. CPA-00151

Gei Co. determined that, due to obsolescence, equipment with an original cost of $900,000 and accumulated depreciation at January 1, 1992, of $420,000 had suffered permanent impairment, and as a result should have a carrying value of only $300,000 as of the beginning of the year. In addition, the remaining useful life of the equipment was reduced from 8 years to 3. In its December 31, 1992, balance sheet, what amount should Gei report as accumulated depreciation?

a. $100,000
b. $520,000
c. $600,000
d. $700,000

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Financial Accounting & Reporting 5

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2. Accounting for leases **6**
3. Investment in debt securities **32**
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Financial Accounting & Reporting 5

PRESENT VALUES AND ANNUITIES

I. GENERAL

Problems involving interest, annuities, and present values are all concerned with the use of money over a period of time, which is referred to as the time value of money. The idea of present value is also the basis for the latest foundational concept, SFAC No. 7. The principles used in computing interest, annuities, and present values are applied to many accounting problems. Accounting for leases, pensions, bonds, and long-term debt are some of the more important applications.

A. CONCEPTS

For examination purposes, present value concepts are divisible into six separate types:

1. Present value of $1,
2. Future value of $1,
3. Present value of an ordinary annuity,
4. Future value of an ordinary annuity,
5. Present value of an annuity due, and
6. Future value of an annuity due.

An explanation of each concept is presented below, with interrelated examples.

B. DEFINITION OF ANNUITIES

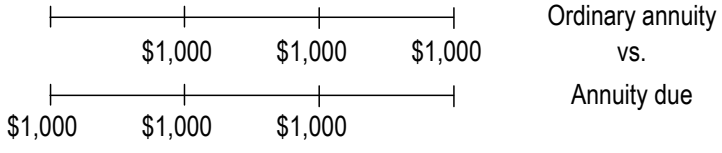
A large number of business transactions involve multiple payments or receipts. Bond interest payments and lease rental payments are two examples. Transactions that result in identical periodic payments or receipts at regular intervals involve annuities. Ordinary annuity (also called "annuity in arrears") payments are made at the end of each period. An annuity is classified as an annuity due (also called "annuity in advance") if payments/receipts occur at the beginning of each period.

C. ORDINARY ANNUITY VS. ANNUITY DUE

The timing of payments is the only difference between an ordinary annuity and an annuity due. This applies to both present value and future value annuities. In calculating the present value of an ordinary annuity, the number of payments is equal to the number of interest periods. In calculating the present value of an annuity due, the number of interest periods is one less than the number of payments.

EXAMPLE

3 Payments of $1,000 Each



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II. PRESENT VALUE OF $1

The present value of $1 is the amount that must be invested now at a specific interest rate so that $1 can be paid or received in the future.

EXAMPLE

Present Value of $1

On January 1, Year 1, ABC Corp. received an offer from a competitor to buy their equipment at the end of Year 4. The competitor would pay $500,000 at the end of Year 4. The equipment is worth $300,000 now, and the prevailing interest rate is 10%, compounded annually.

The present value of the $500,000 is calculated as follows:

Present value of 1 for 4 periods at 10% = .683
$500,000 x .683 = $341,500

ABC should accept the offer of payment at the end of Year 4. The current value of the Year 4 payment is $341,500 which is more than the equipment's current value.

III. FUTURE VALUE OF $1

The future value of $1 is more easily understood as compound interest. It is the amount that would accumulate at a future point in time if $1 were invested now. The interest factor causes the future value of $1 to be greater than $1.

EXAMPLE

Future Value of $1

Your partner is retiring in five years. It will cost $300,000 to purchase her interest. If you invest $200,000 now, earning 10% compounded annually, will you have enough money in five years?

Future value of 1 at 10% for 5 periods = 1.611
$200,000 x 1.611 = $322,200

$322,200 > $300,000, so you will be able to purchase your partner's interest.

IV. PRESENT VALUE OF AN ORDINARY ANNUITY

The present value of an ordinary annuity is the current worth of a series of identical periodic payments to be made in the future.

EXAMPLE

Present Value of an Ordinary Annuity

Parker, Inc. enters into a 10-year noncancelable lease requiring year-end payments of $100,000 each year for 10 years. Parker's borrowing rate is 10% compounded annually. What is the present value of the lease payments?

Present value of an ordinary annuity of 1 at 10% for 10 periods = 6.145
$100,000 x 6.145 = $614,500

Parker should record the lease at $614,500.

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V. FUTURE VALUE OF AN ORDINARY ANNUITY

The future value of an ordinary annuity is the sum, to be received at some point in the future, of identical periodic investments made from the present until that future point.

EXAMPLE

Future Value of an Ordinary Annuity

Jay Planner wants to save for his 12-year-old son's college education. If he sets aside $5,000 at the end of each of the next five years, earning 10% compounded annually, how much money will be in Jay's account at the end of five years?

Future value of an ordinary annuity of 1 at 10% for 5 periods = 6.105
$5,000 x 6.105 = $30,525

VI. PRESENT VALUE AND FUTURE VALUE OF ANNUITY DUE

Remember that the only difference in the calculations of an annuity due and an ordinary annuity is the timing of the payments. Therefore, by adding 1.00 to the present value of an ordinary annuity of 1 for n periods, the present value of an annuity due of 1 for n + 1 periods may be found.

EXAMPLE

Ordinary Annuity vs. Annuity Due

Present value of an *ordinary annuity* of 1 at 6% for 2 periods = 1.833.

Present value of an *annuity due* of 1 at 6% for 3 periods = 2.833 (1.833 + 1.00).

To convert from an annuity due to an ordinary annuity, read the figure from the present value of an annuity due table for one period greater than the number desired, then subtract 1.00 from that number.

EXAMPLE

Conversion

Present value of an *ordinary annuity* for 3 periods at 8%	2.577
Plus: 1.00	1.000
Present value of an *annuity due* for 4 periods at 8%	3.577

EXAMPLE

Present Value of an Annuity Due

Avalanche Inc. enters into a 10-year lease requiring beginning of the year payments of $100,000 each year for 10 years. Avalanche's borrowing rate is 10% compounded annually. What is the present value of the payments?

Present value of an ordinary annuity due of $1 at 10% for 9 periods = 5.759 + 1.000 = 6.759
$100,000 x 6.759 = $675,900

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ACCOUNTING FOR LEASES

I. OVERVIEW

A *lease* is a contractual agreement between a *lessor,* who conveys the right to use real or personal property (an asset), and a *lessee,* who agrees to pay periodic rents over a specified time.

	Rental	Sale (in substance)
Lessee	Operating Lease	Capital Lease
Lessor	Operating Lease	Sales Type or Direct Financing Type

II. OPERATING LEASES

A. DEFINITION

An *operating* lease includes a lessor, who collects rent, and a lessee, who uses the leased asset and pays periodic rent for such use. The lessee merely uses the asset; there is no transfer of ownership, or of any risk or benefit of ownership.

B. ACCOUNTING FOR OPERATING LEASES

1. Lessee Accounting

a. Lease Rent Expense

The lessee records rent expense over the lease term, usually on a straight-line basis unless other methods are warranted (for example, lease expense can be tied to sales, to the Consumer Price Index, or to the prime interest rate).

DR	Rent expense	$XXX	
CR	Cash/rent payable		$XXX

b. Lease Bonus (Prepayment)

Lease bonus (prepayment) for future expenses should be classified as an asset (deferred charge) and amortized using the straight-line method over the life of the lease.

c. Leasehold Improvements

A leasehold improvement is one that is permanently affixed to the property and reverts back to the lessor at the termination of the lease. In general, if the property is not moveable from the premises by the tenant, it is a leasehold improvement. Air conditioning ducts would be considered a leasehold improvement, while a painting hanging on a wall would not.

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(1) Capitalize Leasehold Improvements

The value of leasehold improvements should be capitalized and added to the property, plant, and equipment section or the intangible assets section of the balance sheet.

(2) Depreciation—Useful Life or Lease Term

Leasehold improvements should be depreciated (amortized) over the lesser of:

(a) Lease life

(b) Asset/improvement life

d. Rent Kicker

A premium rent payment required for specific events.

(1) Period expense

e. Refundable Security Deposit

Is reported as an asset until refunded by the lessor.

f. Free or Reduced Rent Consideration

If consideration (free rental months or reduced rental charge at beginning) is part of package, lessee must take total rent expense to be paid for the entire lease term and divide it evenly over each period (matching principle).

EXAMPLE

Rental-Agreement

5 years (60 months) @ $1,000		$60,000	
*First 6 months are free		<6,000>	
Net cost for five years		$54,000	
Total months rented		÷ 60 mo.	
Monthly rental expense		$ 900	
First 6 months (Mo. 1 – 6)			
DR	Rent expense	$900	
CR	Rent payable		$900
Next 54 months (Mo. 7 – 60)			
DR	Rent expense	$900	
DR	Rent payable	100	
CR	Cash/rent payable		$1,000

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2. Lessor Accounting

a. Fixed Asset

The cost of the property is included in the lessor's property, plant, and equipment.

(1) Depreciation—over the asset's useful life

b. Rental Income

Rental income is reported using the straight-line or other systematic method.

DR	Cash/rent receivable	$XXX	
CR	Rental income		$XXX

c. Security Deposits

Security deposits required by the lease may be either refundable or nonrefundable:

(1) Nonrefundable—deferred by the lessor (unearned revenue) and capitalized by the lessee (prepaid rent expense) until the lessor considers the deposit earned.

(2) Refundable—treat as a receivable by the lessee and a liability by the lessor until the deposit is refunded to the lessee.

DR	Cash	$XXX	
CR	Refundable deposit		$XXX

PASS KEY

The CPA exam has attempted to trick candidates into recognizing security deposits as revenue in advance of their being earned (violation of the revenue recognition rule and rule of conservatism). The fact pattern will provide information about the historical percentage of security deposits, which ultimately will be earned. Remember, revenue is only recognized when the earning process is complete; we never anticipate revenue.

d. Temporary Difference

(1) GAAP Rule—report prepaid rental income when earned

(2) Tax Rule—report prepaid rental income when received

e. Lease Bonus

The lease bonus is deferred (unearned income) and amortized (into income) over the life of the lease.

f. Free or Reduced Rent Consideration

If consideration (free rental months or reduced rental charge at beginning) is part of package, lessor must take total rental income to be received over the entire lease term and divide it evenly over each period (matching principle/revenue recognition principle).

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EXAMPLE

Rental-Agreement

5 years (60 months) @ $1,000			$60,000
*First 6 months are free			<6,000>
Net rental income for five years			$54,000
Total months rented			÷ 60 mo.
Monthly rental income			$ 900
First 6 months (Mo. 1 – 6)			
DR	Rent receivable	$900	
CR	Rental income		$900
Next 54 months (Mo. 7 – 60)			
DR	Cash	$1,000	
CR	Rental income		$900
CR	Rent receivable		100

EXAMPLE

Operating Lease with Lease Bonus—Lessor

Jodel Company purchased a machine on January 1, Year 1 for $1,500,000 with an expected life of 10 years from the date of purchase. There is no residual value, and it is to be depreciated on the straight-line method. On January 1, Year 1, Lynn Company leased the machine from Jodel for 3 years at a monthly rate of $32,000. In addition, Lynn paid a lease bonus of $75,000. What amount of related income on this operating lease should Jodel Company report for the year ending December 31, Year 1?

Monthly rentals ($32,000 x 12)	$ 384,000
Plus: Lease bonus amortization ($75,000 x 12/36)	25,000
Less: Depreciation ($1,500,000 / 10 yrs)	(150,000)
Income from leased asset, Year 1	$ 259,000

EXAMPLE

Operating Lease with Lease Bonus—Lessee

Assume the same facts as in the previous example. Calculations of the lessee's expense for Year 1 for the operating lease would be:

Monthly rentals	$ 384,000
Plus: Lease bonus amortization	25,000
Expense for leased asset, Year 1	$ 409,000

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III. CAPITAL LEASE

CAPITAL LEASES

A *capital* lease transfers substantially all of the benefits and risks inherent in ownership of property to the lessee.

(i) This is an accounting transaction, which is, in substance, an installment purchase in the form of a leasing arrangement.

(ii) The lessee accounts for this type of lease as the acquisition of both an asset (leased asset under capital lease) and a related liability (obligation under capital lease).

(iii) The lessor accounts for such a lease as a *sales-type* or a *direct financing* lease. A sales-type lease results in a dealer's or manufacturer's profit or loss to the lessor. A direct financing lease does not result in a dealer's or manufacturer's profit or loss.

A. LESSEE CAPITAL LEASE CRITERIA

1. Must meet just one condition to capitalize.

DR	Fixed asset—leased property	$XXX	
CR	Liability—obligation under capital lease		$XXX

Ownership transfers at end of lease (upon final payment or required buyout)

Written option for bargain purchase

Ninety (90%) percent of leased property FV ≤ PV of lease payments

Seventy-five (75%) percent or more of asset economic life is being committed in lease term

2. Criteria (N) and (S) cannot be used for a lease that begins within the last 25% of the original estimated economic life of the leased property.

EXAMPLE

Equipment FV is $3,500, lease payments are $1,000 per year, on 12-31 lease term is four years, asset life is ten years.

Incremental borrowing rate is 10%

No ownership

No written bargain

FV	PV Cost
$3,500	1 2 3 4
	$1,000 $1,000 $1,000 $1,000
	$ 910
	830
	750
x 90%	680
$3,150	$3,170

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B. LESSOR: SALES-TYPE/DIRECT FINANCING TYPE CRITERIA

1. If a lease, at inception, meets all three of the following conditions, it shall be classified by the lessor as a sales-type or direct financing lease, whichever is appropriate.

Lessee "owns" the leased property (meets any one of the four lessee's criteria).

Uncertainties do not exist regarding any unreimbursable costs to be incurred by the lessor.

Collectibility of the lease payments is reasonably predictable.

2. Comparison of Sales-Type and Direct Financing Leases for Lessors

a. Sales-Type Lease

SALES-TYPE LEASE

In a sales-type lease, the fair value of the leased property at the inception of the lease differs from the cost or carrying amount to the lessor. This difference gives rise to a manufacturer's or dealer's profit or loss. It must be remembered that a lessor need not be a dealer or manufacturer to realize a profit or loss, if at the inception of the lease the fair value differs from the cost or carrying amount.

b. Direct Financing Lease

DIRECT FINANCING LEASE

In a direct financing lease, the fair value of the leased property at the inception of the lease is the same as the cost or carrying amount. Therefore, there is no manufacturer's or dealer's profit or loss.

c. Transfer of Benefits and Risks

Both sales-type and direct financing leases transfer substantially all of the benefits and risks inherent in the ownership of the leased property to the lessee, who records the transaction as a capital lease.

PASS KEY

The CPA examination focuses most of its questions on the following three issues:

1. Capitalized lease criteria
2. Asset capitalized amount and depreciation
3. Liability amortization

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IV. LESSEE (CAPITAL LEASE) ACCOUNTING

A. CALCULATION OF LEASED ASSET AND LIABILITY AMOUNTS

The lessee treats the capital lease as if an asset were being purchased over time; that is, it is a financing transaction in which an asset is acquired and a corresponding obligation (liability) is created.

DR	Fixed asset—leased property	$XXX	
CR	Liability—obligation under capital lease		$XXX

1. Recording the Lease

a. Capitalized Amount

The lessee records the lease as an asset and a liability at the lower (lesser) of:

(1) Fair value of the asset at the inception of the lease, or

(2) Cost = present value of the minimum lease payments.

(a) Includes (all payments that the lessee is obligated to make):

(1) Required Payments

(2) Bargain Purchase Option

When the lease contains a bargain purchase option, the lease obligation includes the present value of the payment required to exercise the bargain purchase option in addition to the present value of the minimum lease payments.

(3) Guaranteed Residual Value

The guaranteed residual value is the amount guaranteed by the lessee to the lessor for the estimated residual value of the asset at the end of the lease term. The lease obligation includes the present value of any guaranteed residual value in addition to the present value of the minimum lease payments.

(b) Exclude:

(1) Executory Costs

Insurance, maintenance, and taxes can be paid by the lessor or lessee. If the *lessor* pays them, a portion of each lease payment representing executory costs is *excluded* from the calculation of minimum lease payments. If the lessee pays these costs directly, they are not included in the minimum lease payments.

(2) Optional Buyout (not required and not a bargain)

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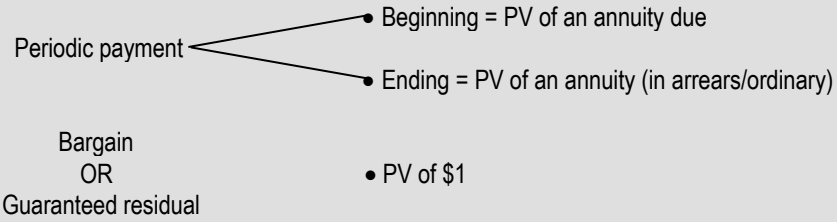
PASS KEY



b. Interest Rate

The lessee uses the incremental borrowing rate, determined as the lower (lesser) of:

(1) Rate implicit in the lease (if known)

(2) Rate available in the market to the lessee (not prime)

c. Summary

INCREMENTAL BORROWING RATE

Capitalized Cost (remember, lower of this cost or market):		
Ownership	=	PV of payments and required buyout—(if any)
Written	=	PV of payments and bargain buyout
Ninety % FV	=	PV of payments (not option buyout)
Seventy-five % life	=	PV of payments (not option buyout)

PASS KEY

A simple way to remember the capitalized amount computation rules is to recall that leases are between a lessee and **lessor**. Therefore, always use the **lesser of**:

- Cost or market
- Implicit interest rate or market rate

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EXAMPLE

Recording a Capital Lease—Lessee's Books

Beta Corporation leases an asset to Omega Corporation for ten years beginning January 1, Year 1 at an annual rental of $5,000. Beta's (lessor) implicit borrowing rate (implicit in the lease) of 10% is known to Omega (lessee). Omega's incremental borrowing rate is 11%. The first payment is due at the beginning of the first year. The asset's economic life is 12 years and the fair value (FV) of the asset at the inception of the lease is $34,000. The lease requires Omega to pay the $800 annual executory costs. The lease does not transfer ownership nor contain a bargain purchase option.

Present Value Amounts

The PV of an annuity due of 1 for 10 periods at 10%	6.759
The PV of an annuity due of 1 for 10 periods at 11%	6.537

Step 1: Does the lease meet the criteria for capitalization?

Ownership transfer → No

Written bargain → No

Ninety % FV → Yes ($34,000 x 90% = $30,600 < $33,795 PV)

Seventy-five % life → Yes (10 years / 12 years)

Step 2: Compute the present value of the minimum lease payments, using the lessee's incremental borrowing rate, unless:

(1) The lessor's implicit rate is lower, *and*

(2) The lessee has knowledge of the lower rate.

Use the lessor's rate since it is lower and the lessee has knowledge of it. The executory costs are excluded from this calculation. They would be expensed annually.

$5,000 x 6.759 (PV of an annuity due for 10 periods at 10%) = $33,795

Step 3: Record the leased asset at the lesser of the asset's fair value at lease inception ($34,000) or the present value of the minimum lease payments ($33,795). Since the present value of the minimum lease payments is less than fair value, capitalize the lease at $33,795.

DR	Leased equipment under capital lease	$33,795	
CR	Obligations under capital lease		$33,795

PASS KEY

The easiest way to determine if a lease should be capitalized is to test the criteria in the following order:

1st the **O**;
2nd the **W**;
4th the **N** (since it is the most difficult to calculate); and
3rd the **S**.

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EXAMPLE

Recording a Capital Lease with Guaranteed Residual Value—Lessee's Books

Assume that Beta Corporation leases an asset with an economic life of five years, to Omega Corporation for five years beginning January 1, Year 1. The annual lease payment is $5,000, with a $1,000 guaranteed residual value. The first payment is due on December 31, Year 1. The lessee's rate is 11%. The lessor's rate is not known. The FV of the asset is $25,000. There is no transfer of ownership. There is no bargain purchase option (PV annuity is 3.696 and PV of $1 is .594). Compute the present value of the minimum lease payments.

Step 1: Does the lease meet the criteria for capitalization?

Ownership transfer → No

Written bargain → No

Ninety % FV → No ($25,000 x 90% = $22,500 > $19,074 PV)

Seventy-five % life → Yes (5 years / 5 years)

Step 2: Compute the present value of the minimum lease payments:

Present value of minimum rental payments:	
$5,000 x 3.696 (PV of an ordinary annuity, 5 periods, 11%)	$18,480
Present value of guaranteed residual value:	
$1,000 x .594 (PV of 1, 5 periods, 11%)	594
Present value of minimum lease payments	$19,074

Step 3: Record the leased asset at lesser of cost or FV:

DR	Leased equipment under capital lease	$19,074	
CR	Obligations under capital lease		$19,074

B. TERM TO USE IN COMPUTING DEPRECIATION OF THE ASSET

1. Formula for Depreciation

Capitalized lease assets
< Salvage value >
Depreciable Basis
÷ Periods of benefit
Depreciation Expense (per period)

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2. Period of Benefit (Depreciable Life)

a. Ownership Transfer and Written Bargain

(1) *Estimated economic life of the asset* if the lessee takes ownership of the leased asset by the end of the lease or if there is a bargain purchase option as part of the agreement. The asset is depreciated in a manner consistent with the lessee's normal policies.

b. Ninety % FV and Seventy-five % Life

(1) The lessee uses the *lease term* if the lessee does not take ownership of the asset by the end of the lease or if there is not a bargain purchase option.

3. Summary

Depreciation Rules: (Capitalized lease asset—salvage value):		
Ownership	=	Depreciate over asset life (legal form)
Written	=	Depreciate over asset life (legal form)
Ninety % FV	=	Depreciate over lease life (substance over form)
Seventy-five % life	=	Depreciate over lease life (substance over form)

EXAMPLE

Depreciation (Amortization) of Asset by Lessee

Assume that Beta Corporation leased an asset to Omega for ten years beginning January 1, Year 0, at $5,000 per year. The present value of the minimum lease payment is $33,795 and the fair value of the asset is $34,000. The useful life of the asset is twelve years. How much depreciation expense should be taken each year if the lessee normally uses the straight-line method of depreciation?

Since the present value of the minimum lease payments is less than the fair value of the asset, the asset is initially recorded at $33,795.

This is a capital lease due to the requirement that stipulates the lease term be 75% or more of the useful life of the asset (10/12). Therefore, because the 75% criteria (OWNS) is met and there is no ownership transfer or written bargain purchase option, the asset will be depreciated over the ten-year term of the lease.

The depreciation expense is as follows:

$33,795 ÷ 10 years = $3,379.50 per year

C. LEASE AMORTIZATION-LIABILITY AND ASSET ON LESSEE'S BOOKS

The Obligation under Capital Lease account and the related Leased Asset account are recorded initially at the same amount. However, subsequent amortization of each account takes place independently and results in different account balances by the end of the first year. The lease liability is amortized using the effective interest method.

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EXAMPLE

Lease Liability and Asset Amortization—Lessee's Books

Assume that Beta Corporation leased an asset to Omega Corporation for ten years beginning January 1, Year 0 at $5,000 per year. The interest rate used is 10%, the lessor's rate, because it is lower than the lessee's rate and it is known. The first payment is due on January 1, Year 0 and the lease qualifies as a capital lease. The present value of the minimum lease payments is $33,795, and it is lower than the fair value of the asset at the inception of the lease.

Required: Show the lease amortization schedule for this asset and the related journal entries on January 1, Year 0 and January 1, Year 1.

Date	(1) Annual Lease Payment	(2) Interest on Unpaid Obligation (10% x Col. 4)	(3) Reduction of Lease Liability (1 - 2)	(4) Carrying Amount of Lease Obligation
1/1/Yr 0				$33,795.00
1/1/Yr 0	$ 5,000.00	—	$ 5,000.00	28,795.00
1/1/Yr 1	5,000.00	$ 2,879.50	2,120.50	26,674.50
1/1/Yr 2	5,000.00	2,667.45	2,332.55	24,341.95
1/1/Yr 3	5,000.00	2,434.20	2,565.80	21,776.15
1/1/Yr 4	5,000.00	2,177.62	2,822.38	18,953.77
1/1/Yr 5	5,000.00	1,895.38	3,104.62	15,849.15
1/1/Yr 6	5,000.00	1,584.92	3,415.08	12,434.07
1/1/Yr 7	5,000.00	1,243.41	3,756.59	8,677.48
1/1/Yr 8	5,000.00	867.75	4,132.25	4,545.23
1/1/Yr 9	5,000.00	454.77*	4,545.28*	—
	$50,000.00	= $16,205.00	+ $33,795.00	

*Rounded

Journal Entry: To record the lease on the lessee's books at January 1, Year 0

DR	Leased equipment under capital lease	$33,795.00	
CR	Obligations under capital lease		$33,795.00

Journal Entry: To record the first payment on January 1, Year 0

DR	Obligations under capital lease	$5,000.00	
CR	Cash		$5,000.00

Journal Entry: To accrue interest expense and liability due on January 1, Year 1

DR	Interest expense	$2,879.50	
CR	Interest payable		$2,879.50

Journal Entry: To depreciate the asset over the ten year lease life $33,795 ÷ 10 years = $3,379.50

DR	Depreciation expense	$3,379.50	
CR	Accumulated depreciation—leased asset		$3,379.50

Journal Entry: To record the payment January 1, Year 1

DR	Interest payable	$2,879.50	
DR	Obligation under capital lease	2,120.50	
CR	Cash		$5,000.00

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D. ASSET RETIREMENT OBLIGATION (FASB 143)

1. Overview

a. Initially based for nuclear decommissioning.

b. Expanded to other similar closure or removal-type costs in other industries such as oil and gas and mining industries.

c. Asset Retirement Obligation (ARO): Balance sheet approach.

2. Retirement

a. Retirement is defined as the other-than-temporary removal of a tangible long-lived asset from service.

b. It does not encompass the temporary idling of a long-lived asset.

3. Scope

a. Applies to all entities.

b. Legal obligations associated with the retirement of a tangible long-lived asset that result from the acquisition, construction, or development and/or normal operation of a long-lived asset, except for certain lease obligations (minimum lease payment and contingent rentals).

c. Excludes obligations:

(1) Relating to the ongoing operation, but not the retirement of, asset (maintenance).

(2) Resulting solely from a plan to dispose of an asset.

(3) Component Parts

(a) Cost of replacement parts is not within the scope.

(b) Legal obligations related to the retirement of the *replaced* part (that is, the ***old*** part), *are* within the scope.

4. Liability Recognition

a. An ARO qualifies for recognition when it meets the definition of a liability:

(1) Duty or responsibility

(2) Little or no discretion to avoid

(3) Obligating event

b. Uncertainty about whether performance will be required does not defer the recognition of a retirement obligation; rather, that uncertainty is factored into the measurement of the fair value of the liability through assignment of probabilities to cash flows.

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5. Leases

a. For Lessees:

(1) If ARO is included in minimum lease payments, no separate ARO accounting (FASB 13 applies).

(2) If ARO is imposed otherwise, then ARO accounting applies.

b. For Lessors:

(1) ARO accounting applies.

6. Basic Accounting

a. Initial balance sheet recognition

(1) Debit asset (asset retirement cost).

(2) Credit liability (asset retirement obligation).

b. Period-to-period income statement

(1) Depreciation expense (asset retirement cost).

(2) Accretion expense (asset retirement liability).

PASS KEY

The asset retirement obligation is recorded at a discounted amount. Accretion expense is the growth of the liability over time so that at the time the liability is satisfied, it is reported at its total non-discounted value.

7. Initial Measurement

a. An entity shall recognize the fair value of a liability for an asset retirement obligation in the period in which it is incurred if a reasonable estimate of fair value can be made.

b. If a reasonable estimate of fair value cannot be made, the liability shall be recognized *when* a reasonable estimate of fair value can be made.

8. Subsequent Measurement

a. In periods subsequent to initial measurement, period-to-period changes in the ARO liability result from:

(1) Passage of time (accretion expense).

(2) Revisions in timing or amount of estimated cash flows.

9. Revisions to Cash Flow Estimates

a. Upward revisions to undiscounted cash flows are "new" liabilities – use current discount rate.

b. Downward revisions require removal of "old" liabilities – use historical (or weighted average) discount rate.

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E. LESSEE'S FINANCIAL STATEMENT DISCLOSURE OF LEASES

1. Capital Lease

a. Assets, accumulated amortization, and liabilities from capital leases should be reported separately in the balance sheet and classified as current or noncurrent in the same manner as other assets and liabilities.

b. Current amortization charges to income must be clearly disclosed, along with this additional information:

(1) The gross amount of assets recorded under capital leases as of each balance-sheet date presented by major property categories. This information may be combined with the information for comparable owned assets.

(2) Future minimum lease payments in the aggregate and for each of the next five years, showing deductions for executory costs, including any profit thereon, and the amount of imputed interest to reduce the net minimum lease payments to present value.

(3) The total of minimum sublease rentals to be received in the future under noncancelable subleases.

(4) Total contingent rentals actually incurred for each period for which an income statement is presented.

2. Operating Leases

a. The following financial statement disclosure is required for all operating leases of lessees having noncancelable lease terms in excess of one year:

(1) Minimum future rental payments: in total, and for each of the next five years.

(2) Minimum sublease income: due in future periods under noncancelable subleases.

b. The following disclosure is required for all operating leases: schedule of total rental expense showing the composition by minimum rentals, contingent rentals, and sublease income (excluding leases with terms of one month or less that were renewed).

3. General Disclosure

General disclosures of the lessee's leasing arrangements include: (1) basis of contingent rental payments; (2) terms of renewals, purchase options, and escalation clauses; and (3) restrictions imposed by lease agreements, such as additional debt, dividends, and leasing limitations.

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F. SUMMARY OF LESSEE CAPITALIZATION RULES

1. Capitalize

As PP&E on the balance sheet, the leased asset at the lower LESSER of:

a. Cost

PV of future lease payments

Include: Guaranteed Residual Value by Lessee

Bargain Purchase Option (if applicable)

Exclude: "Executory Cost" = Insurance, Taxes, and Repair & Maintenance

(1) Discount Rate: Incremental borrowing rate is the lower (LESSER) of:

(a) Rate implicit in the lease (if known)

(b) Rate available in market to lessee (not prime)

b. Fair Value

(Given in the CPA Exam Question)

		Capitalize	Depr. Life
Ownership	=	PV of payments and required buyout	Asset life
Written	=	PV of payments and bargain buyout	Asset life
Ninety % FV	=	PV of payments (ignore option)	Lease life
Seventy-five % life	=	PV of payments (ignore option)	Lease life

PASS KEY

If a lease meets more than one of the criteria, then the order of priority for applying the rules is the exact way they are spelled:

O – W – N – S

V. LESSOR ACCOUNTING

SALES-TYPE LEASE

A. RECORDING A SALES-TYPE LEASE

GROSS INVESTMENT

The terms which are important to know for sales-type leases include:

1. Gross Investment (lease receivable)

The minimum lease payments *plus* any unguaranteed residual value accruing to the benefit of the lessor. This is recorded as Lease Payments Receivable on the lessor's books.

Lease payment
+ Unguaranteed residual value
Gross investment

Note that minimum lease payments would include the periodic lease payments, plus any bargain purchase option or guaranteed residual value.

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2. Net Investment

This is computed as the sum of the present value of the minimum lease payments and the present value of any unguaranteed residual value accruing to the benefit of the lessor, using the interest rate implicit in the lease.

Lease payment
+ Unguaranteed residual value
Gross investment
x PV
Net investment

3. Unearned Interest Revenue (Contra-Lease Receivable)

The gross investment less unearned interest revenue equals net investment. This is amortized over the life of the lease by the effective interest method and is included in the balance sheet as a deduction from the gross investment to report the net investment.

Gross investment
< Net investment >
Unearned interest revenue

4. Cost of Goods Sold

The cost of the leased asset plus any initial direct costs, such as legal fees or commissions to the lessor, minus the present value of any unguaranteed residual value accruing to the lessor's benefit. This is charged against income in the period in which the corresponding sale is recorded.

Cost of Asset
< PV Unguaranteed Residual Value >
Cost of Goods Sold

5. Sales Revenue

The present value of the minimum lease payments is recorded as sales revenue. This does include the present value of any guaranteed residual value but does not include the present value of any unguaranteed residual value.

PASS KEY

Rule for Sales-type Lease

Cost
+ Profit
Present Value = Selling Price = FV

Note: The examiners may give you any of these to help you determine the sales revenue to be recorded in the transaction.

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EXAMPLE

Recording a Sales-Type Lease with Unguaranteed Residual Value (Lessor)

Assume that a lease with a ten-year term requires rental payments of $5,000 on January 1 of each year. The lessor's cost for the leased asset is $35,000. The estimated fair value at the end of the lease (unguaranteed residual value) is $4,000, and the lessor retains ownership at the end of the lease. The implicit interest rate is 10 percent (PV of annuity due is 6.759 and PV of $1 is .386). Compute the information necessary to record this sales-type lease.

1. Gross investment = Minimum lease payments + Unguaranteed residual value
= ($5,000 x 10 yrs) + $4,000
= $54,000

2. Net investment = Lease payments x PV of annuity due of $1, 10 periods, 10%
+ Unguaranteed residual value x PV of $1, 10 periods, 10%
= ($5,000 x 6.759) + ($4,000 x .386)
= $35,339

(The present value of the minimum lease payments, but not the unguaranteed residual value, is recorded as sales, $5,000 x 6.759 = $33,795)

3. Unearned interest revenue = Gross investment – Net investment
= $54,000 – $35,339
= $18,661

4. Cost of goods sold = Lessor's cost of leased asset + Initial direct costs
– PV of unguaranteed residual value
= $35,000 + 0 – ($4,000 x PV of $1, 10 periods, 10%)
= $35,000 – (4,000 x .386)
= $33,456

5. Present value of lease payments (sale) = $5,000 x 6.759 = $33,795

Journal Entry: To record this sales-type lease

DR	Lease payments receivable	$54,000	
DR	Cost of goods sold	33,456	
CR	Sales		$33,795
CR	Equipment		35,000
CR	Unearned interest revenue (contra-lease receivable)		18,661

Note: The lessor's profit on sale is $33,795 – $33,456 = $339, which is recognized at the lease's inception.

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EXAMPLE

Recording Profit on Sale and Interest Income on a Sales-Type Lease

Assume that Moore Company leased equipment from Less Company on January 1, Year 1 for eight years. The lease expires December 31, Year 8. Equal annual payments on the lease are $51,121.08 and are due on January 1 each year, beginning January 1, Year 1. The rate of interest is 10 percent. The equipment's cash selling price is $300,000; the cost of the equipment according to Less's records is $275,000. What is the *profit on sale and interest income* to be recognized by Less Company for the year ended December 31, Year 1? (Assume the lease is recorded appropriately as a sales-type lease.)

Profit on sale = Cash selling price - equipment cost
= $300,000 – $275,000
= $25,000

Interest income = Sales price – first rental payment (since it was received at the beginning of the lease term, January 1) x interest for 12 months at 10%. (See amortization table below.)
= ($300,000 – $51,121.08) x 10%
= $24,887.89

Date	(1) Annual Lease Payment	(2) Interest on Unpaid Obligation (10% x Col. 4)	(3) Reduction of Lease Liability (1 - 2)	(4) Carrying Amount of Lease Obligation
1/1/Yr 1				$300,000.00
1/1/Yr 1	$51,121.08	—	$ 51,121.08	248,878.92
1/1/Yr 2	51,121.08	$ 24,887.89	26,233.19	222,645.73
1/1/Yr 3	51,121.08	22,264.57	28,856.51	193,789.22
1/1/Yr 4	51,121.08	19,378.92	31,742.16	162,047.06
1/1/Yr 5	51,121.08	16,204.71	34,916.37	127,130.69
1/1/Yr 6	51,121.08	12,713.07	38,408.01	88,722.68
1/1/Yr 7	51,121.08	8,872.27	42,248.81	46,473.87
1/1/Yr 8	51,121.08	4,647.21*	46,473.87*	—
	$408,968.76	= $108,968.76	+ $300,000.00	

*Rounded

Journal Entry: To record the sales-type lease

DR	Lease payments receivable	$408,968.76	
CR	Unearned interest income (contra-lease receivable)		$108,968.76
CR	Sales revenue		300,000.00
&			
DR	Cost of goods sold	$275,000.00	
CR	Inventory (asset sold)		$275,000.00

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B. RECORDING A DIRECT FINANCING LEASE

Since no manufacturer's or dealer's profit is realized in a direct financing lease, the fair value of the leased property equals the cost or carrying value at the inception of the lease. The information necessary to record this type of lease is:

1. Gross Investment (Lease Receivable)

Gross investment equals the minimum lease payments plus the unguaranteed residual value and is recorded as Lease Payments Receivable.

Lease payments
+ Unguaranteed residual value
Gross investment

2. Net Investment

Net investment equals the gross investment plus any unamortized initial direct costs less the unearned income. The initial direct costs are amortized over the lease term by the effective interest method.

Gross investment
x PV
Net investment

3. Unearned Interest Revenue

This is the gross investment less the cost of the leased property plus any initial direct costs. It is amortized over the lease term by the effective interest method.

Gross investment
< Net investment >
Unearned interest revenue

Journal Entry: To record a direct financing lease

DR	Lease payments receivable (gross investment)	$ 408,968.76	
CR	Unearned interest revenue (contra-lease receivable)		$108,968.76
CR	Asset		300,000.00

PASS KEY

Rule for Direct Financing Lease

Present value = Carrying amount of receivable = Cost of asset sold

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VI. SALE-LEASEBACK

A. INTRODUCTION

In a sale-leaseback transaction, the owner of a property (seller-lessee) sells the property and simultaneously leases it back from the purchaser-lessor. Usually there is no visible interruption in the use of the property. Sale-leaseback transactions are treated as single financing transactions where, in general, any profit or loss is deferred and amortized. In general, two questions are involved in determining the treatment of any profits:

1. Is the lease a capital or operating lease? And
2. What portion of the rights to the leaseback property are retained?

B. TERMINOLOGY

1. Selling Price

Selling price is the negotiated price in the sale-leaseback agreement. It may be less than, equal to, or greater than the market value of the property, depending on the negotiated terms of the sale-leaseback.

2. Profit or Loss on Sale

Profit or loss on the sale is the amount that would have been recognized by the seller-lessee assuming there was no leaseback. It is calculated by subtracting book value from fair value (sale price).

3. Excess Profit on Sale-Leaseback

a. Operating Lease Excess Profit

The amount of profit on the sale that exceeds the present value of the minimum lease payments.

Sale price
< Asset NBV >
Tentative gain
< PV min. lease payments >
Excess gain

b. Capital Lease Excess Profit

The amount of profit on sale that exceeds the recorded amount of the asset. Note that this amount will be the same as in an operating lease unless the leaseback asset is recorded at the lower fair value.

The recorded amount of the leaseback asset is the lesser of

(i) The fair value of the leased property, or

(ii) The present value of the minimum lease payments.

Sale price
< Asset NBV >
Tentative gain
< Leaseback asset >
Excess gain

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4. Rights to Remaining Use of Property Retained by Seller-Lessee

The rights to the remaining use of the property are determined by the present value of rent payments paid by the seller-lessee. The seller-lessee's rights may be categorized as follows:

a. "Substantially All" Rights Retained (Greater than 90%)

The present value of the rent payments is equal to or greater than 90% of the fair value of the property. These leases are usually accounted for as capital leases.

b. Rights Retained Are Less Than "Substantially All" but Greater than "Minor" (Between 90% - 10%)

The present value of the rent payments is less than 90% of the fair value, but greater than 10% of the fair value of property at the lease inception. These leases are accounted for as either capital or operating leases, depending on the criteria.

c. "Minor" Portion of Rights Retained by Seller-Lessee (Less than 10%)

The present value of the rent payments is 10% or less of the fair value of the property at lease inception or the lease (back) period is 10% or less of the asset's remaining life. These leases are usually accounted for as operating leases.

Note: To determine whether any sales-leaseback transaction should be accounted for as operating or capital, use the "OWNS" test.

C. ACCOUNTING BY SELLER/LESSEE

1. Classification

The lease (back) would be classified as a capital lease or an operating lease based on the criteria previously discussed:

2. Capital Leaseback

Capital lease (back): any gain or loss on the sale is deferred and amortized in proportion to the amortization of the leased asset.

a. The deferred gain (or loss) would be recognized as an "unearned profit (or loss) on sale-leaseback."

b. The "unearned profit (or loss) on sale-leaseback" would be treated as a valuation account of the leased (back) asset.

3. Operating Leaseback

Operating Lease (back): any gain or loss on the sale is deferred and amortized in proportion to the gross rental expense over the life of the lease.

a. The deferred gain (or loss) would be recognized as an "unearned profit (or loss) on sale-leaseback."

b. The "unearned profit (or loss) on sale-leaseback" would be reported as a deferred credit (or debit) in the balance sheet.

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4. Amount of Deferred Gain

The amount of the deferred gain is determined by the retained rights to remaining use of the "leaseback" property.

a. "Substantially All" Rights Retained (Greater Than 90%)

Defer all gain and amortize over the leased asset.

b. Rights Retained Are Less Than "Substantially All" But Greater Than "Minor" (Between 90% - 10%)

Defer gain up to the present value of the minimum leaseback payments (operating lease) or capitalized asset (capital lease). Gain in excess of this amount is recognized immediately.

c. 10% or Less Lease (Back) / No Deferral

Recognize gain or loss immediately when the seller/lessee relinquishes the right to substantially all of the remaining use of the property sold, retaining only a minor portion of the use of the asset (e.g., 10% or less use of asset sold or the lease (back) period is 10% or less of the sold asset's remaining life).

d. Real Economic Loss / Recognize Immediately

(1) Real Economic Loss

A loss that must be recognized immediately is when the fair value of the property at the time of the sale-leaseback is less than book value, in which case the excess of book value over fair value is the loss.

(2) Artificial Loss

When the sales price is below the fair value, the loss is deferred and amortized over the leaseback period.

Sale-Leaseback: Summary

	Major 90% or More	**Middle** 90%—10%	**Minor** 10% or Less (Life or Sales Price)
Gain	Defer All (Amortize over leaseback)	Defer (up to PV of leaseback) (Amortize over leaseback)	No Deferral
Loss (NBV > FV) (real economic losses)	Recognize Immediately	Recognize Immediately	Recognize Immediately
Other Losses (artificial loss)	Defer All (Amortize over leaseback)	Defer All (Amortize over leaseback)	Recognize Immediately

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EXAMPLE

Lease (back)—"Minor" Rights Retained

On December 31, Year 1, Linda, Inc., sold a machine to Denise and simultaneously leased it back for one year. The following information is available:

Sale price, fair value	$360,000
Carrying amount (book value)	315,000
Estimated remaining useful life	12 years
Monthly rent payment	3,000
Present value of lease rentals	34,100

How much profit should Linda recognize on the sale?

First, determine the character of the lease. Since the lease does not meet the capital lease criteria, it is an operating lease.

Next, determine the portion of rights retained by the seller-lessee. Because $34,100 (the present value of the annuity) is less than $36,000 (10% x $360,000), Linda has retained a "minor" portion of rights in the asset. Therefore, Linda would recognize the entire $45,000 gain immediately ($360,000 – $315,000).

EXAMPLE

Leaseback—Less Than "Substantially All" but More Than "Minor"

On January 1, Year 1, Carlson Company sold an airplane with an estimated useful life of ten years. Carlson simultaneously leased back the airplane for three years. The lease is classified as an operating lease. Applicable data follow:

Sale price, fair value	$500,000
Book value of airplane	100,000
Monthly rental	5,100
Present value of lease rentals	153,000

Calculate the amount of Carlson's profit recognized on January 1, Year 1, and rent expense on December 31, Year 1.

The present value of lease rentals exceeds 10% of the fair value ($50,000) but is less than 90% of the fair value ($450,000). Therefore, the amount of profit recognized is the amount in excess of the present value of the minimum lease payments. The calculation follows:

Sale price	$500,000
Less book value	(100,000)
Total profit	400,000
Less present value of lease payments (deferred amount)	(153,000)
Profit recognized at lease inception 1/1/Yr 1 (excess profit on sale leaseback)	$247,000

Carlson's rent expense for the year is calculated as follows:

Annual rent payments ($5,100 x 12 months)	$ 61,200
Less one year recognition of deferred profit ($153,000 ÷ 3 years)	(51,000)
Rent expense 12/31/Yr 1	$ 10,200

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EXAMPLE

Sale-Leaseback Other Losses

On June 30, 19X2, Lang Co. sold equipment with an estimated useful life of eleven years and immediately leased it back for ten years. The equipment's carrying amount was $450,000; the sales price was $430,000; and the present value of the lease payments, which is equal to the fair value of the equipment, as $465,000. In its June 30, 19X2, balance sheet, what amount should Lang report as deferred loss?

This sale-leaseback is classified as a capital lease since the term of 10 years is greater than 75% of the equipment's lifetime (11 years). All gains and losses (other than real economic losses) are deferred since substantially all the use of the equipment is retained (present value exceeds 90% of fair value). The loss of $20,000 ($450,000 book value – $430,000 sales price) is deferred because the fair value of the equipment exceeds its carrying amount.

EXAMPLE

Comprehensive Sale-Leaseback

On December 31, 19X2, Dirk Corp. sold Smith Co. two airplanes and simultaneously leased them back. Additional information pertaining to the sale-leasebacks follows:

	Plane #1	*Plane #2*
Sale price	$600,000	$1,000,000
Carrying amount, 12/31/X2	$100,000	$ 550,000
Remaining useful life, 12/31/X2	10 years	35 years
Lease term	8 years	3 years
Annual lease payments	$100,000	$ 200,000

In its December 31, 19X2, balance sheet, what amount should Dirk report as deferred gain on these transactions?

Plane #1: This sale-leaseback qualifies as a capital lease; the lease term is 80% of its useful life. In the absence of present value information, the percentage of rights retained can only be estimated. The annual lease payments times the term of the lease is well above the sales price, indicating that a substantial portion of the rights have been retained. The profit of $500,000 ($600,000 - $100,000) is deferred and amortized over the life of the lease.

Plane #2: This sale-leaseback qualifies as an operating lease since the lease does not meet any of the criteria of a capital lease. Lacking any information concerning the present value, the inference must be made that only a minor portion of the rights have been retained. The basis for this conclusion is that the lease term (3 years) is far shorter than the remaining life (35 years) and the annual lease payments times the lease term is less than the selling price. Thus, all profit ($1,000,000 – $550,000) is recognized immediately.

D. ACCOUNTING BY PURCHASER-LESSOR

The acquisition of the asset is accounted for as a purchase. If the lease is an operating lease, it is accounted for as such. If the lease is a capital lease, it is accounted for as a direct financing lease.

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VII. SUBLEASES

When a lessee sublets property to another, the newly created sublease must also be classified as either an operating lease or a capital lease.

A. SUBLEASE CLASSIFICATION BY LESSOR

The lessor classifies the sublease in the same category as the original lease.

B. SUBLEASE CLASSIFICATION BY LESSEE

1. Original Lease = Operating Lease

If the original lease was an operating lease, the sublease is also an operating lease.

2. Original Lease = Capital Lease

a. If the original lease was a capital lease due to:

(1) **O**wnership transfer

(2) **W**ritten bargain purchase option

Then the sublease is also a capital lease

b. If the original lease was a capital lease because it met either of the other requirements:

(1) **N**inety percent FV

(2) **S**eventy-five percent of life

Then the sublease will be an operating lease unless it can meet one of the requirements for a capital lease.

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DEBT -- SECURITIES

INVESTMENT IN DEBT SECURITIES

I. INTRODUCTION

According to SFAS No. 115, investments in debt securities classified as *held-to-maturity* are measured at amortized cost, also referred to as "carrying amount" on the balance sheet. SFAS No. 140 clarifies SFAS No. 115 by stating that the held-to-maturity classification may **not** be used for debt securities that may be settled in a way that would cause the holder to recover *less* than substantially all of its original recorded investment.

A. TYPES OF DEBT SECURITIES

A debt security represents a creditor relationship with an entity. Examples of investments in debt securities include U.S. Treasury securities, U.S. government agency securities, municipal securities, corporate bonds, convertible debt, commercial paper, and all securitized debt instruments.

B. GENERAL PURPOSE OF INVESTMENT

The investor purchases a bond in anticipation of a return on its investment. The investor receives a fixed rate of interest in the form of a series of cash payments based on the stated rate on the instrument (coupon rate) in addition to the principal (face value) at maturity.

II. DEFINITIONS

These terms are important to understand when dealing with investments in debt securities. They are referenced to "bonds," as this is the most common instrument of this type tested on the CPA exam.

A. BOND INDENTURE

This document describes the contract between the issuer (borrower) and bondholders (lenders).

B. FACE VALUE

Face value is the total dollar amount of the bond, and this serves as the basis on which periodic interest is paid. Bonds are issued at face value (par) when the stated rate equals the market rate.

C. STATED (NOMINAL) INTEREST RATE

The stated interest rate is the interest to be paid to the investors. This rate is specified in the bond contract.

D. MARKET (EFFECTIVE YIELD) INTEREST RATE

The market interest rate is the rate of interest actually earned by the bondholder and is the rate of return for comparable contracts as of the date of issuance.

E. TREASURY BONDS

Bonds payable that have been reacquired, but not retired, by the issuer are treasury bonds. Their par value is shown on the balance sheet as a deduction from bonds payable.

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III. COST OF INVESTMENT

Investment cost equals the present value of the principal or face value plus the present value of the series of interest payments to be received during the term of the bond. The present value is calculated based on the prevailing market rate at the date of purchase. The market rate and the stated rate may be identical (that is, bonds are issued at par), but it is more probable that the rates would differ because of the time lag between the date the rate was determined and the date the bonds were issued.

Because a bond is a fixed income security (i.e., the cash flows are fixed by contract and known at the time of purchase), the purchase price will equal the present value of the cash flows discounted at the market (effective yield) rate for the grade, type, and maturity of the bond.

IV. DISCOUNT OR PREMIUM

A. DISCOUNT

If the market rate is higher than the stated rate, the bonds will be purchased at a *discount,* in which case the bonds sell for less than the face amount to make up for the lower return being provided.

B. PREMIUM

If the market rate is lower than the stated rate, the bonds will be purchased at a *premium* because the investor will pay more than face value due to the higher return offered.

V. BALANCE SHEET PRESENTATION

A. ASSET: INVESTMENT IN BONDS

Classification as a current asset or noncurrent asset is based upon management intent.

1. Valuation of asset is at total cost of acquisition
2. Premium/Discount is considered an integral part of the asset
    a. Short-term—no amortization
    b. Long-term—amortize

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LONG-TERM LIABILITIES AND BONDS PAYABLE

I. INTRODUCTION

Long-term liabilities are probable future expenditures associated with current obligations that are **not** payable within the current operating cycle or reporting year, whichever is greater. A long-term liability is nothing more than a contract, and as people are able to contract for anything that is legal, long-term liabilities can come in many forms and labels.

A. EXAMPLES OF LONG-TERM LIABILITIES

Examples of long-term liabilities include long-term promissory notes payable, bonds payable, long-term leases, long-term contingent liabilities, purchase commitments, equipment purchase obligations, amounts due under deferred compensation agreements, post-retirement pension and other benefits payable, other financial instruments, short-term debt expected to be refinanced (to the extent of post-balance sheet refinancing with support), and deferred income taxes payable. Most of these types of liabilities are covered in other sections of this course. This portion of the materials will focus on bonds payable, and it will identify the similarities to long-term notes payable.

B. INTRODUCTION TO BONDS PAYABLE

Bonds are one of the most common types of long-term liabilities tested on the CPA Examination. They are an important source of long-term funding for a company needing large amounts of capital that would be too great for a single lender to supply or as an alternative to issuing new equity securities. Bonds represent a contractual promise by the issuing corporation to pay investors (bondholders) a specific sum of money at a designated maturity date plus periodic, fixed interest payments (usually made semi-annually) based on a percentage of the face amount of the bond. The following are various types of bonds that have been tested on the CPA Examination:

1. Debentures

Debentures are unsecured bonds.

2. Mortgage Bonds

Mortgage bonds are bonds that are secured by real property.

3. Collateral Trust Bonds

Collateral trust bonds are secured bonds.

4. Convertible Bonds

Convertible bonds are convertible into common stock of the debtor (generally) at the option of the bondholder.

a. Nondetachable Warrants

The convertible bond itself must be converted into capital stock.

b. Detachable Warrants

The bond is not surrendered upon conversion, only the warrants plus cash representing the exercise price of the warrants. The warrants can be bought and sold separately from the bonds.

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5. Participating Bonds

Participating bonds are bonds that not only have a stated rate of interest but participate in income if certain earnings levels are obtained.

6. Term Bonds

Term bonds are bonds that have a single fixed maturity date. The entire principal is paid at the end of this term/period.

7. Serial Bonds

Serial bonds are pre-numbered bonds that the issuer may call and redeem a portion by serial number (often redeemed pro-rata annually/in a series of annual installments).

8. Income Bonds

Income bonds are bonds that only pay interest if certain income objectives are met.

9. Zero Coupon Bonds

Zero coupon bonds (also known as "deep discount bonds") are bonds sold with no stated interest but rather at a discount and redeemed at the face value without periodic interest payments.

10. Commodity-Backed Bonds

Commodity-backed bonds (also known as "asset-linked bonds") are bonds that are redeemable either in cash or a stated volume of a commodity, whichever is greater.

II. BONDS PAYABLE VS. NOTES PAYABLE

The accounting for long-term notes payable is similar to the accounting for bonds payable. The accounting for long-term non-interest bearing notes is similar to the accounting for short-term non-interest bearing notes (discussed in class F3). The following schedule identifies the typical differences between bonds and notes:

Attribute	Bonds	Notes
Implementing instrument	Bond	Note
Definitive agreement	Indenture	Loan agreement
Book entry only	Yes	No
Face amount increments	$1,000 (general)	Negotiated
Term	10 - 30 years	Negotiated
Payments prior to maturity	Interest only	Negotiated
Payments at maturity	Principal	Negotiated
Number of creditors	Many	Few
Publicly traded	Yes	No
Easily re-negotiable	No	Yes
Secured	Yes and no	Yes
Registered (order) form	Yes	Yes
Bearer (coupon) form	Yes	No
Right of debtor to call/pre-pay	Yes	Yes
Right of creditor to put w/o default	Yes	No

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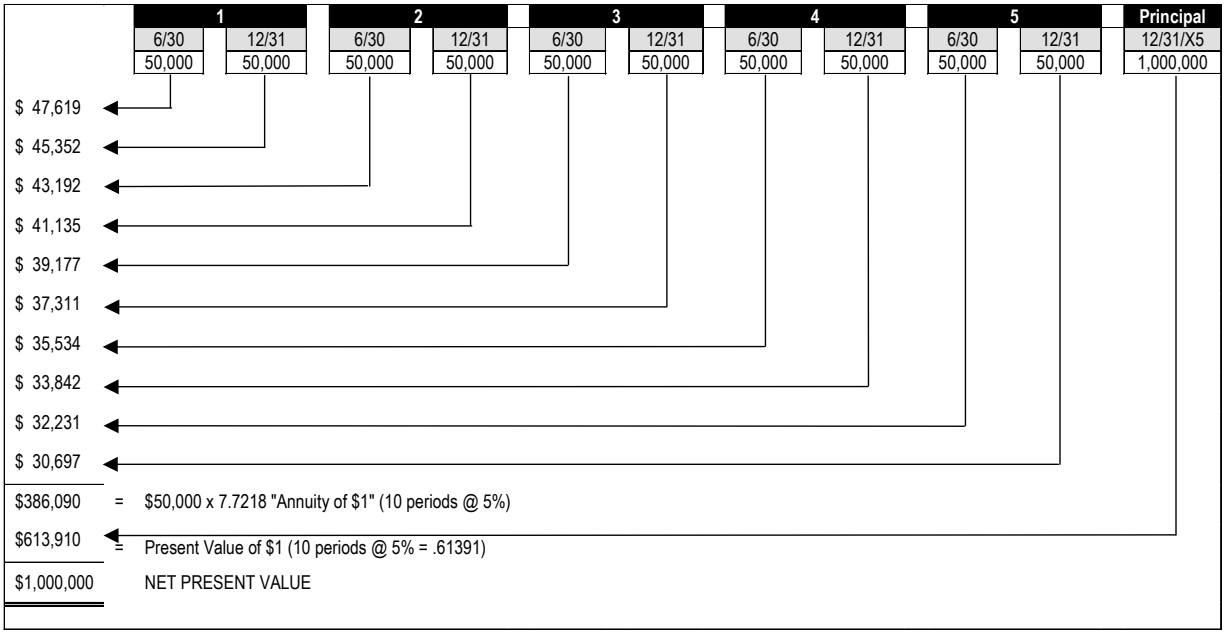
III. PRINCIPLES AND RULES FOR BONDS OVERVIEW: ACCOUNTING FOR BONDS PAYABLE

Bonds payable should be recorded as a long-term liability at face value and adjusted to the present value of their future cash outflows by either subtracting unamortized discounts or adding unamortized premiums. Bonds payable are recorded at the true present value at the date of issuance based on the market rate at that date.

A. Usually in denominations of $1,000
B. Price is always quoted in 100's (% of par value)
C. Indenture is a contract for purchase of bond
D. Coupon rate = the stated interest rate on the bond
E. Bond interest (check amount) = coupon rate × face
F. Principal payoff is always the full face amount
G. Premium/discount is the result of buyer and seller "adjusting" the coupon rate to the prevailing market rate of interest

BOND
$1,000,000
10%
5 years
Semi-annual
June 30
&
December 31



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1. Bond Selling Price

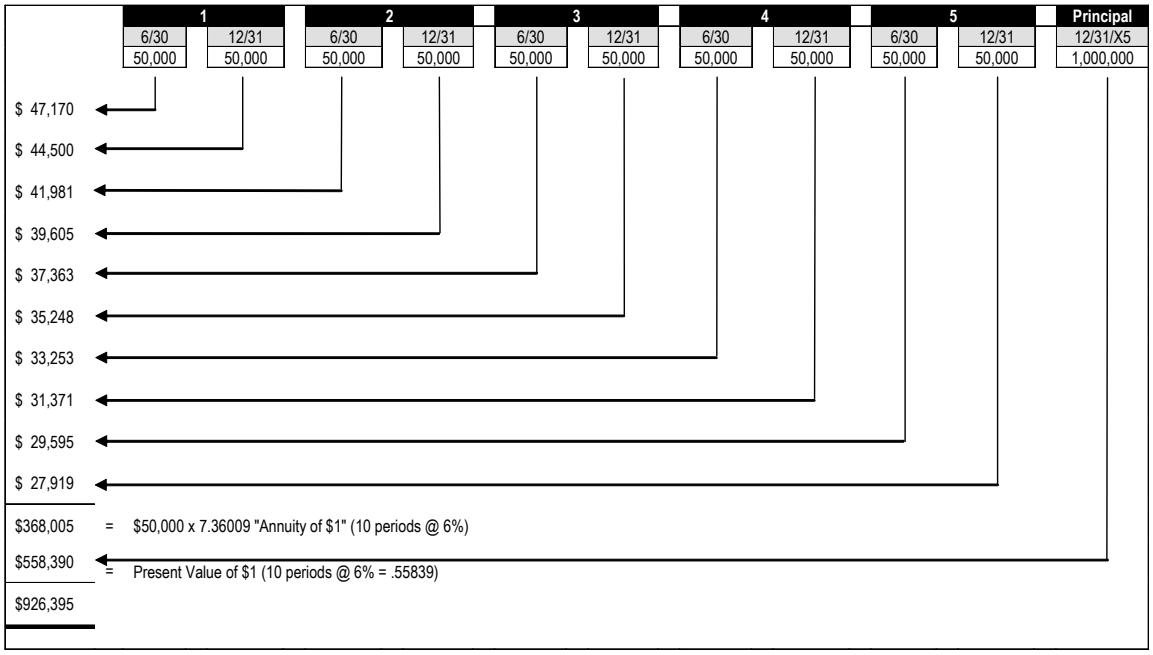
When a bond is issued, the price is computed as the sum of the present value of the future principal payment *plus* the present value of the future periodic interest payments. Both cash flows are discounted at the prevailing market rate of interest. This recorded price is the value of the bond at its current cash equivalent.

EXAMPLE

Computation of Bond Selling Price: Discount

Assume that Kristi Corporation issued a 10%, $1,000,000 bond, due in five years. Interest is due on June 30 and December 31. The yield or market rate is 12%. Determine the selling price of the bond, noting the amount of discount or premium. The bonds were issued January 1.

PV of $1 at 10% for 5 periods	.62092
PV of $1 at 12% for 5 periods	.56743
PV of $1 at 5% for 10 periods	.61391
PV of $1 at 6% for 10 periods	.55839
PV of an annuity of $1 at 10% for 5 periods	3.79079
PV of an annuity of $1 at 12% for 5 periods	3.60478
PV of an annuity of $1 at 5% for 10 periods	7.72173
PV of an annuity of $1 at 6% for 10 periods	7.36009



BORROWER				INVESTOR			
DR	Cash	$926,395		**DR**	Investment in bonds	$926,395	
DR	Discount on bond payable	73,605		**CR**	Cash		$926,395
CR	Bond payable		$1,000,000				

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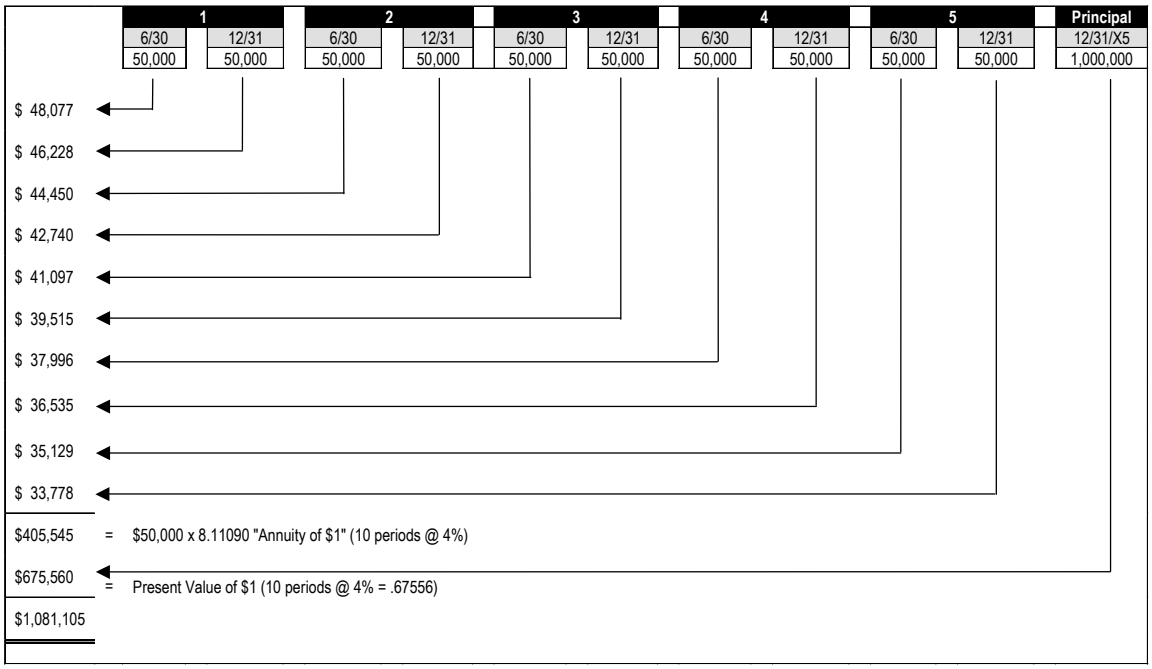
EXAMPLE

Computation of Bond Selling Price: Premium

Assume that Kristi Corporation issued a 10%, $1,000,000 bond, due in five years. Interest is due on June 30 and December 31. The yield or market rate is 8%. Determine the selling price of the bond, noting the amount of discount or premium. The bonds were issued January 1.

PV of $1 at 10% for 5 periods	.62092
PV of $1 at 8% for 5 periods	.68058
PV of $1 at 5% for 10 periods	.61391
PV of $1 at 4% for 10 periods	.67556
PV of an annuity of $1 at 10% for 5 periods	3.79079
PV of an annuity of $1 at 8% for 5 periods	3.99271
PV of an annuity of $1 at 5% for 10 periods	7.72173
PV of an annuity of $1 at 4% for 10 periods	8.11090



BORROWER			INVESTOR		
DR	Cash	$1,081,105	**DR**	Investment in bonds	$1,081,105
CR	Premium on bond payable	$81,105	**CR**	Cash	$1,081,105
CR	Bond payable	1,000,000			

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H. STATED INTEREST RATE

The stated rate of interest of a bond is typically printed on the bond and included in the bond indenture before the bond is brought to market. The stated rate of a bond will **not** change, regardless of the market rate at the date of issuance. The amount of cash received by a bondholder at regular interest payment intervals throughout the life of the bonds will always be at the stated rate applied to the face amount of the bond.

Interest is typically paid on bonds twice a year (semiannually), although interest expense will accrue monthly.

I. EFFECTIVE INTEREST RATE

Because the amount of cash to be received in the future is fixed at the time the bond is sold, the market will automatically adjust the issue price of the bond so that the purchaser receives the **market rate of interest** for comparable risk bonds (i.e., the effective interest rate). A discount or premium on the bonds will exist when the bonds are issued with a stated rate that differs from the market rate at the date of issuance.

DISCOUNT

J. DISCOUNTS

If the market rate of interest is higher than the stated rate of interest on the bond, the bonds will sell "at a discount." This means that the bond will sell for **less** than the face value of the bond (at less than 100% of par). The difference between the face value of the bond and the sales price of the bond (i.e., the discount) is the "automatic adjustment" to the interest rate.

1. Unamortized Discount

The unamortized discount on bonds payable is a contra account to bonds payable, which means that it is presented on the balance sheet as a direct reduction from the face (par) value of the bonds to arrive at the bond's carrying value at any particular point in time.

Long-term liabilities:		
Bonds payable, 10%, due 12/31/Yr x	$1,000,000	
Less: Unamortized discount	(73,605)	
		$926,395

2. Amortization of the Discount: General

Bond discount represents additional interest to be paid to investors at the bond maturity and is amortized over the life of the bond. The discount is amortized over the life of the bond, with amortized amounts **increasing interest expense** each period. Therefore, the amortization of the discount is added to the amount of cash paid at the stated rate to obtain GAAP interest expense (remember that the amount of cash paid could be zero).

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K. PREMIUMS

PREMIUM

If the market rate of interest is lower than the stated interest rate on the bond, the bonds will sell "at a premium." This means that the bonds will sell for **more** than the face value of the bond (at more than 100% of par). The difference between the face value of the bond and the sales price of the bond (i.e., the premium) is the "automatic adjustment" to the interest rate.

1. Unamortized Premium

The unamortized premium on bonds payable is presented on the balance sheet as a direct addition to the face (par) value of the bonds to arrive at the bond's carrying value at any particular point in time.

Long-term liabilities:		
Bonds payable, 10%, due 12/31/Yr x	$1,000,000	
Add: Unamortized premium	81,105	
		$1,081,105

2. Amortization of the Premium: General

Bond premium represents interest paid in advance to the issuer by bondholders who then receive a return of this premium in the form of larger periodic interest payments (at the stated rate). The bond premium is amortized over the life of the bond, with amortized amounts **decreasing interest expense** each period. Therefore, the amortization of the premium is subtracted from the amount of cash paid at the stated rate to obtain GAAP interest expense.

L. CARRYING VALUE

As bonds approach maturity, their carrying values approach face value, so that the carrying value of the bonds equals face value at maturity. The carrying value of a bond equals face plus the balance of unamortized premium or face minus the balance of unamortized discount. The carrying value of a bond with a discount increases to maturity value as the discount is amortized. The carrying value of a bond with a premium decreases to maturity value as the premium is amortized.

FACE
+ Unamortized premium
- Unamortized discount
Carrying value

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IV. BOND ISSUE COSTS

Bond issue costs are transaction costs of the bond issue. Examples include legal fees, accounting fees, underwriting commissions, and printing. These and any other issue costs should be recorded as a deferred charge (an asset) and amortized from the date of issuance of the bonds into expense (typically interest or bond issue expense) using the **straight-line** method.

Bond issue costs are typically paid directly by the broker and are repaid to the broker by the company through the proceeds of the bond issue, which means that the issuing company receives bond proceeds net of the bond issue costs.

EXAMPLE

Bond issue costs

$1,000,000 bond is sold at 98 = $980,000 and costs of $50,000 are incurred for issue.

DEFERRED CHARGE (Amortize straight-line over life of bond)

DR	Cash	$930,000	
DR	Discount	20,000	
DR	**Bond Issue Cost**	50,000	
CR	Bonds Payable		$1,000,000

V. METHODS OF DISCOUNT AND PREMIUM AMORTIZATION

There are generally two methods to calculate bond discount and premium amortization. Regardless of the method of amortization used, however, the period over which to amortize is the time period that the bonds are **outstanding** (i.e., from the date the bonds are **sold**).

EXAMPLE

Amortization Period

A 5-year bond dated January 1 doesn't actually sell until November 1. In this case, the period of amortization is 50 months (not 60 months).

A. STRAIGHT-LINE METHOD

To amortize a discount or premium using the straight-line method, simply divide the unamortized discount or premium by the number of periods the bonds are outstanding and amortize the same amount of discount or premium each period. This method of amortization results in a **constant dollar amount of interest** each period. The straight-line method is **not GAAP** but is allowed if the results are not materially different from the effective interest method, and is tested frequently on the CPA exam. Interest expense is calculated as follows:

1. $\dfrac{\text{Premium or discount}}{\text{Number of periods bond is outstanding}}$ = Periodic amortization

2. Interest expense = (face value x stated interest rate) *minus* premium amortization or *plus* discount amortization

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EXAMPLE

Bond Discount Amortization – Straight-Line Method, Semi-Annual Interest Payments

Continuing with the Kristi Corporation example, this is an example of amortization and interest expense calculated under the straight-line method.

Facts: Assume that Kristi Corporation issued a 10%, $1,000,000 bond, due in five years. Interest is due on June 30 and December 31. The yield or market rate is 12%. Determine the selling price of the bond, noting the amount of discount or premium. The bonds were issued Jan.1.

$1,000,000 – 926,395 = ($73,605 ÷ 10 periods = $7,360.50)

			JE Impact	
			B/S	I/S
Date	Net Carrying Value	Straight-line Amortization	Face × Coupon	Paid + Discount - Premium
6/30/Yr 1	$ 926,395.00	$7,360.50	$50,000	$57,360.50
12/31/Yr 1	933,755.50	7,360.50	50,000	57,360.50
6/30/Yr 2	941,116.00	7,360.50	50,000	57,360.50
12/31/Yr 2	948,476.50	7,360.50	50,000	57,360.50
6/30/Yr 3	955,837.00	7,360.50	50,000	57,360.50
12/31/Yr 3	963,197.50	7,360.50	50,000	57,360.50
6/30/Yr 4	970,558.00	7,360.50	50,000	57,360.50
12/31/Yr 4	977,918.50	7,360.50	50,000	57,360.50
6/30/Yr 5	985,279.00	7,360.50	50,000	57,360.50
12/31/Yr 5	992,639.50	7,360.50	50,000	57,360.50
12/31/Yr 5	$1,000,000.00			

BORROWER				INVESTOR			
JANUARY 1, X1				**JANUARY 1, X1**			
DR	Cash	$926,395		**DR**	Investment in bonds	$926,395	
DR	Discount on bond payable	73,605		**CR**	Cash		$926,395
CR	Bond payable		$1,000,000				
JUNE 30, X1				**JUNE 30, X1**			
DR	Bond interest expense	$57,360.50		**DR**	Cash	$50,000.00	
CR	Discount on bond payable		$7,360.50	**DR**	Investment in bonds	7,360.50	
CR	Cash		50,000.00	**CR**	Bonds interest revenue		$57,360.50

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EXAMPLE

Bond Premium Amortization – Straight-Line Method Semi-Annual Interest Payment

Continuing with the Kristi Corporation example, this is an example of amortization and interest expense calculated under the straight-line method.

Facts: Assume that Kristi Corporation issued a 10%, $1,000,000 bond, due in five years. Interest is due on June 30 and December 31. The yield or market rate is 8%. Determine the selling price of the bond, noting the amount of discount or premium. The bonds were issued January 1.

$1,081,105 – 1,000,000 = ($81,105 ÷ 10 periods = $8,110.50)

			JE Impact	
			B/S	I/S
Date	Net Carrying Value	Straight-line Amortization	Face × Coupon	Paid + Discount - Premium
6/30/Yr 1	$1,081,105.00	$8,110.50	$50,000	$41,889.50
12/31/Yr 1	1,072,994.50	8,110.50	50,000	41,889.50
6/30/Yr 2	1,064,884.00	8,110.50	50,000	41,889.50
12/31/Yr 2	1,056,773.50	8,110.50	50,000	41,889.50
6/30/Yr 3	1,048,663.00	8,110.50	50,000	41,889.50
12/31/Yr 3	1,040,552.50	8,110.50	50,000	41,889.50
6/30/Yr 4	1,032,442.00	8,110.50	50,000	41,889.50
12/31/Yr 4	1,024,331.50	8,110.50	50,000	41,889.50
6/30/Yr 5	1,016,221.00	8,110.50	50,000	41,889.50
12/31/Yr 5	1,008,110.50	8,110.50	50,000	41,889.50
12/31/Yr 5	$1,000,000.00			

BORROWER

JANUARY 1, X1

DR	Cash	$1,081,105	
CR	Premium on bond payable		$81,105
CR	Bond payable		1,000,000

JUNE 30, X1

DR	Bond interest expense	$41,889.50	
DR	Premium on bond payable	8,110.50	
CR	Cash		$50,000.00

INVESTOR

JANUARY 1, X1

DR	Investment in bonds	$1,081,105	
CR	Cash		$1,081,105

JUNE 30, X1

DR	Cash	$50,000.00	
CR	Investment in bonds		8,110.50
CR	Bonds interest revenue		$41,889.50

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B. EFFECTIVE INTEREST METHOD

EFFECTIVE INTEREST METHOD

Use of the effective interest method of accounting for the amortization of unamortized discounts/premiums is required by GAAP. GAAP interest expense is calculated by multiplying the carrying value of the bond at the **beginning** of the period by the effective interest rate. This method of amortization results in a **constant rate** of interest each period. The difference between GAAP interest expense and the cash paid for interest is the amortization for the period of the discount or premium. Interest expense and amortization for the period is calculated as follows:

1. GAAP Interest Expense

GAAP interest expense = Carrying value at the **beginning** of the period x effective interest rate

2. Discount/Premium Amortization

Amortization of the discount = GAAP interest expense – Cash paid at the stated rate

Amortization of the premium = Cash paid at the stated rate – GAAP interest expense

PASS KEY

I/S	Net carrying value	×	Effective interest rate	=	Interest expense
B/S	Bond face	×	Coupon rate	=	< Interest paid >
Diff					**Amortization**

Income Statement		**Balance Sheet**		**Difference**
Net carrying value × Effective interest rate Interest expense	–	Bond Face × Coupon Rate Interest Paid	=	Amortization

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EXAMPLE

Bonds Premium Amortization – Interest (Effective Rate) Method Semiannual Interest Payments

Assume Kristi Corporation issued a 10%, $1,000,000 bond due in five years. The bond sold for $1,081,105 on January 1, Year 1, to yield 8%. Determine the interest expense by the effective interest method (interest is paid semiannually on June 30 and December 31).

			JE Impact			
Date	Beginning of Period Net Carrying Value	4% Semi-Annual Amortization Interest	I/S N.C.V. × Effective	B/S Face × Coupon	Diff Amortization	End of Period Net Carrying Value
6/30/Yr 1	$1,081,105	4%	$43,244	$50,000	6,756	$ 1,074,349
12/31/Yr 1	1,074,349	4%	42,974	50,000	7,026	1,067,323
6/30/Yr 2	1,067,323	4%	42,693	50,000	7,307	1,060,016
12/31/Yr 2	1,060,016	4%	42,401	50,000	7,599	1,052,417
6/30/Yr 3	1,052,417	4%	42,097	50,000	7,903	1,044,514
12/31/Yr 3	1,044,514	4%	41,782	50,000	8,218	1,036,296
6/30/Yr 4	1,036,296	4%	41,453	50,000	8,547	1,027,749
12/31/Yr 4	1,027,749	4%	41,111	50,000	8,889	1,018,860
6/30/Yr 5	1,018,860	4%	40,755	50,000	9,245	1,009,615
12/31/Yr 5	1,009,615	4%	40,385	50,000	9,615	1,000,000
					81,105	

BORROWER				INVESTOR			
JANUARY 1, X1				**JANUARY 1, X1**			
DR	Cash	$1,081,105		**DR**	Investment in bonds	$1,081,105	
CR	Premium on bond payable		$81,105	**CR**	Cash		$1,081,105
CR	Bond payable		1,000,000				
JUNE 30, X1				**JUNE 30, X1**			
DR	Bond interest expense	$43,244		**DR**	Cash	$50,000	
DR	Premium on bonds payable	6,756		**CR**	Investment in bonds		$6,756
CR	Cash		$50,000	**CR**	Bond interest revenue		43,244
DECEMBER 31, X1				**DECEMBER 31, X1**			
DR	Bond interest expense	$42,974		**DR**	Cash	$50,000	
DR	Premium on bonds payable	7,026		**CR**	Investment in bonds		$7,026
CR	Cash		$50,000	**CR**	Bond interest revenue		42,974

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EXAMPLE

Bonds Discount Amortization – Interest (Effective Rate) Method Semiannual Interest Payments

Assume Kristi Corporation issued a 10%, $1,000,000 bond due in five years. The bond sold for $926,395 on January 1, Year 1, to yield 12%. Determine the interest expense by the effective interest method (interest is paid semiannually on June 30 and December 31).

			JE Impact			
Date	Beginning of Period Net Carrying Value	6% Semi-Annual Amortization Interest	I/S NCV × Effective	B/S Face × Coupon	Diff Amortization	End of Period Net Carrying Value
6/30/Yr 1	$926,395	6%	$55,585	$50,000	5,585	$931,980
12/31/Yr 1	931,980	6%	55,920	50,000	5,920	937,900
6/30/Yr 2	937,900	6%	56,275	50,000	6,275	944,175
12/31/Yr 2	944,175	6%	56,651	50,000	6,651	950,826
6/30/Yr 3	950,826	6%	57,050	50,000	7,050	957,876
12/31/Yr 3	957,876	6%	57,473	50,000	7,473	965,349
6/30/Yr 4	965,349	6%	57,921	50,000	7,921	973,270
12/31/Yr 4	973,270	6%	58,396	50,000	8,396	981,666
6/30/Yr 5	981,666	6%	58,900	50,000	8,900	990,566
12/31/Yr 5	990,566	6%	59,434	50,000	9,434	1,000,000
					73,605	

BORROWER				INVESTOR			
JANUARY 1, X1				**JANUARY 1, X1**			
DR	Cash	$926,395		**DR**	Investment in bonds	$926,395	
DR	Discount on bond payable	73,605		**CR**	Cash		$926,395
CR	Bond payable		$1,000,000				
JUNE 30, X1				**JUNE 30, X1**			
DR	Bond interest expense	$55,585		**DR**	Cash	$50,000	
CR	Discount on bonds payable		5,585	**DR**	Investment in bonds	5,585	
CR	Cash		$50,000	**CR**	Bond interest revenue		$55,585
DECEMBER 31, X1				**DECEMBER 31, X1**			
DR	Bond interest expense	$55,920		**DR**	Cash	$50,000	
CR	Discount on bonds payable		5,920	**DR**	Investment in bonds	5,920	
CR	Cash		$50,000	**CR**	Bond interest revenue		$55,920

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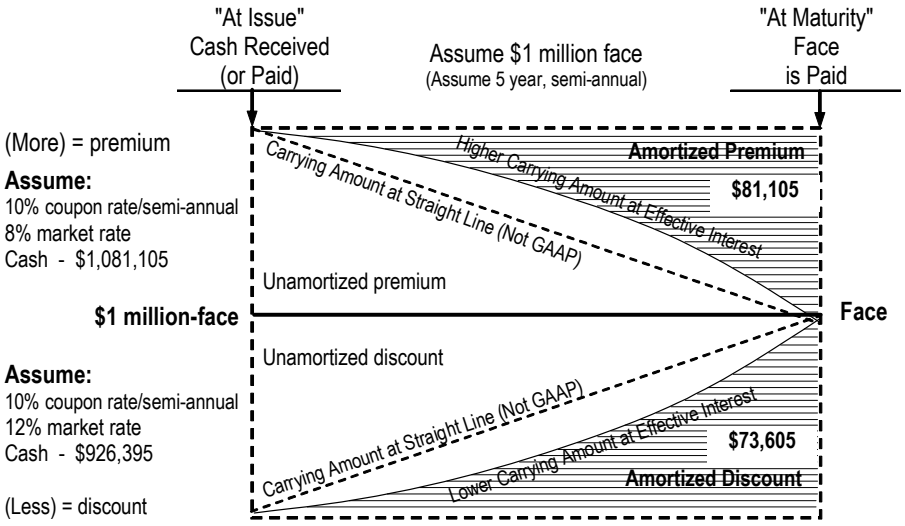
C. COMPARISON OF STRAIGHT-LINE AND EFFECTIVE INTEREST METHOD

Illustration

Diagram of "Carrying Amount" of Bond Liability on the Balance Sheet



Borrower's Initial Journal Entry			
PREMIUM			
DR	Cash	$1,081,105	
CR	Premium on bonds payable		$81,105
CR	Bonds payable		1,000,000
DISCOUNT			
DR	Cash	$926,395	
DR	Discount on bonds payable	73,605	
CR	Bonds payable		$1,000,000

PASS KEY

Examiners often require a candidate to answer questions regarding the comparison of carrying values of bonds accounted for under both methods (e.g., which method will have the higher carrying value in Year 2?). If you think of this diagram with the effective interest method creating a type of oval and the straight-line method cutting a point inside the oval, you will have your answer without crunching any numbers.

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VI. BONDS ISSUED BETWEEN INTEREST DATES

Interest payments on bonds are generally made semiannually. However, bonds are usually sold between interest dates, which requires additional entries for accrued interest at the time of sale. The amount of interest that has accrued since the last interest payment is added to the price of the bond. The purchaser pays such interest and is reimbursed at the next payment date upon receipt of a full period's interest.

EXAMPLE

Bond Issued Between Interest Dates

On April 1, Year 1, Kristi Corporation issued 10% bonds dated January 1, Year 1 in the face amount of $1,000,000. Interest is due on June 30 and December 31. The bonds were issued for $926,395, plus accrued interest for three months (January through March). Determine the cash received.

Selling price ($1,000,000 face)	$926,395
Plus: Accrued interest ($1,000,000 x 10% x 3/12)	25,000
Total cash received	$951,395

Journal Entry: To record the sale on April 1

DR	Cash	$951,395	
DR	Discount on bonds payable	73,605	
CR	Bonds payable		$1,000,000
CR	Bond interest expense (or payable)		25,000

Journal Entry: To record the first interest payment on June 30 ($1,000,000 x 10% x 6/12)

DR	Bond interest expense (or payable)	$50,000	
CR	Cash		$50,000

The interest expense account would then contain a debit balance of $25,000, the proper amount of interest expense for three months at 10% ($1,000,000 x 10% x 3/12 = $25,000).

***Journal Entry**: To record amortization should also be recorded

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VII. YEAR-END BOND INTEREST ACCRUAL

When the date of a scheduled interest payment and the issuer's year-end do not agree, it is necessary to accrue interest by an adjusting entry on the issuer's books at year-end. The accrual must take into account a pro-rated share of discount or premium amortization.

EXAMPLE

Interest Accrual at Year-End

Kristi Corporation, whose year-end is December 31, issued $1,000,000 of 5-year, 10% bonds payable on July 1 and January 1. The bonds sold at a discount for $926,395. Calculate the amount of the year-end accrual for interest and discount amortization.

Year-end Adjustment

Interest payable:

Face value x coupon rate x period ($1,000,000 x 10% x 6/12)	=	$50,000
Amortization (per prior schedule)	=	5,920

Journal Entry: December 31, X1

To record interest accrual from July 1, X1 through December 31, X1:

DR	Interest expense	$50,000	
CR	Interest payable		$50,000

To record discount amortization on bonds from July 1, X1 through December 31, X1:

DR	Interest expense	$5,920	
CR	Discount on bonds payable		$5,920

VIII. BOND SINKING FUNDS

To avoid a cash shortage at the time of debt repayment, a company may build up a separate cash (sinking) fund. A bond sinking fund is a trusteed fund (restricted cash) pursuant to the indenture wherein the company contributes money each year so that at maturity, there is a sum available to repay the entire liability.

A. CLASSIFICATION

The sinking fund is generally a non-current (restricted) asset on the financial statements of the issuer. It is a current asset only to the extent that it offsets a current liability.

B. SINKING FUND BALANCE

The sinking fund earns interest or dividends over time. The accumulated deposits and interest/dividends thereon will be used to pay the bonds upon maturity. The amount accumulated from regular deposits with the trustee serve as collateral for the issued bonds.

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C. APPROPRIATION

A bond sinking fund reserve is merely an appropriation of retained earnings to indicate to the shareholders that certain retained earnings are being accumulated for bond sinking fund purposes.

D. FOOTNOTE

The amount of current maturities of long-term debt does not include the annual sinking fund requirement (which is outlined in the bond indenture), but the amount would be included as a footnote.

E. DETERMINATION OF THE PERIODIC SINKING FUND PAYMENTS

To determine the periodic payments to be made into the fund, the future value of an annuity of $1 at an assumed rate must be used because the periodic deposits are earning interest.

EXAMPLE

Determination of Sinking Fund Payments

Assume that an issuer wished to deposit ten equal semiannual payments to retire $1,000,000, five-year bonds. Deposits are to be made semiannually on June 30 and December 31 for ten periods. Fund earnings, which accrue directly to the fund, are expected to be 10% annually. What should the semiannual payments be, and what are the related journal entries for year 1?

Given

Number of periods	10 (5 yrs/semiannually)
Interest rate	10% annually/5% semiannually

Future value of an annuity of $1 for ten periods at 5% = 12.57789

Calculations

Bond maturity value	=	Periodic (semiannual) payments x future value of an annuity of $1 for ten periods at 5% (semiannually)
$1,000,000	=	Semiannual payments x 12.57789
Semi-annual payments	=	$1,000,000 ÷ 12.57789
	=	$79,505/per period

Journal Entry: To record the sinking fund on June 30, Year 1

DR	Bond sinking fund (asset)	$79,505	
CR	Cash		$79,505

Journal Entry: To record the first semiannual interest payment to the fund

DR	Bond sinking fund	$3,975	
CR	Interest revenue ($79,505 x 5%)		$3,975

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IX. SERIAL BONDS

Serial bonds are an alternative to using sinking funds.

A. MATURE IN INSTALLMENTS

Serial bonds have principals that mature in installments. These bonds allow the issuer to match maturity dates with the organization's cash flow requirements.

B. ACCOUNTING FOR SERIAL BONDS

The present value of *each maturity* in the series should be separately calculated, as in the case of a term bond.

1. Since short and long-term interest rates often differ, there also could be a different discount or premium relating to each maturity.
2. One account, Unamortized Bond Discount or Unamortized Bond Premium, is used to accumulate all the discounts or premiums for each maturity.
3. The present value of the periodic interest payments for each maturity is calculated separately, based on these different yield rates, just as with separate term bonds.
4. When underwriters bid on an entire serial bond issue at one average interest rate, an average yield can be used for all maturities in the series to calculate interest expense. Amortization methods on serial bonds are:
    a. *The effective interest method*, just as explained for term bonds.
    b. *The bonds outstanding method.* This variation of the straight-line method uses the percentage of decrease in outstanding debt each maturity period as the basis for calculating the related amount of premium or discount on the bonds. The bonds outstanding method is not GAAP, but it has been tested on the CPA Exam.

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EXAMPLE

Premium Amortization on Serial Bonds—Bonds Outstanding Method

Assume that $1,000,000 of 10% serial bonds were issued for $1,055,000. Bonds of $100,000 mature semiannually on June 30 and December 31, for five years. Compute premium amortization for these bonds using the bonds outstanding method.

			Diff	B/S	I/S
(1) Period	(2) Outstanding Value	(3) Fraction of Total Bonds Outstanding	(4) Premium Amortization ($55,000 x Col. 3)	(5) Interest Payment (10% x Col. 2 / 2)	(6) Interest Expense (Col. 5 – Col. 4)
1/1/Yr 1	$1,000,000				
6/30/Yr 1	1,000,000	$1,000,000/$5,500,000	$10,000	$ 50,000	$40,000
12/31/Yr 1	900,000	900,000/5,500,000	9,000	45,000	36,000
6/30/Yr 2	800,000	800,000/5,500,000	8,000	40,000	32,000
12/31/Yr 2	700,000	700,000/5,500,000	7,000	35,000	28,000
6/30/Yr 3	600,000	600,000/5,500,000	6,000	30,000	24,000
12/31/Yr 3	500,000	500,000/5,500,000	5,000	25,000	20,000
6/30/Yr 4	400,000	400,000/5,500,000	4,000	20,000	16,000
12/31/Yr 4	300,000	300,000/5,500,000	3,000	15,000	12,000
6/30/Yr 5	200,000	200,000/5,500,000	2,000	10,000	8,000
12/31/Yr 5	100,000	100,000/5,500,000	1,000	5,000	4,000
	$5,500,000	$5,500,000/5,500,000	$55,000		

Journal Entry: To record interest expense for June 30, Year 3

DR	Interest expense	$24,000	
DR	Premium on bonds payable	6,000	
CR	Cash		$30,000

Journal Entry: To record payment of principal for June 30, Year 3

DR	Bonds payable	$100,000	
CR	Cash		$100,000

The bond's carrying value (not shown) each period would decrease by the sum of the principal repayment ($100,000/semiannually) *plus* the corresponding amount of premium amortization.

For example, for June 30, Year 1: $1,055,000 (beginning balance) - $100,000 (principal payment) - $10,000 (premium amortization) = $945,000 (carrying value at the beginning Period 2 = July 1).

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X. CONVERTIBLE BONDS

Convertible bonds are often issued at more than face value because of the value of the conversion feature. However, since the conversion feature cannot be assigned a specific value, the issuance price is allocated to the bonds with no recognition of the conversion feature. Because the right to obtain shares of stock cannot be separated from the bonds, the conversion simply involves an exchange of the bonds for stock.

The conversion may be recorded under either the book value method (GAAP) or the market value method (not GAAP, but tested on the CPA Exam).

A. BOOK VALUE METHOD

Under the book value method, **no gain or loss is recognized**. At conversion, the bond payable and related premium or discount are written off and common stock is credited (at par). Additional paid-in capital is credited for the excess of the bond's carrying value over the stock's par value less any conversion costs. No gain or loss is recognized because the book value method views the conversion as the completion of a prior transaction (issuance of convertible debt), rather than viewing it as culmination of the earning process.

In summary, upon conversion, the issuer must:

1. Pay the accrued interest up to the conversion date,
2. Amortize the bond discount or premium up to the conversion date,
3. Amortize the bond issue costs up to the conversion date, and
4. Record any difference as additional paid-in capital.

B. MARKET VALUE METHOD

The market value method views the conversion as culmination of the earnings process, thereby resulting in a **recognized gain or loss**. At conversion, the bonds payable and related premium are written off, and common stock is credited (at par). The credit to additional paid-in capital is the excess of the market price of the stock over par value. The difference between the market value of the stock and the book value of the bonds is a recognized gain or loss on redemption.

C. PREMIUM

Convertible bonds are often issued at more than face value because of the value of the stock. However, since the conversion feature cannot be assigned a value, the difference between the proceeds and the face value of the bonds is recorded as a premium on bonds payable.

When the conversion feature is exercised, any unamortized premium attributable to that portion of the converted bonds must be written off.

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EXAMPLE

Convertible Bond / Book Value Method

FACTS:

- 1,000 convertible bonds (1,000 x $1,000 = $1,000,000) are issued on January 1, X1
- The convertible bond and $300 are convertible into one share of common stock
- The bonds sold for $1,081,105
- The common stock's par value is $200
- Half (500) of the bonds were converted on January 2, X1
- The company uses the book value method

BORROWER			INVESTOR		
January 1, X1			**January 1, X1**		
DR Cash	$1,081,105		**DR** Investment in bonds	$1,081,105	
CR Bond payable		$1,000,000	**CR** Cash		$1,081,105
CR Premium on bond payable		81,105			

HALF ARE CONVERTED

January 2, X1			**January 2, X1**		
DR Cash	$150,000		**DR** Investment in common stock	$690,552	
DR Bond payable	500,000		**CR** Cash		$150,000
DR Premium on bond payable	40,552		**CR** Investment in bonds		540,552
CR Common stock		$100,000			
CR A.P.I.C.		590,552			

BOND		PREMIUM		CASH		COMMON STOCK
BOND $1,000		$ 81,105		$300		Common Stock Par $200
X 500		X 50%		X 500		X 500
						$ 100,000
					A.P.I.C.	590,552
$500,000	+	$ 40,552	+	$150,000	=	$ 690,552

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EXAMPLE

Convertible Bond / Market Value Method

FACTS:

- 1,000 convertible bonds (1,000 x $1,000 = $1,000,000) are issued on January 1, X1
- The convertible bond and $300 are convertible into one share of common stock
- The bonds sold for $1,081,105
- The common stock's par value is $200
- All of the bonds were converted on January 2, X1
- The company uses the market value method
- The FV of common stock was $1,400

BORROWER				INVESTOR			
January 1, X1				**January 1, X1**			
DR	Cash	$1,081,105		**DR**	Investment in bonds	$1,081,105	
CR	Bond payable		$1,000,000	**CR**	Cash		$1,081,105
CR	Premium on bond payable		81,105				

ALL ARE EXERCISED

January 2, X1				**January 2, X1**			
DR	Cash	$300,000		**DR**	Investment in common stock	$1,400,000	
DR	Bond payable	1,000,000		**CR**	Cash		$300,000
DR	Premium on bond payable	81,105		**CR**	Investment in bonds		1,081,105
DR	Loss on conversion	18,895		**CR**	Gain on conversion		18,895
CR	Common stock		$200,000				
CR	A.P.I.C.		1,200,000				

BONDS	PREMIUM	CASH	COMMON STOCK	A.P.I.C.	GAIN < LOSS >
Bond $1,000	$81,105	$300	Common Stock Par $200	FV 1,400 PAR – 200 DIFF 1,200	PLUG
X 1,000	X 100%	X 1,000	X 1,000	X 1,000	
$1,000,000	+ $ 81,105	+ 300,000	= 200,000	+ 1,200,000	+ < 18,895 >

XI. BONDS SOLD WITH DETACHABLE STOCK PURCHASE WARRANTS

WARRANTS

Warrants are option contracts that are issued with, and detachable from, bonds (and notes). The warrant gives the bondholder the right to buy stock at a fixed price within a specific time period. Because they are detachable, the warrants are traded separately and are considered to be a separate financial instrument. Thus, they are accounted for differently than convertible bonds.

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A. ACCOUNT FOR SEPARATELY

A conversion feature that is separate from a security should be accounted for separately, and a value should be assigned to it. The value assigned to a separate conversion feature is its relative fair value at the time of issue. This amount is credited to A.P.I.C.—Warrants. It is important to remember that a value is assigned to a conversion feature only if it is detachable and has its own market value.

DR	Cash		$XXX	
CR		Bonds payable		$XXX
CR		A.P.I.C.—Warrants		XXX

B. ACCOUNTING TREATMENT

Bonds with detachable stock purchase warrants may be recorded at issuance using two different methods. The **warrants only method** is used if only the fair value of the warrants is known. The **market value method** (warrants and bonds method) is used if the fair value of both the warrants and bonds are known. Following are the general steps to account for bonds issued with detachable stock purchase warrants.

1. Separate the warrants from the debt at the date of issuance of the bonds.
2. Generally, allocate the amount received upon issuance separately to debt and to the detachable warrants according to their relative fair values at the date of issuance (using the market value method).
    a. In some cases, it is not possible to obtain the relative fair values of both the debt and the warrants, but the fair value of one of them can typically be determined (usually, this is the warrants).
    b. In this case (the warrants only method), allocate the known fair value to its related item (again, usually the warrants) and allocate the remainder of the proceeds to the other item (typically the debt).
3. The amount that is allocated to warrants is credited to an account called "Additional paid-in capital: warrants" in the shareholders' equity section.
4. Any difference between the amount allocated to the bonds and the face value of the bonds should be debited or credited to discount or premium on bonds payable.
5. Exercise of the warrants
    a. Additional cash is received by the company upon exercise of the warrants.
    b. At this time, the following journal entry is typical to record issued shares of stock due to the exercise of the warrants:

DR	Cash (additional received)		$XXX	
DR	A.P.I.C.—Warrants		XXX	
CR		Common stock (at par)		$XXX
CR		A.P.I.C.		XXX

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EXAMPLE

Detachable Warrants (Warrants Only Method)

FACTS:

- 1,000 bonds (1,000 x $1,000 = $1,000,000) with a detachable warrant (to purchase 1 share of common stock) are issued on January 1, X1
- One warrant and $1,250 can be exchanged for one share of common stock
- The bonds sold for $1,076,395
- The common stock's par value is $200
- The FV of the warrants are $150,000 (1,000 x $150 cash)
- Half the warrants (500) are exercised on January 2, X1
- The other half of the warrants expired (later)

BORROWER				INVESTOR			
January 1, X1				**January 1, X1**			
DR	Cash	$1,076,395		**DR**	Investment in bonds	$926,395	
DR	Discount on bonds payable	73,605		**DR**	Warrants	150,000	
CR	Bond payable		$1,000,000	**CR**	Cash		$1,076,395
CR	A.P.I.C. - Warrants		150,000				
	HALF ARE EXERCISED						
January 2, X1				**January 2, X1**			
DR	Cash	$625,000		**DR**	Investment in common stock	$700,000	
DR	A.P.I.C. - Warrants	75,000		**CR**	Cash		$625,000
CR	Common stock		$100,000	**CR**	Warrants		75,000
CR	A.P.I.C.		600,000				
	OTHER HALF EXPIRE						
DR	A.P.I.C. - Warrants	$75,000		**DR**	Loss on investment	$75,000	
CR	A.P.I.C.		$75,000	**CR**	Warrants		$75,000

BONDS		PREMIUM DISCOUNT		WARRANTS		CASH		COMMON STOCK
BONDS $1,000		$73,605				$1,250		Common Stock Par $200
				Warrants $150,000				
x 0		x 0		X 50%		x 500		x 500
								$100,000
							A.P.I.C.	$600,000
0	+	0	+	$75,000	+	$625,000	=	$700,000

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XII. EXTINGUISHMENT OF DEBT

EXTINGUISHMENT OF DEBT

Corporations issuing bonds may call or retire them prior to maturity. Callable bonds can be retired after a certain date at a stated price. Refundable bonds allow an existing issue to be retired and replaced with a new issue at a lower interest rate.

A. DEFINITION OF EXTINGUISHMENT

SFAS No. 140 states that a liability cannot be derecognized in the financial statements until it has been extinguished. A liability is considered extinguished if either of the following conditions is met:

1. Debtor Pays

A liability is considered extinguished if the debtor pays the creditor and is relieved of its obligation for the liability.

2. Debtor Legally Released

A liability is considered extinguished if the debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

B. IN-SUBSTANCE DEFEASANCE NOT EXTINGUISHMENT

An in-substance defeasance is an arrangement where a company places purchased securities into an irrevocable trust and pledges them for the future principal and interest payments on its long-term debt. Because the company remains the primary obligor while there is outstanding debt, the liability is not considered extinguished by an in-substance defeasance.

C. DETERMINING AND RECORDING GAIN OR LOSS

1. Adjust Items in the Financial Statements

In any bond reacquisition, the following items must be accounted for and adjusted in the financial statements:

a. Bond issue costs,

b. Any related unamortized discount or premium, and

c. The difference between the bond's face value and the reacquisition proceeds.

2. Calculation of the Gain or Loss

Gain or loss on extinguishment of debt is the difference between the reacquisition price and the net carrying amount of the bond at the date of extinguishment.

(Gain) or loss = Reacquisition price – Net carrying amount

a. Reacquisition Price

Reacquisition price is usually shown as a percentage of the bond's face value (e.g., $100,000 at 102 or $100,000 at 95). To calculate the reacquisition price, multiply the percentage by the face value (e.g., $100,000 x 102% = $102,000 or $100,000 x 95% = $95,000).

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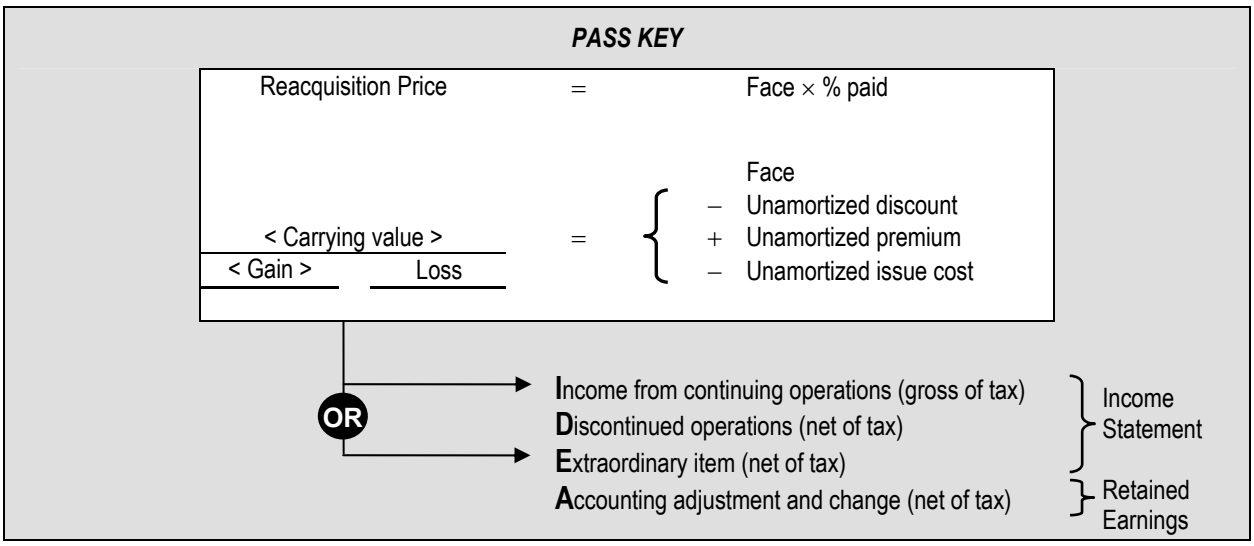
b. Net Carrying Amount

The net carrying amount of the bond is the carrying value (i.e., face value of the bond plus unamortized premium or minus unamortized discount) minus unamortized bond issue costs (the unamortized bond issue costs are the difference between the carrying value of the bond used for the effective interest method and the net carrying amount of the bond on the financial statements).



D. POSSIBLE EXTRAORDINARY ITEM TREATMENT

The gain or loss on bond extinguishments (including bond refundings) by the company will be treated as an extraordinary item, net of the related tax effect, if it is material in aggregate, unusual in nature, and has occurred infrequently (per SFAS No. 145 and APBO No. 30). Note that the classification of gain or loss on extinguishments of debt as an extraordinary item is no longer automatic under SFAS 145, but is subject to the normal criteria of unusual in nature and infrequent in occurrence.

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EXAMPLE

Loss on Extinguishment of Bonds

Assume that $1,000,000 bonds due in 5 years are issued on January 1, Year 1 at a discount for $926,395. There are $50,000 of bond issue costs being amortized over 5 years. Two years later, on January 1, Year 3, the entire issue is redeemed at 101 and cancelled. (Ignore income tax considerations).
(Note: this example uses the numbers from the table on page F5-46.)

Reacquisition price:			
(Face x % Paid)			
$1,000,000 x 101	=		$1,010,000
Bond Carrying Value:			
Face	1,000,000		
Less: Unamortized discount	< 49,174 >		
		950,826	
Less: Unamortized bond issue cost		< 30,000 >	
Net Carrying Value			< 920,826 >
Total Loss on Extinguishment			89,174

Components of the loss are:

▫ Unamortized bond discount	$49,174
▫ Unamortized bond issue cost	30,000
▫ Premium paid to retire ($1,000,000 x 1%)	10,000
TOTAL LOSS	$89,174

Journal Entry:

DR	Bonds payable	$1,000,000	
DR	Loss on extinguishment of bonds [possibly extraordinary]	89,174	
CR	Discount on bonds payable		$ 49,174
CR	Unamortized bond issue costs		30,000
CR	Cash		1,010,000

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EXAMPLE

Gain on Extinguishment of Bonds

Assume that $1,000,000 bonds due in 5 years are issued on January 1, Year 1 at a premium for $1,081,105. There are $50,000 of bond issue costs being amortized over 5 years. The entire issue is redeemed two years later, on January 1, Year 3 for 96 and cancelled. (Ignore income tax considerations).
(Note: this example uses the numbers from the table on page F5-45.)

Reacquisition price: (Face x % Paid) $1,000,000 x 96	=		$960,000
Bond Carrying Value:			
Face	1,000,000		
Plus: Unamortized premium	52,417		
		1,052,417	
Less: Unamortized bond issue cost		< 30,000 >	
Net Carrying Value			< 1,022,417 >
Total Gain on Extinguishment			< 62,417 >

Components of the loss are:

▫ Unamortized bond premium	$52,417
▫ Unamortized bond issue cost	< 30,000 >
▫ Discount to retire ($1,000,000 x 4%)	40,000
TOTAL GAIN	$62,417

Journal Entry:

DR	Bonds payable	$1,000,000	
DR	Premium on bond payable	52,417	
CR	Cash		$960,000
CR	Unamortized bond issue costs		30,000
CR	Gain on extinguishment of bonds [possibly extraordinary]		62,417

XIII. DISCLOSURE REQUIREMENTS

A. Companies having large amounts of debt issues often report only one balance sheet total that is supported by comments and schedules in the accompanying notes. Notes often show details regarding the liability maturity dates, interest rates, call and conversion privileges, assets pledged as security, and borrower-imposed restrictions.

B. Part of the disclosure should include any future sinking fund payments and maturities for each of the next five years to aid users in evaluating the timing and amounts of cash flows. (The maturity amounts and sinking fund requirements are reported in the aggregate.)

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TROUBLED DEBT RESTRUCTURINGS (IMPAIRED LOANS)

TROUBLED DEBT RESTRUCTURING

I. INTRODUCTION

A troubled debt restructuring is one in which the creditor allows the debtor certain concessions to improve the likelihood of collection that would not be considered under normal circumstances. Concessions include items such as reduced interest rates, extension of maturity dates, reduction of the face amount of the debt, and reduction of the amount of accrued interest. The concessions must be made in light of the debtor's financial difficulty, and the objective of the creditor must be to maximize recovery of the investment. Troubled debt restructurings are often the result of legal proceedings or of negotiation between parties.

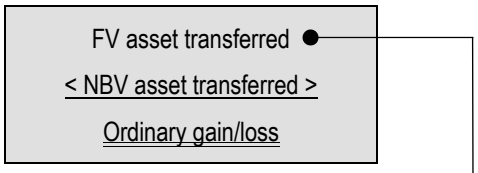
II. ACCOUNTING AND REPORTING BY DEBTORS

A debtor accounts for a troubled debt restructuring according to the type, as follows:

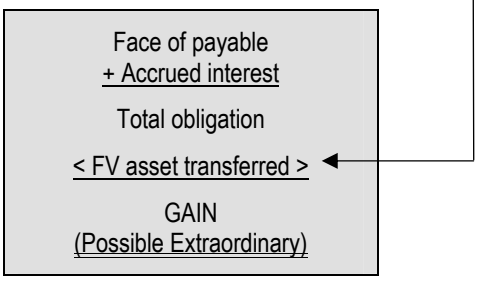
A. TRANSFER OF ASSETS

The debtor will recognize a gain in the amount of the excess of the carrying amount of the payable (including accrued interest, premiums, etc.) over the fair value (an arm's length purchase or sale price) of the assets given up. The gain or loss on disposition of the asset (i.e., difference between book value and fair value) is reported in income of the period. Per SFAS No. 145, the restructuring gain is possibly reported as an extraordinary item, if it meets the requirements of APBO No. 30 (i.e., material in aggregate, infrequent, and unusual in nature).

1. Recognize ordinary gain/loss on:



2. Recognize [possibly extraordinary] gain on:



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B. TRANSFER OF EQUITY INTEREST

Per SFAS No. 145, the difference between the fair value of the equity interest and the carrying amount of the payable may be recognized as an extraordinary gain, if it meets the requirements of APBO No. 30 (see above).

1. Recognize [possibly extraordinary] gain on:

FV equity transferred
< Face of payable >
GAIN
(Possible Extraordinary)

C. MODIFICATION OF TERMS

A restructuring that does not involve the transfer of assets or equity will often involve the modification of the terms of the debt. In a modification, the debtor usually accounts for the effects of the restructuring prospectively. The debtor does not change the carrying amount unless the carrying amount exceeds the total future cash payments specified by the new terms.

1. Total Future Cash Payments

The total future cash payments are the principal and any accrued interest at the time of the restructuring that continues to be payable by the new terms.

2. Interest Expense

Interest expense is computed by a method that causes a constant effective rate (e.g., the effective interest method). The new effective rate of interest is the discount rate at which the carrying amount of the debt is equal to the present value of the future cash payments.

3. Future Payments

When the total future cash payments are less than the carrying amount, the debtor should reduce the carrying amount accordingly and recognize the difference as a gain (note that the gain may be treated as extraordinary if it is material in the aggregate, unusual in nature, and infrequent in occurrence, per SFAS No. 145 and APBO No. 30). When there are several related accounts (discount, premium, etc.), the reduction may need to be allocated among them. All cash payments after the restructuring reduce the carrying amount, and no interest expense is recognized after the date of restructure.

When there are indeterminate future payments, or any time the future payments might exceed the carrying amount, the debtor recognizes no gain. The debtor should assume that the future contingent payments will have to be made at least to the extent necessary to obviate any gain.

Note: In estimating future cash payments for any purpose in this area, it is assumed that the maximum amount of periods (and interest) is going to occur.

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D. COMBINATION OF TYPE

When a restructuring involves a combination of asset or equity transfers and modification of terms, the fair value of any asset or equity is used first to reduce the carrying amount of the payable. The difference between the fair value and the carrying amount of any assets transferred is recognized as gain or loss. No gain on restructuring can be recognized unless the carrying amount of the payable exceeds the total future cash payments.

All gains on debt restructuring are aggregated and included in net income for the period. Per SFAS No. 145 and APBO No. 30, if the gains are material in the aggregate, are unusual in nature, and have occurred infrequently, they are reported as an extraordinary item (net of tax effects) on the income statement. Otherwise, they are treated and classified along with other gains of the company, typically in the continuing operations section of the income statement.

EXAMPLE

Debtor's Accounting for Restructuring

Hull Company is indebted to Apex under a $500,000, 12%, three-year note dated December 31, Year 1. Because of Hull's financial difficulties developing in Year 3, Hull owed accrued interest of $60,000 on the note at December 31, Year 3. Under a troubled debt restructuring, on December 31, Year 3, Apex agreed to settle the note and accrued interest for a tract of land having a fair value of $450,000. Hull's acquisition cost of the land is $360,000. On its Year 3 income statement, what should Hull report as a result of the troubled debt restructuring?

Hull's total debt is the $500,000 face value of the note plus $60,000 of accrued interest, or $560,000.

The debt was forgiven in exchange for Hull giving Apex (the lender) land worth $450,000, with a cost to Hull of $360,000.

Hull's total gain is:

Debt forgiven	$560,000		
Carrying value of asset given	(360,000)		
Total gain	$200,000		[$90,000 + $110,000, per below]

Breakout of Gain

Ordinary Gain on Disposal of Land (Adjustment to Fair Value)

Fair value of land		$450,000
Acquisition cost		(360,000)
Holding gain on sale of land		$ 90,000

Gain on Restructuring (Extraordinary if it Meets Criteria of APBO No. 30)

3-year note	$500,000	
Accrued interest	60,000	
Amount owed		560,000
Settlement amount (fair value of land)		(450,000)
Gain on restructuring of debt		$110,000 [Extraordinary if it meets the criteria]

Journal Entry: To record the troubled debt restructuring on the books of the debtor

DR	Notes payable	$500,000	
DR	Interest payable	60,000	
CR	Land		$360,000
CR	Gain on disposal of land		90,000
CR	Gain on restructuring		110,000 [Extraordinary if it meets the criteria]

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III. IMPAIRMENT OF LOANS BY CREDITORS

SFAS No. 114 and No. 118 address the reporting of impairment of loans due in over one year by creditors. Simply stated, impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate. Creditors should assess the need to evaluate all loans when assessing the need for a loss accrual.

A. RECOGNITION OF IMPAIRMENT

A loan is considered impaired if it is probable (likely to occur) that the creditor will be unable to collect all amounts due under the original contract when due. Normal loan procedures should be used to judge whether or not a loan is impaired.

B. MEASUREMENT OF IMPAIRMENT

1. Receipt of Assets or Equity

When the creditor receives either assets or equity as full settlement of a receivable, these are accounted for at their fair value at the time of the restructuring. The fair value of the receivable satisfied can be used if it is more clearly determinable than the fair value of the asset or equity acquired. In a partial payment, the creditor must use the fair value of the asset or equity received.

The excess of the recorded receivable over the fair value of the asset received is recognized as an ordinary loss. The creditor accounts for these assets as if they were acquired for cash.

2. Modification of Terms (Use Present Value)

Impairment should be measured based on the loan's present value of expected future cash flows discounted at the loan's historical effective interest rate. The observable market rate can be used if more readily available. Likewise, the fair value of the collateral can be used if the loan is collateral dependent. Any costs to sell should be estimated and should reduce the cash flows.

The impairment is recorded by creating a valuation allowance with a corresponding charge to bad debt expense:

DR	Bad debt expense	$XXX	
CR	Allowance for credit losses		$XXX

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EXAMPLE

Modification of Terms

Creditor Y holds a 5-year, 9%, $100,000 note from X Corp. The note was issued January 1, Year 1. On January 1, Year 2, Creditor Y determines that X Corp. is unable to pay the note and agrees to restructure the terms. The interest due is forgiven and the interest rate is dropped to 5%. Make the entry to record the modification of terms on the books of Creditor Y.

First, the investment needs to be revalued, using the present value of the expected future cash flows:

Present value of $100,000 at 9%, due in 4 years $100,000 x .7084	$ 70,840
Present value of annuity, 9% (original rate), 4 years $100,000 x 5% (new rate) x 3.2397	16,198
Present value of cash flows	$ 87,038
Carrying value of loan (book value plus accrued interest)	$109,000
Restructured loan	(87,038)
Impairment of loan	$ 21,962

Journal Entry: To record the modification of terms and the reclassification of the note to the new note account

DR	Note receivable	$109,000	
DR	Bad debt expense	21,962	
CR	Accrued interest receivable		$ 9,000
CR	Note receivable		100,000
CR	Valuation allowance for impaired loan		21,962

Subsequent period accounting is as follows: Interest revenue will be recognized by the creditor at the historical effective interest rate even though actual interest received will be calculated under the new terms of 5%. The balance is accounted for through amortization of the difference.

C. EXCEPTIONS

SFAS No. 114 and No. 118 do not apply to:

1. Groups of loans collectively evaluated for impairment (e.g., credit card loans and residential mortgage loans).
2. Loans measured at market value (or lower of cost or market).
3. Leases.
4. Held-to-maturity debt securities.

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IV. DISCLOSURE REQUIREMENTS FOR IMPAIRED LOANS AND RESTRUCTURED DEBT

The following information must be disclosed either in the body of the financial statements or in the notes:

A. GENERAL DISCLOSURES FOR DEBTORS

1. A description of the main changes in terms and/or features of settlements
2. Gain on restructuring of payables (in the aggregate)
3. Net gain or loss on transfers of assets recognized in the period (in the aggregate)
4. Per share amount of the aggregate gain on the restructuring of payables
5. The amount of contingently payable amounts included in the carrying amount of restructured payables (and any conditions that would cause those amounts to become payable or to be forgiven)

B. GENERAL DISCLOSURES FOR CREDITORS

1. The creditor's policy for recognizing interest income
2. Any commitment the creditor has to lend additional funds to the debtor
3. The activity in the allowance account for the reporting period
4. The average recorded investment in impaired loans for the period (including the amount of related interest income and the interest income recognized on a cash basis)

C. ADDITIONAL DISCLOSURES FOR CREDITORS

If restructured debt is still impaired or does not provide an acceptable rate of interest, also disclose the:

1. Total recorded investment in troubled debt,
2. Amount of debt with a bad debt allowance, and
3. Amount of debt without a bad debt allowance.

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NOTES

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HOMEWORK READING

Liabilities

LIABILITIES

I. ACCOUNTS PAYABLE AND OTHER MISCELLANEOUS CURRENT LIABILITIES

SFAC No. 6 defines current liabilities as obligations with maturities within one year or the operating cycle, whichever is longer. Current liabilities are valued at their settlement values. Settlement value is also known as net realizable value.

A. TRADE ACCOUNTS PAYABLE

Trade accounts payable are amounts owed for goods, raw materials, and supplies that are not evidenced by a promissory note. Purchases of goods and services on credit are usually determinable as to amounts due and the due date. Cash discounts associated with accounts payable can be anticipated and journalized. The purchase may be recorded gross or net.

1. Gross Method

The gross method records the purchase without regard to the discount. When invoices are paid, within the discount period, a purchase discount is credited.

2. Net Method

Under the net method, purchases and accounts payable are recorded net of the discount. If payment is made within the discount period, no adjustment is necessary. If payment is made after the discount period, a purchase discount lost account is debited.

B. DIVIDENDS PAYABLE

Dividends payable are dividends that have been declared payable by a company's board of directors. Upon declaration, they become a debt of the corporation (credit to dividends payable) and are debited to retained earnings. Upon the payment of the dividend, the dividends payable account is simply debited and the cash account is credited. Preferred dividends in arrears are not debt.

C. RETURNABLE DEPOSITS

RETURNABLE DEPOSITS

Returnable deposits are cash deposits that must be returned upon the satisfaction of certain conditions. Examples include the return of a security deposit upon the termination of a lease and the return of a deposit on containers that required a deposit upon the purchase of the items they contained.

D. SALES TAXES PAYABLE

Sales taxes payable are sales taxes collected from customers on behalf of the taxing authority and held in trust until remission to the taxing authority. Sales taxes payable should be credited to a payable account after collected and until remitted, and it does not originate from an entry recording an expense of the company.

E. USE TAXES PAYABLE

Use taxes are taxes collected from the buyer on goods purchased by the buyer outside of the taxing jurisdiction. Use taxes must be accrued by the buyer until remitted to the taxing authority.

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F. PROPERTY TAXES PAYABLE

Property taxes are often invoiced in arrears. There are two methods of accrual, and either one is acceptable, provided the method used is consistently applied. Property taxes payable may be accrued prior to the receipt of the tax invoice and matched in the year for which the invoice pertains. Property taxes may also be recorded as a payable upon the receipt of the tax invoice and expensed in the year of receipt (which is often different from the year to which the invoice pertains).

G. ACCRUED SALARIES AND WAGES PAYABLE

Accrued salaries and wages payable is the unpaid portion of salaries and wages as of the balance sheet date. Unpaid salaries and wages generally result from pay periods that overlap the balance sheet date. Accruals are calculated as the ratio of days occurring prior to the balance sheet date divided by the total days in the pay period times the amount of the affected payroll.

H. PAYROLL DEDUCTIONS

Payroll deductions for social security, Medicare, and income taxes are items withheld from employees out of the gross pay on their paychecks. Payroll deductions are held in trust until remission to the taxing authorities and should be credited to a payable account until remitted. They do not represent an expense to the employer.

I. UNEMPLOYMENT TAXES AND THE EMPLOYER'S SHARE OF PAYROLL TAXES

Unemployment taxes and the employer's share of payroll taxes (e.g., social security and Medicare) should be accrued by the employer as an expense (e.g., unemployment tax expense and payroll tax expense). These items are treated similar to trade accounts payable and are kept on the books until remission to the taxing authorities.

J. COMPENSATED ABSENCES (VACATION AND SICK PAY)

COMPENSATED ABSENCES

Compensated absences shall be accrued if all of the criteria are satisfied for accrual. The criteria include (1) the employee has performed the services to which the vacation or sick pay is attributable; (2) the liability is vested or accumulated; (3) payment is probable; and (4) the amount can be reasonably estimated. The accrual of non-vesting but accumulating sick pay is not required.

K. EMPLOYEE BONUSES

Many companies have incentives for employees to obtain additional pay in the form of a bonus. Often, bonuses are paid based on the performance of an employee of the performance of a division in which the employee works and are evaluated at the end of the period. These bonuses are, therefore, often paid at the end of the year. Bonuses should be recorded (accrued) as an expense and a current liability in the year in which the services that qualified for the bonus were rendered.

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L. ONE-TIME TERMINATION BENEFITS/CONTRACT TERMINATION COSTS

Liabilities for the costs associated with one-time termination benefits, contract termination, consolidation of facilities, relocation of employees, etc. that are associated with exit or disposal activities that are not covered by SFAS No. 143 (Asset Retirement) or No. 144 (Discontinued Operations) are covered by SFAS No. 146, which nullified EITF Issue No. 94-3. According to SFAS No. 146, a liability for costs associated with exit or disposal activities may not be recognized until the liability is actually **incurred** (previously, under EITF Issue 94-3, a liability was recognized on the date the entity made a commitment to an exit plan). The liability is measured initially at fair value on the date the liability is incurred.

II. IMPUTING INTEREST ON PAYABLES (AND RECEIVABLES)

GAAP requires that certain receivables and payables (contractual rights to receive or pay money at a fixed or determinable rate) must be recorded at the true present value at the date of issuance. If a note is non-interest bearing or the interest rate is unreasonable (usually below market), the value of the note must be determined by imputing the market rate of the note and by using the effective interest method.

Many of these rules apply when notes are exchanged for goods and services and the interest rate varies from the prevailing interest rates. Notes must be recorded at present value so that income or loss for the period is not distorted.

A. STATED INTEREST FACTORS

A note issued or received solely for cash equal to its face amount is presumed to earn the interest stated. However, if rights or privileges are attached to the note, they must be evaluated separately. If no rights or privileges are attached, record the note payable at face value without any present value considerations.

There is a general presumption that the interest stated on a note resulting from a business transaction entered into at arm's length is fair and adequate.

B. UNREASONABLY LOW OR ABSENT INTEREST FACTORS

When a note contains either no interest or an unreasonable rate of interest, the substance rather than the form of the transaction must be recorded. This involves determining the present value of the obligation at an appropriate market interest rate, and:

1. Recording the receivable or payable at its face amount;
2. Recording the sale of the asset at the present value of the obligation; and
3. Recording any difference between the face amount of the note and its present value as a discount or premium that must be amortized over the life of the note.

C. TRANSACTIONS NOT REQUIRING PRESENT VALUE CALCULATION

Receivables and payables that generally do not require this type of evaluation, and are presumed to be recorded at a fair valuation, are those:

1. Arising in the ordinary course of business, the terms of which do not exceed approximately one year.
2. Paid in property or services (not in cash).
3. Representing security or retainage deposits.
4. Bearing an interest rate determined by a government agency.
5. Arising from transactions between a parent and its subsidiaries.

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D. DETERMINING THE APPROPRIATE INTEREST RATE

There is no predetermined formula for computing an appropriate interest rate. However, provided there is a market for these types of notes (i.e., they are not the more complex assets and liabilities discussed in SFAC No. 7) the objective is to approximate what the rate would have been, using the same terms and conditions as if it had been negotiated by an independent lender. The following issues are recommended for consideration in determining an appropriate rate:

1. Credit rating of the issuer,
2. Restrictive covenants or collateral involved,
3. Prevailing market rates, and
4. The rate at which the debtor could borrow funds.

E. AMORTIZATION OF THE DISCOUNT OR PREMIUM

Any discount or premium resulting from imputing interest on a note must be amortized over the life of the note using the effective interest method. The amortization is reported as interest.

F. EFFECTIVE INTEREST METHOD

The effective interest method is a method under which each payment on a note (or other loan) would be divided between an interest component and a principal component as though the note had a constant effective stated rate (or adequate rate) of interest.

EXAMPLE

Effective Interest Method

1. Company X is making three annual loan payments of $1,000 each to Company A. There is no stated rate of interest. The present value of the aggregate loan payments at the appropriate interest rate of 10% is $2,486.

2. Under the effective interest method, each payment would be allocated between interest and principal as follows:

(a) Payment	(b) Interest (d) X 10%	(c) Principal (a) – (b)	(d) Balance (d) – (c)
			$2,486
$1,000	$249	$751	1,735
1,000	174	826	909
1,000	91	909	-0-
	$514	$2,486	

PASS KEY

A solid understanding of the calculations of the effective interest method will assist you in getting the correct answers not only on questions relating to investments, but also on questions relating to payables. Many different types of questions may be answered with just knowing this simple format. Use a blank sheet of paper and prepare this schedule on your own a few times. Memorize the format. You'll be glad you did!

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G. STATEMENT PRESENTATION OF DISCOUNT OR PREMIUM

The premium or discount that arises from the use of present values on cash and noncash transactions is inseparable from the related asset or liability. Therefore, such premium or discount valuation accounts are added to (or deducted from) their related asset or liability on the balance sheet. Discounts or premiums resulting from imputing interest must not be classified as deferred charges or credits.

H. DISCLOSURE

A full description of the receivable or payable, the effective interest rate, and the face amount of the note should be disclosed in the financial statements or notes thereto.

Issue costs should be reported separately in the balance sheet as deferred charges (and amortized over the life of the note).

EXAMPLE

Imputed Interest — Seller

A manufacturer sells a machine for $10,000 and accepts a $10,000 note receivable bearing no interest for five years. 10% is an appropriate interest rate.

The present value of $1 at 10% for 5 years is 0.621.

Journal Entry: To record the sale

Note receivable	10,000	
Sales (present value at 10%)		6,210
Discount on note receivable		3,790

Journal Entry: End of year to amortize the discount on notes receivable using the interest method

1st year:

Discount on notes receivable	621	
Interest income (10% x $6,210)		621

Balance Sheet Presentation:

Notes receivable	$10,000
Less: Discount on notes receivable	(3,169) [$3,790 - $621]
	$6,831

In the above example, the manufacturer records the note at its face amount but records the sale at the present value of the note. The difference between the face amount of the note and its present value is recorded as "discount on notes receivable." This deferred interest income is payment for the use of the manufacturer's funds for the five years. Interest income is realized each year, using the effective interest method (e.g., in year 2, 10% x ($6,210 + $621) = $683.10 interest income).

Note that this example and the effective interest example in Item F illustrate notes with periods longer than one year, even though this section covers working capital (current assets and current liabilities).

The concepts are better illustrated with these long-term examples, and they will also be useful during our discussion of long-term payables (class F5).

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NOTES PAYABLE

III. NOTES PAYABLE

Short-term notes payable are amounts owed to creditors that are evidenced by a promissory note. They may be interest bearing or non-interest bearing.

A. INTEREST BEARING

If a note bears interest at the market rate for loans of similar risk (or trade notes payable), the note payable is simply recorded at its face value, and interest payable is accrued at the stated rate of interest until it is paid. If the interest rate on the notes varies significantly from the market rate for similar risk items, the note should be adjusted to the true present value (likely causing a discount to be recorded), and the effective interest method should be used to amortize the discount (or premium, if applicable).

B. NON-INTEREST BEARING

If the note is non-interest bearing, it should be recorded at its present value by discounting the face of the note using an appropriate interest rate and amortizing the difference using the effective interest method.

EXAMPLE

Non-interest Bearing Note

Facts and Requirement: Cinders Manufacturing has a one-year non-interest bearing note payable to Township Bank for $1,000. The appropriate interest rate for notes of similar risk and maturity is 10%. The present value of $1,000 at 10% for one year is $909. What is the journal entry to record the note?'

Solution: The journal entry to record the note is as follows:

DR	Cash	$909	
DR	Discount on note payable	91	
CR	Note payable		$1,000

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FINANCIAL ACCOUNTING & REPORTING 5

Class Questions Answer Worksheet

MC Question Number	First Choice Answer	Correct Answer	NOTES
1.			
2.			
3.			
4.			
5.			
6.			
7.			
8.			
9.			
10.			
11.			
12.			
13.			
14.			
15.			
16.			
17.			
18.			
19.			
20.			

Grade:

Multiple-choice Questions Correct / 20 = _____% Correct

Detailed explanations to the class questions are located in the back of this textbook.

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NOTES

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CLASS QUESTIONS

1. CPA-00394

On December 30, 1994, Chang Co. sold a machine to Door Co. in exchange for a non-interest-bearing note requiring ten annual payments of $10,000. Door made the first payment on December 30, 1994. The market interest rate for similar notes at date of issuance was 8%. Information on present value factors is as follows:

Period	*Present value of $1 at 8%*	*Present value of ordinary annuity of $1 at 8%*
9	0.50	6.25
10	0.46	6.71

In its December 31, 1994, balance sheet, what amount should Chang report as note receivable?

a. $45,000
b. $46,000
c. $62,500
d. $67,100

2. CPA-00438

On January 1, 1989, Park Co. signed a 10-year operating lease for office space at $96,000 per year. The lease included a provision for additional rent of 5% of annual company sales in excess of $500,000. Park's sales for the year ended December 31, 1989 were $600,000. Upon execution of the lease, Park paid $24,000 as a bonus for the lease. Park's rent expense for the year ended December 31, 1989 is:

a. $98,400
b. $101,000
c. $103,400
d. $125,000

3. CPA-00410

Wall Co. leased office premises to Fox, Inc. for a five-year term beginning January 2, 1992. Under the terms of the operating lease, rent for the first year is $8,000 and rent for years 2 through 5 is $12,500 per annum. However, as an inducement to enter the lease, Wall granted Fox the first six months of the lease rent-free. In its December 31, 1992, income statement, what amount should Wall report as rental income?

a. $12,000
b. $11,600
c. $10,800
d. $8,000

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4. CPA-00434

Lease A does not contain a bargain purchase option, but the lease term is equal to 90 percent of the estimated economic life of the leased property. Lease B does not transfer ownership of the property to the lessee by the end of the lease term, but the lease term is equal to 75 percent of the estimated economic life of the leased property. How should the lessee classify these leases?

	Lease A	*Lease B*
a.	Operating lease	Capital lease
b.	Operating lease	Operating lease
c.	Capital lease	Capital lease
d.	Capital lease	Operating lease

5. CPA-00424

On December 31, 1990, Day Co. leased a new machine from Parr with the following pertinent information:

Lease term	6 years
Annual rental payable at beginning of each year	$50,000
Useful life of machine	8 years
Day's incremental borrowing rate	15%
Implicit interest rate in lease (known by Day)	12%
Present value of an annuity of 1 in advance for 6 periods at 12%	4.61
Present value of an annuity of 1 in advance for 6 periods at 15 %	4.35

The lease is not renewable, and the machine reverts to Parr at the termination of the lease. The cost of the machine on Parr's accounting records is $375,500. At the beginning of the lease term, Day should record a lease liability of:

a. $375,500
b. $230,500
c. $217,500
d. $0

6. CPA-00411

On January 2, 1992, Nori Mining Co. (lessee) entered into a 5-year lease for drilling equipment. Nori accounted for the acquisition as a capital lease for $240,000, which includes a $10,000 bargain purchase option. At the end of the lease, Nori expects to exercise the bargain purchase option. Nori estimates that the equipment's fair value will be $20,000 at the end of its 8-year life. Nori regularly uses straight-line depreciation on similar equipment. For the year ended December 31, 1992, what amount should Nori recognize as depreciation expense on the leased asset?

a. $48,000
b. $46,000
c. $30,000
d. $27,500

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7. CPA-00397

On January 2, 1995, Marx Co. as lessee signed a five-year noncancelable equipment lease with annual payments of $200,000 beginning December 31, 1995. Marx treated this transaction as a capital lease. The five lease payments have a present value of $758,000 at January 2, 1995, based on interest of 10%. What amount should Marx report as interest expense for the year ended December 31, 1995?

a. $0
b. $48,400
c. $55,800
d. $75,800

8. CPA-00439

Peg Co. leased equipment from Howe Corp. on July 1, 1988 for an eight-year period expiring June 30, 1996. Equal payments under the lease are $600,000 and are due on July 1 of each year. The first payment was made on July 1, 1988. The rate of interest contemplated by Peg and Howe is 10%. The cash selling price of the equipment is $3,520,000, and the cost of the equipment on Howe's accounting records is $2,800,000. The lease is appropriately recorded as a sales-type lease. What is the amount of profit on the sale and interest revenue that Howe should record for the year ended December 31, 1988?

	Profit on Sale	*Interest Revenue*
a.	$720,000	$176,000
b.	$720,000	$146,000
c.	$45,000	$176,000
d.	$45,000	$146,000

9. CPA-00417

The following information pertains to a sale and leaseback of equipment by Mega Co. on December 31, 1991:

Sales price	$400,000
Carrying amount	$300,000
Monthly lease payment	$ 3,250
Present value of lease payments	$ 36,900
Estimated remaining life	25 years
Lease term	1 year
Implicit rate	12%

What amount of deferred gain on the sale should Mega report at December 31, 1991?

a. $0
b. $36,900
c. $63,100
d. $100,000

10. CPA-00458

The market price of a bond issued at a premium is equal to the present value of its principal amount:

a. Only, at the stated interest rate.
b. And the present value of all future interest payments, at the stated interest rate.
c. Only, at the market (effective) interest rate.
d. And the present value of all future interest payments, at the market (effective) interest rate.

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11. CPA-00460

On December 1, 1995, Money Co. gave Home Co. a $200,000, 11% loan. Money paid proceeds of $194,000 after the deduction of a $6,000 nonrefundable loan origination fee. Principal and interest are due in 60 monthly installments of $4,310, beginning January 1, 1996. The repayments yield an effective interest rate of 11% at a present value of $200,000 and 12.4% at a present value of $194,000. What amount of income from this loan should Money report in its 1995 income statement?

a. $0
b. $1,833
c. $2,005
d. $7,833

12. CPA-00470

On January 2, 1994, West Co. issued 9% bonds in the amount of $500,000, which mature on January 2, 2004. The bonds were issued for $469,500 to yield 10%. Interest is payable annually on December 31. West uses the interest method of amortizing bond discount. In its June 30, 1994, balance sheet, what amount should West report as bonds payable?

a. $469,500
b. $470,475
c. $471,025
d. $500,000

13. CPA-00463

On July 1, 1994, Eagle Corp. issued 600 of its 10%, $1,000 bonds at 99 plus accrued interest. The bonds are dated April 1, 1994 and mature on April 1, 2004. Interest is payable semiannually on April 1 and October 1. What amount did Eagle receive from the bond issuance?

a. $579,000
b. $594,000
c. $600,000
d. $609,000

14. CPA-00477

On January 31, 1992, Beau Corp. issued $300,000 maturity value, 12% bonds for $300,000 cash. The bonds are dated December 31, 1991, and mature on December 31, 2001. Interest will be paid semiannually on June 30 and December 31. What amount of accrued interest payable should Beau report in its September 30, 1992, balance sheet?

a. $27,000
b. $24,000
c. $18,000
d. $9,000

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15. CPA-00493

On March 31, 1992, Ashley, Inc.'s bondholders exchanged their convertible bonds for common stock. The carrying amount of these bonds on Ashley's books was less than the market value but greater than the par value of the common stock issued. If Ashley used the book value method of accounting for the conversion, which of the following statements correctly states an effect of this conversion?

a. Stockholders' equity is increased.
b. Additional paid-in capital is decreased.
c. Retained earnings is increased.
d. An extraordinary loss is recognized.

16. CPA-00473

On December 31, 1993, Moss Co. issued $1,000,000 of 11% bonds at 109. Each $1,000 bond was issued with 50 detachable stock warrants, each of which entitled the bondholder to purchase one share of $5 par common stock for $25. Immediately after issuance, the market value of each warrant was $4. On December 31, 1993, what amount should Moss record as discount or premium on issuance of bonds?

a. $40,000 premium.
b. $90,000 premium.
c. $110,000 discount.
d. $200,000 discount.

17. CPA-00476

On March 1, 1987, Somar Co. issued 20-year bonds at a discount. By September 1, 1992, the bonds were quoted at 106 when Somar exercised its right to retire the bonds at 105. The amount is material and considered to be unusual in nature and infrequently occurring with respect to Somar Co. How should Somar report the bond retirement on its 1992 income statement?

a. A gain in continuing operations.
b. A loss in continuing operations.
c. An extraordinary gain.
d. An extraordinary loss.

18. CPA-00471

On July 31, 1993, Dome Co. issued $1,000,000 of 10%, 15-year bonds at par and (as a typical risk-management strategy to Dome Co.) used a portion of the proceeds to call its 600 outstanding 11%, $1,000 face value bonds, due on July 31, 2003, at 102. On that date, unamortized bond premium relating to the 11% bonds was $65,000. In its 1993 income statement, what amount should Dome report as gain or loss from retirement of bonds?

a. $53,000 gain.
b. $0
c. $(65,000) loss.
d. $(77,000) loss.

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19. CPA-00532

The following information pertains to the transfer of real estate pursuant to a troubled debt restructuring (considered to be an extraordinary event for Knob Co.) by Knob Co. to Mene Corp. in full liquidation of Knob's liability to Mene:

Carrying amount of liability liquidated	$150,000
Carrying amount of real estate transferred	100,000
Fair value of real estate transferred	90,000

What amount should Knob report as ordinary gain (loss) on transfer of real estate?

a. ($10,000)
b. $0
c. $50,000
d. $60,000

20. CPA-00528

The following information pertains to the transfer of real estate pursuant to a troubled debt restructuring (considered to be an extraordinary event for Knob Co.) by Knob Co. to Mene Corp. in full liquidation of Knob's liability to Mene:

Carrying amount of liability liquidated	$150,000
Carrying amount of real estate transferred	100,000
Fair value of real estate transferred	90,000

What amount should Knob report as a pretax extraordinary gain (loss) on restructuring of payables?

a. ($10,000)
b. $0
c. $50,000
d. $60,000

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Financial Accounting & Reporting 6

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PENSION PLANS

PENSIONS

I. OVERVIEW

A pension plan is an agreement in which the employer provides employees with defined or estimated retirement benefits in exchange for current or past services. Pension benefits are not paid currently; rather, they are a form of deferred compensation and are paid to retired employees, usually on a periodic basis.

In a defined benefit plan, the benefits that the employer receives at retirement are determined by formula. It is the sponsor company's responsibility to ensure that contributions to the plan are sufficient to pay benefits as they come due.

In a defined contribution plan, the contributions that the sponsor company makes to the plan are determined by formula. The employees' retirement benefits are based on the amount of funds in the plan.

Accounting for defined contribution plans is very simple whereas accounting for defined benefit plans is complex.

It is very important to note that a pension plan and the sponsoring company are two separate legal entities. The CPA exam and GAAP for pensions addressed in this chapter are not concerned with the pension plan's accounting. Rather, they are concerned with how the sponsor company accounts for the plan.

Also keep in mind that, for a defined contribution plan, the sponsor company makes just one journal entry and, for defined benefit plans, the sponsor company makes multiple journal entries.

PASS KEY

Accounting for pension plans is concerned primarily with determining the amount of:

(1) Pension expense that appears on the sponsor company's income statement, and

(2) Any related pension accounts (asset, liability, and/or other comprehensive income accounts) that appear on the sponsor company's balance sheet.

(i) For defined benefit and defined contribution plans, pension expenses are not necessarily equal to the amount funded (paid) to the pension trust during the year. Pension accounting is concerned with amounts accrued and expensed by the employer company and the funded status of the plan. It is based on accrual accounting.

(ii) The accounting problems, which arise primarily for defined benefit plans, are caused by necessary use of estimates and assumptions, which affect the timing and measurement of pension costs (expense), gains and losses from investments of plan assets, and liabilities.

A. CHARACTERISTICS

A pension plan can be:

1. Written or Implied (Unwritten)

A plan's provisions must be applied to both written plans and those plans whose existence may be implied from a well-defined, although perhaps unwritten, practice of paying postretirement benefits.

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2. Contributory or Noncontributory

Employees are required to contribute to the plan if it is contributory; only the employer contributes to the plan if it is noncontributory.

3. Funding

The term "funding" refers to the sponsor company making contribution to the pension plan.

4. Funded or Nonfunded

a. The employer makes cash contributions to the plan if it is funded. The amount funded does not have to equal the pension plan expense for the period.

b. For a nonfunded plan, the employer makes entries on the books to reflect the pension plan liability.

5. Overfunded vs. Underfunded (Funded Status)

a. Applies only to defined benefit plans.

b. An overfunded plan has assets that exceed its liabilities, whereas an underfunded plan has liabilities that exceed its assets.

B. TYPES OF PLANS

1. Non-GAAP Methods

a. "Pay-as-you-go"

A cash basis method of expensing pension plan payments after someone has retired. Because it is a cash basis method, it is not GAAP.

b. Terminal Funding

A company pays an entire pension plan liability upon retirement of an employee, generally by purchasing an annuity-type insurance policy. Terminal funding is also a cash basis method and is not GAAP.

2. GAAP Methods

a. Defined Contribution Plan

This type of plan specifies the periodic amount of contributions to the plan and the way that the contributions should be allocated to employees. The types of factors considered when calculating contributions to the plan include:

(1) Employees' length of service, and

(2) Compensation amounts.

b. Defined Benefit Plan

This type of plan defines the benefits to be paid to employees at retirement. Contributions are computed using actuarial estimates of future benefit payments based on factors such as:

(1) Employees' compensation levels at or near retirement.

(2) The number of years of employee service.

(3) The number of years until the employee retires.

(4) The number of years that the plan expects to pay benefits after an employee retires.

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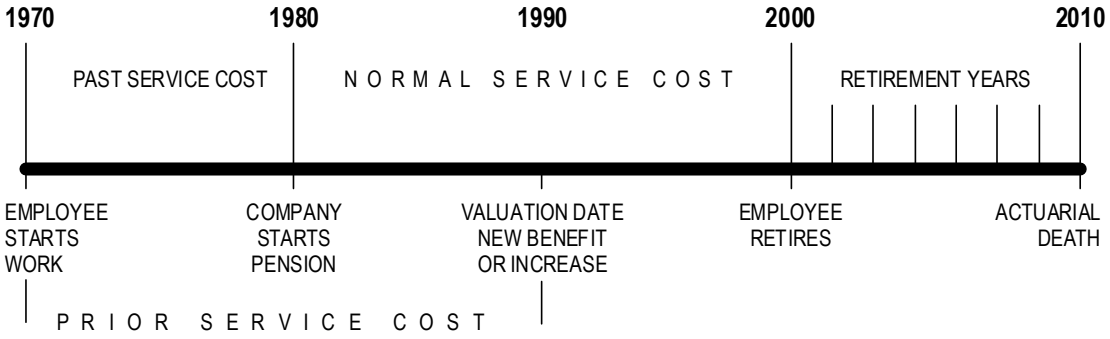
C. OVERVIEW TIMELINE

The following example will illustrate the various terms and their respective placement within the pension concepts.

EXAMPLE

Suppose that employee R. Houston begins work on 1/1/70, and that his company does not implement a pension plan until 1/1/80. All employees receive credit for all years of service for the company, even those years prior to inception of the plan. Then, in 1990, the plan is amended to increase the amount of benefits earned each year, and this amendment is applied retroactively to the day the employee began to work for the company. Our employee is expected to retire on 1/1/2000 and die on 1/1/2010 (these are estimates made by the actuary).



D. DEFINITIONS

ACCUMULATED BENEFIT OBLIGATION

1. Accumulated Benefit Obligation (ABO)

The actuarial present value of benefits attributed by a formula based on current and past compensation levels. An ABO differs from a PBO only in that the ABO includes no assumption about future compensation levels (uses current salaries).

PROJECTED BENEFIT OBLIGATION

2. Projected Benefit Obligation (PBO)

The actuarial present value of all benefits attributed by the plan's benefit formula to employee service rendered prior to that date. PBO only uses an assumption as to future compensation levels.

3. Vested Benefits

Pension plan benefits that already belong (vest) to employees who have earned their benefits by reason of having reached retirement age and/or who otherwise meet unique pension plan requirements (e.g., are fully vested after only 10 years of service). The benefits are vested whether or not that person has actually retired, and they are not contingent on remaining in the service of the employer. Generally, pension plan documents require money to be left in the plan until retirement.

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4. Prior Service Cost

The cost of benefits based on past service granted for:

a. Service prior to the initiation of a pension plan that employees retroactively receive credit for when the plan is implemented (i.e., in the timeline above, benefits based on service provided from 1970 to 1980).

b. Subsequent plan amendment, reflecting new or increased benefits, that also is applied to service already provided (i.e., 1970 to 1990 in the diagram above).

Prior service cost should be amortized over the future periods benefited.

5. Service Cost

Service cost is the present value of all pension benefits earned by company employees in the current year. It is provided by the actuary. The service cost component increases the projected benefit obligation and is unaffected by the funded status of the plan.

6. Interest Cost

The increase in the projected benefit obligation (PBO) due to the passage of time. Measuring the PBO as a present value requires accrual of an interest cost on the projected benefit obligation, at rates equal to the assumed discount rates. Interest cost always increases the PBO because the present value of any liability increases as you get closer to the due date.

7. Actual Return on Plan Assets

Returns on all of the assets held by the pension plan. Calculated based on the fair value of plan assets at the beginning and ending of the period, adjusted for contributions and benefit payments (a squeeze).

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II. INCOME STATEMENT ACCOUNTING FOR THE EMPLOYER'S NET PERIODIC PENSION COST

NET PERIODIC PENSION COST

Very loosely defined, pension expense represents the contribution that the sponsor company should have made to the plan based on what happened in the current year. However, keep in mind that standard setters implemented some rules that attempt to "smooth" pension expense (e.g., the return on plan assets and amortization of <gains> losses), and that the company is not obligated contractually to make a contribution to the pension plan's assets.

A. INCOME STATEMENT (EXPENSE) FORMULA

CURRENT **S**ERVICE COST

INTEREST COST

<EXPECTED **R**ETURN ON PLAN ASSETS>

AMORTIZATION OF PRIOR SERVICE COST

< **G**AIN > LOSS AMORTIZATION

AMORTIZATION OF **E**XISTING NET OBLIGATION OR NET ASSET

NET PENSION EXPENSE

PASS KEY

The easy way to remember all the elements which are components of the net pension expense: **SIR-AGE**

PASS KEY

The following journal entries are "simplified" versions of the **net** impact on the income statement for the periodic recording of the pension expense (**SIR-AGE**).

DR	Net periodic pension cost	$XXX	
CR	Pension benefit liability - current		$XXX

To record the net pension expense on the income statement and record the liability

DR	Pension benefit liability - current	$XXX	
CR	Cash		$XXX

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B. COMPONENTS OF "NET PERIODIC PENSION COST"

1. Current Service Cost

The present value of all benefits earned in the current period. In other words, the increase in the PBO (Projected Benefit Obligation) resulting from employee services in the current period. The pension benefit formula is applied to compute a present value. The actuary provides service cost.

2. Interest Cost

The increase in the projected benefit obligation during the current period that is due to the passage of time. (Similar to the recognition of interest expense.)

FORMULA:

Beginning of period PBO
x Discount rate
Interest cost

3. <Expected Return on Plan Assets>

Standard setters decided that having actual return be a part of pension expense could result in large fluctuations in pension expense from year-to-year (performance of plan investments can vary widely over time – think of the recent performance of the stock market). Consequently, this component is defined as actual return adjusted for the difference between actual and expected return – in other words, expected return.

FORMULA:

Beginning FV of plan assets
x Expected rate of return on plan assets
Expected return on plan assets

We will see shortly that this difference between actual and expected return is reflected in <gains> and losses (unrecognized).

PASS KEY

In order to accurately determine activity in an account, the account's ending balance or any missing detail, use "BASE":

Beginning

Additions

Subtraction

Ending

To determine actual return on plan assets:

FORMULA:

Beginning fair value of plan assets
+ Contributions
+ Actual return on plan assets (squeeze)
– Benefit payment
Ending fair value of plan assets

B A S E

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4. Amortization of Unrecognized Prior Service Cost

The cost of retroactive benefits (measured by the increase in the PBO) is amortized by assigning an equal amount to each future period of service of each employee who is active at the date of initiation of the plan (or amendment). Prior service cost is reflected in the financial statements of the current period and future years.

EXAMPLE

Prior Service Costs

ABC Company has had a defined benefit pension plan for the last ten years. ABC Company's plan calls for employees who are fully vested to receive 50% of their last year's salary with the company upon retirement. ABC Company has been funding the plan and expensing the annual Net Periodic Pension cost on the income statement based upon those assumptions.

ABC Company has now decided to amend the plan and pay a benefit of 55% of their last year's salary to retirees. The amendment is to be applied retroactively. The increase in the PBO based on this amendment being applied to services provided in the last ten years is the prior service cost.

5. <Gains> or Losses (Unrecognized)

Gains and losses arise from two sources:

(i) Difference between expected and actual return on plan assets, and

(ii) Changes in actuarial assumptions (actuarial gains and losses).

It is easy to determine whether something results in a gain or loss by considering whether it is good <gain> or bad <loss> for the pension plan.

For example, if a company actually earns more than expected on its plan assets, that is good for the plan (it has more assets than expected), therefore it is a gain.

In addition, if employees are expected to live longer after they retire, that is bad for the pension plan because it increases the amount of benefits it expects to pay, therefore it is a loss (even though it is good for the employee who expects to live longer).

a. Minimum Reportable Amount:

Amortize the net gain/loss over the average remaining service period, if as of the beginning of the year, this amount exceeds 10% of the *greater* of the beginning of the year balances of:

(1) Market related value of plan assets = Assets

(2) Projected Benefit Obligation (PBO) = Liabilities

FORMULA:

Beg. of Year: → Unrecognized gain or loss
Beg. of Year: → < 10% of PBO **OR** Market Related Value (greater)>
Excess
÷ Average remaining service life
Minimum recognized amount to be reported

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6. Amortization of Existing Net Obligation or Net Asset at Implementation

An employer must determine the amount to be amortized as of the beginning of the first year FASB 87 is applied by formula and using the long-term settlement rate. FASB 87 was effective for most large companies for fiscal years beginning after December 15, 1986 (December 15, 1988 for nonpublic companies that sponsor plans for 100 or fewer people).

Simply put, this transition adjustment is the difference between the PBO and fair value of plan assets when the sponsor company adopted FASB 87.

At the transition date, if PBO > FV of assets (net obligation), then the amortization of the difference will increase pension expense.

If PBO < FV of assets (net asset), then the amortization of the difference will decrease pension expense.

FORMULA:

Projected Benefit Obligation
< Fair market value plan assets>
Initial unfunded obligation
÷ 15 years **OR** average employee job life (greater)
Minimum amortization

PASS KEY

Pensions are "GREAT"!

- When deciding which balance (assets or liabilities) for the gains/losses component, use the "GREATER" of the two.
- When deciding which period to amortize the existing obligation over (15 years or average service life), use the "GREATER" of the two.

EXAMPLE

Annual Pension Cost

The following information pertains to Duffy Corp.'s defined benefit pension plan for Year 1:

Service cost	$300,000
Actual return on plan assets	80,000
Amortization of unrecognized prior service cost	70,000
Amortization of actuarial gain	30,000
Interest on projected benefit obligation	164,000
Existing net obligation amortization	20,000

What amount should Duffy report as pension expense in its Year 1 income statement?

The following items are included in determining pension expense:

(1)	Service cost	$300,000
(2)	Interest on projected benefit obligation	164,000
(3)	Return on plan assets	<80,000>
(4)	Amortization of unrecognized prior service cost	70,000
(5)	Gain (actuarial) amortization	<30,000>
(6)	Existing net obligation amortization	20,000
	Pension expense	$444,000

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III. FASB STATEMENT NO. 158, EMPLOYERS' ACCOUNTING FOR DEFINED BENEFIT PENSION AND OTHER POSTRETIREMENT PLANS

SFAS No. 158 was issued in September 2006. This statement represents a fundamental shift in the balance sheet reporting for defined benefit pension plans and postretirement benefit plans. Both *SFAS No. 87 – Employers' Accounting for Pensions* and *SFAS No. 106 - Employers' Accounting for Postretirement Benefits Other than Pensions* allowed for delayed recognition of certain components of pension and postretirement plans. This delayed recognition generally resulted in a significant difference between the pension plan asset or liability reported on the balance sheet and the funded status of the pension plan, making it difficult for financial statement users to assess a company's ability to meet its pension obligations.

In order to improve the transparency of the balance sheet reporting for defined benefit pension plans and postretirement plans (hereafter referred to collectively as "pension plan(s)"), SFAS No. 158 requires that businesses with one or more single-employer defined benefit pension plan(s):

- Report the funded status of all pension plans on the balance sheet. (Previously, under SFAS No. 87 and SFAS No. 106, the funded status of a pension plan was required to be reported in the footnotes only.)
- Recognize changes in the funded status of a pension plan due to gains or losses, prior service costs, and net transition assets or obligations in other comprehensive income in the year the changes occur, eliminating the delayed balance sheet recognition of these items that was permitted under SFAS No. 87 and SFAS No. 106.
- Adjust other comprehensive income when the gains or losses, prior service costs, and net transition assets or obligations are recognized as components of net period benefit cost through amortization.
- Use SFAS No. 109 to determine the income tax effects of the above items.
- Measure the funded status of the plan as of the date of the year-end statement of financial position, with limited exceptions. The effective date of this provision is fiscal years ending after December 15, 2008.

The effective dates of the above items (i) – (iv) are as of the end of the fiscal year ending after December 15, 2006, for companies with publicly traded securities and as of the end of the fiscal year ending after June 15, 2007, for companies without publicly traded securities.

A. BALANCE SHEET REPORTING FOR PENSION PLANS

Under SFAS No. 158, the balance sheet shows a pension asset and/or liability reflecting the funded status of a company's pension plan(s) and an accumulated other comprehensive income component reflecting the changes in the funded status of the pension plan(s) due to gains or losses, prior service costs, and net transition assets or obligations. Note that the recognition of a pension asset and/or liability replaces the SFAS No. 87 recognition of prepaid pension cost (a current asset) or accrued pension cost (a current liability).

1. Funded Status

Companies must report the funded status of their pension plan(s) on the balance sheet as an asset or a liability (or both). The funded status of a pension plan is calculated using the following formula:

FORMULA:

Fair Value of Plan Assets
< PBO >
Funded Status

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If a company has multiple defined benefit pension plans, the funded status of each plan is calculated separately. Because the funded status of the pension plan(s) is shown on the balance sheet, there is no need for the additional minimum liability adjustment that was required under SFAS No. 87.

a. Pension Plan Asset (Noncurrent)

A positive funded status (fair value of plan assets > PBO) indicates that the pension is overfunded. For balance sheet reporting purposes, all overfunded pension plans are aggregated and reported in total as a noncurrent asset.

b. Pension Plan Liability (Current, Noncurrent or Both)

A negative funded status (fair value of plan assets < PBO) indicates that the pension is underfunded. All underfunded pension plans are also aggregated and reported as a current liability, a noncurrent liability, or both. Underfunded pension plans are reported as a current liability to the extent that the benefit obligation payable within the next 12 months exceeds the fair value of the plans' assets.

EXAMPLE

ABC Company has three defined benefit pension plans. The company's actuary has provided the company with the following information as of December 31, 20X8.

	Plan A	Plan B	Plan C
Expected Benefit Payments – 20X9	$5,000,000	$5,000,000	$5,000,000
Fair Value of Plan Assets	$7,000,000	$5,500,000	$4,500,000
Projected Benefit Obligation	$6,000,000	$6,000,000	$6,000,000

What is the over(under)funded status of each pension plan and what amounts should be reported as noncurrent asset, current liability, and noncurrent liability on ABC's December 31, 20X9 balance sheet?

Calculation:	Plan A	Plan B	Plan C	Total
Fair value of plan assets	$7,000,000	$5,500,000	$4,500,000	
Less: PBO	(6,000,000)	(6,000,000)	(6,000,000)	
Over(under)funded status	$1,000,000	$(500,000)	$(1,500,000)	$(1,000,000)
Noncurrent asset	$1,000,000	-0-	-0-	$ 1,000,000
Current liability	-0-	-0-	$ 500,000	$ (500,000)
Noncurrent liability	-0-	$ 500,000	$1,000,000	$(1,500,000)

A current liability will be recorded for Plan C because the expected benefits payable in the next 12 months exceed the fair value of the plan assets by $500,000.

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2. Accumulated Other Comprehensive Income

SFAS No. 158 requires that changes in the funded status of a pension plan due to pension gains or losses, prior service costs, and net transition assets or obligations be reported in other comprehensive income when incurred. SFAS No. 158 also requires that the tax effects of these items be recognized in other comprehensive income, consistent with S*FAS No. 109 – Accounting for Income Taxes*.

Pension losses, prior service costs, and net transition obligations will increase pension expense when recognized for tax purposes. They will, therefore, result in a deferred tax asset when recorded.

DR	Other comprehensive income	$XXX	
DR	Deferred tax asset	$XXX	
CR	Deferred tax benefit – OCI		$XXX
CR	Pension benefit asset/liability		$XXX

When pension losses, prior service costs, and net transition obligations are recognized in net periodic pension cost through the amortization process the following reclassification adjustment is recorded.

DR	Net periodic pension cost	$XXX	
DR	Deferred tax benefit – OCI	$XXX	
CR	Deferred tax benefit – net income		$XXX
CR	Other comprehensive income		$XXX

Pension gains and net transition assets will decrease pension expense when recognized for tax purposes. They will, therefore, result in a deferred tax liability when recorded.

DR	Pension benefit asset/liability	$XXX	
DR	Deferred tax expense – OCI	$XXX	
CR	Deferred tax liability		$XXX
CR	Other comprehensive income		$XXX

When pension gains and net transition assets are recognized in net periodic pension cost through the amortization process the following reclassification adjustment is recorded.

DR	Other comprehensive income	$XXX	
DR	Deferred tax expense – net income	$XXX	
CR	Deferred tax expense – OCI		$XXX
CR	Net periodic pension cost		$XXX

3. Pension Plan Contributions

A company's contribution to its defined benefit pension plan(s) increases the pension plan asset (overfunded pension plans) or decreases the pension plan liability (underfunded pension plans).

DR	Pension benefit asset/liability	$XXX	
CR	Cash		$XXX

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PASS KEY

The beginning and ending funded status of a defined benefit pension plan can be reconciled as follows:

Beginning funded status (pension benefit asset/liability)
+ Contributions
- Service cost
- Interest cost
+ Expected return on plan assets
- Prior service cost incurred in the current period due to plan amendment
+ Net gains incurred during the current period
- Net losses incurred during the current period

Ending funded status (pension benefit asset/liability)

Note that transition net assets/obligations are not listed as a reconciling item as these items arose from the application of SFAS No. 87, which had an effective date of December 1986. Any unamortized transition net asset/obligation will be recognized in accumulated other comprehensive income at the time of the initial application of SFAS No. 158. No further transition amounts will be incurred and reported in accumulated other comprehensive income.

Pension Accounting

Balance Sheet

Assets

Non current asset

Liabilities

Current liability
Noncurrent liability

Stockholder's Equity

Accumulated Other Comprehensive Income
Prior Service Cost
(Gains) Losses
Transition liability
Retained Earnings

Income Statement

Revenues

Expenses

S ervice
I nterest costs
R eturn on plan assets
A mortization of prior service costs
(G ain) / Loss amortization
E xisting liability

Net Income

- Expenses are computed on the income statement as the sum of six components that result in an increase to the Projected Benefit Obligation. **S I R A G E**
- Expenses are used as a component of income determination and will either increase the unfunded status (the liability) or decrease the over funded status (the asset).

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- Accumulated Other Comprehensive Income includes the most recently valued amounts for prior service costs, the unamortized amounts of cumulative gains and losses, and the unamortized amounts of the transition liabilities.
- Accumulated Other Comprehensive Income components are reduced by amortization. Amounts of amortization are determined using various rules.
- Amortized amounts are reclassified out of Accumulated Other Comprehensive Income and recognized as an expense.
- Fair presentation allows the sponsor to smooth expense determination and insulate profitability, however, the full unfunded status of the pension must be displayed and the impact of pension plan solvency shown on the balance sheet.

B. INCOME STATEMENT REPORTING FOR PENSION PLANS

SFAS No. 158 does not change the income statement reporting for pension plans. Net periodic pension cost is calculated as outlined.

C. COMPREHENSIVE EXAMPLE OF SFAS NO. 158 ACCOUNTING

At December 31, 20X7, Brown House, Inc. had the following pension-related information, given an average remaining employee service life of 20 years, an expected and actual return on plan assets of 10%, a discount rate of 8%, and a net loss incurred during 20X7 of $20,000:

	12/31/X6	12/31/X7
Fair value of plan assets	$ 200,000	$ 290,000
Projected benefit obligation	(1,450,000)	(1,636,000)
Funded status	$(1,250,000)	$(1,346,000)
Items not yet recognized as components of net periodic pension cost:		
Unrecognized prior service cost	$ 500,000	$ 475,000
Unrecognized net loss	525,000	526,000*
Unrecognized net transition obligation	100,000	95,000
	$ 1,125,000	$ 1,096,000

* The change in the net loss from 2006 to 2007 can be calculated as follows:

Beginning unrecognized net loss	$525,000
Less: Amortization of net loss	(19,000)
Plus: Net loss incurred in 2007	20,000
Ending unrecognized net loss	$526,000

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Expected benefit obligation – 20X8	$250,000
Service cost	$400,000
Interest cost	116,000
Return on plan assets	(20,000)
Amortization of prior service cost	25,000
Amortization of net (gain) loss	19,000
Amortization of existing net transition obligation	5,000
Net periodic benefit cost	$545,000

The company contributed $420,000 to the pension plan during 20X7.

Assume a 40% tax rate.

Brown should record the following journal entries related to its pension plan during 20X7:

DR	Pension benefit liability – noncurrent	$420,000	
CR	Cash		$420,000
To record the contribution to the pension plan during 20X7:			

DR	Other comprehensive income	$20,000	
DR	Deferred tax asset	$8,000	
CR	Deferred tax benefit – OCI		$8,000
CR	Pension benefit liability – noncurrent		$20,000
To record the net loss incurred during 20X7:			

DR	Net periodic pension cost	$496,000	
DR	Deferred tax asset	$198,400	
CR	Deferred tax benefit – income statement		$198,400
CR	Pension benefit liability – noncurrent		$496,000
To record pension liability and net periodic pension cost, net of tax, for the service cost of $400,000, interest cost of $116,000, and the return on plan assets of $20,000:			

DR	Net periodic pension cost	$25,000	
DR	Deferred tax benefit – OCI	$10,000	
CR	Deferred tax benefit – net income		$10,000
CR	Other comprehensive income		$25,000
To record net periodic pension cost and an increase in other comprehensive income, net of tax, for the 20X7 amortization of prior service cost:			

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To record net periodic pension cost and an increase in other comprehensive income, net of tax, for the 20X7 amortization of the net loss:

DR	Net periodic pension cost	$19,000	
DR	Deferred tax benefit – OCI	$7,600	
CR	Deferred tax benefit – net income		$7,600
CR	Other comprehensive income		$19,000

To record net periodic pension cost and an increase in other comprehensive income, net of tax, for the 20X7 amortization of the net transition obligation:

DR	Net periodic pension cost	$5,000	
DR	Deferred tax benefit – OCI	$2,000	
CR	Deferred tax benefit – net income		$2,000
CR	Other comprehensive income		$5,000

Brown's balance sheet at December 31, 20X7, will reflect the following:

Funded status – 12/31/X6	$(1,250,000)
+ Contributions	420,000
- Net loss incurred during 20X7	(20,000)
- Service cost/interest cost/return on plan assets	(496,000)
Funded status – 12/31/X7	$(1,346,000)
Accumulated OCI (before tax) – 12/31/X6	$(1,125,000)
Net loss incurred during 20X7	(20,000)
Amortization of prior service cost	25,000
Amortization of net loss	19,000
Amortization of net transition obligation	5,000
Accumulated OCI (before tax) – 12/31/X7	$(1,096,000)[a]

[a] Accumulated other comprehensive income is reported on an after-tax basis: $1,096,000 x (1 – 40%) = $657,600.

Additionally, assuming that Brown has no other transactions that affect comprehensive income, Brown's 2007 presentation of comprehensive income will include the following:

Other comprehensive income, net of tax	
Net loss incurred during 2007	$(12,000)
Prior service cost – amortization	15,000
Net loss – amortization	11,400
Net transition obligation – amortization	3,000
Other comprehensive income	$ 17,400

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D. MEASUREMENT DATE

SFAS No. 158 requires that the measurement date of the plan assets and benefit obligations of a defined benefit pension plan must be aligned with the date of the employer's balance sheet, with few exceptions. The deadline to implement this provision is fiscal years ending after December 15, 2008.

1. Exceptions

a. When a plan is sponsored by a subsidiary that has a different fiscal year-end from the parent company, then the subsidiary's plan assets and benefit obligations can be measured as of the subsidiary's balance sheet date.

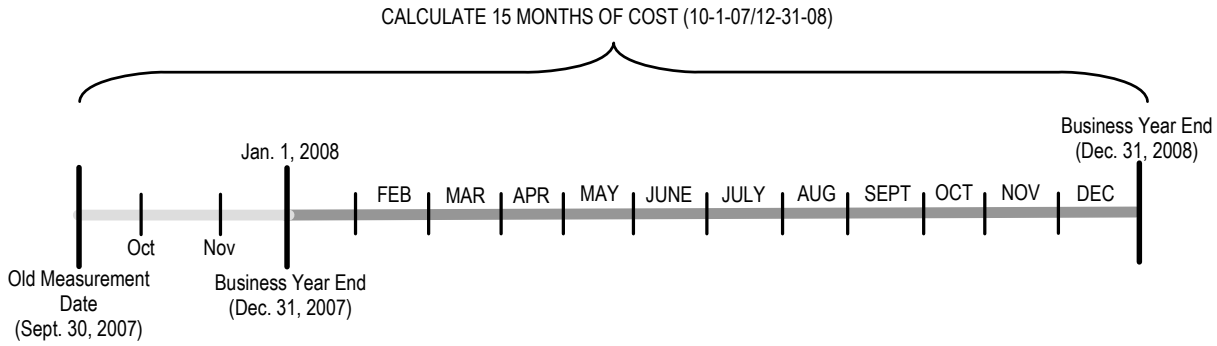
b. When a plan is sponsored by an equity method investee that has a different fiscal year-end from the investor's fiscal year-end, then the investee's plan assets and benefit obligations can be measured as of the date of the investee's financial statements used to apply the equity method.

PASS KEY

SFAS 158 provides two methods of transition for entities that have not used the balance sheet date as the measurement date of pension plan assets and obligations:

1. Dual measurement approach
2. The "15-month" approach

These approaches are explained in Appendix II.



IV. PENSION SETTLEMENT AND CURTAILMENT AND TERMINATION BENEFITS (SFAS 88)

A. SETTLEMENTS

SETTLEMENTS

Settlements occur when the pension plan assets increase in value to the point that sale of the pension plan assets allows a company to purchase annuity contracts to satisfy pension obligations. Remaining funds from the sale of assets may, with restrictions, be used by the corporation.

B. CURTAILMENTS

CURTAILMENTS

Curtailments are events that reduce the expected remaining years of service for present employees or eliminate accrual of defined benefits for future services of a significant number of employees.

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C. TERMINATION BENEFITS

Termination benefits arise when employees are paid to terminate their rights to future pension payments.

FORMULA:	Lump sum payments + PV Termination benefit Special Term Benefit

DR	Special term benefit expense	$XXX	
CR	Special term benefit liability		$XXX

V. OFF-BALANCE SHEET FOOTNOTE DISCLOSURES

There are extensive required pension plan footnote disclosures:

A. PENSION PLAN DISCLOSURES (SFAS 132, AS AMENDED BY SFAS NO. 158)

Required pension plan disclosures have been revised and simplified. The disclosure requirements are the same for pension plans and post-retirement benefits.

PASS KEY

For the CPA Examination, the rule of thumb is:

1. More disclosure is better than less disclosure.
2. Disclose as much as reasonably possible.

1. Reconciliations of Beginning and Ending Balances

a. Reconciliation of the beginning and ending balances of the benefit obligation, with separate disclosure of:

(1) Service cost

(2) Interest cost

(3) Contributions by plan participants

(4) Actuarial gains and losses

(5) Foreign currency exchange rate changes

(6) Benefits paid

(7) Plan amendments

(8) Divestitures

(9) Curtailments

(10) Settlements

(11) Special termination benefits

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b. Reconciliation of the beginning and ending balances of the fair value of plan assets, including the effects of:

(1) Actual return on plan assets

(2) Foreign currency exchange rate changes

(3) Contributions by employer

(4) Contributions by plan participants

(5) Benefits paid

(6) Business combinations

(7) Divestitures

(8) Settlements

2. Funding and Plan Assets

a. The funded status of the plan and the amounts recognized on the balance sheet, showing separately the assets and current and noncurrent liabilities recognized.

b. The amounts and types of securities included in plan assets.

c. The amount of future annual benefits of plan participation covered by plan contracts issued by the employer or related parties.

d. Any significant transactions between the employer or related parties and the plan during the year.

3. Components of Net Periodic Pension (Benefit) Cost

Amount of net periodic benefit cost recognized, showing separately:

a. Service cost component

b. Interest cost component

c. Expected return on plan assets for the period

d. The prior service cost component

e. The gain or loss component

f. The transition asset or obligation component

g. Amount of gain or loss recognized due to a settlement or curtailment

4. Impact on Other Comprehensive Income

The impact on OCI includes:

a. The net gain or loss and prior service cost recognized in other comprehensive income for the period, and reclassification adjustments of other comprehensive income for the period for the amortization of net gains and losses, prior service cost, and net transition asset or obligation to net periodic pension cost.

b. The amounts in accumulated other comprehensive income that have not been recognized in net periodic pension cost, showing separately the net gain or loss, prior service cost, and net transition asset or obligation.

c. The amounts in accumulated other comprehensive income expected to be recognized in net periodic pension cost during the next fiscal year, showing separately the net gain or loss, prior service cost, and net transition asset or obligation.

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5. Rates and Assumptions

On a weighted-average basis, the following assumptions used in accounting for the plan:

a. Assumed discount rate

b. Rate of compensation increased

c. Expected long-term rate of return on plan assets

6. Amortization Methods

Any alternative amortization method used to amortize prior service costs or net gains and losses pursuant to SFAS 87.

7. Assumptions and Commitments

a. Any substantive commitment (e.g., past practice or a history of regular benefit increases) used as the basis for accounting for the benefit obligation recognized during the period and a description of the nature of the event

b. An explanation of any significant change in the benefit obligation or plan asset not otherwise apparent in the above disclosures.

c. Disclosure of the estimated future contributions is not required.

8. Termination Benefits

The cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event.

9. Disclosure Requirements for Nonpublic Entities

Nonpublic entities are permitted to present less information, essentially eliminating the reconciliations required.

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POSTRETIREMENT BENEFITS

ACCOUNTING FOR POSTRETIREMENT BENEFITS OTHER THAN PENSIONS

SFAS 106 (As modified by SFAS 132)

I. INTRODUCTION

A. OVERVIEW

Many companies provide benefits to their employees after the employees have retired. These benefits include:

1. Health care insurance
2. Life insurance
3. Welfare benefits
4. Tuition assistance
5. Legal services
6. Day care

B. ACCRUAL REQUIREMENT

Accrue the cost of retiree health and other postretirement benefits if:

1. The obligation is attributable to employees' services already rendered;
2. The employees' rights accumulate or vest;
3. Payment is probable; and
4. The amount of the benefits can be reasonably estimated.

C. ACCOUNTING

1. GAAP Method

This cost must now be projected and accrued during the (but not necessarily the entire) period the employee works, called the "attribution period" (date hired to date fully eligible).

a. Steps in implementation include:

(1) Determining whether a plan exists.

(2) Projecting the obligation.

(3) Discounting the obligation to its present value.

(4) Accrual of the obligation over the employees' active period of working.

2. Non-GAAP Methods

Methods used in the past, but no longer acceptable, include:

a. Pay-as-you-go (cash basis)

b. Terminal accrual (accrue at retirement)

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II. DEFINITIONS

A. SUBSTANTIVE PLAN

The postretirement plan is called the substantive plan, which is what is understood by the company and the employees.

B. ACCUMULATED POSTRETIREMENT BENEFIT OBLIGATION (APBO)

The APBO is the present value of future benefits that have vested as of the measurement date. The APBO is discounted using an assumed discount rate.

1. This rate should reflect returns on high quality, fixed income investments.
2. The discount rate is used to determine the APBO, EPBO, and the service and interest cost components of net periodic postretirement benefit cost.

C. EXPECTED POSTRETIREMENT BENEFIT OBLIGATION (EPBO)

The present value of all future benefits expected to be paid as of the measurement date. It includes:

1. The amount that has vested (APBO),
2. Plus, the present value of expected future benefits that have not yet vested.

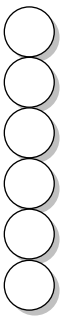
III. INCOME STATEMENT

A. INCOME STATEMENT APPROACH

Costs are allocated in a manner similar to pension costs.

1. The benefit-years-of-service approach is used. (The expected postretirement benefit obligation is attributed to each year of service in the attribution period.)
2. The postretirement benefit obligation is accrued during the period the employee works (the attribution period); generally beginning at the employee's date of hire, and ending at the full eligibility date.

B. INCOME STATEMENT FORMULA



CURRENT **S**ERVICE COST

INTEREST COST (on APBO)

<ACTUAL **R**ETURN>

AMORTIZATION OF PRIOR SERVICE COST

< **G**AINS > LOSSES

AMORTIZE / **E**XPENSE TRANSITION AMOUNT (NET OBLIGATION)

NET POSTRETIREMENT BENEFIT EXPENSE/COST

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C. COMPONENTS OF "NET POSTRETIREMENT BENEFIT COST"

PASS KEY

Postretirement benefits are "GREAT" too.

1. Service Cost

Service cost is the part of the EPBO arising from employee service this period.

2. Interest Cost

Interest cost is the increase in the APBO due to the passage of time. It is calculated as the beginning APBO multiplied by the discount rate, less benefit payments.

3. < Actual Return on Plan Assets >

Based upon fair value of plan assets at beginning and end of the period, adjusted for contributions and benefits payments.

4. Amortization of Prior-service Cost

Amortization of prior-service cost is the amortization of the cost of retroactive benefits.

5. < Gains > and Losses

Gains and losses result from the changes in APBO due to changes in assumptions or experience.

6. Amortization or Expense of the Transition Obligation

Amortization of the transition obligation is the amortization of the effect of adopting SFAS 106.

a. Transition to accrual accounting can be done one of two ways:

(1) Immediate expense recognition by recording the entire obligation in one year as the effect of a change in accounting principle.

(2) Delayed recognition by using straight-line amortization over the average remaining service period of active plan participants. If this period is less than 20 years, a 20-year amortization period may be elected.

Accumulated postretirement benefit obligation < Fair value of plan assets > Initial unfunded ÷ 20 years **OR** avg. employee job life (greater of) Minimum amortization **OR** Expense full amount	at adoption of SFAS 106

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PASS KEY

The two significant differences, you should remember for the CPA exam, are:

1. 20 years (instead of 15 years for pensions).
2. The option to expense the entire amount.

D. BALANCE SHEET PRESENTATION

Per SFAS No. 158, postretirement benefit plans are required to have the same balance sheet presentation as pension plans.

1. Funded Status

Companies must report the funded status of their postretirement benefit plan(s) on the balance sheet as an asset or a liability (or both). The funded status of a postretirement benefit plan is calculated using the following formula:

FORMULA:

Fair Value of Plan Assets
< APBO >
Funded Status

If a company has multiple postretirement benefit plans, the funded status of each plan is calculated separately.

a. Postretirement Benefit Plan Asset (Noncurrent)

A positive funded status (fair value of plan assets > APBO) indicates that the postretirement benefit plan is overfunded. For balance sheet reporting purposes, all overfunded postretirement benefit plans are aggregated and reported in total as a noncurrent asset.

b. Postretirement Benefit Plan Liability (Current, Noncurrent or Both)

A negative funded status (fair value of plan assets < APBO) indicates that the postretirement benefit plan is underfunded. All underfunded postretirement benefit plans are also aggregated and reported as a current liability, a noncurrent liability, or both. Underfunded postretirement benefit plans are reported as a current liability to the extent that the benefit obligation payable within the next 12 months exceeds the fair value of the plans' assets.

2. Accumulated Other Comprehensive Income

SFAS No. 158 requires that companies report postretirement benefit gains or losses, prior service costs, and transition net assets or net obligations in other comprehensive income when incurred. SFAS No. 158 also requires that the tax effects of these items be recognized in other comprehensive income, consistent with SFAS No. *109 – Accounting for Income Taxes*.

Postretirement benefit gains or losses, prior service costs and transition net assets or net obligations remain in accumulated other comprehensive income until recognized in net periodic postretirement benefit cost on the income statement through amortization.

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E. REQUIRED DISCLOSURES

Required disclosures are the same for pension plans and include:

1. For public companies:
   a. Reconciliations of beginning and ending balances of the:
      (1) Accumulated postretirement benefit obligation and
      (2) Fair value of plan assets.
   b. The funded status.
   c. The components of expense.
   d. The impact on other comprehensive income.
   e. The assumed discount rate.
   f. The assumed healthcare cost trend rate.
   g. The effect on the APBO, service cost, and interest cost of a 1% increase and a 1% decrease in the healthcare cost trend rate.
2. Non-public companies may elect simplified disclosures.
3. If an obligation cannot be accrued solely because the amount cannot be reasonably estimated, the financial statements should disclose that fact.
4. Required disclosures for postretirement benefits may not be combined with required disclosures about pension plans, except that the total amount of contributions for both purposes to a multi-employer plan may be combined.

PASS KEY

Remember our previous pass key on disclosures:

1. More disclosure is better than less disclosure.
2. Disclose as much as reasonably possible.

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ACCOUNTING FOR POSTEMPLOYMENT BENEFITS (SFAS 112)

I. DEFINITION

Postemployment benefits are paid by companies to former or inactive employees during the period after their employment and before their retirement. This is not the same as postretirement benefits.

II. POSTEMPLOYMENT BENEFITS

Postemployment benefits include the following employer-sponsored benefits:

A. Salary continuation

B. Severance benefits

C. Continuation of other fringe benefits (insurance)

D. Job training

E. Disability related—including workers' compensation

III. LIABILITY REPORTING CRITERIA (MUST MEET ALL FOUR)

A. The employer's obligation relating to employees' rights to receive compensation for future absences is attributable to services already rendered.

B. The obligation relates to rights that vest or accumulate.

C. Payment of the compensation is probable.

D. The amount can be reasonably estimated.

DR	Severance expense	$XXX	
CR	Severance liability		$XXX

IV. FOOTNOTE DISCLOSURE

When all four criteria are not met.

PASS KEY

CPA examination candidates should treat this issue in a similar manner to contingencies.

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ESTIMATED LIABILITY (VS. ACCRUED LIABILITY)

I. ESTIMATED LIABILITY

A. An estimated liability represents recognition of a probable future charge that results from a prior act, such as "estimated liability for warranties," trading stamps, or coupons.

II. ACCRUED LIABILITY

A. An accrued liability (accrued expense) represents an expense recognized or incurred (through passage of time or other criteria) but not yet paid (e.g., accrued interest, accrued wages, accrued unemployment taxes, and accrued employer's portion of FICA taxes).

Note to students: Please see the *Homework Reading* at the back of this chapter.

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CONTINGENCIES (SFAS 5)

I. GENERAL

A contingency is an existing condition, situation, or set of circumstances involving varying degrees of uncertainty that may result in the increase or decrease in an asset or the incurrence or avoidance of a liability. This condition is known as a "gain contingency" or a "loss contingency." The existence or absence of the impaired asset or liability (in the case of a loss contingency) is proven by subsequent events. Examples of loss contingencies are:

A. Collectibility of receivables.

B. Obligations regarding product warranties and defects and unredeemed coupons.

C. Risk of loss of property by fire, explosion, or other hazards.

D. Threat of expropriation of assets.

E. Pending or threatened litigation.

F. Actual or possible claims and assessments.

G. Risk of loss from catastrophes assumed by property and casualty insurance companies.

H. Guarantees of indebtedness of others.

I. Obligations of commercial banks under standby letters of credit.

J. Agreements to repurchase receivables (or related property) that have been sold.

K. Environmental damages.

II. CLASSIFICATION OF CONTINGENCIES

GAAP classifies contingencies as follows:

A. Probable: likely to occur.

B. Reasonably possible: more than remote, but less than likely.

C. Remote: slight chance of occurring.

III. LOSS CONTINGENCIES

A. LOSS IS PROBABLE AND CAN BE REASONABLY ESTIMATED

Provision for a loss contingency should be accrued by a charge to income, providing that both of the following conditions exist:

1. It is probable that as of the date of the financial statements an asset has been impaired or a liability incurred, based on information available prior to the issuance of the financial statements.

2. The amount of loss can be reasonably estimated.

   In the event that a range of probable losses is given (e.g., $100,000 to $250,000), GAAP requires that the best estimate of the loss be accrued. If no amount in the range is a better estimate than any other amount within the range, the minimum amount in the range should be accrued (in this case $100,000), and a note disclosing the possibility of an additional $150,000 loss should be presented.

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B. LOSS IS REASONABLY POSSIBLE

In the event that both of the conditions above are not met, a financial statement disclosure shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.

1. Disclose the nature of contingency, and
2. Disclose the nature of the possible loss or range of loss or that an estimate cannot be made.

C. LOSS IS REMOTE

Generally, no disclosure is necessary for a remote loss contingency; however, disclosure (nature, amount of guarantee, and any expected recovery) should be made for "guarantee type" remote loss contingencies such as:

1. **D**ebts of others guaranteed (officers/related parties)
2. **O**bligations of commercial banks under standby letters of credit, and
3. **G**uarantees to repurchase receivables (or related property) that have been sold or assigned.

D. UNASSERTED CLAIMS

If it is probable that an unasserted claim will be filed, then it is treated similarly to any other loss contingency (i.e., accrue if the loss is probable and the amount can be reasonably estimated). If the loss contingency is reasonably possible, disclosure is required. If the loss contingency is remote, then no disclosure is required.

E. GENERAL OR UNSPECIFIED BUSINESS RISKS

1. General or unspecified business risks (such as fire, floods, strikes, and war) do not meet the conditions for accrual, and no loss accrual shall be made (nor is disclosure required).

F. APPROPRIATION OF RETAINED EARNINGS

1. Any appropriation of retained earnings (such as for general loss contingencies) must be shown within the stockholders' equity section and clearly identified.
2. Costs or losses shall not be charged to an appropriation of retained earnings, and no part of the appropriate shall be transferred to income.
3. Any appropriation should be restored to retained earnings as soon as its purpose is no longer deemed necessary.

G. SUBSEQUENT EVENTS

If both conditions are not met because an asset was impaired or a liability incurred after the date of the financial statements but not before issuance:

1. Disclosure may be necessary for the financial statements not to be misleading.
2. Occasionally, where the amount of the asset impairment or liability incurrence can be reasonably estimated, disclosure may be best made by supplementing the historical financial statements with pro-forma financial data (usually balance sheet only), giving effect to the loss as if it had occurred at the date of the financial statements.

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IV. GAIN CONTINGENCIES

A. FINANCIAL STATEMENTS

Contingencies that might result in gains usually are not reflected in the accounts because to do so may cause recognition of revenue prior to its realization (conservatism).

B. DISCLOSURES

Adequate disclosure shall be made of contingencies that might result in gains, but be careful to avoid misleading implications as to the likelihood of realization.

CONTINGENCY TREATMENTS				
	Accrue Amounts	Disclose Amt	Disclose Nature	Ignore
1. LOSS contingency that is probable and:				
a. Amount or range can be reasonably estimated	X (or minimum)		X	
b. Amount cannot be reasonably estimated		Range	X	
2. LOSS contingency that is a reasonable possibility		Range	X	
3. LOSS contingency that is remote				X
a. Loss contingency that is remote, but is guarantee for others		X	X	
4. GAIN contingencies that are probable or reasonably possible		X	X	
5. GAIN contingencies that are remote				X*
*Rule of conservatism				

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ACCOUNTING FOR INCOME TAXES

I. OVERVIEW

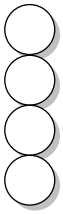
DEFERRED TAXES -- INCOME TAXES

Accounting for income taxes involves both intraperiod and interperiod tax allocation. Intraperiod allocation matches a portion of the provision for income tax to the applicable components of net income and retained earnings.

Income for federal tax purposes and financial accounting income frequently differ. Obviously, income for federal tax purposes is computed in accordance with the prevailing tax laws, whereas financial accounting income is determined in accordance with GAAP. Therefore, a company's income tax expense and income taxes payable may differ. The incongruity is caused by temporary differences in taxable and/or deductible amounts and requires interperiod tax allocation.

II. INTRAPERIOD TAX ALLOCATION

Intraperiod tax allocation involves apportioning the total tax provision for financial accounting purposes in a period between the income or loss from:



1. Income from continuing operations,
2. Discontinued operations,
3. Extraordinary items,
4. Accounting principle change (retrospective)
5. Other comprehensive income
   - a. Pension funded status change
   - b. Unrealized gain/loss on available for sale security
   - c. Foreign translation adjustment
   - d. Effective portion of cash flow hedge
6. Components of stockholders' equity
   - a. Retained earnings for prior period adjustments and accounting principle changes (retrospective), and
   - b. Items of accumulated (other) comprehensive income

A. GENERAL RULE

Any amount not allocated to continuing operations is allocated to other income statement items, other comprehensive income, or to shareholders' equity in proportion to their individual effects on income tax or benefit for the year. Such items (e.g., discontinued operation, extraordinary items, etc.) are shown net of their related tax effects.

The amount of income tax expense (or benefit) allocated to continuing operations is the tax effect of pretax income or loss from continuing operations plus or minus the tax effects of changes in:

1. Tax laws or rates,
2. Expected realization of a deferred tax asset, and the
3. Tax status of the entity.

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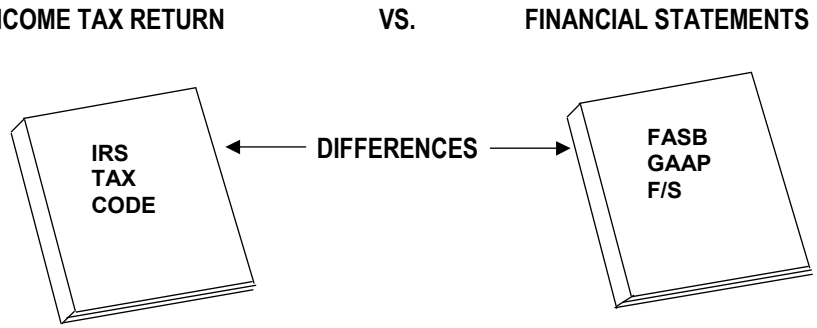
III. COMPREHENSIVE INTERPERIOD TAX ALLOCATION



A. OBJECTIVE

The objective of interperiod tax allocation is to recognize through the matching principle the amount of current and future tax related to events that have been recognized in financial accounting income.

1. Current Year Taxes:
   a. Payable (liability) or
   b. Refundable (asset)
2. Future Year Taxes:
   a. Deferred tax liability, or
   b. Deferred tax asset/benefit

B. DIFFERENCES

There are two types of differences between pretax GAAP financial income and taxable income. All differences are either permanent differences or temporary differences.

1. Permanent Differences

a. Permanent differences do not affect the deferred tax computation. They only affect the current tax computation. These differences affect only the period in which they occur. They do not affect future financial or taxable income.

b. Permanent differences are items of revenue and expense that either:
   (1) Enter into pretax GAAP financial income, but never enter into taxable income (e.g., interest income on state or municipal obligations), or
   (2) Enter into taxable income, but never enter into pretax GAAP financial income (e.g., dividends received deduction).

2. Temporary Differences

a. Temporary differences affect the deferred tax computation.

b. Temporary differences are items of revenue and expense that may:
   (1) Enter into pretax GAAP financial income in a period before they enter into taxable income.
   (2) Enter into pretax GAAP financial income in a period after they enter into taxable income.

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C. COMPREHENSIVE ALLOCATION

LIABILITY METHOD

The asset and liability (sometimes referred to as the Balance Sheet Approach) method is required by GAAP for comprehensive allocation. Under comprehensive allocation, interperiod tax allocation is applied to all temporary differences. The asset and liability method requires that either income taxes payable or a deferred tax liability (asset) be recorded for all tax consequences of the current period.

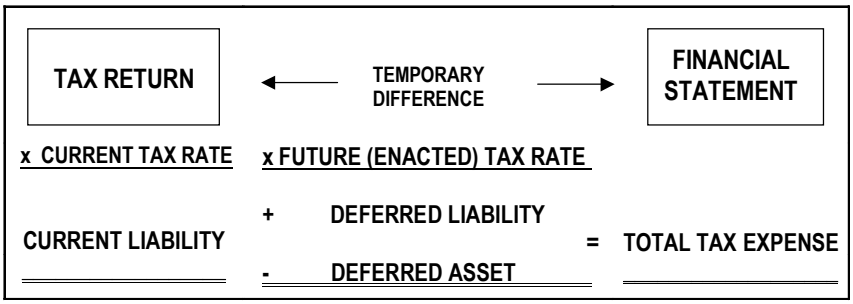
1. Temporary differences are recognized for GAAP purposes before or after they are recognized for tax purposes; the related income tax effect will be recognized for GAAP purposes before or after it is recognized for tax purposes.
   a. Items that are first recognized for tax purpose will eventually be recognized for GAAP purposes (or vice versa), therefore, the differences are temporary and will eventually "turn around."
   b. These temporary differences affect future period(s) and require that:
      (1) A liability (for future taxable amounts), or
      (2) An asset (for future deductible amounts)

      Should be recognized in the financial statement until the difference turns around completely.

D. ACCOUNTING FOR INTERPERIOD TAX ALLOCATION

1. Total income tax expense (GAAP income tax expense) or benefit for the year is the sum of:
   a. Current income tax expense/benefit, and
   b. Deferred income tax expense/benefit.
2. Current income tax expense/benefit is equal to the income taxes payable or refundable for the current year, as determined on the corporate tax return (Form 1120) for the current year.
3. Deferred income tax expense/benefit is equal to the change in deferred tax liability or asset account on the balance sheet from the beginning of the current year to the end of the current year (called the "Balance Sheet Approach").
4. Thus, total income tax expense/benefit can be depicted as follows:

Current income tax payable or refundable as determined on the corporate tax return	±	Change in the deferred income tax asset or liability from the beginning to the end of the reporting period	=	Total income tax expense or benefit



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PASS KEY

Total tax expense for financial statements is the combination of current tax plus/minus deferred taxes.

The CPA examiners frequently provide an incorrect calculation of financial statement income times the current tax rate. This is an incorrect method to determine the total expense for the following reasons:

- Use of financial statement income (which has permanent differences) is incorrect
- Use of the current tax rate ignores future changes to the enacted rate

IV. PERMANENT DIFFERENCES

A permanent difference is a transaction that affects only income per books or taxable income, but not both. Income tax expense for a period is calculated only on taxable items. For example, tax-exempt interest (municipal and state bonds) is included in financial income, but is excluded in computing income tax expense.

In effect, permanent differences create a discrepancy between taxable income and financial accounting income that will never reverse.

A. NO DEFERRED TAXES

Because they do not reverse themselves, no interperiod tax allocation is necessary for permanent differences. The income tax provision for financial accounting purposes is computed on the basis of pretax book income adjusted for all permanent differences.

B. EXAMPLES

Permanent differences are either (a) nontaxable, (b) nondeductible, or (c) special tax allowances. Examples are:

1. Tax-exempt interest (municipal, state);
2. Life insurance proceeds on officer's key man policy;
3. Life insurance premiums when corporation is beneficiary;
4. Certain penalties, fines, bribes, kickbacks, etc.;
5. Nondeductible portion of meal and entertainment expense;
6. Dividends-received deduction for corporations; and
7. Excess percentage depletion over cost depletion.

PASS KEY

Investment interest expense is limited to net (taxable) investment income.

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EXAMPLE

Permanent Differences

ABC Company reported $200,000 of pretax financial income. Included in this income was $10,000 of life insurance premiums for policies on which the corporation is the beneficiary and interest income on municipal bonds of $50,000.

What should ABC Company report on the income statement for federal taxes, assuming a 30% tax rate?

TAX RETURN		TEMPORARY DIFFERENCES	INCOME STATEMENT	
Income	$160,000		Income	$160,000
Muni. int.	-0-	← PERMANENT →	Muni. int.	50,000
Life Ins. Prem.	-0-	← PERMANENT →	Life Ins. Prem.	(10,000)
Taxable income	$160,000		Pre-tax Financial Income	$200,000

B A S E

x 30%		x 30%		
$48,000	+	-0-	=	$48,000

Note that there are no deferred taxes resulting from temporary differences, and that the income tax expense and the income tax liability are the same.

Journal Entry: To record income tax expense and income tax liability

DR	Income tax expense	$48,000	
CR	Income tax payable		$48,000

V. TEMPORARY DIFFERENCES

Temporary differences are the differences between the tax basis of an asset or liability and its reported amount in the financial statement that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively.

A. TRANSACTIONS THAT CAUSE TEMPORARY DIFFERENCES

There are four basic causes of temporary differences, which reverse in future periods.

1. Revenues or gains that are included in taxable income, after they have been included in financial accounting income, which results in a deferred tax liability.
2. Revenues or gains that are included in taxable income, before they are included in financial accounting income, which results in a deferred tax asset.

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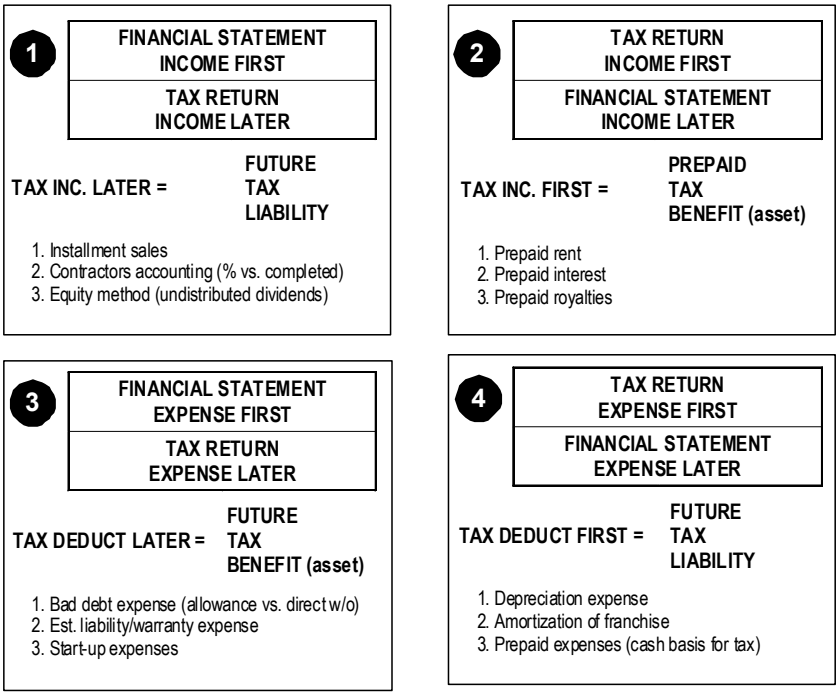
3. Expenses or losses deducted from taxable income, after they have been deducted from financial accounting income, which results in a deferred tax asset.

4. Expenses or losses deducted for taxable income, before they are deducted from financial accounting purposes, which results in a deferred tax liability.



5. Additional causes of temporary differences are:

   a. Differences between the financial reporting and tax basis of assets and liabilities arising in a business combination accounted for as a purchase.

   b. Differences in the tax basis of assets due to indexing, whenever the local currency is the functional currency.

B. DEFERRED TAX LIABILITIES AND ASSETS RECOGNITION

1. Deferred Tax Liabilities

Deferred tax liabilities are anticipated future tax liabilities derived from situations where future taxable income will be greater than future financial accounting income due to temporary differences. All deferred tax liabilities are recognized on the balance sheet.

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EXAMPLE

Temporary Differences

Stone Co. began operations in Year 2 and reported $225,000 in financial income for the year. Stone Co.'s Year 2 tax depreciation exceeded its book depreciation by $25,000. Stone's tax rate for Year 2 and years thereafter was 30%. In its December 31, Year 2, balance sheet, what amount of deferred income tax liability should Stone report?

TAX RETURN	TEMPORARY DIFFERENCE	FINANCIAL STATEMENT
Taxable Income $200,000	$25,000	Pre-tax Financial Income $225,000
x 30%	x 30%	
$60,000	+ $7,500	= $67,500

The excess depreciation on the tax return results in a future liability, a financial accounting expense in future years that will not be deductible in future years since it was deducted in Year 2. This is because less depreciation will be deducted on the tax return in future years, compared to the financial statements. This yields a future taxable income which will be greater than the future financial accounting income.

Journal Entry: To record the taxes

DR	Income tax expense — current	$60,000	
DR	Income tax expense — deferred	7,500	
CR	Deferred tax liability		$ 7,500
CR	Income tax payable		60,000

The provision for income taxes in the income statement for the current period would appear as follows:

Provision for income taxes	
Current	$60,000
Deferred	7,500
Total provision for income taxes	$67,500

Total income tax expense for financial accounting purposes is the net of income tax payable and any changes in the deferred tax asset and deferred tax liability accounts.

2. Deferred Tax Assets

Deferred tax assets arise when the amount of taxes paid in the current period exceeds the amount of income tax expense in the current period. They are anticipated future benefits derived from situations where future taxable income will be less than future financial accounting income due to temporary differences.

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3. Valuation Allowance (Contra Account)

VALUATION ALLOWANCE

If it is more likely than not (a likelihood of more than 50 percent) that part or all of the deferred tax asset will not be realized, a valuation allowance is recognized. The net deferred tax asset should equal that portion of the deferred tax asset that, based on available evidence, is more likely than not to be realized.

EXAMPLE

Deferred Tax Asset

Black Co., organized on January 2, Year 1, had pretax accounting income of $500,000 and taxable income of $800,000 for the year ended December 31, Year 1. The enacted tax rate for all years is 30%. The only temporary difference is accrued product warranty costs which are expenses to be paid as follows:

Year 2, $100,000; Year 3, $100,000; Year 4, $100,000.

TAX RETURN	TEMPORARY DIFFERENCE	FINANCIAL STATEMENT
Taxable Income $800,000	← $300,000 →	Pre-tax Financial Income $500,000

x 30%		x 30%		
$240,000	-	$90,000	=	$150,000

Journal Entry: To record the taxes

DR	Deferred tax asset	$ 90,000	
DR	Income tax expense	150,000	
CR	Income tax payable		$240,000

EXAMPLE

Valuation Account

Black expects to have taxable income of $100,000 in Year 2, but no taxable income after. The deferred tax asset would be limited to the amount to be realized in Year 2 ($30,000 = $100,000 x 30%). A deferred tax asset of $90,000 would be recognized, but a valuation account of $60,000 would result in a net deferred tax asset of $30,000.

Journal Entry:

DR	Deferred tax asset	$ 90,000	
DR	Income tax expense ($150,000 + $60,000)	210,000	
CR	Deferred tax asset valuation allowance		$ 60,000
CR	Income tax payable		240,000

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EXAMPLE

Temporary vs. Permanent Differences

Foxy Inc.'s financial statement and taxable income for Year 1 follows:

(Income before the effect of tax-related differences was $140,000)

FINANCIAL STATEMENT PRE-TAX INCOME			$115,000
Differences:	Muni. interest income		(12,000)
	Penalty expense		7,000
	Tax depreciation	$40,000	
	Book depreciation	(30,000)	
	Excess tax depreciation		(10,000)
INCOME TAX RETURN			$100,000

The enacted tax rate is 40% for this year and future years.

TAX RETURN		TEMPORARY DIFFERENCES		INCOME STATEMENT	
Income	$140,000			Income	$140,000
Muni. int.	-0-	← PERMANENT	→	Muni. int.	12,000
Penalty	-0-	← PERMANENT	→	Penalty	(7,000)
	$140,000				$145,000
Depr.	(40,000)	← $10,000	→	Depr.	(30,000)
Taxable income	$100,000			Pre-tax Financial Income	$115,000

B A S E

x 40%		x 40%		
$40,000	+	$4,000	=	$44,000

Journal Entry:

DR	Income tax expense—current	$40,000	
DR	Income tax expense—deferred	4,000	
CR	Income taxes currently payable		$40,000
CR	Deferred tax liability		4,000

C. UNCERTAIN TAX POSITIONS (FIN 48)

"An uncertain tax position is defined as some level of uncertainty of the sustainability of a particular tax position taken by a company. FIN 48 will require a more-likely-than-not level of confidence before reflecting a tax benefit in an entity's financial statements."

1. Scope

Applies to all tax positions within the scope of Statement 109. A tax position is a filing position that an enterprise has taken or expects to take on its tax return.

a. A tax deduction is the most common type of tax position.

b. A decision to not file a tax return.

c. An allocation or shift of income between jurisdictions.

d. The characterization of income, or a decision to exclude reporting taxable income, in a tax return.

e. A decision to classify a transaction, entity, or other position in a tax return as tax exempt.

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2. The Two-Step Approach

a. Step 1: Recognition of the Tax Benefit

(1) Test "more-likely-than-not"

Threshold that must be met before a tax benefit can be recognized in the financial statements.

(a) Assessment: If a dispute with the taxing authority were taken to the court of last resort.

(2) Threshold Considerations

(a) Based on the technical merits of the position.

(b) Presume that the relevant taxing authority will examine the tax position and has full knowledge of all relevant information.

(c) Each tax position should be evaluated separately.

(3) Test Failed

(a) Tax benefit is not recognized in the financial statements.

(b) Financial statement tax expense is increased.

b. Step 2: Measurement of the Tax Benefit

(1) Recorded Amount

(a) Recognize the largest amount of tax benefit that has greater than 50 percent likelihood of being realized upon ultimate settlement with the taxing authority.

(b) Tax position based on clear and unambiguous tax law – recognize the full benefit in the financial statements.

PASS KEY

STEP 1: The evaluation is based on the expected outcome in the court of last resort.

STEP 2: The evaluation is based on the expected outcome in a settlement with the taxing authority.

EXAMPLE

Foxy, Inc. prepared their 20X1 tax return. Foxy, Inc. has taken a tax deduction for $1,000 that results in a $400 tax savings/benefit (40% tax rate). Foxy, Inc. believes that there is a greater than 50% chance that, if audited, the tax deduction would be sustained as filed (the tax deduction meets the "more-likely-than-not" test). However, Foxy, Inc. concludes that if challenged, they would negotiate a settlement. The following is their assessment of outcomes:

Potential Outcomes	Probability	Cumulative Probability
$400 savings	26%	26
$300 savings	25%	51 >50%
$200 savings	21%	72
$100 savings	18%	90
$0 savings	10%	100

RESULT

- Based on Foxy, Inc.'s assessment of possible outcomes, Foxy, Inc. should recognize a tax savings/benefit of $300.
- This amount represents the largest benefit that has a greater than 50% likelihood of being realized.
- Accordingly, Foxy, Inc. must record a $100 (FIN 48) income tax liability.

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D. ENACTED TAX RATE

ENACTED RATE -- CHANGE IN TAX RATE

Measurement of deferred taxes is based on the applicable tax rate. This requires using the enacted tax rate expected to apply to taxable items (temporary differences) in the periods the taxable item is expected to be paid (liability) or realized (asset).

PASS KEY

Use the tax rate in effect when the temporary difference reverses itself. Do not allow the CPA examiners to trick you into using the following tax rates:

- Anticipated
- Proposed
- Unsigned

E. TREATMENT OF AND ADJUSTMENT FOR CHANGES

1. Changes in Tax Laws or Rates

The liability method requires that the deferred tax account balance (asset or liability) be adjusted when the tax rates change. Thus if future tax rates have been enacted, not just proposed or estimated, the deferred tax liability and asset accounts will be calculated using the appropriate enacted future effective tax rate.

Changes in tax laws or rates are recognized in the period of change (enactment).

a. The amount of the adjustment is measured by the change in applicable laws/rates applied to the remaining cumulative temporary differences.

b. The adjustment enters into income tax expense for that period as a component of income from continuing operations.

2. Change in the Valuation Allowance

A change in circumstances that causes a change in judgment about the ability to realize the related deferred tax asset in future years should be recognized in income from continuing operations in the period of the change.

3. Change in the Tax Status of an Enterprise

a. An entity's tax status may change from taxable to nontaxable (e.g., corporation to partnership) or from nontaxable to taxable (S-corporation to C-corporation).

b. At the date a nontaxable entity becomes a taxable entity, a deferred tax liability or asset should be recognized for any temporary differences.

c. At the date a taxable entity becomes a nontaxable entity, any existing deferred tax liability or asset should be eliminated (written off).

d. The effect of recognizing or eliminating a deferred tax liability or deferred tax asset should be included in income from continuing operations in the period of the change.

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EXAMPLE

Temporary Differences and Different Tax Rates (for Future Years)

Stone Co. began operations in Year 2 and reported $225,000 in income before income taxes for the year. Stone's Year 2 tax depreciation exceeded its book depreciation by $25,000. Stone's tax rate for Year 2 was 30%, and the enacted rate for years after Year 2 is 25%. In its December 31, Year 2, balance sheet, what amount of deferred income tax liability should Stone report?

x 30%		x 25%		
$60,000	+	$6,250	=	$66,250

DR	Income tax expense—current	$60,000	
DR	Income tax expense—deferred	6,250	
CR	Deferred tax liability		$ 6,250
CR	Income tax payable		60,000

F. NET TEMPORARY ADJUSTMENT (FROM BEGINNING BALANCE)

The deferred tax account is adjusted for the change in deferred taxes (asset or liability), due to the current year's events. The income tax expense/benefit – deferred is the difference between the beginning balance in the deferred tax account and the properly computed ending balance in the account.

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EXAMPLE

EXAMPLE

Julie Co. had previously recorded temporary differences of $10,000. The enacted rate in the year the temporary differences originated was 20%. The deferred tax liability has a beginning balance of $2,000 ($10,000 x 20%). For the current year, taxable income is $100,000 and financial statement income is $120,000. The $20,000 difference is a temporary difference caused by depreciation. The newly enacted rate for the current and future periods is 30%. The previously recorded temporary differences have not yet reversed.

TAX RETURN	TEMPORARY DIFFERENCES	FINANCIAL STATEMENT
	$10,000 (Beg)	
Taxable Income $100,000	$20,000 →	Pre-tax Financial Income $120,000
	$30,000	
x 30%	x 30%	
	$9,000	
	<2,000> (Beg)	
$30,000	+ $7,000	= $37,000

B A S E

Journal Entry: To record the taxes

DR	Income tax expense—current	$30,000	
DR	Income tax expense—deferred	7,000	
CR	Deferred tax liability		$ 7,000
CR	Income tax payable		30,000

G. BALANCE SHEET PRESENTATION

1. Deferred tax liabilities and assets should be classified and reported as a current amount and a noncurrent amount on the balance sheet.

   a. Deferred tax items should be classified based on the classification of the related asset or liability for financial reporting. For example:

      (1) A deferred tax asset that relates to product warranty liabilities (accrued expenses) would be classified as "current" because warranty obligations are part of the current operating cycle.

      (2) A deferred tax liability that relates to asset depreciation (fixed assets) would be classified as "noncurrent" because the related assets are noncurrent.

   b. Deferred tax items not related to an asset or liability should be classified (e.g., current or noncurrent) based on the expected reversal date of the temporary difference. Such items include:

      (1) Deferred tax assets related to carry forwards,

      (2) Organization costs expensed for GAAP financial income (no asset) but deducted in later years for tax purposes, and

      (3) Percentage completion method used for contracts for GAAP financial income (no asset or liability) but completed contract method used for tax purposes.

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c. All deferred tax assets and liabilities classified as current must be offset (netted) and presented as one amount (a net current asset or a net current liability).

d. All deferred tax liabilities and assets classified as noncurrent must be offset (netted) and presented as one amount (a net noncurrent asset or a net noncurrent liability).

e. Any valuation allowance for a deferred tax asset should be allocated pro rata to current and noncurrent deferred assets.

PASS KEY

Always remember to net across (the balance sheet) not up and down (the balance sheet).

VI. OPERATING LOSSES

Under the present tax law, an operating loss of a period may be carried back two years or forward twenty years and be applied as a reduction of taxable income in those periods as permitted by the tax laws. An election must be made in the year of loss to either (1) carryback the portion of the loss that can be absorbed by the prior years' taxable income, and carryforward any excess, or (2) carryforward the entire loss. Taxable income and financial accounting income will differ for the periods to which the loss is carried back or forward.

A. OPERATING LOSS CARRYBACKS

The tax effects of any realizable loss carryback should be recognized in the determination of the loss period net income. A claim for refund of past taxes is shown on the balance sheet as a separate item from deferred taxes. This income tax refund receivable is usually classified as current.

1. Tax carrybacks that can be used to reduce taxes due or to receive a refund for a prior period are a tax benefit (asset) and should be recognized (to the extent they can be used) in the period they occur.

Journal Entry: A current net operating loss that can be used to obtain a refund of $30,000 taxes previously paid would be recorded as:

DR	Tax refund receivable	$30,000	
CR	Tax benefit*		$30,000

* This is a reduction of the book loss (not a contra-expense)

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B. OPERATING LOSS CARRYFORWARDS

If an operating loss is carried forward, the tax effects are recognized to the extent that the tax benefit is more likely than not to be realized.

1. Tax carryforwards should be recognized as deferred tax assets (because they represent future tax savings) in the period they occur.
   a. NOL carryforwards should be "valued" using the enacted (future) tax rate for the period(s) they are expected to be used.
   b. Tax credit carryforwards should be "valued" at the amount of tax payable to be offset in the future.

      Journal Entry: A current net operating loss of $100,000 (which is not and cannot be used as a tax carryback) is carried forward to be used in a period for which the current enacted tax rate is 40%. The deferred tax benefit would be recorded as:

DR	Deferred tax asset	$40,000	
CR	Tax benefit*		$40,000

      * This is a reduction of the book loss (not a contra-expense)

   c. The deferred tax asset (DR) will reduce tax payable in a future period.
   d. The tax benefit (CR) would reduce the net operating loss of the current period.

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CONCEPT EXERCISE

CONCEPT EXERCISE: Net Operating Loss Carrybacks and Carryforward

The pretax financial accounting income and taxable income of ABC Company were the same for each of the following years. No temporary or permanent differences exist.

	Income	*Enacted Rates*
Year 1	$10,000	30%
Year 2	15,000	30%
Year 3	6,000	30%
Year 4	5,000	35%
Year 5 (current year)	(60,000)	35%
Year 6 (next year – expected)	4,000	40%
Year 7 & forward	– 0 –	40%

Assuming ABC elects to use the 2-year carryback/20 carryforward option and that it is more likely than not that there will be no taxable earnings after Year 6, what is the journal entry to record the Year 5 income taxes? How will income taxes be presented in the income statement and balance sheet?

NOL

Year 5 Net operating loss (NOL)		$ 60,000
NOL carryback:		
Year 3 (2 year carryback)	$ 6,000	
Year 4 (1 year carryback)	5,000	(11,000)
NOL carryforward to Year 6 and future years		$ 49,000

Carryback

Income Tax Receivable:	
Year 3 ($6,000 x 30%)	$ 1,800
Year 4 ($5,000 x 35%)	1,750
Income tax refund receivable	$ 3,550

Carryforward

[a] Deferred Tax Asset (NOL Carryforward Benefit):

Year 6 and future years ($49,000 x 40%)	$ 19,600

[b] Deferred Tax Asset Valuation Allowance:

NOL carryforward	$ 49,000	
Less: Year 6 income	(4,000)	
Carryforward that will not be used	$ 45,000	
Tax rate (enacted)	x 40%	
Deferred tax asset valuation allowance		$ 18,000
Net realizable deferred tax asset (A – B)		$ 1,600

Journal Entry

To record income taxes for Year 5

DR	Income tax refund receivable	[a] $ 3,550		
DR	Deferred tax asset	[b] 19,600		
CR	Deferred tax asset valuation allowance		[c] $18,000	
CR	Income tax benefit (residual)		5,150	

INCOME STATEMENT
YEAR 5

Income Tax Benefit	
Current	$ 3,550
Deferred (net)	1,600
	$ 5,150

BALANCE SHEET
YEAR 5

Current Assets		
Inc. tax ref. rec.		$ 3,550
Deferred tax asset	$ 19,600	
Less: val. allow.	<18,000>	1,600
		$ 5,150

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VII. INVESTEE'S UNDISTRIBUTED EARNINGS

A. INCOME TAX RETURN

Taxable income is the dividend received. There is a dividend received deduction (exclusion) based upon the percentage of ownership in the stock of the other corporation:

1. Ownership 0-19%: 70% exclusion
2. Ownership 20%-80%: 80% exclusion
3. Ownership over 80%: 100% exclusion

B. GAAP FINANCIAL STATEMENT

Report percentage of investee's income using the equity method for an investment between 20% and 50%.

C. TEMPORARY DIFFERENCE

It should be presumed that all undistributed earnings will ultimately be distributed to the investor/parent at some future time (REVERSE). Financial statement income of investee claimed by investor/parent as earning is greater than actual dividends received from the investee that are claimed on the tax return.

EXAMPLE

EXAMPLE

Facts:

- 25% owned investee (GAAP requires use of equity method)
- Investee's net income $2,400,000 ($600,000 = GAAP income) ← (TEMPORARY)
- Investee's dividends $2,000,000 ($500,000 = tax return) ←
- Tax return: Dividend received deduction (exclusion) is 80% (PERMANENT)
- Tax rate is 40%

TAX RETURN			INCOME STATEMENT	
Investee div Income	$500,000	←TEMP & PERM→	Equity in Earnings	$600,000
80% Exclusion	(400,000)	← (PERM) →		(480,000)
Taxable	$100,000	← $20,000 →		$120,000
	x 40%	x 40%		
	$40,000	+ $8,000 =		$ 48,000

Journal Entry:

DR	Income tax expense — current	$40,000	
DR	Income tax expense — deferred	8,000	
CR	Income taxes currently payable		$40,000
CR	Deferred tax liability		8,000

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VIII. INTERPERIOD AND INTRAPERIOD DISCLOSURES

A. BALANCE SHEET DISCLOSURES

1. The components of a net deferred tax liability or asset should be disclosed, including the total of:
    a. All deferred tax liabilities,
    b. All deferred tax assets, and
    c. The valuation allowance for deferred tax assets.
2. Other balance sheet disclosures include:
    a. The net change during the year in the total valuation allowance, and
    b. The tax effect of each type of temporary difference and carryforward that is significant to the deferred tax liability or asset.

B. INCOME STATEMENT DISCLOSURES

1. The amount of income tax expense (or benefit) allocated to continuing operations and the amount(s) separately allocated to other item(s) must be disclosed.
2. The significant components of income tax expense attributable to continuing operations must be disclosed. These include:
    a. Current tax expense or benefit,
    b. Deferred tax expense or benefit,
    c. Investment tax credits,
    d. Government grants (that cause a reduction of income tax expense),
    e. Benefits of NOL carryforwards,
    f. Tax expense allocated to shareholders' equity items,
    g. Adjustments of deferred taxes from changes in tax laws or rates, and
    h. Adjustments of the beginning-of-the-year deferred tax asset valuation due to changes in expectations.
3. The tax benefit of an operating loss carryback or carryforward should be reported in the same manner (I/S location) as the current year source of income or loss that gave rise to the benefit recognition.
4. A recognition (in either percentages or dollar amounts) of income tax expense attributable to continuing operations and the amount of income tax expense that would have resulted from applying the statutory rate to pretax income from continuing operations should be presented.

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SUMMARY

I. METHOD

Asset and liability approach—balance sheet approach

II. DIFFERENCES

Between income tax returns and GAAP financial statements fall into two groups:

A. PERMANENT

No deferred tax asset or liability is required because the difference will never "REVERSE."

B. TEMPORARY

Deferred tax asset or liability must be recorded because the temporary difference will "REVERSE."

1. Deferred Tax Liability

The consequences of temporary differences that will reverse in the future and create future taxes.

2. Deferred Tax Asset

The consequences of temporary differences that will reverse in the future and create future tax benefits.

a. Valuation Allowance

The contra-asset that is to be established to reflect that it is "more likely than not" that the deferred tax asset will not be completely realized.

III. MEASUREMENT

Use applicable enacted tax rates. This is the tax rate expected to apply to taxable income in the future periods that the deferred tax asset or liability is expected to be paid or realized.

A. TAX RATE CHANGES

Adjusted in the period of a new tax rate (when signed into law). The new impact (increase or decrease) to the deferred tax account will be reflected in "income from continuing operations" (IDEA).

IV. CLASSIFICATION

Criteria for current vs. noncurrent

A. BALANCE SHEET RELATED

Classify according to the related asset or liability causing the temporary difference.

B. NONBALANCE SHEET RELATED

Classify based upon the expected reversal or benefit period.

C. NETTING/OFFSETTING

- Current (asset and liability) must be netted.
- Noncurrent (asset and liability) from a particular jurisdiction must be netted.

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CORPORATE TAXATION SUMMARY

	GAAP FINANCIAL STATEMENTS	IRC TAX RETURN	TEMP	PERM	NONE
GROSS INCOME:					
Gross Sales	Income	Income			✓
Installment Sales	Income	Income when received	✓		
Rents and Royalties in Advance	Income when earned	Income when received	✓		
State Tax Refund	Income	Income			✓
Dividends					
Equity Method	Income is subsidiary's earnings	Income is dividends received	✓		
100/80/70% Exclusion	No exclusion	Excluded forever		✓	
ITEMS NOT INCLUDIBLE IN "TAXABLE INCOME":					
State and Municipal Bond Interest	Income	Not taxable income		✓	
Life Insurance Proceeds	Income	Not taxable income		✓	
Gain/Loss on Treasury Stock	Not reported	Not reported			✓
ORDINARY EXPENSES:					
Cost of Goods Sold	Uniform capitalization rules	Uniform capitalization rules			✓
Special deduction	None	07-08-09 = 6% qualified production		✓	
Officers' Compensation (Top)	Expense	$1,000,000 limit		✓	✓
Bad Debt	Allowance (estimated)	Direct write-off	✓		
Estimated Liability for Contingency (e.g., warranty)	Expense (accrue estimated)	No deduction until paid	✓		
Interest Expense					
Business Loan	Expense	Deduct			✓
Tax-free Investment	Expense	Not deductible		✓	
Taxable Investment	Expense	Deduct up to taxable income	✓	✓	✓
Contributions	All expensed	Limited to 10% of income	✓		✓
Loss on Abandonment/Casualty	Expense	Deduct			✓
Loss on Worthless Subsidiary	Expense	Deduct			✓
Depreciation					
MACRS vs. Straight Line	Slow depreciation	Fast depreciation	✓		
Section 179 Depreciation	Not allowed (must depreciate)	2006 = $108,000	✓		
Different Basis of Asset	Use GAAP basis	Use tax basis		✓	
Amortization					
Start Up Expenses	Expense	$5,000 max./15 year excess	✓		
Franchise	Amortize	Amortize over 15 years	✓		
Goodwill	Impairment Test	Amortize over 15 years	✓		
Depletion					
Percentage vs. Straight Line (cost)	Cost over years	Percentage of sales	✓		
Percentage in Excess of Cost	Not allowed	Percentage of sales		✓	
Profit and Pension Expense	Expense accrued	No deduction until paid	✓		
Accrued Expense (50% owner/family)	Expense accrued	No deduction until paid	✓		
State Taxes (Paid)	Expense	Deduct			✓
Meals and Entertainment	Expense	Generally 50% deductible		✓	
GAAP EXPENSE ITEMS THAT ARE NOT TAX DEDUCTIONS:					
Life Insurance Expense (corporation)	Expense	Not deductible		✓	
Penalties	Expense	Not deductible		✓	
Lobbying/Political Expense	Expense	No deduction		✓	
Federal Income Taxes	Expense	Not deductible		✓	
SPECIAL ITEMS:					
Net Capital Gain	Income	Income			✓
Net Capital Loss	Report as loss	Not deductible	✓		
Carryback/Carryover (3 years back and 5 years forward)	Not applicable	Unused loss allowed as a STCL	✓		
Shareholder Dealing	Report as a loss	Not deductible		✓	
Net operating loss	Report as a loss	Carryover 2 or 20	✓		
Research and Development	Expense	Expense/Amortize/Capitalize	✓	✓	✓

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HOMEWORK READING

I. OTHER LIABILITIES

A. PREMIUMS

Premiums are offers to customers for the purpose of stimulating sales. They are offered in return for coupons, box tops, labels, etc. The cost of the premium is charged to sales in the period(s) that benefit from the premium offer. Generally, all premiums will not be redeemed in the same period. Therefore, the number of outstanding premium offers must be estimated accurately to reflect the current liability at the end of each period.

Total number coupons issued	×	Estimated redemption rate	=	Total estimated Coupon redemptions

EXAMPLE

Premium Offer

AAA Corp. kicked off a sales promotion on August 31, Year 9. AAA included a redeemable coupon on each can of soup sold. Five coupons must be presented to receive a premium that costs AAA $2.00. AAA estimates that 70% of the coupons will be redeemed. Information available at December 31, Year 9, is as follows:

Cans of Soup Sold	Premiums Purchased	Coupons Redeemed
1,500,000	200,000	600,000

The calculation of the estimated liability for premium claims outstanding is as follows:

Total estimated coupon redemptions (1,500,000 x 70%)	1,050,000
Less: Coupons redeemed	(600,000)
Coupons to be redeemed	450,000
Outstanding premium claims (450,000 ÷ 5)	90,000

The estimated liability for premium claims is 90,000 x $2 = $180,000. Note that you were given information about premiums purchased that was not used in the computation in determining estimated liability.

B. WARRANTIES

Warranties are a seller's promise to "correct" any product defects. Sellers offering warranties must create a liability account if the cost of the warranty can be reasonably estimated.

The entire liability for the warranty should be accrued in the year of sale to "match" the cost with the corresponding revenue. The accrual should take place even if part of the warranty expenditure will be incurred in a later year.

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EXAMPLE

Warranty Liability

ABC Corp. has a three-year warranty against defects in the machinery it sells. Warranty costs are estimated at 2% of sales in the year of sale, 4% and 6% in the succeeding years. ABC sales and actual warranty expenses for Year 7 – Year 9 were as follows:

	Sales	Actual Warranty Costs
Year 7	$ 250,000	$10,000
Year 8	500,000	20,000
Year 9	750,000	30,000
	$1,500,000	$60,000

ABC's total liability should be accrued in the year of sale even though it will not be incurred in that year. The balance in the account is total liability less actual expenditures and is calculated as follows:

Sales x Total estimated expense	=	Total liability
$1,500,000 x 12% [2% + 4% + 6%]	=	$180,000
Total liability – Actual expenditures	=	Balance, liability account, 12/31/Year 9
$180,000 – $60,000	=	$120,000

C. SERVICE CONTRACTS

Service contracts usually include cash received prior to the period in which the related expense occurs. As such, they are treated as unearned revenue and are estimated and accrued in the financial statements. Then, when services are performed, unearned revenue is debited and revenue is credited.

EXAMPLE

Unearned Service Contract Revenue

Brook Company offers service contracts on the major appliances it sells for a one-year, two-year or three-year period. Cash receipts from contracts are credited to the unearned service contract revenue account which had an unadjusted balance of $1,200,000 at December 31, Year 1, before year-end adjustment. Service contract costs are charged to expense as incurred. This account totaled $250,000 at December 31, Year 1. Outstanding service contracts at December 31, Year 1, expire as follows:

During Year 2:	$250,000
During Year 3	$270,000
During Year 4:	$420,000

What amount should Brook report as unearned service contract revenue at December 31, Year 1?

$250,000 + $270,000 + $420,000 = $940,000

D. BONUSES

Many CPA examinations test on computing the amount of a bonus to be paid to a key employee. The amount of the bonus is normally based on company profits. Computation problems result because while the bonuses are based on net income, they are a business expense that reduces net income. The following example illustrates the difficulties.

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PASS KEY

These questions frequently give the CPA candidate a complicated formula to apply to a complex set of facts. The easiest way to solve these questions is to select the "middle answer" and work your way backwards.

EXAMPLE

Employee Bonus Agreements

X Corp. offers its sales vice president a bonus equal to 10% of net income after deducting taxes but before deducting the bonus. Income without taxes or the bonus is $100,000, and the tax rate is 40%. Calculate the bonus.

Although the bonus is based on after-tax income, the bonus itself is deductible from pretax income.

1) Bonus = 10% ($100,000 – Taxes)
2) Taxes = 40% ($100,000 – Bonus)

Substitute equation 2) for "Taxes" in equation 1)

Bonus = 10% [$100,000 – 40% ($100,000 – Bonus)]
B = 10% [$100,000 – 40% ($100,000 – B)]
B = 10% [$100,000 – $40,000 + 40% B)]
B = $6,000 + 4% B
96% B = $6,000
B = $6,250

E. COMPENSATION FOR FUTURE ABSENCES (SFAS 43)

Liabilities for employees' compensation for future absences are accrued if *all* of the following conditions are met. If only the first three conditions are met, disclosure in a note to the financial statements is adequate.

1. The employer's obligation to compensate employees for future absences is attributable to services already rendered by employees.
2. The obligation relates to rights that *vest* (are not contingent on an employee's future service) or *accumulate* (may be carried forward to one or more accounting periods subsequent to that in which earned).
3. Payment of the compensation is probable.
4. The amount can be reasonably estimated.

Note: An employer is not required to accrue a liability for nonvesting accumulating rights to receive sick pay benefits because the lower degree of reliability of estimates of future sick pay and the cost of making and evaluating those estimates do not justify making an accrual. However, the employer should accrue sick pay benefits if the four criteria are met and the estimate is reliable.

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EXAMPLE

Compensation for Future Absences

Taney Company's employees earn two weeks of paid vacation for each year of employment. Unused vacation time is carried forward and paid at the current salary in effect at the balance sheet date. As of December 31, Year 9, James had earned a total of 8 weeks and taken 4 weeks of vacation. His salary as of December, Year 9, was $300 per week. How much should Taney Company carry as a liability for James' accumulated vacation time?

Accrued vacation = Current salary rate x Number of weeks of accumulated vacation
= $300 x 4
= $1,200

F. DIVIDENDS PAYABLE

Dividends become a legal liability on the date dividends are declared by the board of directors. Dividends are classified as current obligations because payment will be made shortly after the end of the fiscal period.

1. Common Stock Dividends

Recognize a liability when the dividend is declared.

2. Preferred Stock

Recognize a liability when the dividend is declared.

a. Cumulative preferred stock dividends in arrears are not a liability until declared. Disclosure regarding any arrears should be included in the footnotes.

PASS KEY

A CPA candidate should remember that the "**Declaration** of Independence" was the day everything was recorded. Therefore, with all dividends, "the date of **declaration**" is when all the journal entries are recorded.

G. PURCHASE COMMITMENTS

The probable loss on a noncancelable purchase contract should be accrued with the following journal entry:

DR	Estimated loss on purchase commitment	$XXX	
CR	Estimated liability on purchase commitment		$XXX

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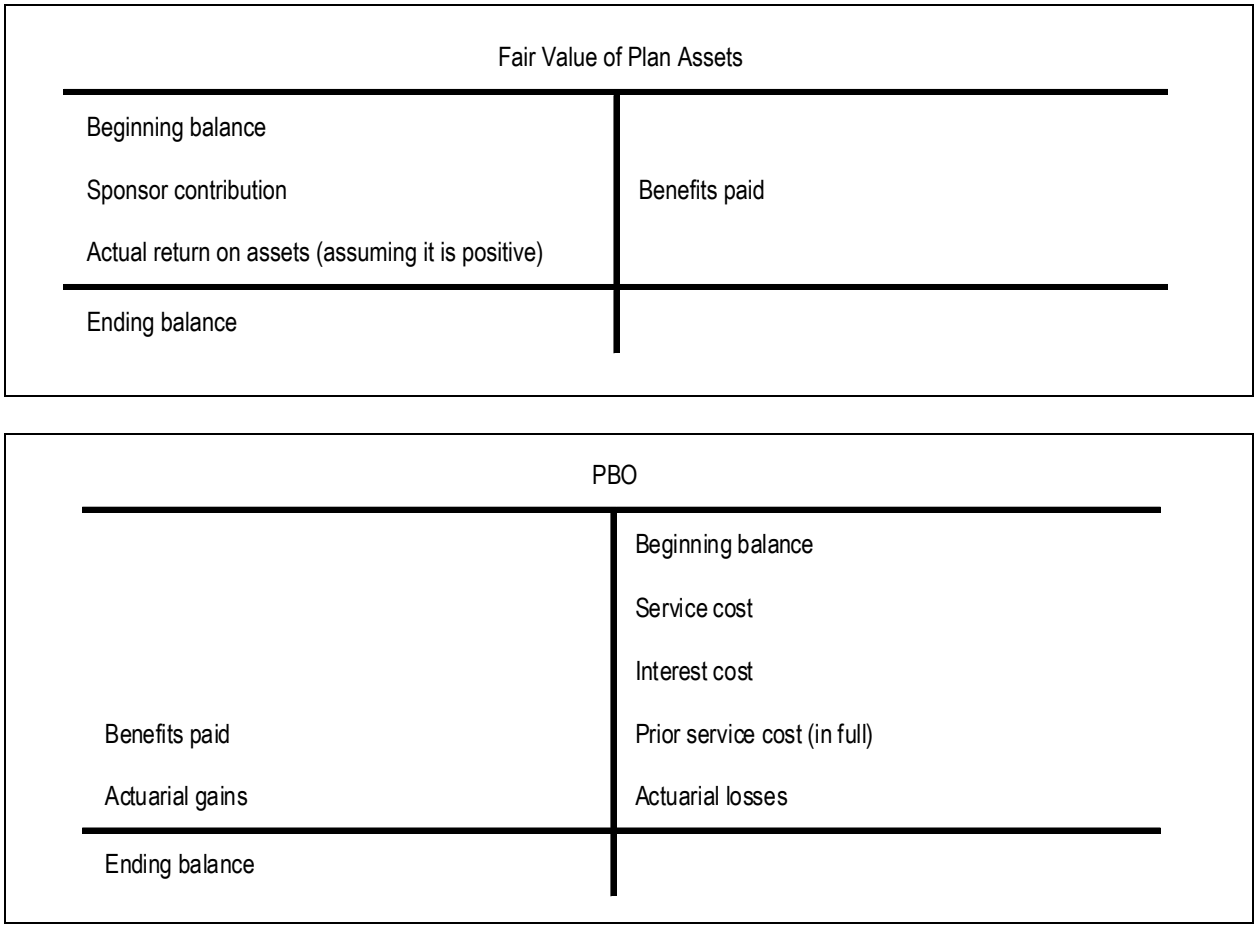
APPENDIX I

Using T-accounts illustrate fair value of plan assets and the PBO:



Notice that amortization of prior service cost, gains/losses, and transition amounts do not affect the PBO in the current period (even though they affect pension expense).

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EXAMPLE

Houston Corporation reports the following concerning its pension plan as of 12/31/09:

	1/1/08	12/31/08	12/31/09
Projected Benefit Obligation	612,500	900,000	1,150,000
Accumulated Benefit Obligation	500,000	700,000	790,000
Fair Value of Plan Assets	537,500	600,000	670,000
Unamortized Loss	100,000	186,000	230,000

Also:

1. No existing balances for pension-related accounts on Houston's balance sheet.
2. Discount rate = 9%; Expected return on plan assets = 10%.
3. An amendment on 1/1/09 resulted in prior service cost of $120,000.
4. The average remaining service period for all amortization (except the transition adjustment) is 16 years.
5. Service cost for 2009 is $76,500.
6. In 2009, Houston contributed $87,500 to the plan and the plan paid $107,500 in benefits.
7. During 2009, the actuaries for the plan determined that employees would live longer after retirement and earn higher salaries than expected while still employed. These changes in assumptions increased the PBO as of 12/31/09 by $80,000.
8. When the company adopted FASB 87 on 1/1/87, the transition amount was $250,000, and it was to be amortized over 25 years. On 12/31/08, the unamortized transition obligation was $30,000.

Based on these facts, Houston Corporation reported a $300,000 pension benefit liability at 12/31/08 reflecting the funded status of their pension plan as required by SFAS No. 158. Per SFAS No. 158, Houston also reported the $186,000 unamortized loss and the $30,000 unamortized transition obligation in accumulated other comprehensive income on 12/31/08. Prepare the journal entries related to Houston's pension plan for 2009. Houston's effective tax rate for 2009 is 40%.

1. Service cost. **+76,500** (given)
2. Interest cost. 900,000 * 9% = **+81,000**
3. Return (expected) on plan assets. 600,000 * 10% = **-60,000**

> What is actual return? The plan received $87,500 from Houston and paid out $107,500 in benefits (implying a reduction is assets of $20,000). Because the total increase in plan assets for the year was $70,000, then actual return must have been **$90,000**. Notice that expected return on assets has nothing to do with this calculation.

4. Amortization of unrecognized prior service cost. $120,000 / 16 = **+7,500**
5. Gain or loss amortization?
   Greater of **beginning PBO ($900,000)** or FV of plan assets ($600,000) * 10% = $90,000.
   Unamortized loss at beginning of year ($186,000) is larger, so it should be amortized.
   Amortize ($186,000 - $90,000)/16 = **+6,000**
6. Existing net obligation amortization
   $250,000/25 years (greater than 15 years) = **$10,000**

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EXAMPLE (continued)

Therefore, total pension expense is:

+	Service cost	76,500
+	Interest cost	81,000
-	Return (expected) on plan assets	(60,000)
+	Amortization (PSC)	7,500
+	(Gain) or loss amortization	6,000
+	Existing net obligation amortization	10,000
		121,000

Journal Entry: To record the 2009 pension plan contribution.

DR	Pension benefit liability	$87,500	
CR	Cash		$87,500

Journal Entry: To recognize the 2009 service cost of $76,500, interest cost of $81,000 and offsetting expected return on plan assets of $60,000.

DR	Net periodic pension cost	$97,500	
DR	Deferred tax asset	39,000	
CR	Deferred tax benefit – income statement		$39,000
CR	Pension benefit liability		97,500

Journal Entry: To recognize $120,000 prior service cost from 2009 plan amendment.

DR	Other comprehensive income	$120,000	
DR	Deferred tax asset	48,000	
CR	Deferred tax benefit – OCI		$ 48,000
CR	Pension benefit liability		120,000

Journal Entry: To recognize 2009 net loss of $50,000 ($80,000 actuarial increase in PBO - $30,000 difference between actual and expected return on plan assets).

DR	Other comprehensive income	$50,000	
DR	Deferred tax asset	20,000	
CR	Deferred tax benefit – OCI		$20,000
CR	Pension benefit liability		50,000

Journal Entry: Reclassification adjustment to recognize the amortization of the prior service cost, net loss and net transition obligation components of accumulated other comprehensive income to net periodic pension cost ($7,500 + 6,000 + 10,000 = $23,500).

DR	Net periodic pension cost	$23,500	
DR	Deferred tax benefit – OCI	9,400	
CR	Deferred tax benefit – income statement		$ 9,400
CR	Other comprehensive income		23,500

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T-Accounts for Example:

PBO

		$900,000	Beginning balance
		76,500	Service cost
Benefits paid	$107,500	81,000	Interest cost
		120,000	Prior service cost
		80,000	Loss
		$1,150,000	Ending balance

Fair Value of Plan Assets

Beginning balance	$600,000		
Sponsor contributions	87,500	$107,500	Benefits paid
Actual return on assets	90,000		
Ending balance	$670,000		

Pension Plan Liability

		$300,000	Beginning balance
		97,500	Net periodic pension cost
Sponsor contributions	$87,500	120,000	Prior service cost
		50,000	Net loss
		$480,000[1]	Ending balance

[1] The $480,000 ending pension plan liability reflects Houston's 2009 funded status: $670,000 fair value of plan assets - $1,150,000 PBO = $480,000 underfunded.

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Accumulated OCI – Pension Funded Status Changes (before tax)

Beginning balance[2]	$ 216,000		
Prior service cost	120,000		
Net loss	50,000		
		7,500	Amortization of prior service cost
		6,000	Amortization of net loss
		10,000	Amortization of net transition obligation
Ending balance[3]	$362,500		

[2] Beginning balance = $186,000 unamortized loss + $30,000 unamortized net transition obligation.

[3] Ending balance = $112,500 unamortized prior service cost
+ $230,000 unamortized net loss
+ $20,000 unamortized net transition
obligation = $362,500

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APPENDIX II
MEASUREMENT DATE PROVISION OF SFAS NO. 158

I. MEASUREMENT DATE TRANSITION RULES

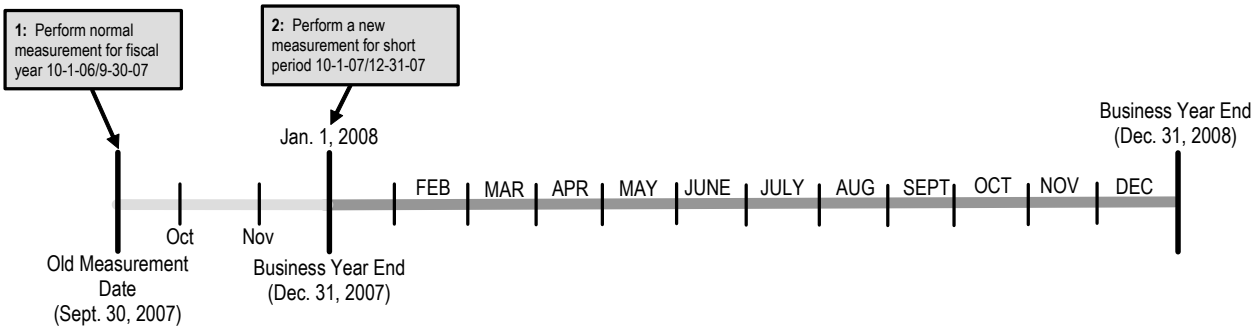
SFAS 158 provides two methods of transition for entities that have not used the balance sheet date as the measurement date of pension plan assets and benefit obligations:

A. DUAL MEASUREMENT APPROACH

When this approach is used, two measurements are performed within a few months of each other.

For example, if a company had a September 30th fiscal year end for its defined benefit pension plan and a December 31st balance sheet date, then the company would do the following when using the dual measurement approach to transition its pension plan to the December 31, 2008 fiscal year end required by SFAS No. 158:

1. Perform the normal pension plan measurements and reporting for the fiscal year ended September 30, 2007.
2. Perform a new measurement for the short period from September 30, 2007 to December 31, 2007.
    a. The net periodic pension cost for this period will be reported as an adjustment to beginning retained earnings on January 1, 2008.
    b. Any changes in plan assets or benefit obligations resulting from the measurement during the short period will be reported as an adjustment to beginning accumulated other comprehensive income (net of tax) on January 1, 2008.
    c. Any curtailment and/or settlement of the plan during the short period will be recognized and recorded in the entity's 2007 income statement, not as an adjustment to beginning retained earnings.



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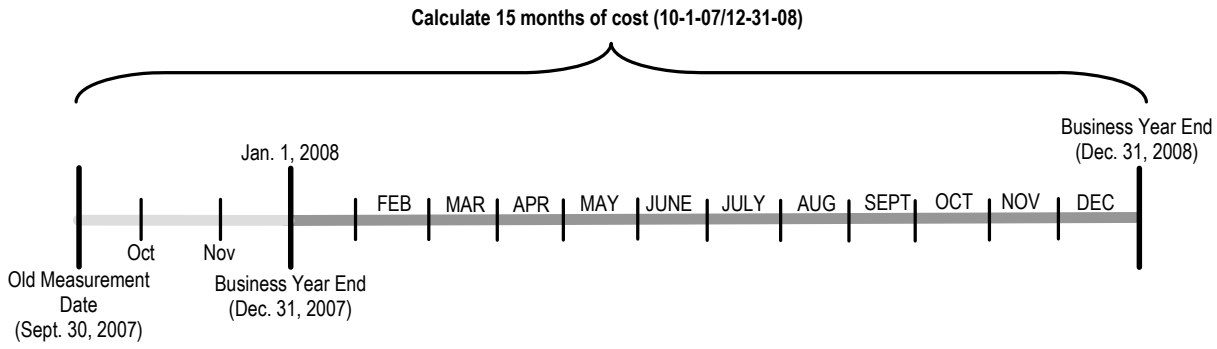
B. THE "15-MONTH" APPROACH

When this method is used one measurement is performed for up to a 15-month period.

For example, if a company had a September 30th fiscal year end for its defined benefit pension plan and a December 31st balance sheet date, then the company would do the following when using the "15 month" approach to transition its pension plan to the December 31, 2008 fiscal year end required by SFAS No. 158:

1. Calculate net periodic pension cost and measure plan assets and benefit obligations over the 15-month period from October 1, 2007 to December 31, 2008.
   a. Of the net periodic pension cost incurred over the 15-month period, 3/15 will be recorded as an adjustment to retained earnings (net of tax) during 2008 and 12/15 will be reported as net periodic pension cost on the 2008 income statement.
   b. Any changes in plan assets or benefit obligations incurred during the 15-month period will be recognized in other comprehensive income in 2008.
   c. Any curtailment and/or settlement of the plan during October 1, 2007 – December 31, 2007 will be recognized and recorded in the entity's 2007 income statement, not as an adjustment to beginning retained earnings.



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FINANCIAL REPORTING & ACCOUNTING 6
Class Questions Answer Worksheet

MC Question Number	First Choice Answer	Correct Answer	NOTES
1.			
2.			
3.			
4.			
5.			
6.			
7.			
8.			
9.			
10.			
11.			
12.			
13.			
14.			
15.			
16.			
17.			

Grade:

Multiple-choice Questions Correct / 17 = _____% Correct

Detailed explanations to the class questions are located in the back of this textbook.

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NOTES

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CLASS QUESTIONS

1. CPA-00690

The following information pertains to Gali Co.'s defined benefit pension plan for 1994:

Fair value of plan assets, beginning of year	$350,000
Fair value of plan assets, end of year	525,000
Employer contributions	110,000
Benefits paid	85,000

In computing pension expense, what amount should Gali use as actual return on plan assets?

a. $65,000
b. $150,000
c. $175,000
d. $260,000

2. CPA-05398

Big Books, Inc. has the following information related to its defined benefit pension plan:

December 31, 20X6:	
Projected benefit obligation	$1,500,000
Fair value of plan assets	1,200,000
Unrecognized prior service cost	200,000
Unrecognized net transition asset	60,000
December 31, 20X7:	
Projected benefit obligation	$1,740,000
Fair value of plan assets	1,800,000
Service cost	220,000
Assumptions:	
Discount rate	6%
Expected return on plan assets	8%

Big Book's makes an annual pension plan contribution of $200,000. The company's employees had an average remaining service life of 10 years on 12/31/X6 and the company expects to pay benefits totaling $170,000 to retired employees in 20X8. Big Books has an effective tax rate of 30%. What is the funded status of Big Book's pension plan on December 31, 20X6?

a. $60,000 underfunded.
b. $60,000 overfunded.
c. $300,000 underfunded.
d. $300,000 overfunded.

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3. CPA-05399

Big Books, Inc. has the following information related to its defined benefit pension plan:

December 31, 20X6:	
Projected benefit obligation	$1,500,000
Fair value of plan assets	1,200,000
Unrecognized prior service cost	200,000
Unrecognized net transition asset	60,000
December 31, 20X7:	
Projected benefit obligation	$1,740,000
Fair value of plan assets	1,800,000
Service cost	220,000
Assumptions:	
Discount rate	6%
Expected return on plan assets	8%

Big Book's makes an annual pension plan contribution of $200,000. The company's employees had an average remaining service life of 10 years on 12/31/X6 and the company expects to pay benefits totaling $170,000 to retired employees in 20X8. Big Books has an effective tax rate of 30%. The funded status of Big Books' pension plan will be reported on the December 31, 20X7 balance sheet as a:

a. Current asset.
b. Noncurrent asset.
c. Current liability.
d. Noncurrent liability.

4. CPA-00702

Bounty Co. provides postretirement health care benefits to employees who have completed at least 10 years service and are aged 55 years or older when retiring. Employees retiring from Bounty have a median age of 62, and no one has worked beyond age 65. Fletcher is hired at 48 years old. The attribution period for accruing Bounty's expected postretirement health care benefit obligation to Fletcher is during the period when Fletcher is aged:

a. 48 to 65
b. 48 to 58
c. 55 to 65
d. 55 to 62

5. CPA-00703

What information should be disclosed by a company providing health care benefits to its retirees?

I. The assumed health care cost trend rate used to measure the expected cost of benefits covered by the plan.
II. The accumulated postretirement benefit obligation.

a. I and II.
b. I only.
c. II only.
d. Neither I nor II.

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6. CPA-00701

An employer's obligation for postretirement health benefits that are expected to be provided to or for an employee must be fully accrued by the date the:

a. Employee is fully eligible for benefits.
b. Employee retires.
c. Benefits are utilized.
d. Benefits are paid.

7. CPA-00704

Which of the following is **not** one of the liability reporting criteria for post-employment benefits under SFAS No. 112?

a. The amount of the obligation can be reasonably estimated.
b. The obligation relates to rights that vest or accumulate.
c. The obligation depends upon whether the individual continues to be available for questions and assistance after employment ceases.
d. The payment of the compensation is probable.

8. CPA-00733

Ace Co. settled litigation on February 1, 2002 for an event that occurred during 2001. An estimated liability was determined as of December 31, 2001. This estimate was significantly less than the final settlement. The transaction is considered to be material. The financial statements for year-end 2001 have not been issued. How should the settlement be reported in Ace's year-end 2001 financial statements?

a. Disclosure only of the settlement.
b. Only an accrual of the settlement.
c. Neither a disclosure nor an accrual.
d. Both a disclosure and an accrual.

9. CPA-00736

During 1994, Haft Co. became involved in a tax dispute with the IRS. At December 31, 1994, Haft's tax advisor believed that an unfavorable outcome was probable. A reasonable estimate of additional taxes was $200,000 but could be as much as $300,000. After the 1994 financial statements were issued, Haft received and accepted an IRS settlement offer of $275,000.

What amount of accrued liability should Haft have reported in its December 31, 1994 balance sheet?

a. $200,000
b. $250,000
c. $275,000
d. $300,000

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10. CPA-00802

For the year ended December 31, 1993, Grim Co.'s pretax financial statement income was $200,000 and its taxable income was $150,000. The difference is due to the following:

Interest on municipal bonds	$70,000
Premium expense on keyman life insurance	(20,000)
Total	$50,000

Grim's enacted income tax rate is 30%. In its 1993 income statement, what amount should Grim report as current provision for income tax expense?

a. $45,000
b. $51,000
c. $60,000
d. $66,000

11. CPA-00843

Ram Corp. prepared the following reconciliation of income per books with income per tax return for the year ended December 31, 1989:

Book income before income taxes	$750,000
Add temporary difference	
Construction contract revenue which will reverse in 1993	100,000
Deduct temporary difference	
Depreciation expense which will reverse in equal amounts in each of the next four years	(400,000)
Taxable income	$450,000

Ram's effective income tax rate is 34% for 1989. What amount should Ram report in its 1989 income statement as the current provision for income taxes?

a. $34,000
b. $153,000
c. $255,000
d. $289,000

12. CPA-00782

Zeff Co. prepared the following reconciliation of its pretax financial statement income to taxable income for the year ended December 31, 1994, its first year of operations:

Pretax financial income	$160,000
Nontaxable interest received on municipal securities	(5,000)
Long-term loss accrual in excess of deductible amount	10,000
Depreciation in excess of financial statement amount	(25,000)
Taxable income	$140,000

Zeff's tax rate for 1994 is 40%.

In its 1994 income statement, what amount should Zeff report as income tax expense-current portion?

a. $52,000
b. $56,000
c. $62,000
d. $64,000

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13. CPA-00783

Zeff Co. prepared the following reconciliation of its pretax financial statement income to taxable income for the year ended December 31, 1994, its first year of operations:

Pretax financial income	$160,000
Nontaxable interest received on municipal securities	(5,000)
Long-term loss accrual in excess of deductible amount	10,000
Depreciation in excess of financial statement amount	(25,000)
Taxable income	$140,000

Zeff's tax rate for 1994 is 40%.

In its December 31, 1994, balance sheet, what should Zeff report as deferred income tax liability?

a. $2,000
b. $4,000
c. $6,000
d. $8,000

14. CPA-00785

As a result of differences between depreciation for financial reporting purposes and tax purposes, the financial reporting basis of Noor Co.'s sole depreciable asset, acquired in 1994, exceeded its tax basis by $250,000 at December 31, 1994. This difference will reverse in future years. The enacted tax rate is 30% for 1994, and 40% for future years. Noor has no other temporary differences. In its December 31, 1994, balance sheet, how should Noor report the deferred tax effect of this difference?

a. As an asset of $75,000.
b. As an asset of $100,000.
c. As a liability of $75,000.
d. As a liability of $100,000.

15. CPA-00781

On its December 31, 1994, balance sheet, Shin Co. had income taxes payable of $13,000 and a current deferred tax asset of $20,000 before determining the need for a valuation account. Shin had reported a current deferred tax asset of $15,000 at December 31, 1993. No estimated tax payments were made during 1994. At December 31, 1994, Shin determined that it was more likely than not that 10% of the deferred tax asset would not be realized. In its 1994 income statement, what amount should Shin report as total income tax expense?

a. $8,000
b. $8,500
c. $10,000
d. $13,000

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16. CPA-00791

Thorn Co. applies Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes. At the end of 1993, the tax effects of temporary differences were as follows:

	Deferred tax assets (liabilities)	*Related asset classification*
Accelerated tax depreciation	($75,000)	Noncurrent asset
Additional costs in inventory for tax purposes	25,000	Current asset
	($50,000)	

A valuation allowance was not considered necessary. Thorn anticipates that $10,000 of the deferred tax liability will reverse in 1994. In Thorn's December 31, 1993, balance sheet, what amount should Thorn report as noncurrent deferred tax liability?

a. $40,000
b. $50,000
c. $65,000
d. $75,000

17. CPA-00789

Mobe Co. reported the following operating income (loss) for its first three years of operations:

1992	$ 300,000
1993	(700,000)
1994	1,200,000

For each year, there were no deferred income taxes (before 1992), and Mobe's effective income tax rate was 30%. In its 1993 income tax return, Mobe elected the two year carry back of the loss. In its 1994 income statement, what amount should Mobe report as total income tax expense?

a. $120,000
b. $150,000
c. $240,000
d. $360,000

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Financial Accounting & Reporting 7

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Financial Accounting & Reporting 7

FINANCIAL INSTRUMENTS

I. TYPES OF FINANCIAL INSTRUMENTS

A. Cash, Foreign Currency, and Demand Deposits

B. Evidence of an Ownership Interest in an Entity (e.g., Stock Certificate, Partnership Interests, or Limited Liability Company (LLC) Interests)

C. Contracts (or Series of Linked Contracts), Which Result in an Exchange of Cash or Ownership Interest in an Entity

D. Derivatives (Financial Instruments Whose Value or Settlement Amount is Derived from the Value of Another Unit of Measure Covered in V, Below)

II. FAIR VALUE DISCLOSURES REQUIRED FOR FINANCIAL INSTRUMENTS

Fair values must be disclosed for all financial instruments (except as noted below) for which it is practicable to estimate that value, together with the related carrying amounts showing clearly whether the amounts represent assets or liabilities.

These disclosures apply to all entities (except non-public entities that have total assets less than $100 million and have no instruments that are accounted for as derivatives, as defined by SFAS No. 133).

III. DISCLOSURES ABOUT "CONCENTRATION OF CREDIT RISK" OF ALL FINANCIAL INSTRUMENTS

Credit risk is the possibility of loss from the failure of another party to perform according to the terms of a contract. Concentration of credit risk occurs when an entity has contracts of material value with one or more parties in the same industry or region or having similar economic characteristics (e.g., a group of highly leveraged entities).

A. REQUIREMENT TO DISCLOSE

All entities must disclose all significant concentrations of credit risk arising from all financial instruments (except as noted in B), whether from a single party or a group of parties engaged in similar activities and that have similar economic characteristics.

B. APPLICABILITY

These disclosures apply to all entities (**except** non-public entities that have total assets less than $100 million and have no instruments that are accounted for as derivatives, as defined by SFAS No. 133).

IV. DISCLOSURE ABOUT "MARKET RISK" OF ALL FINANCIAL INSTRUMENTS

Market risk is the possibility of loss from changes in market value (not necessarily due to the failure of another party, but due to changes in economic circumstances).

All entities are encouraged, but not required, to disclose quantitative information about the market risk of financial instruments that is consistent with the way it manages or adjusts those risks.

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V. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES (SFASs No. 133 AND 149)

SFAS No. 133 established accounting for derivative instruments and hedging activities. Its requirements apply to all entities, including not-for-profit organizations and pension plans.

A. DEFINITIONS AND CONCEPTS

1. Derivative Instrument

A "derivative instrument" is a financial instrument (or other contract) that "derives" its value from the value of some other instrument and has all three of the following characteristics:

a. One or more underlyings and one or more notional amounts or payment provisions (or both), and

b. It requires no initial net investment or one that is smaller than would be required for other types of similar contracts, and

c. Its terms require or permit a net settlement (i.e., it can be settled for cash in lieu of physical delivery), or it can readily be settled net outside the contract (e.g., on an exchange) or by delivery of an asset that gives substantially the same results (e.g., an asset readily convertible to cash).

2. Underlying

An "underlying" is a specified price, rate, or other variable (e.g., interest rate, security or commodity price, foreign exchange rate, index of prices or rates, etc.), including a scheduled event (e.g., a payment under contract) that may or may not occur.

3. Notional Amount

A "notional amount" is a specified unit of measure (e.g., currency units, shares, bushels, pounds, etc.).

4. Value or Settlement Amount

The value or settlement amount of a derivative is the amount determined by the multiplication (or other arithmetical interaction) of the notional amount and the underlying. For example, shares of stock times the price per share.

5. Payment Provision

A "payment provision" is a specified (fixed) or determinable settlement that is to be made if the underlying behaves in a specified way.

6. Examples

The following contracts are examples of common derivatives:

a. Option contracts (e.g., a stock option that requires the maker to deliver stock at a later time in exchange for a fixed price)

b. Forward contracts (e.g., similar to futures contracts, but between contracting parties, not through a clearinghouse)

c. Futures contracts (e.g., to deliver a commodity or foreign currency in the future at a price stated at the present; made through a clearinghouse)

d. Swap contracts (e.g., to exchange currencies, debt securities, etc.)

e. Origination mortgage loan commitments that will be held for sale by the lender (issuer of the commitment)

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VI. ACCOUNTING FOR DERIVATIVE INSTRUMENTS INCLUDING HEDGES

A. BALANCE SHEET

All derivative instruments are recognized in the balance sheet as either assets or liabilities, depending on the rights or obligations under the contracts.

All derivative instruments are measured at fair value.

Accounting for changes in the fair value is dependent on whether the derivative has been designated and whether it qualifies as a hedge, combined with the reason for holding the instrument.

B. REPORTING GAINS AND LOSSES

1. No Hedging Designation

Gains/losses on a derivative instrument not designated as a hedging instrument are recognized currently in earnings.

2. Fair Value Hedge

A fair value hedge is an instrument designated as hedging the exposure to changes in fair value of an asset or liability or an identified portion thereof that is attributed to a particular risk. Gains/losses on such instruments as well as the offsetting gain/loss on the hedged item are recognized in earnings in the same accounting period. It must also be expected to be highly effective in offsetting the fair value change (that could affect income) of the hedged item.

3. Cash Flow Hedge

A cash flow hedge is an instrument designated as hedging the exposure to variability in expected future cash flows attributed to a particular risk. Gains/losses on the **effective** portion of a cash flow hedge are deferred and are reported as a component of other comprehensive income (outside earnings) until the cash flows associated with the hedged item are realized. Gains/losses on the **ineffective** portion of a cash flow hedge are reported in current income.

4. Foreign Currency Hedge

A foreign currency hedge is an instrument designated as hedging the exposure to variability in foreign currency in a variety of foreign currency transactions.

a. Gains and losses from changes in the fair value of foreign currency transaction hedges classified as fair value hedges are accounted for in the same manner as gains/losses on other fair value hedges—in earnings.

b. Gains and losses from changes in the fair value of foreign currency transaction hedges classified as cash flow hedges are accounted for in the same manner as gains/losses on cash flow hedges—in other comprehensive income for the effective portion and current income for the ineffective portion.

c. Gains and losses from changes in the fair value of foreign currency transaction hedges entered into to hedge a net investment in a foreign operation are reported in other comprehensive income as part of the cumulative translation adjustment, discussed in F-2.

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C. REPORTING CASH FLOWS

If the derivative (e.g., hedge) contains an other-than-insignificant financing element at inception (which is often a matter of judgment), all cash flows associated with that derivative should be reported as cash flows from financing activities (per SFAS 95, as amended by SFAS 149), not just those related to the financing element. Otherwise, account for the cash flows from the derivative (e.g., hedge) in the same category as the item being hedged.

PASS KEY

Hedging transactions are often quite complicated. However, the examiners tend to focus on the effects of the hedging transactions on the income statement or the balance sheet of the company. The following summary is a great way to get many of the points of this topic.

Type of Hedge Instrument	*Accounting for Changes in Fair Value*
• No hedge designation	Included in current earnings
• Fair value hedge	Included in current earnings*
• Cash flow hedge:	
Effective portion	Included in other comprehensive income
Ineffective portion	Included in current earnings
• Foreign exchange hedge:	
Fair value hedge	Included in current earnings*
Cash flow hedge	Included in other comprehensive income (effective portion)
Net investment hedge	Included in other comprehensive income, as cumulative translation adjustment

* Note: Changes in the value of the offsetting asset/liability are also included in current earnings.

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STOCKHOLDERS' EQUITY

I. OVERVIEW

Stockholders' equity (also called shareholders' equity or owners' equity) is the owners' claim to the net assets (i.e., assets minus liabilities) of a corporation. It is generally presented on the statement of financial position (balance sheet) as the last major section (following liabilities). The various elements constituting stockholders' equity must be clearly classified according to source. The stockholders' equity section of the balance sheet contains five major components: (1) capital stock (also called legal capital); (2) additional paid-in capital; (3) retained earnings or deficit; (4) accumulated other comprehensive income; and (5) treasury stock, which is accounted for differently, depending upon the method used by the company (detailed discussion follows).

Capital Corp

Shareholders' Equity – December 31, 20XX

CAPITAL STOCK (capital equal to par or stated value)		
Preferred stock, non-cumulative, $100 par value, authorized 1,000 shares, issued and outstanding 500 shares		$ 50,000
Common stock, $10 par value, authorized 50,000 shares, issued 30,000 shares of which 5,000 are held in the treasury		300,000
		350,000
ADDITIONAL PAID-IN CAPITAL (capital in excess of par or stated value)		
Excess of issue price over par value of common/preferred stock sold	$ 29,000	
Excess of sales price over cost of treasury shares sold	15,000	
Excess of FMV over par of stock issued as stock dividend	20,000	
Defaulted stock subscriptions	10,000	
FMV of common shares contributed by shareholders to corporation	75,000	
FMV of fixed assets contributed by local government	60,000	209,000
RETAINED EARNINGS		
Appropriated (reserved) for general contingencies	50,000	
Appropriated (reserved) for possible future inventory decline	20,000	
Appropriated (reserved) for plant expansion	40,000	
Appropriated (reserved) for higher replacement cost of fixed assets	60,000	
Unappropriated (unreserved)	200,000	370,000
		929,000
ACCUMULATED OTHER COMPREHENSIVE INCOME		10,000
LESS: COST OF SHARES IN TREASURY		(85,000)
TOTAL SHAREHOLDERS' EQUITY		$ 854,000

Note: The preceding example assumes that treasury stock is reported under the *cost method*. (If the par value method is used to account for treasury stock, then treasury stock must be reported as a deduction from the same class of stock.) A detailed discussion of the methods to account for treasury stock is presented in this module.

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II. CAPITAL STOCK (LEGAL CAPITAL)

CAPITAL STOCK

Legal capital is the amount of capital that must be retained by the corporation for the protection of creditors. The par or stated value of both preferred and common stock is legal capital and is frequently referred to as "capital" stock.

A. PAR VALUE

Generally, preferred stock is issued with a par value, but common stock may be issued with or without a par value. No-par common stock may be issued as true no-par stock or no-par stock with a stated value. Any excess of the actual amount received over the par or stated value of the stock is accounted for as additional paid-in capital.

B. AUTHORIZED, ISSUED, AND OUTSTANDING

A corporation's charter contains the amounts of each class of stock that it may legally issue, and this is called "authorized" capital stock. When part or all of the authorized capital stock is issued, it is called "issued" capital stock. Because a corporation may own issued capital stock in the form of treasury stock, the amount of issued capital stock in the hands of shareholders is called "outstanding" capital stock. In summary, capital stock may be (1) authorized, (2) authorized and issued, or (3) authorized, issued, and outstanding. The number of shares of each class of stock authorized, issued, and outstanding must be disclosed.

C. COMMON STOCK

Common stock is the basic ownership interest in a corporation. Common shareholders bear the ultimate risk of loss and receive the ultimate benefits of success, but they are not guaranteed dividends or assets upon dissolution. Common shareholders generally control management. They have the right to vote, the right to share in earnings of the corporation, and the right to share in assets upon liquidation after satisfaction of creditors' claims and those of preferred shareholders.

PASS KEY

Common shareholders may have preemptive rights to a proportionate share of any additional common stock issued if granted in the articles of incorporation.

1. Book Value per Common Share

Book value per common share measures the amount that common shareholders would receive for each share if all assets were sold at their book (carrying) values and all creditors were paid. Book value per common share can be determined as follows:

$$\text{Book value per common share} = \frac{\text{Common shareholders' equity}}{\text{Common shares outstanding}}$$

2. Common Stockholders' Equity Formula

Total shareholders' equity
− Preferred stock outstanding (at greater of call price or par value)
− Cumulative preferred dividends in arrears
= **Common shareholders' equity**

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D. PREFERRED STOCK

Preferred stock is an equity security with preferences and features not associated with common stock. Preferred stock may include a preference relating to dividends, which may be cumulative or non-cumulative and participating or nonparticipating. Preferred stock may also include a preference relating to liquidation. Usually, preferred stock does not have voting rights.

1. Cumulative Preferred Stock

The cumulative feature provides that all or part of the preferred dividend not paid in any year *accumulates* and must be paid in the future before dividends can be paid to common shareholders. The accumulated amount is referred to as *dividends in arrears*. The amount of dividends in arrears is not a legal liability, but it must be disclosed in total and on a per share basis either parenthetically on the balance sheet or in the footnotes.

2. Non-Cumulative Preferred Stock

With non-cumulative preferred stock, dividends not paid in any year do not accumulate. The preferred shareholders lose the right to receive dividends that are not declared.

3. Participating Preferred Stock

The participating feature provides that preferred shareholders share (participate) with common shareholders in dividends in excess of a specific amount. The participation may be full or partial. *Fully participating* means that preferred shareholders participate in excess dividends without limit. Generally, preferred shareholders receive their preference dividend first, and then additional dividends are shared between common and preferred shareholders. *Partially participating* means preferred shareholders participate in excess dividends, but to a limited extent (e.g., a percentage limit).

4. Non-Participating Preferred Stock

When preferred stock is non-participating, preferred shareholders are limited to the dividends provided by their preference. They do not share in excess dividends.

5. Preference Upon Liquidation

Preferred stock may include a preference to assets upon liquidation of the entity. If the liquidation preference is significantly greater than the par or stated value, the liquidation preference must be disclosed. The disclosure of the liquidation preference must be in the equity section of the balance sheet, not in the notes to the financial statements.

6. Convertible Preferred Stock

Convertible preferred stock may be exchanged for common stock (at the option of the stockholder) at a specified conversion rate.

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7. Callable (Redeemable) Preferred Stock

Callable preferred stock may be called (repurchased) at a specified price (at the option of the issuing corporation). The aggregate or the per share amount at which the preferred stock is callable must be disclosed either on the balance sheet or in the footnotes.

EXAMPLE

Distribution of Dividends to Participating Preferred Stockholders

On January 1, Year 1, Samuel Co. issued 100,000 shares of $5 par common stock and 25,000 shares of $10 par fully participating 8% cumulative preferred stock. Cash dividends of $81,000 were declared and paid in Year 1.

Schedule 1: Dividends Remaining for Distribution

Cash dividends	$81,000
Preferred dividends [(25,000 × $10) × .08]	(20,000)
	61,000
Common stock [(100,000 × $5) × .08]*	(40,000)
Remaining for proration between preferred and common stock	$21,000

Schedule 2: Proration of Remaining Dividends According to Par Values

Preferred stock

$$\frac{250,000}{750,000} \times \$21,000 = \$7,000$$

Common stock

$$\frac{500,000}{750,000} \times \$21,000 = \$14,000$$

Schedule 3: Total Dividends Paid on Preferred and Common Stock

Preferred stock	$ 7,000 + $20,000 =	$27,000
Common stock	$14,000 + $40,000 =	54,000
Total cash dividends distributed		$81,000

* The principle applied here is that, with participating cumulative preferred stock, before any proration of dividends may exist, the common shareholders must receive an equal dividend as the preferred shareholders. In this case, preferred shareholders receive an 8% dividend first; common shareholders receive an 8% dividend second; and the balance ($21,000) is shared prorata.

ADDITIONAL PAID-IN CAPITAL

III. ADDITIONAL PAID-IN CAPITAL

Additional paid-in capital is generally contributed capital in excess of par or stated value. It can also arise from many other different types of transactions. Examples include the sale of treasury stock at a gain, quasi-reorganization, the issuance of liquidating dividends, conversion of bonds, and the declaration of a small stock dividend. Additional paid-in capital from these sources may be aggregated and shown as one amount on the balance sheet.

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IV. RETAINED EARNINGS

Retained earnings (or deficit) is accumulated earnings (or losses) during the life of the corporation that have not been paid out as dividends. The amount of accumulated retained earnings is reduced by distributions to stockholders and transfers to additional paid-in capital for stock dividends. Retained earnings does not include treasury stock or accumulated other comprehensive income. If the retained earnings account has a negative balance, it is called a deficit.

A. FORMULA

	Net income/loss
–	Dividends (cash, property, and stock) declared
±	Prior period adjustments
±	Accounting changes reported retrospectively
+	Adjustment from quasi-reorganization
	Retained Earnings

B. CLASSIFICATION OF RETAINED EARNINGS (APPROPRIATIONS)

Retained earnings may be classified as either appropriated or unappropriated. The purpose of appropriating retained earnings is to disclose to the shareholders (usually the common shareholders) that some of the retained earnings are not available to pay dividends because they have been restricted for legal or contractual reasons (e.g., a bond indenture) or as a discretionary act of management for specific contingency purposes (e.g., plant expansion). An appropriation of retained earnings may not be used to absorb costs or losses and may not be transferred to income.

The following entry should be recorded when an appropriation is to be made (and should be reversed when the purpose of the appropriation has occurred):

DR	Retained earnings (unappropriated)	
CR		Retained earnings appropriated for [purpose]

C. QUASI-REORGANIZATION

A quasi-reorganization (or corporate readjustment) is an accounting adjustment (not a legal reorganization) that revises the capital structure of a corporation as though it had been legally reorganized. It allows a corporation with a significant deficit in retained earnings to eliminate that deficit and have a "fresh start." A quasi-reorganization requires formal approval by the shareholders.

1. Purposes

The purposes of a quasi-reorganization are to restate overvalued assets to their lower fair values (and thus reduce future depreciation) and to eliminate a retained earnings deficit (and thus facilitate the declaration of dividends).

2. Procedures

a. Revalue assets to current fair values and liabilities to their present values. (No net increase in asset value is permitted, and the write-down is charged directly to retained earnings, thus increasing the deficit temporarily.)

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b. Bring retained earnings to zero (i.e., eliminate the deficit) against additional paid-in capital. (If additional paid-in capital is insufficient to absorb the deficit, more additional paid-in capital can be created by reducing the par or stated value of the stock, thus reducing capital stock.)

c. Following a quasi-reorganization, retained earnings on the balance sheet must be dated to show the date of the adjustment, and that date must continue to be disclosed until such time as it is insignificant (usually 3-10 years).

EXAMPLE

Accounting for Quasi-reorganizations

On December 31, Year 4, the stockholders' equity section of Duffy Co.'s balance sheet consisted of the following:

Common stock, $30 par, 10,000 shares authorized and outstanding	$300,000
Additional paid-in capital	150,000
Retained earnings (deficit)	(210,000)
Total Equity	$240,000

On January 2, Year 5, Duffy put into effect a stockholder-approved quasi-reorganization by reducing the par value of the stock to $5 and eliminating the deficit against additional paid-in capital.

Journal Entry: To eliminate the deficit in retained earnings

DR	Common stock	$250,000	
CR	Retained earnings		$210,000
CR	Additional paid-in capital		40,000

After the quasi-reorganization the stockholders' equity section of Duffy's Co.'s balance sheet consisted of:

Common stock, $5 par, 10,000 shares authorized and outstanding	$ 50,000
Additional paid-in capital	190,000
Retained earnings	0
Total Equity	$240,000

OTHER COMPREHENSIVE INCOME

V. ACCUMULATED OTHER COMPREHENSIVE INCOME

Components of accumulated other comprehensive income include foreign currency translation adjustments, adjustments for pension funded status changes, unrealized gains and losses on available-for-sale securities, and deferred gains and losses on the effective portion of cash flow hedges.

These components of other comprehensive income are not included in determining net income and, therefore, do not enter into retained earnings. Rather, they are recognized in the period in which they occur and are combined with net income to determine comprehensive income (as discussed in lecture F1). Total accumulated other comprehensive income must be shown in the shareholders' equity section separate from capital stock, additional paid-in capital, and retained earnings.

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VI. TREASURY STOCK

Treasury stock is a corporation's own stock that has been issued to shareholders and subsequently reacquired (but not retired). Treasury stock is not generally considered an asset because it is widely held that a corporation cannot own part of itself. Treasury stockholders are not entitled to any of the rights of ownership given to common shareholders, such as the right to vote or to receive dividends. In addition, a portion of retained earnings equal to the cost of treasury stock may be restricted and may not be used as a basis for the declaration or payment of dividends (depending on applicable state law).

A. METHODS OF ACCOUNTING FOR TREASURY STOCK

GAAP permits two methods of accounting for treasury stock: (1) the cost method and (2) the legal (or par/stated value) method. The primary difference between the two methods is the timing of the recognition of "gain or loss" on treasury stock transactions. Note that under both methods, the "gains and losses" are recorded as a direct adjustment to stockholders' equity and are **not** included in the determination of net income. Also, under both methods, shares held as treasury stock are not considered to be outstanding shares.

1. Cost Method (used approximately 95% of the time)

Under the cost method, the treasury shares are recorded and carried at their reacquisition cost. A gain or loss will be determined when treasury stock is reissued or retired, and the original issue price and book value of the stock do not enter into the accounting. The account "additional paid-in capital from treasury stock" is credited for gains and debited for losses when treasury stock is reissued at prices that differ from the original selling price. Losses may also decrease retained earnings if the additional paid-in capital from treasury stock account does not have a balance large enough to absorb the loss. Net income or retained earnings will never be increased through treasury stock transactions.

a. Journal Entry to Record Purchase of Treasury Stock

DR	Treasury stock (1,000 shares @ $15 per share cost)	$15,000	
CR	Cash (paid for treasury stock)		$15,000

b. Balance Sheet Presentation

On the balance sheet, the treasury stock would be subtracted from the total of other shareholder equity in the following (shortened) manner:

Common stock (100,000 shares @ $1)	$ 100,000
Additional paid-in capital (assumed)	900,000
Total paid-in capital (subtotal)	1,000,000
Retained earnings (assumed)	200,000
	1,200,000
Less: Cost of 1,000 shares of treasury stock	**(15,000)**
Total shareholders' equity	$1,185,000

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c. Journal Entry to Record the Resale of Treasury Stock (Example displays a resale for more than cost.)

DR	Cash (amount of the sale)	$18,000	
CR	Treasury stock (at cost)		$15,000
CR	Additional paid-in capital (sales proceeds > cost)		3,000

2. Legal (or Par/Stated Value) Method (used approximately 5% of the time)

TREASURY STOCK: PAR VALUE METHOD

Under the legal method, the treasury shares are recorded by reducing the amounts of par (or stated) value and additional paid-in capital received at the time of the original sale. Treasury stock is debited for its par (or stated) value. Additional paid-in capital is debited (reduced) for the pro rata share of the original issue price attributable to the reacquired shares. Retained earnings is debited (reduced) for any excess of treasury stock cost over the original issue price. Paid-in capital is credited (increased) for any excess of the original issue price over the treasury stock cost. Note that, under this method, the sources of capital associated with the original issue are maintained.

a. Journal Entry to Record the Purchase of Treasury Stock (Example displays stock originally sold at $10 per share.)

DR	Treasury stock (1,000 shares @ $1 par)	$1,000	
DR	Additional paid-in capital (pro rata: 1,000 x $9)	9,000	
DR	Retained earnings (1,000 x $5)	5,000	
CR	Cash (paid for treasury stock)		$15,000

b. Balance Sheet Presentation

On the balance sheet, the treasury stock would be subtracted from the related capital stock, additional paid-in capital, and retained earnings in the following (shortened) manner:

Common stock (100,000 shares @ $1 par)	$100,000
Less: Treasury stock (1,000 shares @ $1 par)	**(1,000)**
Common stock outstanding	99,000
Additional paid-in capital ($75,000 – **$9,000**)	66,000
Retained earnings ($200,000 – **$5,000**)	195,000
Total shareholders' equity	$360,000

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c. Journal Entry to Record the Resale of Treasury Stock (Example displays a resale for more than cost.)

DR	Cash (amount of the sale)	$18,000	
CR	Treasury stock (1,000 shares @ $1 par)		$1,000
CR	Additional paid-in capital		17,000

B. RETIREMENT OF TREASURY STOCK

When treasury stock is acquired with the intent of retiring the stock (regardless of whether it is accomplished) and the price paid is in excess of the par or stated value, that excess may be charged against either (1) all paid-in capital arising from past transactions in the same class of stock or (2) retained earnings. When the price paid for the acquired treasury stock is less than par or stated value, the difference must be credited to paid-in capital. The retirement of treasury stock would be accomplished with the following journal entry:

DR	Common stock @ par (under both methods)	$XXX	
DR	Additional paid-in capital (under the cost method)	XXX	
CR	Treasury stock (under both methods)		$XXX
CR	Additional paid-in capital from treasury stock retirement (if the cost is less than the original issue price under the cost method)		XXX

C. DONATED STOCK

Donated stock is a company's own stock received as a donation from a shareholder. There is no change in total shareholders' equity as a result of the donation. The company should record donated stock at fair market value, as follows:

DR	Donated treasury stock (@FMV)	$XXX	
CR	Additional paid-in capital (@FMV)		$XXX

If the donated stock is sold, the journal entry would be:

DR	Cash (@ sales price)	$XXX	
DR	Additional paid-in capital (if SP < Original FMV)	XXX	
CR	Additional paid-in capital (if SP > Original FMV)		$XXX
CR	Donated treasury stock (@ book value, or Original FMV)		XXX

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VII. ACCOUNTING FOR A STOCK ISSUANCE (TO NON-EMPLOYEES)

CAPITAL STOCK: ISSUANCE OF SHARES

If par (or stated) value exists, stock may be issued above, at, or below par (or stated) value. Often, stock subscriptions are sold before the stock is actually issued.

A. STOCK ISSUED ABOVE PAR VALUE

If stock is issued above par value, cash will be debited for the proceeds, common (or preferred) capital stock will be credited for par (or stated) value, and additional paid-in capital will be credited for the excess over par (or stated) value.

B. STOCK ISSUED AT PAR VALUE

If stock is issued at par value, cash will be debited and common (or preferred) capital stock will be credited for the proceeds. There is no entry to additional paid-in capital.

C. STOCK ISSUED BELOW PAR VALUE

If stock is issued at less than par (or stated) value, additional paid-in capital would be debited to reflect a discount on the stock. The discount represents a contingent liability to the original owners.

D. STOCK SUBSCRIPTIONS

Frequently, a corporation sells its capital stock by subscription. This means that a contractual agreement to sell a specified number of shares at an agreed-upon price on credit is entered into. Upon full payment of the subscription, a stock certificate evidencing ownership in the corporation is issued.

1. Sale of Subscriptions

When the subscription method is used to sell capital stock, a "subscriptions receivable" account is debited and a "capital stock subscribed" account is credited, as is a regular additional paid-in capital account. Subscriptions not paid for at year-end are treated as a contra-equity item, offsetting the amount of par (or stated) value and additional paid-in capital related to subscriptions not paid for at year-end (if subscriptions are paid after year-end but before the financial statements are issued, the subscriptions receivable may be reported as an asset and will increase paid-in capital at year-end). The journal entry to record subscriptions receivable is as follows:

DR	Subscriptions receivable (1,000 shares @ sales price of $100/share)	$100,000	
CR	Common stock subscribed ($10 par x 1,000 shares)		$10,000
CR	Additional paid-in capital (1,000s x $90/share)		90,000

2. Collection of Subscriptions

Upon payment of the subscription, the subscription receivable account is credited and cash or other assets are debited, as follows [assume that $85,000 of the $100,000 subscription from above is collected, including $80,000 in full payment of subscriptions and $5,000 in partial subscription payments (common stock cannot be issued until partial payments are paid in full)].

DR	Cash	$85,000	
CR	Subscriptions receivable		$85,000

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3. Issuance of Stock Previously Subscribed

On the actual issuance of the stock certificates, the capital stock subscribed account is debited and the regular capital stock account is credited, as follows (assume that the $80,000 in fully-paid subscriptions from above become issued shares):

DR	Common stock subscribed (800 shares @ $10)	$8,000	
CR	Common stock (issued)		$8,000

4. Default/Forfeiture of a Subscription

If all or part of a subscription is not collected, the terms of the subscription agreement and corporate policy will determine the appropriate accounting treatment. Generally, the treatment is to reverse the applicable portion of the original entry and either (1) issue stock in proportion to the amount paid; (2) refund the partial payment; or (3) retain the partial payment (as liquidated damages for breach of contract) by a credit to additional paid-in capital.

E. STOCK RIGHTS

A stock right provides an existing shareholder with the opportunity to buy additional shares. The right usually carries a price below the stock's market price on the date the rights are granted. The issuance of stock rights requires a memorandum entry only. It is possible that the rights may subsequently be redeemed by the company, which will cause a decrease in stockholders' equity in the amount of the redemption price. The exercise of stock rights requires the following journal entry:

DR	Cash	[amount received]	
CR	Common stock		[par value]
CR	Additional paid-in capital		[residual]

F. OTHER STOCK VALUATION ISSUES

Stock issued for **outside services** should be recorded at the fair value of the stock, and the trading price of the stock is the best evidence of fair value. Stock issued in a "basket sale" with other securities (e.g., bonds) should be allocated a portion of the sales proceeds based on the relative fair market values of the different securities (covered in lecture F5).

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VIII. DISTRIBUTIONS TO SHAREHOLDERS

A dividend is a pro-rata distribution by a corporation based on the shares of a particular class of stock and usually represents a distribution of earnings. Cash dividends are the most common type of dividend distribution, although there are many other types (covered below). Preferred stock usually pays a fixed dividend, expressed in dollars or as a percentage.

A. TERMINOLOGY

1. Date of Declaration

The declaration date is the date the board of directors formally approves a dividend. On the declaration date, a liability is created (dividends payable) and retained earnings is reduced (debited).

2. Date of Record

The date of record is the date the board of directors specifies as the date the names of the shareholders to receive the dividend are determined.

3. Date of Payment

The date of payment is the date on which the dividend is actually disbursed by the corporation or its paying agent.

B. CASH DIVIDENDS

Cash dividends distribute cash to shareholders and may be declared on common or preferred stock. They are paid from retained earnings. Dividends are paid only on authorized, issued, and outstanding shares. They are not paid (or declared) on treasury stock.

C. PROPERTY (IN-KIND) DIVIDENDS

Property dividends distribute non-cash assets (e.g., inventory, investment securities, etc.) to shareholders. They are non-reciprocal transfers of nonmonetary assets from the company to its shareholders. On the date of declaration, the property to be distributed should be restated to fair value and any gain or loss should be recognized in income. The dividend liability and related debit to retained earnings should be recorded at the fair value of the assets transferred.

D. SCRIP DIVIDENDS

Scrip dividends are simply a special form of notes payable whereby a corporation commits to paying a dividend at some later date. Scrip dividends may be used when there is a cash shortage. On the date of declaration, retained earnings is debited and notes payable (instead of dividends payable) is credited. Some scrip dividends even bear interest from the declaration date to the date of payment (and, thus, require accrual).

E. LIQUIDATING DIVIDENDS

Liquidating dividends occur when dividends to shareholders exceed retained earnings. Dividends in excess of retained earnings would be charged (debited) first to additional paid-in capital and then to common or preferred stock (as appropriate). Liquidating dividends reduce total paid-in capital.

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F. STOCK DIVIDENDS

Stock dividends distribute additional shares of a company's own stock to its shareholders. The treatment of stock dividends depends on the size (percentage) of the dividend in proportion to the total shares outstanding before the dividend.

1. Treatment of a Small Stock Dividend (< 20 – 25%)

When less than 20-25% of the shares previously outstanding are distributed, the dividend is treated as a small stock dividend because the issuance is not expected to affect the market price of the stock. The fair market value of the stock dividend at the date of declaration is transferred from retained earnings to capital stock and additional paid-in capital. There is no effect on total shareholders' equity, as paid-in capital is substituted for retained earnings (i.e., retained earnings is "capitalized" and made part of paid-in capital).

EXAMPLE

Small Stock Dividend

Capital Corporation has 100,000 shares of $10 par value common stock outstanding. The company declares a stock dividend of 5,000 shares when the fair market value is $15 (on the date of declaration). 5,000 shares/100,000 shares = 5%, which is considered a small stock dividend. What is the journal entry to record the dividend?

Journal Entry:

DR	Retained earnings (5,000 × $15 FMV)	$75,000	
CR	Common stock (5,000 × $10 par value)		$50,000
CR	Paid-in capital (difference = $75,000 − 50,000)		25,000

2. Treatment of a Large Stock Dividend (> 20 –25%)

When more than 20-25% of the previously issued shares outstanding are distributed, the dividend is treated as a large stock dividend, as it may be expected to reduce the market price of the stock (similar to a stock split). The par (or stated) value of the stock dividend is normally transferred from retained earnings to capital stock in order to meet legal requirements. The amount transferred is the number of shares issued multiplied by the par (or stated) value of the stock. However, if state law does not require capitalization of retained earnings for stock dividends (which is rare because it requires amendment to the articles of incorporation), record the stock dividend distribution (like a stock split) by changing the number of shares outstanding and the par (or stated) value per share.

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EXAMPLE

Stock Dividend Greater Than 20% to 25% of Previous Outstanding Shares

LMT Corp. declares a 40% stock dividend on its 1,000,000 shares of outstanding $10 par common stock (5,000,000 authorized). On the date of declaration, LMT stock is selling for $20 per share.

Total stock dividend (.40 × 1,000,000)	400,000 shares	
Value of 400,000 shares @ $10 per share (par)	$4,000,000	
Journal Entry: To record the declaration of the stock dividend at par		
DR Retained earnings	4,000,000	
CR Common stock distributable		4,000,000
Journal Entry: To record the distribution of the stock dividend		
DR Common stock distributable	4,000,000	
CR Capital stock, $10 par common		4,000,000

3. Stock Dividends on Treasury Stock

Stock dividends are generally not distributed on treasury stock because such stock is not considered outstanding. However, an exception is made when (1) the company is maintaining a ratio of treasury shares to shares outstanding in order to meet stock option or other contractual commitments or (2) state law requires that treasury stock be protected from dilution.

G. STOCK SPLITS

Stock splits occur when a corporation issues additional shares of its own stock (without charge) to current shareholders and reduces the par (or stated) value per share proportionately. There is no change in the total book value of the shares outstanding. Thus, the memo entry to acknowledge a stock split is merely a formality. A stock split usually does not affect retained earnings or total shareholders' equity, as is exhibited below:

Before the Split:		
Common stock (10,000 shares outstanding @ $10 par)		$100,000
After the Split:	(x 2)	(÷2)
Common stock (20,000 shares outstanding @ $5 par)		$100,000

1. Reverse Stock Splits

A reverse stock split would involve reducing the number of shares outstanding and increasing the par (or stated) value proportionately. One way to reduce the amount of outstanding shares is to recall outstanding stock certificates and issue new certificates.

2. Stock Splits on Treasury Stock

Stock splits are usually not applied to treasury stock because such stock is not considered outstanding. However, an exception is made when (1) the company is maintaining a ratio of treasury shares to shares outstanding in order to meet stock option or other contractual commitments or (2) state law requires that treasury stock be protected from dilution.

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IX. DISCLOSURE OF INFORMATION ABOUT CAPITAL STRUCTURE (SFAS NO. 129)

A. APPLICABILITY

All entities, public and nonpublic, that have issued securities are required to make certain disclosures about their capital structures. These disclosure requirements, previously covered in various pronouncements, were consolidated into one pronouncement, SFAS No.129 Disclosure of Information about Capital Structure.

B. RIGHTS AND PRIVILEGES OF SECURITIES

An entity is required to disclose in the financial statements, in summary form, the pertinent rights and privileges of the various securities outstanding. Examples include dividend and liquidation preferences, participation rights, call prices and dates, conversion or exercise prices or rates and pertinent dates, sinking-fund requirements, unusual voting rights, and significant terms of contracts to issue additional shares.

C. NUMBER OF SHARES

An entity is required to disclose the number of shares issued upon conversion, exercise, or satisfaction of required conditions during at least the most recent annual fiscal period and any subsequent interim period presented.

D. LIQUIDATION PREFERENCE OF PREFERRED STOCK

1. If an entity issues preferred stock or other senior stock that has a preference in involuntary liquidation considerably in excess of the par or stated value of the shares, it is required to disclose this information in the equity section of the statement of financial position. The disclosure may be made parenthetically or "in short," but not on a per-share basis or in the notes.
2. In addition, the entity is required to disclose, either on the statement of financial position or in the notes, the aggregate or per-share amounts at which preferred stock may be called or is subject to redemption through sinking-fund operations, and the aggregate or per share amounts of arrearages in cumulative preferred dividends.

E. REDEEMABLE

The amount of redemption requirements related to redeemable stock must be disclosed for all issues of capital stock that are redeemable at fixed or determinable prices on fixed or determinable dates in each of the five years following the date of the latest statement of financial position presented.

X. ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES

A stock option is the right to purchase shares of a corporation's capital stock under fixed conditions of time, place, and amount.

Under traditional stock option and stock purchase plans, an employer corporation grants options to purchase shares of its stock, often at a price lower than the prevailing market, making it possible for the individual exercising the option to have a potential profit at the moment of acquisition. Most option agreements provide that the purchaser must retain the stock for a minimum period, thus eliminating the possibility of speculation. The cost of compensation is measured by the fair value based on an option pricing model. Stock options or purchase plans can be either noncompensatory or compensatory depending on the relationship of the exercise price of the option to the market price of the stock at the date the option is granted.

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A. NONCOMPENSATORY STOCK OPTION/PURCHASE PLANS

1. Intention

There are certain stock options and stock purchase plans that may not be intended primarily to compensate employees. For example, a corporation may wish to raise capital or diversify ownership of its stock among its employees or officers.

2. Characteristics Essential in Noncompensatory Stock Options or Stock Purchase Plans

a. Substantially all full-time employees meeting limited employee qualifications may participate. Excluded are officers and employees owning a specific amount of the outstanding stock in the corporation.

b. Stock is offered to eligible employees equally, but the plan may limit the total amount of shares that can be purchased.

c. The time permitted to exercise the rights is limited to a reasonable period.

d. Any discount from the market price is no greater than would be a reasonable offer of stock to shareholders or others.

Stock option plans that meet the requirements of a noncompensatory plan do not require the recognition of compensation expense by the sponsoring company. Plans that do not contain these characteristics are usually classified as compensatory plans.

B. COMPENSATORY STOCK OPTION/PURCHASE PLANS

SFAS No.123R, issued in December, 2004, now requires that compensatory stock options be valued at the fair value of the options issued, not on the market value of the underlying stock. Using the market value of the stock was previously permitted under APBO 25 and SFAS 123.

1. Definitions

a. The **option price** (also called the exercise price) is the price at which the underlying stock can be purchased pursuant to the option contract.

b. The **exercise date** is the date by which the option holder must use the option to purchase the underlying (and typically the date at which the stock options outstanding account is reduced).

c. **Fair value** of the option as determined by an economic pricing model such as the Black-Scholes method.

d. The **grant date** is the date the option is issued.

e. The **vesting period** is the period over which the employee has to perform services in order to earn the right to exercise the options (i.e., the time from the grant date to the vesting date). Compensation is recognized over the **service** period (i.e., the period the employee performs the service), and this is generally the vesting period.

2. Compensation Expense

Under the fair value based method, total compensation expense is measured by applying an acceptable fair value pricing model such as the *Black-Scholes Option Pricing Model*. Any CPA exam question will supply this number. This compensation expense, calculated on the grant date of the options, is allocated over the service period, in accordance with the matching principle. The service period is the vesting period, which is the time between the grant date and the vesting date.

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3. Compensation Cost

The compensation cost should be recognized as an expense over the periods of employment attributable to the option.

EXAMPLE

Accounting for Stock Options

On January 1, Year 1, ABC Co. granted options exercisable after December 31, Year 2, to purchase 10,000 shares of $5 par common stock for $25 per share. Using an acceptable valuation model, the options had a total fair value of $50,000. The options are to serve as compensation for services during Year 1 and Year 2.

Journal Entry: January 1, Year 1 – *No entry required*

Journal Entry: To allocate compensation cost to Year 1 operations

DR	Compensation expense	$25,000	
CR	Additional paid-in capital – stock options		$25,000

Journal Entry: To allocate compensation cost to Year 2 operations

DR	Compensation expense	$25,000	
CR	Additional paid-in capital – stock options		$25,000

On January 1, Year 3, all options are exercised.

Journal Entry: To record the exercise of the options

DR	Cash (10,000 × $25)	$250,000	
DR	Additional paid-in capital—stock options	50,000	
CR	Common stock (10,000 × $5 par)		$50,000
CR	Additional paid-in capital in excess of par (common stock) [to balance entry]		250,000

d. Expiration of Options

Expiration of options requires a reclassification of the remaining balance in the "additional paid-in capital—stock options" account. Reclassification is accomplished by means of the following journal entry:

DR	Additional paid-in capital—stock options	XXX	
CR	Additional paid-in capital—expired stock options		XXX

Note: Compensation expense is not affected by the expiration of options.

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EXAMPLE

Expiration of Options

Assume that in the previous example, only one half of the options are exercised. The journal entry to record the exercise of options follows:

DR	Cash (5,000 × $25)	$125,000	
DR	Additional paid-in capital—stock options	25,000	
CR	Common stock (5,000 × $5)		$25,000
CR	Additional paid-in capital (common stock)		125,000

If the remaining options expire, the "additional paid-in capital–stock options" account would have to be reclassified as expired. The required journal entry follows:

DR	Additional paid-in capital—stock options	$25,000	
CR	Additional paid-in capital—expired stock options		$25,000

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C. STOCK APPRECIATION RIGHTS (SARS)

STOCK APPRECIATION RIGHTS

A stock appreciation right entitles an employee to receive an amount equal to the excess of the market price of stock at the exercise date over a predetermined amount (usually market price at grant date). This excess times the number of rights outstanding is the compensation expense of the corporation. Compensation expense for stock appreciation rights outstanding must be adjusted annually to account for changes in the market price of the stock. Unlike stock options, stock appreciation rights do not require the employee to make a cash payment.

EXAMPLE

Stock Appreciation Rights

On January 1, Year 1, Loud Corp. granted Mort, its president, 10,000 stock appreciation rights expiring on January 3, Year 4. Upon exercise, Mort may receive cash for the excess of market price of the stock on that date over the market price on the grant date, and the service period runs for two years. Market prices were as follows:

January 1, Year 1	$30
December 31, Year 1	$45
December 31, Year 2	$40

How much compensation expense should Loud record in Year 1 and Year 2?

Year 1 (First Year Calculation)

Market price at December 31, Year 1	$ 45
Market price at January 1, Year 1	(30)
Appreciation in market value	15
Number of stock rights outstanding	× 10,000
Total compensation expense	$150,000

Compensation expense for Year 1 is then ½ x $150,000 since the service period is for two years. Loud's journal entry at 12/31/Yr 1 follows:

DR	Compensation expense	$75,000	
CR	Liability for SAR plan		$75,000

A liability account is credited since Mort will receive cash. Otherwise, paid-in capital would be credited if stock is to be issued.

Year 2

Market price at December 31, Year 2	$ 40
Market price at January 1, Year 1	(30)
Appreciation in market value	10
Number of rights outstanding	× 10,000
Required balance in liability, Year 2	$100,000

Compensation expense is $100,000 less the $75,000 previously recognized, or $25,000. The required journal entry for Year 2 follows:

DR	Compensation expense	$25,000	
CR	Liability for SAR plan		$25,000

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EXAMPLE

Continued

Exercise of Option

If Mort exercises all his options on January 2, Year 3, when the market value of Loud's stock is still $40, Loud would make the following entry:

DR	Liability for SAR plan	$100,000*	
CR	Cash		$100,000

* This amount may be computed using either method presented below:

Market price at exercise date	$ 40
Market price at grant date	(30)
Total appreciation	10
Number of rights outstanding	× 10,000
Total liability for SAR plan	$100,000

or

Liability for SAR plan - 12/31/Yr 1 balance	$ 75,000
Add: Year 2 liability	25,000
Total liability for SAR plan	$100,000

Date	Market price	Grant price	Compensation	% recognized	Expense 12/31/Yr 1	Expense 12/31/Yr 2
1/1/Yr 1	$30	$30				
12/31/Yr 1	45	30	$150,000	50%	$75,000	
12/31/Yr 2	40	30	100,000	100%		$25,000

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EARNINGS PER SHARE

EARNINGS PER SHARE

I. OVERVIEW

FASB Statement No. 128 requires all public entities (or entities that have made a filing for a public offering) to present earnings per share on the face of the income statement. An entity's capital structure determines the manner in which earnings per share will be disclosed.

An entity has a simple capital structure if it has only common stock outstanding. The entity presents basic per share amounts for income from continuing operations and for net income on the face of the income statement.

All other entities present basic and diluted per share amounts for income from continuing operations and for net income on the face of the income statement with equal prominence.

If the entity reports a discontinued operation, or an extraordinary item, the entity presents the basic and diluted (if applicable) per share amounts for those items either on the face of the income statement or in the notes to the financial statements.

II. SIMPLE CAPITAL STRUCTURE (BASIC EPS ONLY)

An entity that issues only common stock (or no other securities that can become common stock, such as noncovertible preferred stock) is said to have a simple capital structure. This organization will present EPS for income from continuing operations and for net income on the face of the income statement. The number of common shares outstanding (the denominator) used in the EPS calculation is arrived at by the weighted average method.

A. BASIC EPS FORMULA

For an organization with a simple capital structure, the formula for earnings per share is as follows:

$$\text{Basic EPS} = \frac{\text{Income available to common shareholders}}{\text{Weighted average number of common shares outstanding}}$$

B. INCOME AVAILABLE TO THE COMMON SHAREHOLDERS

Income available to common shareholders is determined by deducting from the line item income from continuing operations and net income (1) dividends declared in the period on non-cumulative preferred stock (regardless of whether they have been paid) and (2) dividends accumulated in the period on cumulative preferred stock (regardless of whether they have been declared).

If there is a loss from continuing operations (or a net loss), the amount of the loss should be increased by the preferred shareholders' dividends or claims to determine income available to the common shareholders.

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C. WEIGHTED-AVERAGE NUMBER OF COMMON SHARES OUTSTANDING

WEIGHTED-AVERAGE COMPUTATION

The weighted-average number of common shares outstanding during the period is the mean (average) of shares outstanding and assumed to be outstanding for EPS calculations. Shares sold or reacquired during the period (including treasury stock) should be weighted for the portion of the period they were outstanding.

	Shares outstanding at the beginning of the period
+	Shares **sold** during the period (on a time-weighted basis)
–	Shares **reacquired** during the period (on a time-weighted basis)
+	Stock **dividends** and stock **splits** (retroactively adjusted)
–	**Reverse** stock **splits** (retroactively adjusted)
	Weighted-average number of common shares outstanding for the entire period

1. Stock Dividends and Stock Splits

Stock dividends and stock splits (to the same class of shareholders in the same company) must be treated as though they occurred at the **beginning** of the period. The shares outstanding before the stock dividend or stock split must be restated for the portion of the period before the stock dividend/split. If prior periods are presented, the effects of stock dividends and stock splits must be retroactively adjusted for those periods.

a. If a stock dividend or stock split occurs after the end of the period but before the financial statements are issued, those shares should enter into the shares outstanding for the EPS calculation for all periods presented.

b. Reverse stock splits would retroactively reduce shares outstanding for all periods presented.

2. Rules for Stock Issued in a Business Combination

If the purchase method is used, the weighted-average is measured from the date of the combination. If the pooling method is used (only those having previously used pooling after the issuance of SFAS No. 141), the shares issued (including a dividend or a split) are retroactively adjusted for all periods presented. (Business combinations are covered in detail in lecture F3.)

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EXAMPLE

Weighted-average Number of Shares Outstanding Computation
(with adjustments for a stock split, a new sale, and a repurchase)

Facts

Date	Transaction	Change in Shares	Total Shares
1/1	Shares outstanding		1,000,000
3/31	2-for-1 stock split	1,000,000	2,000,000
4/1	Additional shares sold	3,000,000	5,000,000
12/1	Reacquired shares (treasury)	(500,000)	4,500,000

Computation of Weighted-average Number of Shares Outstanding

Total Shares	×	Period Outstanding	×	Adjustment for Split	=	Weighted-Average
1,000,000		3/12 (Jan - Mar)		2		500,000
5,000,000		8/12 (April - Nov)				3,333,333
4,500,000		1/12 (Dec)				375,000
		Weighted-average shares outstanding				4,208,333

Alternate Method of Weighted-average Number of Shares Outstanding

Date	Transaction	Gross Change in Shares	Adjustment to Weighted-average Shares
1/1	Shares outstanding	(beginning number)	1,000,000
3/31	2-for-1 stock split	1,000,000	1,000,000 [effective 1/1]
4/1	Additional shares sold	3,000,000	2,250,000 [3,000,000 x 9/12]
12/1	Reacquired shares	(500,000)	(41,667) [500,000 x 1/12]
	Weighted-average shares outstanding		4,208,333

III. COMPLEX CAPITAL STRUCTURE (BASIC AND DILUTED EPS)

An entity has a complex capital structure when it has securities that can potentially be converted to common stock and would therefore dilute (reduce) EPS (of common stock). Both basic and diluted EPS must be presented. The basic EPS calculation ignores potentially dilutive securities in the weighted-average number of shares outstanding calculation. The objective of diluted EPS is to measure the performance of an entity over the reporting period while giving effect to all potentially dilutive common stock shares outstanding during the period. Potentially dilutive securities include:

(i) Convertible securities (e.g., convertible preferred stock, convertible bonds, etc.),

(ii) Warrants and other options,

(iii) Contracts that may be settled in cash or stock, and

(iv) Contingent shares.

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A. DILUTED EPS FORMULA

$$\text{Diluted EPS} = \frac{\text{Income available to the common stock shareholder} + \text{interest on dilutive securities}}{\text{Weighted-average number of common shares, assuming all dilutive securities are converted to common stock}}$$

B. DILUTION FROM OPTIONS, WARRANTS, AND THEIR EQUIVALENTS

The dilutive effect of options and warrants and their equivalents is applied using the treasury stock method. The treasury stock method assumes that the proceeds from the exercise of stock options, warrants, and their equivalents will be used by the company to repurchase treasury shares at the prevailing market price, resulting in an incremental increase in shares outstanding, but not the full amount of shares that are issued on exercise of the common stock equivalents. The equivalents of options and warrants include nonvested stock granted to employees, stock purchase contracts, and partially paid stock subscriptions. Any canceled or issued options or warrants during the period shall be included in the denominator of diluted EPS for the period they were outstanding.

1. Dilutive vs. Antidilutive

Options and similar instruments are only dilutive when the average market price of the underlying common stock exceeds the exercise price of the options or warrants because it is unlikely they would be exercised if the exercise price were higher than the market price. These options or warrants would be "out of the money" and antidilutive. Previously reported EPS should not be adjusted retroactively in the case of options or similar instruments to reflect subsequent changes in market prices of the common stock.

2. Treasury Stock Method

a. If the average market price of the stock is greater than the exercise price (called "in the money"), assume that the warrants or other options are exercised at the beginning of the period (or at the time of issue, if later).

b. Also assume that the proceeds received (the option or exercise price) are used to purchase common shares at the average market price during the period.

c. When the average market price is in the money, the proceeds (assumed to be) received will not be sufficient to buy back an (assumed) equal number of shares.

d. This will always result in dilution.

e. The difference between the number of shares assumed issued to satisfy the options or warrants and the number of share assumed to be purchased with the proceeds should be included in the number of shares (denominator) for diluted EPS.

f. Previously reported EPS data should not be retroactively adjusted for changes in market price.

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The formula to compute additional shares for options and similar instruments is:

$$\text{Number of shares} - \left(\frac{\text{number of shares} \times \text{exercise price}}{\text{average market price}}\right) = \text{additional shares outstanding}$$

The following example will illustrate how the incremental shares are computed for options and similar instruments.

EXAMPLE

Options and Warrants

A company has 1,000 stock options outstanding, which are exercisable at $30 each. If the average market price is $50 per share, determine the number of shares of common stock equivalents that should be included for diluted EPS.

For diluted EPS:

$$1{,}000 - \frac{1{,}000 \times \$30}{\$50} = 400$$

OPTIONS & WARRANTS
TREASURY STOCK METHOD

FACTS: 1000 options to purchase 1000 common stock shares
$15.00 exercise price per share
$20.00 average market price
$25.00 period end market price

		DILUTED
Options/common stock shares	1,000 ● →	1,000
Exercise price per share	$15.00	
Cash corp. received (hypothetically)	$15,000	
Diluted "repurchase price"	÷$20.00	
Repurchase shares (hypothetically)		<750>
Net increase "pretend" common stock		250

FORMULA APPROACH

$$1000 - \frac{1{,}000 \times \$15.00}{\$20.00} = 250$$

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C. DILUTION FROM CONVERTIBLE SECURITIES (BONDS OR PREFERRED STOCK)

CONVERTIBLE SECURITIES

The "if-converted" method should be used to determine the dilutive effects of the convertible securities. The "if-converted" method assumes that the securities were converted to common stock at the **beginning** of the period (or at the time of issue, if later).

1. Convertible Bonds

a. Add to the numerator (i.e., income available to common shareholders) the interest expense, net of tax, due to the assumed conversion of bonds to common stock.

b. Add to the denominator (i.e., weighted-average number of shares outstanding) the number of common shares associated with the assumed conversion.

c. If the convertible bonds were issued during the period, assume the stock was issued at that date for the weighted-average calculation.

CONVERTIBLE BONDS
IF-CONVERTED METHOD
(Recalculation of "Income Available to Common Shareholder")

ACTUAL		PRETEND
$100	Income	$100
< 20 >	Bond interest	< 0 >
80	Income before taxes	100
< 32 >	Taxes (40%)	< 40 >
$48	N.I. available to common stockholders	$60

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2. Antidilution

Use the results of each assumed conversion only if it results in dilution (i.e., reduces EPS). Do not include the results of the *assumed* conversion if it is antidilutive (i.e., increases EPS). In determining whether potential common shares are dilutive or antidilutive, each issue will be considered separately in sequence from most to least dilutive, with options and warrants generally included first. The tests for dilutive or antidilutive effects should be based on income from continuing operations, if available (otherwise use income before extraordinary items).

EXAMPLE

Application of the If-Converted Method (Convertible Debentures)

X Company has outstanding 100,000 shares of common stock and $500,000 in 6% debentures convertible into 10 shares for each $1,000 bond. Net income for the year is $100,000. What is diluted EPS assuming a 34% tax rate?

Diluted shares outstanding:	
Common stock	100,000
Convertible debentures (500 × 10)	5,000
Total common shares outstanding	105,000
Diluted net income:	
Net income	$100,000
Add: Interest on bonds, less tax effects	
(0.06 × $500,000 × (1– 0.34))	19,800
Total net income	$119,800
Diluted EPS	
($119,800 ÷ 105,000 shares)	$1.14

Once again, we must check to see whether the inclusion of the convertible debentures in the computation of diluted EPS is antidilutive, by comparing basic EPS computed with the bonds to diluted EPS computed without the bonds, as follows:

Basic EPS (without conversion)	
($100,000 ÷ 100,000 shares)	$1.00

Diluted EPS with conversion of the convertible bonds ($1.14) is more than basic EPS without the conversion ($1.00). The convertible bonds are, therefore, antidilutive and would be excluded.

3. Convertible Preferred Stock

a. Adjust the numerator (as preferred stock dividends do not affect net income).

b. Add to the denominator the number of shares associated with the assumed conversion.

c. Antidilution rules apply to convertible preferred stock.

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EXAMPLE

Application of the If-Converted Method (Convertible Preferred Stock)

Carlin Company has outstanding 100,000 shares of common stock and 10,000 shares of convertible preferred stock, convertible into five shares of common stock for each share of preferred. Net income for the year is $100,000. Dividends paid during the year were $20,000 on the preferred, and $30,000 on the common. What is diluted EPS assuming a 34% tax rate?

Diluted shares outstanding:	
Common stock	100,000
Convertible preferred stock (10,000 × 5)	50,000
Total common share outstanding	150,000
Diluted net income	$100,000
Diluted EPS ($100,000 ÷ 150,000)	$ 0.67

Note: The preferred stock dividends are not subtracted from net income. We assume that since the preferred stock was converted into common stock, the preferred stock dividends were not paid. Finally, antidilution is checked:

Basic EPS: $\frac{\$100,000 - \$20,000}{100,000} = \$0.80$

Since diluted EPS is less than basic EPS (without conversion), the preferred stock is dilutive, and diluted EPS is $0.67.

D. DILUTION FROM CONTRACTS THAT MAY BE SETTLED IN CASH OR IN STOCK

If a contract could be settled in either stock or cash at the election of either the entity or the holder, the facts available each period determine whether it is reflected in the computation of EPS. It is presumed that the contract will be settled in common stock and the resulting shares included in diluted EPS if the effect is more dilutive.

E. DILUTION FROM CONTINGENT SHARES

Contingent issuable shares do not require cash consideration and depend on some future event or on certain conditions being met. Contingent shares (that are dilutive) are also included in the calculation of **basic** EPS if (and as of the date) all conditions for issuance are met.

Issuable shares contingent on the attainment of a certain level of earnings are treated as follows, if dilutive:

1. If the necessary conditions have been satisfied by the end of the period, those shares are included in basic EPS as of the beginning of the period in which the conditions were satisfied.
2. If the necessary conditions have not been satisfied by the end of the period, the number of contingently issuable shares included in diluted EPS is based on the number of shares that would be issuable, if any, if the end of the reporting period were the end of the contingency period. These shares are included as of the beginning of the period (or as of the date of the contingent stock agreement, if later). If the contingency is due to attainment of future earnings and/or future prices of the shares, both earnings to date and current market price, as they exist at the end of the reporting period, are used.

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IV. DISCLOSURES

DISCLOSURES

Cash flow per share should not be reported. In addition to reporting basic EPS and diluted EPS for both income from continuing operations and net income and the effects of discontinued operations, and extraordinary items, the following disclosure requirements must be met:

(i) A reconciliation of the numerators and the denominators of the basic and diluted per-share computations for income from continuing operations.

(ii) The effect that has been given to preferred dividends in arriving at income available to common stockholders in computing basic EPS.

(iii) Securities that could potentially dilute basic EPS in the future that were not included in the computation of diluted EPS because the effect was antidilutive for the period(s) presented.

(iv) Description of any transaction that occurred after the period end that would have materially affected the number of actual and/or potential common shares outstanding.

EXAMPLE

Illustration of EPS (Dual) Presentation for a Complex Capital Structure with No Discontinued Operations but with an Extraordinary Item Reported

	20X1
Basic Earnings per (Common) Share	
Income before extraordinary item	$3.20
Extraordinary item	.22
Net income	$3.42
Diluted Earnings per (Common) Share	
Income before extraordinary item	$3.11
Extraordinary item	.21
Net income	$3.32

PASS KEY

	Weighted Average	Options & Warrants	Convertible Bond	Convertible P/S	Contingent Issues
BASIC	YES	N/A	N/A	N/A	Conditions have been fully satisfied
DILUTED	YES	Average Market Value > Exercise Price Treasury Stock Method "Pretend" Repurchase common stock at the *average* price	Any Dilutive If Converted Method "Pretend" Adjust net income for interest expense (not incurred) reduced by taxes	Any Dilutive If Converted Method "Pretend" Do NOT reduce N.I.A.T. by the preferred stock dividend (pretend they were converted)	Based upon conditions having been met to date

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STATEMENT OF CASH FLOWS

I. OVERVIEW

GAAP requires a statement of cash flows as part of a full set of financial statements for all business enterprises. The purpose of the statement of cash flows is to provide information about the sources of cash and cash equivalents (i.e., cash receipts) and the uses of cash and cash equivalents (i.e., cash disbursements), specifically information about:

(i) **Operating** cash flows (e.g., the cash effects of the line items that make up the calculation of net income and the cash receipts and cash payments resulting from transactions involving securities classified as "trading securities" according to SFAS No. 115),

(ii) **Investing** cash flows (e.g., the cash effects of noncurrent asset transactions, such as purchases and sales of fixed assets and investments and lending activities), and

(iii) **Financing** cash flows (e.g., the cash effects of borrowing and paying back debt, and issuing or repurchasing the equity of the company).

The statement also presents information about material non-cash events. Cash flow amounts per share are **not** disclosed.

II. CASH AND CASH EQUIVALENTS

The statement of cash flows reconciles the cash and cash equivalents amount presented on the beginning balance sheet to the cash and cash equivalents amount presented on the ending balance sheet (i.e., the change in cash for the period). (*Note*: Often, the examiners simply refer to the changes as changes in "cash," but it should be assumed they mean changes in "cash and cash equivalents.")

A. DEFINITIONS

1. Cash is defined as actual cash (i.e., currency and demand deposits).
2. Cash equivalents are defined as short-term, liquid investments that are:
   a. Quickly convertible into specific amounts of cash **and**
   b. So near maturity (i.e., the original maturity date to the investor was within three months of the purchase date) that the risk of changes in the value because of interest rate changes is insignificant.

B. PURPOSE

The cash concept is used because investors, creditors, and other interested parties need information about the entity's available cash and cash needs (i.e., ability to pay obligations, dividends, etc.).

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EXAMPLE

Summarized Statement Format

X Company
STATEMENT OF CASH FLOWS
For the Year Ended December 31, Year X

Net cash provided by (used in) operating activities	XX	
Net cash provided by (used in) investing activities	XX	
Net cash provided by (used in) financing activities	XX	
Net increase (decrease) in cash		XX
Cash and cash equivalents at beginning of year		XX
Cash and cash equivalents at end of year		XX

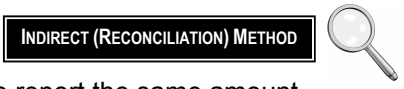
III. METHODS OF PRESENTING THE STATEMENT OF CASH FLOWS

Regardless of the method used, the presentation of investing and financing activities is the same. Only the section that presents operating activities and certain of the required disclosures are different.

A. DIRECT METHOD

GAAP encourages enterprises to report cash flows from operating activities using the direct method, by showing major classes of **operating** cash receipts and disbursements. A reconciliation of net income to net cash flows from operating activities is required to be provided in a separate schedule.

B. INDIRECT METHOD



Companies that choose not to use the direct method are required to report the same amount of net cash flows from operating activities indirectly, by adjusting net income to reconcile it to net cash flows from operating activities.

IV. SECTIONS OF THE FORMAL STATEMENT

A. OPERATING ACTIVITIES

Operating activities involve producing goods and delivering services to customers. Operating activities is also a residual category in that all transactions not categorized as investing or financing activities (discussed below) are categorized as operating activities. There are differences in the two methods in the presentation of the operating activities section. Regardless of the method used, however, the reconciliation of net income to net cash provided by operating activities must be calculated. If the direct method is chosen, the reconciliation will appear in a separate schedule to the statement. If the indirect method is chosen, this reconciliation is part of the body of the formal statement.

1. Direct Method

If the direct method is used, major classes of cash receipts and disbursements are presented in their gross amounts and totaled to arrive at "net cash flow provided by (used in) operating activities."

a. Categories to Report Separately

The following categories should be reported separately:

(1) Cash received from customers (increases cash)

(2) Interest received (increases cash)

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(3) Dividends received (increases cash)

(4) Other operating cash receipts such as the receipt of insurance proceeds and lawsuit settlements (increases cash)

(5) Cash received from the sales of securities classified as trading securities (increases cash)

(6) Cash paid to suppliers and employees (decreases cash)

(7) Interest paid (decreases cash)

(8) Income taxes paid (decreases cash)

(9) Cash paid to acquire securities classified as trading securities (decreases cash)

(10) Other operating cash payments (decreases cash)

b. Determination of Cash Received/Disbursed

(1) Cash Collections

Cash collections generally includes sales to customers, interest income, and dividend revenue. Cash received from customers represents cash received from two sources: (i) cash collected from current year's sales and (ii) cash collected from prior years' sales.

	Sales to customers
–	Increase in receivables
+	Decrease in receivables
+	Increase in unearned revenue
–	Decrease in unearned revenue
	Cash Collections

(2) Cash Paid to Suppliers and Employees

Cash paid to suppliers is defined broadly and may include cash paid for insurance, advertising, and most general, selling, and administrative expenses in addition to payments for materials (and other inventories). Due to the broad nature of this line item category, companies are encouraged to provide further meaningful breakdowns if they are feasible.

	Cost of goods sold
+	Increase in inventory
–	Decrease in inventory
+	Expenses
+	Increase in prepaid
–	Decrease in prepaid
–	Increase in accounts payable or other liability
+	Decrease in accounts payable or other liability
	Cash Paid to Suppliers and Employees

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2. Indirect Method

Under the indirect method, net income is adjusted to arrive at net cash flows from operating activities. In addition, supplemental disclosure of cash paid for interest and income taxes is required.

a. Adjustment to Net Income

The adjustment to net income is performed by removing the effects on net income of the following items:

(1) All **deferrals** of past operating cash receipts and disbursements (e.g., subtracting increases in inventory and prepaid expenses),

(2) All **accruals** of expected future operating cash receipts and disbursements (e.g., subtracting increases in accounts receivable and adding increases in accounts payable and accrued expenses),

(3) All items that are included in net income that **do not affect operating cash receipts and disbursements** (e.g., those that should be omitted altogether or categorized as investing or financing activities, such as adding depreciation and amortization and subtracting gains on sales of productive assets).

b. Determination of Effect on Cash Flow

The effect on cash flows for comparative balance sheet changes in asset, liability, and equity accounts can be easily determined (these rules apply to all changes in balance sheet items, including those in the investing and financing activities sections), as follows:

(1) An increase to an asset or a "debit balance" account (e.g., accounts receivable) will have the effect on the statement of cash flows as a decrease to cash (indirect effect).

(2) A decrease to an asset of a "debit balance" account (e.g., inventory) will have the effect on the statement of cash flows as an increase to cash (indirect effect).

(3) An increase in a liability, an equity, or a "credit balance" account (e.g., accounts payable) will have the effect on the statement of cash flows as an increase to cash (direct effect).

(4) A decrease in a liability, an equity, or a "credit balance" account (e.g., allowance for doubtful accounts) will have the effect on the statement of cash flows as a decrease to cash (direct effect).

c. Short-Cut Cash Flow Effects

(1) Changes in debit balance accounts will have the opposite effect on cash flows (because cash is a debit balance account).

(2) Changes in credit balance accounts will have the same effect on cash flows.

d. Gains and Losses

(1) **Gains** are adjusted out of the operating activities section and (generally) into the investing activities section by **subtracting** their effects from net income.

(2) **Losses** are adjusted out of the operating activities section and (generally) in to the investing activities section by **adding** their effects to net income.

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PASS KEY

You will be able to easily remember approximately 85% of the adjustments made to the operating activities section under the indirect method by remembering the mnemonic **CLAD**.

Current assets and liabilities
Losses and gains
Amortization and depreciation
Deferred items

B. INVESTING ACTIVITIES

The following cash receipts and disbursements are categorized as investing activities:

1. Making loans to other entities [cash outflow],
2. Purchasing [cash outflow] or disposing of [cash inflow] available-for-sale and held-to-maturity investment securities of other entities (debt or equity), and
3. Acquiring [cash outflow] or disposing of [cash inflow] property, plant, and equipment (productive assets).

C. FINANCING ACTIVITIES

The following cash receipts and disbursements are categorized as financing activities (these may be further broken down between owner-oriented and creditor-oriented activities):

1. Owner-Oriented Activities

a. Obtaining resources from owners, such as issuing stock [cash inflow]

b. Providing owners with a return on their investment, such as paying dividends or repurchasing stock [cash outflow]

2. Creditor-Oriented Activities

a. Obtaining resources from creditors, such as issuing bonds, notes, and other borrowings [cash inflow]

b. Payments of principal (not interest, which is part of the operating activities section) on amount borrowed [cash outflow]

D. NON-CASH INVESTING AND FINANCING ACTIVITIES

Information about material non-cash financing and investing activities (those that do not result in cash receipts or payments) should be provided separately in a supplemental disclosure. Of course, any part of the transaction that does involve cash would be included in the statement of cash flows. Examples include:

1. A purchase of fixed assets by issuance of stock, which is not a cash transaction, but would likely be a material transaction for the entity.
2. The conversion of bonds to equity, which generally does not involve cash.
3. Acquiring assets through the incurrence of a capital lease obligation.
4. The exchange of one non-cash asset for another non-cash asset.

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V. COMPARISON OF INDIRECT AND DIRECT METHODS

A. INDIRECT METHOD

Cox Company
Consolidated Statement of Cash Flows
for the Year Ended December 31, 20XX
Increase (Decrease) in Cash and Cash Equivalents

CASH FLOWS FROM OPERATING ACTIVITIES			
Net income		$ 760	
Adjustments to reconcile net income to net cash provided by operating activities			
Depreciation and amortization	$ 445		
Provision for losses on accounts receivable	200		
Gain on sale of facility	(80)		
Undistributed earnings of affiliate	(25)		
Payment received on installment note receivable for sale of inventory	100		
Change in current assets and liabilities:			
Increase in accounts receivable	(215)		
Decrease in inventory	205		
Increase in prepaid expenses	(25)		
Decrease in accounts payable and accrued expenses	(250)		
Increase in interest and income taxes payable	50		
Increase in deferred tax liability	150		
Increase in other liabilities	50		
Total adjustments		605	
Net cash provided by operating activities			**$ 1,365**
CASH FLOWS FROM INVESTING ACTIVITIES			
Proceeds from sale of facility	600		
Payment received on note for sale of plant	150		
Capital expenditures	(1,000)		
Payment for purchase of Company S, net of cash acquired	(925)		
Net cash used in investing activities			**(1,175)**

(continued)

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CASH FLOWS FROM FINANCING ACTIVITIES

Net borrowings under line-of-credit agreement	300	
Principal payments under capital lease obligation	(125)	
Proceeds from issuance of long-term debt	400	
Proceeds from issuance of common stock	500	
Dividends paid	(200)	
Net cash provided by financing activities		**875**
NET INCREASE IN CASH AND CASH EQUIVALENTS		1,065
Cash and cash equivalents at beginning of year		600
Cash and cash equivalents at end of year		**$ 1,665**

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION

Cash paid during the year for:

Interest (net of amount capitalized)	$ 220
Income taxes	325

SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES

The Company purchased all of the capital stock of Company S for $950. In conjunction with the acquisition, liabilities were assumed as follows:

Fair value of assets acquired	$ 1,580 (includes $25 cash)
Cash paid for the capital stock	(950)
Liabilities assumed	$ 630

A capital lease obligation of $850 was incurred when the Company entered into a lease for new equipment.

Additional **common stock** was issued upon the **conversion** of $500 **of long-term debt.** (Each conversion needs to be disclosed separately.)

DISCLOSURE OF ACCOUNTING POLICY

For purposes of the statement of cash flows, the Company considers all highly liquid debt instruments purchased with an **original** maturity of three (3) months or less to be cash equivalents.

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B. DIRECT METHOD WITH COMPARISON TO INDIRECT METHOD

COMPARISON TO INDIRECT METHOD

Cox Company
Consolidated Statement of Cash Flows
for the Year Ended December 31, 20XX
Increase (Decrease) in Cash and Cash Equivalents

CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from customers	$13,850	
Cash paid to suppliers and employees	(12,000)	
Dividend received from affiliate	20	
Interest received	55	
Interest paid (net of amount capitalized)	(220)	
Income taxes paid	(325)	
Insurance proceeds received	15	
Cash paid to settle lawsuit for patent infringement	(30)	
Net cash provided by operating activities		$ 1,365
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sale of facility	600	
Payment received on note for sale of plant	150	
Capital expenditures	(1,000)	
Payment for purchase of Company S, net of cash acquired	(925)	
Net cash used in investing activities		(1,175)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net borrowings under line-of-credit agreement	300	
Principal payments under capital lease obligation	(125)	
Proceeds from issuance of long-term debt	400	
Proceeds from issuance of common stock	500	
Dividends paid	(200)	
Net cash provided by financing activities		875
NET INCREASE IN CASH AND CASH EQUIVALENTS		1,065
Cash and cash equivalents at beginning of year		600
Cash and cash equivalents at end of year		$ 1,665

(continued)

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COMPARISON TO INDIRECT METHOD

RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES

Net income		$ 760
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	$445	
Provision for losses on accounts receivable	200	
Gain on sale of facility	(80)	
Undistributed earnings of affiliate	(25)	
Payment received on installment note receivable for sale of inventory	100	
Change in current assets and liabilities		
Increase in accounts receivable	(215)	
Decrease in inventory	205	
Increase in prepaid expenses	(25)	
Decrease in accounts payable and accrued expenses	(250)	
Increase in interest and income taxes payable	50	
Increase in deferred taxes	150	
Increase in other liabilities	50	
Total adjustments		605
Net cash provided by operating activities		$ 1,365

SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES

The Company purchased all of the capital stock of Company S for $950. In conjunction with the acquisition, liabilities were assumed as follows:

Fair value of assets acquired	$ 1,580
Cash paid for the capital stock	(950)
Liabilities assumed	$ 630

A capital lease obligation of $850 was incurred when the Company entered into a lease for new equipment.

Additional common stock was issued upon the conversion of $500 of long-term debt.

DISCLOSURE OF ACCOUNTING POLICY

For purposes of the statement of cash flows, the Company considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

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HOMEWORK READING:
Ratio Analysis

I. OVERVIEW

Ratios are financial indicators that distill relevant information about a business entity by quantifying the relationship among selected items on the financial statements. An entity's ratios may be compared to ratios of a different period and to industry ratios. These comparative analyses identify trends that may be important to investors, lenders, and other interested parties.

II. BASIC FINANCIAL ANALYSIS RATIOS

Key financial ratios may be classified as:

A. LIQUIDITY RATIOS

Liquidity ratios are measures of a firm's short-term ability to pay maturing obligations.

B. ACTIVITY RATIOS

Activity ratios are measures of how effectively an enterprise is using its assets.

C. PROFITABILITY RATIOS

Profitability ratios are measures of the success or failure of an enterprise for a given time period.

D. INVESTOR RATIOS

Investor ratios are measures that are of interest to investors.

E. LONG-TERM DEBT-PAYING ABILITY RATIOS (COVERAGE RATIOS)

Coverage ratios are measures of security for long-term creditors/investors.

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Gi Company
BALANCE SHEET

	December 31	
	Year 2	*Year 1*
Current Assets:		
Cash and cash equivalents	$ 50,000	$ 35,000
Trading securities (at fair value)	75,000	65,000
Accounts receivable	300,000	290,000
Inventory (at lower of cost or market)	290,000	275,000
Total current assets	715,000	665,000
Investments available-for-sale (at fair value)	350,000	300,000
Fixed Assets:		
Property, plant, and equipment (at cost)	1,900,000	1,800,000
Less: Accumulated depreciation	(380,000)	(350,000)
	1,520,000	1,450,000
Goodwill	30,000	35,000
Total assets	$2,615,000	$2,450,000
Current Liabilities:		
Accounts payable	$ 150,000	$ 125,000
Notes payable	325,000	375,000
Accrued and other liabilities	220,000	200,000
Total current liabilities	695,000	700,000
Long-term Debt:		
Bonds and notes payable	650,000	600,000
Total liabilities	1,345,000	1,300,000
Stockholders' Equity:		
Common stock (100,000 shares outstanding)	500,000	500,000
Additional paid-in capital	350,000	350,000
Retained earnings	420,000	300,000
Total equity	1,270,000	1,150,000
Total liabilities and equity	$2,615,000	$2,450,000

In addition, assume the following information for Gi Company for the year ended December 31, Year 2:

Sales	$1,800,000
Cost of goods sold	(1,000,000)
Gross profit	800,000
Operating expenses	(486,970)
Interest expense	(10,000)
Net income before income taxes	303,030
Income taxes (34%)	(103,030)
Net income after income taxes	$ 200,000
Earnings per share	$2
Operating cash flows	$255,000
Dividends for the year	$0.80 per share
Market price per share	$12

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Liquidity Ratios

1. **Working capital** = Current assets − Current liabilities

   Year 2: $715,000 − $695,000 = $20,000

   Year 1: $665,000 − $700,000 = ($35,000)

2. **Current ratio (working capital ratio)** $= \dfrac{\text{Current assets}}{\text{Current liabilities}}$

   $$\text{(Year 2)} = \frac{\$715,000}{\$695,000} = 1.03$$

   $$\text{(Year 1)} = \frac{\$665,000}{\$700,000} = 0.95$$

   (Industry average = 1.5)

   The ratio, and therefore Gi's ability to meet its short-term obligations, has improved, though it is low compared to the industry's average.

3. **Acid-test ratio** $= \dfrac{\text{Cash equivalents} + \text{Marketable securities} + \text{Net receivables}}{\text{Current liabilities}}$

   $$\text{(Year 2)} = \frac{\$50,000 + \$75,000 + \$300,000}{\$695,000} = 0.61$$

   $$\text{(Year 1)} = \frac{\$35,000 + \$65,000 + \$290,000}{\$700,000} = 0.56$$

   (Industry average = 0.80)

   The industry average of .80 is higher than Gi's ratio, which indicates that Gi may have trouble meeting short-term needs.

4. **Cash ratio** $= \dfrac{\text{Cash equivalents} + \text{Marketable securities}}{\text{Current liabilities}}$

   $$\text{(Year 2)} = \frac{\$50,000 + \$75,000}{\$695,000} = 0.18$$

   $$\text{(Year 1)} = \frac{\$35,000 + \$65,000}{\$700,000} = 0.14$$

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Activity Ratios

1. **Accounts receivable turnover** $= \dfrac{\text{Net credit sales}}{\text{Average net receivables}}$

$= \dfrac{\$1,800,000}{(\$300,000 + \$290,000) / 2}$

$= \dfrac{\$1,800,000}{\$295,000}$

$= 6.10 \text{ times}$

This ratio indicates the receivables' quality and indicates the success of the firm in collecting outstanding receivables. Faster turnover gives credibility to the current and acid-test ratios.

2. **Accounts receivable turnover in days** $= \dfrac{\text{Average net receivables}}{\text{Net credit sales} / 365}$

$= \dfrac{365 \text{ days}}{\text{Receivable turnover}}$

$= \dfrac{365}{6.1}$

$= 59.84 \text{ days}$

This ratio indicates the average number of days required to collect accounts receivable.

3. **Inventory turnover** $= \dfrac{\text{Cost of goods sold}}{\text{Average inventory}}$

$= \dfrac{\$1,000,000}{(\$290,000 + \$275,000) / 2}$

$= \dfrac{\$1,000,000}{\$282,500}$

$= 3.54 \text{ times}$

This measure of how quickly inventory is sold is an indicator of enterprise performance. The higher the turnover, in general, the better the performance.

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4. **Inventory turnover in days** $= \dfrac{\text{Average inventory}}{\text{Cost of goods sold / 365}}$

$= \dfrac{\text{365 days}}{\text{Inventory turnover}}$

$= \dfrac{\text{365 days}}{\text{3.54}}$

$=$ 103.11 days

This ratio indicates the average number of days required to sell inventory.

5. **Operating cycle** $=$ AR turnover in days + Inventory turnover in days

$=$ 59.84 days + 103.11 days

$=$ 162.95 days

The operating cycle indicates the number of days between acquisition of inventory and realization of cash from selling the inventory.

6. **Working capital turnover** $= \dfrac{\text{Sales}}{\text{Average working capital}}$

$= \dfrac{\$1{,}800{,}000}{[(\$715{,}000 - \$695{,}000) + (\$665{,}000 - \$700{,}000)] / 2}$

$=$ 240 times

This ratio indicates how effectively working capital is used.

7. **Total asset turnover** $= \dfrac{\text{Net sales}}{\text{Average total assets}}$

$= \dfrac{\$1{,}800{,}000}{(\$2{,}615{,}000 + \$2{,}450{,}000) / 2}$

$= \dfrac{\$1{,}800{,}000}{\$2{,}532{,}500}$

$=$ 0.71 times

This ratio is an indicator of how Gi makes effective use of its assets. A high ratio indicates effective asset use to generate sales.

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Profitability Ratios

1. **Net profit margin** $= \dfrac{\text{Net income}}{\text{Net sales}}$

$= \dfrac{\$200,000}{\$1,800,000}$

$= 11.11\%$

This ratio indicates profit rate and, when used with the asset turnover ratio, indicates rate of return on assets, as shown below.

2. **Return on total assets** $=$ Net income ÷ Average total assets

$=$ \$200,000 / \$2,532,500

$= 7.9\%$

3. **DuPont return on assets** $=$ Net profit margin x Total asset turnover

$= \dfrac{\text{Net income}}{\text{Net sales}} \times \dfrac{\text{Net sales}}{\text{Average total assets}}$

$= 11.11\% \times 0.71 \text{ times} = 7.9\%$

Note that this ratio uses both net profit margin and the total asset turnover. This ratio allows for increased analysis of the changes in the percentages. The net profit margin indicates the percent return on each sale while the asset turnover indicates the effective use of assets in generating that sale.

4. **Return on investment** $= \dfrac{\text{Net income + Interest expense } (1 - \text{Tax rate})}{\text{Average (Long-term liabilities} + \text{Equity)}}$

$= \dfrac{\$200,000 + \$10,000\ (1 - 0.34)}{(\$650,000 + \$1,270,000 + \$600,000 + \$1,150,000) / 2}$

$= 11.3\%$

ROI measures the performance of the firm without regard to the method of financing.

5. **Return on common equity** $= \dfrac{\text{Net income} - \text{Preferred dividends}}{\text{Average common equity}}$

$= \dfrac{\$200,000 - \$0}{(\$1,270,000 + \$1,150,000) / 2}$

$= 16.5\%$

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Long-Term Debt-Paying Ability Ratios

1. **Debt / Equity** = $\frac{\text{Total liabilities}}{\text{Common stockholders' equity}}$

   (Year 2) = $1,345,000 / $1,270,000 = 1.06

   (Year 1) = $1,300,000 / $1,150,000 = 1.13

   This ratio indicates the degree of protection to creditors in case of insolvency. The lower this ratio the better the company's position. In Gi's case, the ratio is very high, indicating that a majority of funds come from creditors. However, the ratio is improving.

2. **Debt ratio** = $\frac{\text{Total liabilities}}{\text{Total assets}}$

   (Year 2) = $1,345,000 / $2,615,000 = 51.4%

   (Year 1) = $1,300,000 / $2,450,000 = 53.1%

   This debt ratio indicates that more than half of the assets are financed by creditors.

3. **Times interest earned** = $\frac{\text{Recurring income before taxes and interest}}{\text{Interest}}$

   = $\frac{\$303,030 + \$10,000}{\$10,000}$

   = 31.30 times

   This ratio reflects the ability of a company to cover interest charges. It uses income before interest and taxes to reflect the amount of income available to cover interest expense.

4. **Operating cash flow / Total debt** = $\frac{\text{Operating cash flow}}{\text{Total debt}}$

   = $\frac{\$255,000}{\$1,345,000}$

   = 18.96%

   This ratio indicates the ability of the company to cover total debt with yearly cash flow.

F. LIMITATIONS OF RATIOS

Although ratios are easy to compute, they depend entirely on the reliability of the data on which they are based (e.g., on estimates and on historical costs). Additional information is also valuable when analyzing a company: common size analysis (vertical and horizontal), industry statistics, trend analysis, etc.

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HOMEWORK READING:
Detailed Treasury Stock Examples

EXAMPLE

Cost Method

Original Issue

10,000 shares $10 par value common stock sold for $15 per share.

Cash	150,000	
Common stock (10,000 × $10 par)		100,000
Additional paid-in capital–C/S		50,000

Whether purchased above or below par value, the repurchase of shares is recorded at cost.

Buy Back Above par and Above Issue Price

200 shares were repurchased for $16 per share.

Treasury stock (200 × $16)	3,200	
Cash		3,200

Buy Back Below Par

200 shares were repurchased for $9 per share.

Treasury stock (200 × $9)	1,800	
Cash		1,800

Treasury stock may then be reissued. The reissue may be above or below the reacquisition price. If the reissue price exceeds the reacquisition price, then the excess is simply credited to "additional paid-in capital from treasury stock." If the reissue price is less than the reacquisition price, then the following accounts must be reduced, in order: First, "additional paid-in capital from treasury stock" is reduced (debited) if available; then retained earnings is reduced (debited) for the excess.

Reissue Above Cost

100 shares repurchased for $16 were resold for $18.

Cash (100 × $18)	1,800	
Treasury stock (100 × $16)		1,600
Additional paid-in capital–T/S		200

The following journal entry was made after the preceding entry:

Reissue Below Cost

100 shares repurchased for $16 were resold for $13.

Cash (100 × $13)	1,300	
Additional paid-in capital–T/S	200	
Retained earnings	100	
Treasury stock (100 × $16)		1,600

Of course, there will not always be a balance in the additional paid-in capital from treasury stock account. For purposes of the next journal entry, presume the two preceding journal entries did not occur (i.e., ignore the reissue for $18).

Reissue Below Cost

100 shares repurchased for $16 were resold for $13.

Cash (100 × $13)	1,300	
Retained earnings	300	
Treasury stock (100 × $16)		1,600

Retirement of Shares

200 shares of $10 par common stock originally sold for $15 and reacquired for $9 are retired.

Common stock (200 × $10)	2,000	
Additional paid-in-capital–C/S (200 × $5)	1,000	
Treasury stock (200 × $9)		1,800
Additional paid-in-capital from retirement of treasury stock		1,200

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EXAMPLE

Par Value Method

Original Issue

10,000 shares of $10 par value common stock sold for $15 per share.

Cash	150,000	
Common stock (10,000 × $10 par)		100,000
Additional paid-in capital–C/S[a] (10,000 × $5)		50,000

[a]C/S refers to common stock. T/S refers to treasury stock

Buy Back Above Issue Price

200 shares repurchased for $20 per share.

Treasury stock (200 × $10 par)	2,000	
Additional paid-in capital–C/S	1,000	
Retained earnings[b]	1,000	
Cash		4,000

[b]This entry should be made to retained earnings if there is no balance in the additional paid-in capital–T/S account.

Buy Back Below Issue Price

200 shares repurchased for $12 per share.

Treasury stock (200 × $10 par)	2,000	
Additional paid-in capital–C/S (200 × $5)	1,000	
Cash (200 × $12)		2,400
Additional paid-in capital–T/S[c]		600

[c]Any excess of original issue price ($3,000 = 200 × $15) over the acquisition price ($2,400) is credited to "additional paid-in capital from treasury stock." Under the par value method, the treasury stock should then be treated as though retired. As such, subsequent reissues should be treated similarly with original issues (i.e., credit treasury stock at par and credit additional paid-in capital for any excess). An exception to the rule involves reissues below par. In such instances, additional paid-in capital from treasury stock is reduced (debited) until exhausted. Any excess would reduce retained earnings.

Reissue Above Par

100 shares repurchased for $12 were resold for $20.

Cash (100 × $20 par)	$2,000	
Treasury stock (100 × $10 par)		$1,000
Additional paid-in-capital–C/S		1,000

Reissue Below Par

100 shares repurchased for $12 were resold for $3.

Cash (100 × $3)	$300	
Additional paid-in capital–T/S	600	
Retained earnings	100	
Treasury stock (100 × $10 par)		$1,000

To retire treasury stock under the par value method, debit common stock at par and credit treasury stock at par.

Retirement of Shares

Common stock (200 × $10 par)	$2,000	
Treasury stock (200 × $10 par)		$2,000

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EXAMPLE

Summary Chart of Journal Entries

	Cost Method			Par Value Method		
1. Original Issue						
10,000 shares of $10 par value common stock are sold for $15 per share	Cash	150,000		Same Entry		
	Common stock		100,000			
	APIC-C/S		50,000			
2. Buy Back Below Issue Price						
200 shares are repurchased for $12 per share	Treasury stock	2,400		Treasury stock	2,000	
	Cash		2,400	APIC-C/S	1,000	
				Cash		2,400
				APIC-T/S		600
3. Reissue Above Par						
100 shares repurchased for $12 are resold for $15	Cash	1,500		Cash	1,500	
	Treasury stock		1,200	Treasury stock		1,000
	APIC-T/S		300	APIC-C/S		500
4. Reissue Below Cost and Below Par						
100 shares repurchased for $12 are resold for $3	Cash	300		Cash	300	
	APIC-T/S	300		APIC-T/S	600	
	R/E	600		R/E	100	
	Treasury stock		1,200	Treasury stock		1,000
5. Buy Back Above Issue Price						
200 shares are repurchased for $16 per share	Treasury stock	3,200		Treasury stock	2,000	
	Cash		3,200	APIC-C/S	1,000	
				R/E	200	
				Cash		3,200
6. Reissue Below Cost						
100 shares purchased for $16 are resold for $12 per share	Cash	1,200		Cash	1,200	
	R/E	400		Treasury stock		1,000
	Treasury stock		1,600	APIC-C/S		200
7. Retirement						
100 shares of stock repurchased for $16 are retired	Common stock	1,000		Common stock	1,000	
	APIC-C/S	500		Treasury stock		1,000
	R/E	100				
	Treasury stock		1,600			

EXAMPLE

Effect of Cost and Par Value Methods on Balance Sheet Presentation

The equity sections of the cost balance sheet and par value balance sheet would appear as follows:

Cost Method		Par Value Method	
Common stock (par value)	XXX	Common stock (par value)	XXX
Additional paid-in capital	XX	Less: Treasury stock at par	X
Total paid-in capital	XXX	Common stock o/s at par	XX
Retained earnings	XX	Additional paid-in capital	XX
	XXX		XXX
Less: Treasury stock at cost	X	Retained earnings	XX
Total stockholders' equity	XXX	Total stockholders' equity	XXX

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HOMEWORK READING:
Detailed Statements of Cash Flows (Both Methods and Summary)

EXAMPLE

Direct Method

Example Company
STATEMENT OF CASH FLOWS
For the Year Ended December 31, Year X

Cash flows from operating activities:		
Cash received from customers	XX	
Cash paid to suppliers and employees	(XX)	
Dividends received from affiliate	XX	
Interest received	XX	
Interest paid	(XX)	
Income taxes paid	(XX)	
Insurance proceeds received	XX	
Lawsuit proceeds	XX	
Cash paid to settle lawsuit	(XX)	
Proceeds from sales of trading securities	XX	
Net cash provided by operating activities		XXX
Cash flows from investing activities:		
Proceeds from sale of debt or securities of other entities, classified as available-for-sale and held-to-maturity securities	XX	
Proceeds from collection of loans to other entities	XX	
Proceeds from sale of equipment	XX	
Payments to purchase debt or securities of other entities, classified as available-for-sale and held-to-maturity securities	(XX)	
Payments to purchase equipment	(XX)	
Net cash provided by investing activities		XXX
Cash flows from financing activities:		
Proceeds from stock issue	XX	
Proceeds from bond issue	XX	
Cash dividends paid	(XX)	
Payments to repurchase stock	(XX)	
Payments of principal on amounts borrowed	(XX)	
Net borrowings under line-of-credit agreement	XX	
Net cash provided by financing activities		XXX
Net increase in cash and cash equivalents		XXX
Cash and cash equivalents at beginning of year		XX
Cash and cash equivalents at end of year		XXX

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EXAMPLE

Direct Method continued

Reconciliation of net income to net cash provided by operating activities:

Net income		XXX
Adjustments to reconcile net income to net cash provided:		
Depreciation and amortization	XX	
(Gain) loss on sale of equipment	XX	
Exchange (gain) loss	XX	
(Increase) decrease in trading securities	XX	
(Increase) decrease in accounts receivable	XX	
(Increase) decrease in inventory	XX	
Increase (decrease) in accounts payable and accrued expenses	XX	
Increase (decrease) in interest and taxes payable	XX	
Increase (decrease) in deferred taxes	XX	
Total adjustments		XX
Net cash provided by operating activities		XXX

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EXAMPLE

Indirect Method

Example Company
STATEMENT OF CASH FLOWS
For the Year Ended December 31, Year X

Cash flows from operating activities:		
Net income		XX
Adjustments to reconcile net income to net cash provided:		
Depreciation and amortization	XX	
(Gain) loss on sale of equipment	XX	
Exchange (gain) loss	XX	
(Increase) decrease in trading securities	XX	
(Increase) decrease in accounts receivable	XX	
(Increase) decrease in inventory	XX	
Increase (decrease) in accounts payable and accrued expenses	XX	
Increase (decrease) in interest and taxes payable	XX	
Increase (decrease) in deferred taxes	XX	
Total adjustments		XX
Net cash provided by operating activities		XX
Cash flows from investing activities:		
Proceeds from sale of debt or securities of other entities, classified as available-for-sale and held-to-maturity securities	XX	
Proceeds from collection of loans to other entities	XX	
Proceeds from sale of equipment	XX	
Payments to purchase debt or securities of other entities, classified as available-for-sale and held-to-maturity securities	(XX)	
Payments to purchase debt or securities of other entities	(XX)	
Payments to purchase equipment	(XX)	
Net cash provided by investing activities		XXX
Cash flows from financing activities:		
Proceeds from stock issue	XX	
Proceeds from bond issue	XX	
Cash dividends paid	(XX)	
Payments to repurchase stock	(XX)	
Payments of principal on amounts borrowed	(XX)	
Net borrowings under line-of-credit agreement	XX	
Net cash provided by financing activities		XXX
Net increase in cash and cash equivalents		XXX
Cash and cash equivalents at beginning of year		XX
Cash and cash equivalents at end of year		XXX

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SUMMARY OF STATEMENT OF CASH FLOWS

Operating Activities
(Direct Method)

1. Cash received from customers.
2. Cash paid to suppliers and employees.
3. Interest received and paid.
4. Dividends received.
5. Purchases & sales of trading securities.
6. Income taxes paid.
7. All other cash transactions not accounted for elsewhere.

Operating Activities
(Indirect Method)

1. Record net income.
2. Adjust net income for non-cash items such as depreciation and goodwill.
3. Reverse the income statement gain or loss shown on the sale of any asset.
4. Adjust for changes in current assets and current liabilities except for cash and accounts treated elsewhere in the statement.

Current assets increase: subtract

Current assets decrease: add

Current liabilities increase: add

Current liabilities decrease: subtract

Financing Activities
(Direct and Indirect Methods)

1. All sums borrowed &/or repaid (principal amount only).
2. Issuance &/or repurchase of own company stock.
3. Dividends paid (not received).

Investing Activities
(Direct and Indirect Methods)

1. All sums lent &/or repaid (principal only).
2. Purchase &/or sale of asset (including intangible assets & marketable securities that are not trading securities).

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PRESENTATION

The recommended presentation is the statement using the direct method and a separate schedule, which reconciles net income to net cash provided by operating activities. Required disclosures include noncash investing and financing activities, and a disclosure of accounting policy concerning cash equivalents. Presentation of cash flow per share is specifically prohibited. Examples are presented below.

EXAMPLE

Direct vs. Indirect Method

Selected data from Letterman Inc.'s balance sheet and income statement follows:

Sales	$100,000
Cost of sales	(40,000)
Gross profit	60,000
Less: income tax expense	(10,000)
Net income	$ 50,000
Cash received from customers	$125,000
Cash paid to suppliers and employees	30,000
Increase in inventory	10,000
Increase in accounts payable	20,000
Decrease in accounts receivable	25,000
Income taxes paid	4,000
Cash paid to purchase available-for-sale equity securities	3,000
Cash dividends paid	2,000
Beginning balance of cash and cash equivalents	99,000

Prepare a statement of cash flows under both the direct and the indirect methods.

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DIRECT METHOD (PREFERRED PRESENTATION)

Letterman, Inc.
STATEMENT OF CASH FLOWS
For the Year Ended 12/31/Yr X

Cash flows from operating activities:		
Cash received from customers	$125,000	
Cash paid to suppliers and employees	(30,000)	
Income taxes paid	(4,000)	
Net cash provided by operating activities		$ 91,000
Cash flows from investing activities:		
Cash paid to purchase equity securities	(3,000)	
Net cash used in investing activities		(3,000)
Cash flows from financing activities:		
Cash dividends paid		(2,000)
Net cash used in financing activities		(2,000)
Net increase in cash and cash equivalents		86,000
Cash and cash equivalents at the beginning of the year		99,000
Cash and cash equivalents at end of the year		$185,000
Reconciliation of net income to net cash provided by operating activities:		
Net income		$ 50,000
Adjustments to reconcile net income to net cash provided:		
Decrease in accounts receivable	$ 25,000	
Increase in inventory	(10,000)	
Increase in accounts payable	20,000	
Increase in income taxes payable	6,000	
Total adjustments		41,000
Net cash provided by operations		$ 91,000

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INDIRECT METHOD

Letterman, Inc.
STATEMENT OF CASH FLOWS
For the Year Ended 12/31/Yr X

Cash flows from operating activities:		
Net income		$ 50,000
Adjustments:		
Decrease in accounts receivable	$25,000	
Increase in inventory	(10,000)	
Increase in accounts payable	20,000	
Increase in income taxes payable	6,000	
Total adjustments		41,000
Net cash provided by operating activities		91,000
Cash flows from investing activities:		
Cash paid to purchase equity securities	(3,000)	
Net cash used in investing activities		(3,000)
Cash flows from financing activities:		
Cash dividends paid	(2,000)	
Net cash used in financing activities		(2,000)
Net increase in cash and cash equivalents		86,000
Cash and cash equivalents at the beginning of the year		99,000
Cash and cash equivalents at end of the year		$185,000

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NOTES

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FINANCIAL ACCOUNTING & REPORTING 7
Class Questions Answer Worksheet

MC Question Number	First Choice Answer	Correct Answer	NOTES
1.			
2.			
3.			
4.			
5.			
6.			
7.			
8.			
9.			
10.			
11.			

Grade:

Multiple-choice Questions Correct / 11 = _____% Correct

Detailed explanations to the class questions are located in the back of this textbook.

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NOTES

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CLASS QUESTIONS

1. CPA-00929

Whether recognized or unrecognized in an entity's financial statements, disclosure of the fair values of the entity's financial instruments is required when:

a. It is practicable to estimate those values.
b. The entity maintains accurate cost records.
c. Aggregated fair values are material to the entity.
d. Individual fair values are material to the entity.

2. CPA-00943

A derivative designated as a fair value hedge must be:

I. Specifically identified to the hedged asset, liability or unrecognized firm commitment.
II. Expected to be highly effective in offsetting changes in the fair value of the hedged item.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

3. CPA-00974

Selected information from the accounts of Row Co. at December 31, 1995, follows:

Total income since incorporation	$420,000
Total cash dividends paid	130,000
Total value of property dividends distributed	30,000
Excess of proceeds over cost of Treasury stock sold, accounted for using the cost method	110,000

In its December 31, 1995, financial statements, what amount should Row report as retained earnings?

a. $260,000
b. $290,000
c. $370,000
d. $400,000

4. CPA-00982

Asp Co. was organized on January 2, 1994, with 30,000 authorized shares of $10 par common stock. During 1994 the corporation had the following capital transactions:

January 5 - Issued 20,000 shares at $15 per share.

July 14 - Purchased 5,000 shares at $17 per share.

December 27 - Reissued the 5,000 shares held in Treasury at $20 per share.

Asp used the par value method to record the purchase and reissuance of the treasury shares. In its December 31, 1994, balance sheet, what amount should Asp report as additional paid-in capital?

a. $100,000
b. $125,000
c. $140,000
d. $150,000

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5. CPA-00970

Plack Co. purchased 10,000 shares (2% ownership) of Ty Corp. on February 14, 2001. Plack received a stock dividend of 2,000 shares on April 30, 2001, when the market value per share was $35. Ty paid a cash dividend of $2 per share on December 15, 2001. In its 2001 income statement, what amount should Plack report as dividend income?

a. $20,000
b. $24,000
c. $90,000
d. $94,000

6. CPA-01033

On January 2, 2004, Kine Co. granted Morgan, its president, compensatory stock options to buy 1,000 shares of Kine's $10 par common stock. The options call for a price of $20 per share and are exercisable for 3 years following the grant date. Morgan exercised the options on December 31, 2004. The market price of the stock was $45 on January 2, 2004, and $70 on December 31, 2004. Using an acceptable options pricing model, Morgan determined that the fair value of the options granted was $30,000. By what net amount should stockholders' equity increase as a result of the grant and exercise of the options?

a. $20,000
b. $30,000
c. $50,000
d. $70,000

7. CPA-01200

On December 1, 20X3, Clay Co. declared and issued a 6% stock dividend on its 100,000 shares of outstanding common stock. There was no other common stock activity during 20X3. What number of shares should Clay use in determining basic earnings per share for 20X3?

a. 100,000
b. 100,500
c. 103,000
d. 106,000

8. CPA-01198

Ute Co. had the following capital structure during 19X3 and 19X4:

Preferred stock, $10 par, 4% cumulative, 25,000 shares issued and outstanding	$ 250,000
Common stock, $5 par, 200,000 shares issued and outstanding	1,000,000

Ute reported net income of $500,000 for the year ended December 31, 19X4. Ute paid no preferred dividends during 19X3 and paid $16,000 in preferred dividends during 19X4. In its December 31, 19X4, income statement, what amount should Ute report as basic earnings per share?

a. $2.42
b. $2.45
c. $2.48
d. $2.50

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9. CPA-01199

West Co. had earnings per share of $15.00 for 20X2 before considering the effects of any convertible securities. No conversion or exercise of convertible securities occurred during 20X2. However, possible conversion of convertible bonds would have reduced earnings per share by $0.75. The effect of possible exercise of common stock options would have increased earnings per share by $0.10. What amount should West report as diluted earnings per share for 20X2?

a. $15.00
b. $14.35
c. $14.25
d. $15.10

10. CPA-01224

In preparing its cash flow statement for the year ended December 31, 1994, Reve Co. collected the following data:

Gain on sale of equipment	$ (6,000)
Proceeds from sale of equipment	10,000
Purchase of A.S., Inc. bonds (par value $200,000)	(180,000)
Amortization of bond discount	2,000
Dividends declared	(45,000)
Dividends paid	(38,000)
Proceeds from sale of Treasury stock (carrying amount $65,000)	75,000

In its December 31, 1994, statement of cash flows, what amount should Reve report as net cash used in investing activities?

a. $170,000
b. $176,000
c. $188,000
d. $194,000

11. CPA-01226

In preparing its cash flow statement for the year ended December 31, 1994, Reve Co. collected the following data:

Gain on sale of equipment	$ (6,000)
Proceeds from sale of equipment	10,000
Purchase of A.S., Inc. bonds (par value $200,000)	(180,000)
Amortization of bond discount	2,000
Dividends declared	(45,000)
Dividends paid	(38,000)
Proceeds from sale of Treasury stock (carrying amount $65,000)	75,000

In its December 31, 1994, statement of cash flows, what amount should Reve report as net cash provided by financing activities?

a. $20,000
b. $27,000
c. $30,000
d. $37,000

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NOTES

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Financial Accounting & Reporting 8

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2. Modified accrual accounting **14**
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4. Proprietary funds **51**
5. Fiduciary funds **62**
6. Class questions **73**

Financial Accounting & Reporting 8

GOVERNMENTAL ACCOUNTING OVERVIEW

I. GOVERNMENTAL ACCOUNTING AND REPORTING CONCEPTS

A. OBJECTIVES OF GOVERNMENTAL AND NOT-FOR-PROFIT REPORTING

Governmental and not-for-profit organization financial reporting is designed to demonstrate the accountability of each organization for the stewardship of the resources in their care.

1. Accountability Issues

While the accountability for privately owned enterprises may be clearly measured in either the net income of the entity or the increased wealth of its shareholders, governmental and not-for-profit organizations are focused on providing efficient and effective delivery of services with either public resources or private resources shielded from taxation.

2. Accountability and Reporting

Identifying and displaying the accountability objectives of governmental and not-for-profit organizations is integral to this type of financial reporting and related accounting.

a. Resources

Governmental entities often derive their revenues from taxes or answer to public authorities, not-for-profit entities often derive their income from contributions or fees and are not taxable and commercial entities usually derive their income from sales or fees and are usually taxable.

b. Dual Objectives

In accounting for public funds, both governments and not-for-profit organizations seek to demonstrate their operational accountability for the entity taken as a whole and their fiscal accountability for specific funding.

B. OBJECTIVES OF FUND ACCOUNTING AND REPORTING

Foundational to governmental and not-for-profit organization accounting is the concept of fund accounting.

1. Purpose

Fund accounting enables service and mission-driven organizations to easily monitor and report compliance with spending purposes (fund restrictions), spending limits (budget), and other fiscal accountability objectives.

2. Use

Fund reporting, however, is only used for external reporting for governments.

a. Governments

Governments use fund accounting for a portion of external reporting and for internal reporting.

b. Not-for-Profit Organizations

Not-for-profit organizations use fund accounting exclusively for internal reporting.

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II. INDUSTRIES THAT USE GOVERNMENTAL OR NOT-FOR-PROFIT ACCOUNTING AND REPORTING PRINCIPLES

Governmental, not-for-profit, and commercial accounting are applied to entities consistent with their basis of organization and their funding sources, not their industries.

EXAMPLE	Hospitals could be governmentally funded and accounted for using an enterprise fund (explained later), could be organized as a not-for-profit organization and reported using FAS 117 guidance (explained later) or organized as a private businesses reporting net income and profitability to their shareholders. Although this can be confusing in practice, the CPA exam is generally very clear as to the manner in which an entity is organized and the applicable accounting principles.

The following industries commonly have the organizational characteristics and funding streams that lend themselves to the accountability objectives met by governmental and not-for-profit accounting and reporting models.

A. GOVERNMENTAL UNITS

Governmental units include federal, state, county, municipal, and a variety of local governmental units (e.g., townships, villages, and special districts) and entities (e.g., hospitals and universities) that are run by governments and use governmental accounting and reporting principles.

1. Not-for-profit organizations which are organizations that are not run by governments (e.g., hospitals, universities, voluntary health and welfare organizations, and research organizations) do NOT use governmental accounting and reporting principles.

B. COLLEGES AND UNIVERSITIES

Colleges and universities may be governmental entities or non-governmental entities, depending upon whether the college or university is financially accountable to a primary government. In addition, some colleges and universities are organizations that are operated to obtain a profit (i.e., "for-profit" entities); thus, they follow FASB standards for commercial entities rather than the standards developed for governmental entities or not-for-profit entities.

C. HEALTH CARE ORGANIZATIONS

Organizations that provide health care services to individuals include hospitals, nursing care facilities, home health agencies, and clinics. Health care providers can be organized as governmental, not-for-profit or commercial entities. If the health care entity is financially accountable to a primary government, it could be classified as a component unit of the government. If a health care entity is organized as a not-for-profit or commercial organization, it follows applicable FASB standards rather than the standards developed for governmental entities.

D. VOLUNTARY HEALTH AND WELFARE ORGANIZATIONS

Voluntary health and welfare organizations include organizations for the blind, mental health associations, the Salvation Army, and a variety of other not-for-profit organizations. Organizations that are funded primarily by contributions and that provide services which are not funded to any great degree by any other source and which benefit community health or welfare are termed Voluntary Health and Welfare organizations.

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E. FOUNDATIONS

Foundations are private trusts and foundations that are organized for specific benefit to society (e.g., educational purposes, religious purposes, or for some other charitable purpose).

F. OTHER NOT-FOR-PROFIT ORGANIZATIONS

All other not-for-profit organizations include organizations such as professional and trade associations, scientific research organizations and religious organizations.

III. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AND AUDITING STANDARDS FOR GOVERNMENTAL ENTITIES

A. GOVERNMENTAL ACCOUNTING PRINCIPLES AND STANDARDS ARE ESTABLISHED BY:

1. The Governmental Accounting Standards Board (GASB), which is the governmental counterpart of the FASB.
2. The Governmental Finance Officers Association (GFOA), which is the professional trade organization for governmental officers (i.e., similar to the AICPA for public accountants).
3. Audit and Accounting Guides.
4. Industry-specific literature.

B. NOT-FOR-PROFIT ORGANIZATIONS, ACCOUNTING PRINCIPLES AND STANDARDS ARE ESTABLISHED BY:

1. The Financial Accounting Standards Board (FASB),
2. Audit and Accounting Guides, and
3. Industry-specific literature.

C. THE GOVERNMENT ACCOUNTABILITY OFFICE (GAO)

1. The GAO governs audits under the federal "Single Audit Act."
2. The GAO prescribes "Government Auditing Standards" for audits of governmental organizations and federal assistance programs, activities, and functions.
3. Federal financial assistance is primarily awarded to governments and not-for-profit organizations and is subject to "Government Auditing Standards."

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IV. ISSUES UNIQUE TO GOVERNMENTAL ACCOUNTING

Governmental accounting generally revolves around three themes that make it different from commercial and even not-for-profit accounting. This outline covers fund structure and fund accounting issues and how these issues relate to external reporting. Our second outline on governmental accounting is exclusively devoted to external reporting.

A. DEFINITION OF A FUND

A fund is a sum of money or other resource segregated for the purpose of carrying on a specific activity or attaining certain objectives in accordance with specific regulations, restrictions or limitations and constituting an independent fiscal and accounting entity. Each fund is a self-balancing set of accounts.

PASS KEY

Governmental Accounting is generally tested within the context of one of three themes:

- Fund Structure
- Fund Accounting
- External Reporting

Use these themes to organize your study.

B. FUND ACCOUNTING

Fund classifications within the fund structure defined by the GASB impact the basis of accounting (timing of revenue and expenditure/expense recognition) and the measurement focus (flow of funds display or net income determination) principles associated with each fund category. The application of distinct accounting principles to different segments of an organization provides the accounting mechanism for establishing and reporting accountability objectives. This feature of governmental accounting is what makes this area unique.

C. FUND STRUCTURE

GASB 34 establishes a fund structure for governments using fund accounting to provide specific fund financial statements. Fund financial statements should be separately presented for governmental, fiduciary, and proprietary funds to report additional and detailed information about the primary government. Eleven fund types (described later) are classified in the following three generic categories:

1. Governmental funds,
2. Proprietary funds, and
3. Fiduciary funds.

D. EXTERNAL REPORTING

GASB 34 establishes minimum reporting requirements to be in compliance with GAAP. Reporting requirements include fund-based and government-wide presentations supported by notes to the financial statements and a variety of required supplementary information.

Presentation of a reconciliation of fund financial statements to government-wide financial statements to fully integrate reporting objectives is also required.

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1. Government-Wide Presentations

- Full accrual accounting
- Economic resources measurement focus

Government-wide financial statements convert disaggregated fund-based financial statements using multiple measurement focuses and basis of accounting to a single consolidated set of financial statements that use the full accrual basis of accounting and the economic resources measurement focus. Financial activity of the primary government is classified in the following two different ways:

a. Governmental activities and

b. Business-type activities.

2. Major Fund Financial Statements

Major funds are presented using the basis of accounting and measurement focus unique to each category of fund. Only major funds (as defined by the GASB) are presented. Non-major funds are displayed in the aggregate.

3. Dual Perspective Reporting

a. Governmental Fund Reconciliation

Governmental fund financial statements are reconciled to the Governmental Activities section of the government-wide presentation.

b. Disposition of Other Funds

Fiduciary funds are excluded from the government-wide presentation. Enterprise funds are carried into the Business-type Activities section of the government-wide financial statements, generally with no reconciling items. Internal service funds are often merged with Governmental Activities displayed in the government-wide financials.

4. Disclosures and Supplementary Information

Financials statements are presented with appropriate note disclosures and required (and optional) supplementary information. Budget versus actual data, management's discussion and analysis, presentation of non-major funds and modified approaches to presentation of infrastructure are included as part of the supplementary information.

V. FUND STRUCTURE: CATEGORIES OF FUNDS

A governmental entity, although a single entity, consists of a number of separate funds. Funds are generally classified into three categories:

- Governmental funds
- Proprietary funds
- Fiduciary funds

A. GOVERNMENTAL FUNDS

- Modified accrual accounting
- Current financial resources measurement focus

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Governmental funds are accounted for using the modified accrual basis of accounting and use the current financial resources measurement focus. The source, use, and balance of the government's current financial resources and the related current liabilities are accounted for through the use of governmental funds. Government funds often have a budgetary focus. Government funds seek to measure financial position and the changes in financial position. The main financial statement is the statement of revenues, expenditures, and changes in fund balance, which is used to demonstrate compliance with laws, rules, and regulations. Governmental fund types include:

G **1. General Fund**

The general fund is set up to account for the ordinary operations of a governmental unit that are financed from taxes and other general revenues. All transactions not accounted for in some other fund are accounted for in this fund. All accounts are of a "current" nature, thus this fund contains no fixed asset accounts or long-term debt accounts.

R **2. Special Revenue Funds**

AND Special revenue funds are set up to account for revenues from specific taxes or other earmarked sources that (by law) are designated to finance particular activities of government. (Note that transactions accounted for in expendable trust funds previous to GASB 34 are accounted for in special revenue funds under GASB 34. The expendable trust fund no longer exists as a fund type.)

S **3. Debt Service Funds**

Debt service funds are set up to account for the accumulation of resources and the payment of interest and principal on all "general obligation debt" other than that serviced by enterprise funds or by special assessments in another fund.

P **4. Capital Projects Funds**

Capital projects funds are set up to account for resources used for the acquisition or construction of major capital assets by a governmental unit, except those projects financed by an enterprise fund or by a special assessment.

P **5. Permanent Fund**

Permanent funds are used to report resources that are legally restricted to the extent that income, and not principal, may be used for purposes that support the reporting government's programs (i.e., for the benefit of the public).

Balance Sheet	Statement of Revenues, Expenditures, and Changes in Fund Balance
Current assets	Revenues
< Current liabilities >	< Expenditures >
Fund balance	Other financing sources < uses >
	Net change in fund balance

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B. PROPRIETARY FUNDS

- Full accrual accounting
- Economic resources measurement focus

Proprietary funds account for business-type activities and their accounting is similar to commercial accounting. Proprietary funds use the full accrual basis accounting and should be reported using the economic resources measurement focus. Proprietary funds include:

1. Internal Service Funds

Internal service funds are set up to account for goods and services provided by designated departments on a (cost reimbursement) fee basis to other departments and agencies within a single governmental unit or to other governmental units.

EXAMPLE	A central motor pool or building maintenance department may be accounted for with an internal service fund.

2. Enterprise Funds

Enterprise funds are set up to account for the acquisition and operation of governmental facilities and services that are intended to be primarily (over 50%) self-supported by user charges.

EXAMPLE	Enterprise funds are often used for utilities (water and sewer), airports, and transit systems.

Enterprise funds are required when any one of three criteria is met: 1) The activity of the fund is financed by debt secured by a pledge of fee revenue, 2) Laws require collection fees adequate to recover cover costs, or 3) Pricing policies are established to produce fees that recover costs.

Statement of Net Assets	Statement of Revenues, Expenses, and Changes in Fund Net Assets
All assets	Operating revenue
< All liabilities >	< Operating expenses >
Net assets	Non-operating revenue < expenses >
	Change in net assets

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C. FIDUCIARY (TRUST) FUNDS

- Full accrual accounting
- Economic resources measurement focus

Fiduciary funds account for assets received where the government acts in the capacity of a trust or agency fund. Financial statements of fiduciary funds should be reported using the economic resources measurement focus and the full accrual basis of accounting, except for certain pension liabilities and post employment health care plans. Fiduciary funds include:

1. Pension (and Other Employee Benefit) Trust Funds

Pension trust funds account for resources of defined benefit plans, defined contribution plans, post retirement benefit plans, and other long-term employee benefit plans.

2. Agency Trust Funds

Agency trust funds account for resources in the temporary custody of a governmental unit (e.g., taxes collected for another governmental entity).

3. Private Purpose Trust Funds

Private purpose trust funds are the designated funds for all other trust fund arrangements under which principal and income are for the benefit of specific individuals, private organizations, and other governments. Often, the government will need to record escheat property (i.e., property that has been forfeited as a result of the passage of time or process of law) in a private purpose trust fund.

4. Investment Trust Funds

Investment trust funds account for external investment pools.

Statement of Fiduciary Net Assets	Statement of Changes in Fiduciary Net Assets
All assets	Additions
< All liabilities >	< Deductions >
Net assets	Change in net assets

PASS KEY

To help remember the differences in focus and accounting, use the following:

Governmental funds are "MAC-GRASPP"	Proprietary and fiduciary funds have "SPACE"
Modified	**SE**
Accrual accounting	**PAPI**
Current financial resources measurement focus	**A**ccrual accounting
	Carry fixed asset and long-term debt
GRASPP	**E**conomic resources measurement focus

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VI. MEASUREMENT FOCUS AND THE BASIS OF ACCOUNTING

The measurement focus and basis of accounting used in government-wide and fund financial presentations contributes to the accomplishment of accountability objectives unique to each fund and to government-wide presentations. The measurement focus of a fund or fund type is complemented by the basis of accounting used.

- The modified accrual basis of accounting is used to accomplish the current financial resources measurement focus.
- The accrual basis of accounting is used to complement the economic resources measurement focus.

PASS KEY

The use of a measurement focus and basis of accounting in the governmental funds different from the measurement focus and basis of accounting used in the government-wide financial statements provides the elements of the reconciliation between the governmental fund financial statements and the government-wide financial statements.

A. BALANCE SHEET—MEASUREMENT FOCUS

Measurement focus refers to the economic values emphasized and determined by the financial presentation.

1. Current Financial Resources (GRaSPP)

CURRENT FINANCIAL RESOURCES MEASUREMENT FOCUS

The current financial resources measurement focus seeks to value and report fund balances as a measure of available, spendable or appropriable resources. Only current assets and current liabilities are included on the balance sheet.

a. No fixed assets are reported.

b. No non-current liabilities are reported.

PASS KEY

Adding fixed assets excluded from governmental fund financial statements and subtracting non-current liabilities also excluded from governmental fund financial statements are two of the most significant reconciling items between governmental fund financials and government-wide financials.

2. Economic Resources (SE-PAPI)

ECONOMIC RESOURCES MEASUREMENT FOCUS

The economic resources measurement focus seeks to determine the costs of services and the efficiency and effectiveness with which invested capital has been used. All assets and all liabilities (current or non-current) are included on the balance sheet. Net assets are analyzed and reported as between restricted, unrestricted and invested in property and equipment net of related debt.

a. Fixed assets are reported.

b. Non-current liabilities are reported.

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B. INCOME STATEMENT—BASIS OF ACCOUNTING

Basis of accounting refers to when revenues and expenditures or expenses are recognized in the accounts and reported in the financial statements. The basis of accounting relates to the timing of the measurements made.

1. Modified Accrual (GRaSPP)

MODIFIED ACCRUAL BASIS OF ACCOUNTING

The modified accrual basis of accounting is used with the current financial resources measurement focus and is a blend of accrual and cash basis accounting concepts into an entirely different basis of accounting.

a. Revenue is recognized when measurable and available to finance the expenditures of the current period. The only difference between the timing of revenue recognition under the modified accrual basis of accounting and the full accrual basis of accounting is the manner in which each basis defines the word available.

(1) Available, under modified accrual, means collectible within the current period or soon enough thereafter to be used to pay liabilities in the current period (generally within 60 days after year-end).

(2) Measurable means quantifiable in monetary terms.

b. Expenditures are generally recorded when the related fund liability is incurred with some exceptions.

(1) Unmatured interest on long-term debt is not accrued, it is only recorded when legally due.

PASS KEY

Addition of accrual basis revenues in excess of modified accrual revenues along with subtraction of accrued debt related expenses not recognized in governmental financial statements are frequent reconciling items between the governmental fund financial statements and the government-wide financial statements.

2. Full Accrual (SE-PAPI)

The full accrual basis of accounting is used with the economic resources measurement focus and is identical to the accounting methods used in commercial enterprises.

a. Revenue is recognized when earned.

b. Expenses are recognized when incurred.

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C. SUMMARY OF APPLICATIONS

1. Modified Accrual Basis of Accounting and Current Financial Resources Measurement Focus

Modified accrual basis of accounting and current financial resources measurement focus are used in connection with the governmental funds (**GRaSPP**).

a. **G**eneral

b. Special **R**evenue

and

c. Debt **S**ervice

d. Capital **P**rojects

e. **P**ermanent

2. Economic Resources Measurement Focus and Full Accrual Basis of Accounting

The economic resources measurement focus and full accrual basis of accounting is used for both the government-wide financial statements as well as the fund presentations of the fiduciary and proprietary funds (**SE-PAPI**).

a. **S**ervice (Internal)

b. **E**nterprise

c. **P**ension

d. **A**gency

e. **P**rivate Purpose

f. **I**nvestment Trust

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FUND ACCOUNTING IN GOVERNMENTAL FUND TYPES

MODIFIED ACCRUAL ACCOUNTING

I. FUND ACCOUNTING: APPLYING THE CURRENT FINANCIAL RESOURCES MEASUREMENT FOCUS AND MODIFIED ACCRUAL BASIS TO GOVERNMENTAL FUNDS

Applying the modified accrual basis of accounting to the current financial resources measurement focus and accomplishing the related fiscal accountability objectives of governmental fund accounting requires understanding the unique procedures associated with accounting for budgetary, actual and encumbrance activity within governmental funds.

PASS KEY

Modified Accrual Accounting CPA Exam Issues

Most candidates have a fairly strong understanding of the manner in which accrual basis accounting is applied to specific transactions and the manner in which that method of accounting shapes the presentation of financial statements. The accrual basis of accounting is the accounting method used in commercial accounting and is taught throughout most accounting curriculums. Our outline gives no special attention to applying accrual basis accounting to applicable funds. The modified accrual basis of accounting, however, and the manner in which it complements the current financial resources measurement focus, is unique and often foreign to many CPA candidates. The unique series of fund accounting applications related to using the modified accrual basis and current financial resources measurement focus in individual funds, particularly the manner in which transactions are journalized, and are used in reconciling this activity to the accrual basis of accounting, is worthy of significant attention.

A. SIMILARITIES OF GOVERNMENTAL FUND ACCOUNTING (MODIFIED ACCRUAL) TO COMMERCIAL GAAP (FULL ACCRUAL)

1. Both can use double entry bookkeeping (debit/credit).
2. Both serve to produce periodic balance sheets or statements of financial position (current assets – current liabilities = fund balance).
3. Both serve to produce periodic operating statements (no "income statements" in governmental fund reporting).
4. Both use historical cost and comply with most GAAP.
5. Terminology is similar, however there are additional terms unique to modified accrual.
6. Both are concerned with safeguarding assets and providing information for internal and external use.

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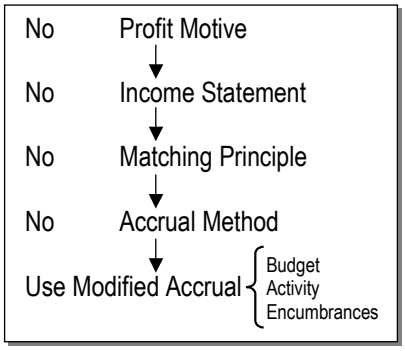
B. DIFFERENCES BETWEEN GOVERNMENTAL FUND ACCOUNTING (MODIFIED ACCRUAL) AND COMMERCIAL GAAP (FULL ACCRUAL) (RECONCILING ITEMS)

1. Funds must comply with both legal statutes and GAAP.
2. There is no profit motive in any governmental fund, thus there is no income determination (amount).



3. Each fund is a separate entity, a self-balancing set of accounts.
4. **Budgetary** accounting is emphasized in order to control spending.
5. **Activity** emphasizes flow of current financial resources.
6. **Encumbrance** accounting is used to record purchase orders.

PASS KEY

The governmental funds (GRaSPP) use modified accrual accounting, which means:

	Book		Close
B	Budget	B	Budget
A	Activity	A	Activity
E	Encumbrances	E	Encumbrances

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General Fund **R**evenue (Special) Fund **A**nd **S**ervice (Debt) Fund **P**rojects (Capital) Fund **P**ermanent Fund	Modified Accrual	**Budget:** Activity: Encumbrances:	**Book on opposite side as control**

C. BUDGETARY ACCOUNTING

BUDGETARY ACCOUNTING

Budgetary accounting is used by the "GRASPP" funds. It is used to control expenditures and to account for the levy of taxes sufficient to cover estimated expenditures. A balanced budget supports interperiod equity as an objective of public administration and fiscal accountability.

Budgetary accounting may use the cash basis of accounting or modified accrual basis of accounting but expanded reporting is required if budgets are not displayed on a GAAP basis.

Revenue
- Taxes - Income and sales
- Taxes - Property and real estate
- Fines and penalties

Other Financing Sources
- Debt proceeds (bonds and notes)
- Interfund transfers

PASS KEY

The CPA Examination focuses many questions on the details involving journal entries. It is important for candidates to understand the basic journal entries in order to properly answer these questions on the CPA Examination.

1. Budgetary Accounting Journal Entries

a. Budgetary accounts are "estimated accounts" that are the opposite (in terms of "natural" debit and credit balances) from "real," "proprietary," or "actual" accounts.

b. Budgetary accounts are posted only twice during the year (unless a supplemental appropriation is made).

(1) At the beginning of year the difference between estimated revenues and appropriations goes to an account called Budgetary Fund Balance (which is the budgetary "equity account"). Although the illustrative journal entry shown below makes a distinction between appropriations and transfers, the term appropriations embraces both transfers and estimated expenditures.

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PASS KEY

The journal entry that records the budgeted amounts for estimated revenue and approved expenses (appropriations) are posted on the opposite side of the "T" account compared to actual amounts.

DR	Estimated revenue control	$2,000,000	
DR	Estimated transfers from other funds (transfer-in)	85,000	
DR	Budgetary fund balance (negative/deficit)	–	
CR	Appropriations control		$1,950,000
CR	Estimated transfers to other funds (transfer-out)		4,000
CR	Budgetary fund balance (positive/surplus)		131,000

(2) End of year the budget is reversed and closed. The journal entry uses the same amounts that were recorded at the beginning of the period plus or minus any amendments. Do not be confused by information showing actual activity in different amounts because the actual activity will be closed out separately.

PASS KEY

The journal entry at period end to reverse the budget is always for the same dollar amounts as the original budgetary journal entry +/- any amendments.

DR	Appropriations	$1,950,000	
DR	Estimated transfers to other funds	4,000	
DR	Budgetary fund balance (positive)	131,000	
CR	Estimated revenue control		$2,000,000
CR	Est. transfers from other funds		85,000
CR	Budgetary fund balance (negative)		–

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General Fund **R**evenue (Special) Fund **A**nd **S**ervice (Debt) Fund **P**rojects (Capital) Fund **P**ermanent Fund	Modified Accrual	Budget: **Activity:** Encumbrances:	Book on opposite side as control **Revenue—measurable and available** **Expenditures—all spending** **Assets—expenditured** **Debts—other financing sources**

D. ACTIVITY

Emphasis is on the flow of current financial resources (very nearly cash flow), not on profit and loss. Therefore, there is no application of the matching principle as required in preparing accrual (commercial GAAP) income statements.

1. Revenue

NON-EXCHANGE REVENUES

Governmental fund revenues are recorded when measurable and available. This usually means the collection period does not exceed 60 days after fiscal year-end.

Governmental fund revenues often arise from non-exchange transactions. A non-exchange transaction is defined by GASB #33 as a transaction in which a government gives or receives value without directly receiving or giving equal value in return. Exchange transactions, which we typically see in commercial accounting, involve the government giving or receiving equal values in an arms length transaction.

The timing and recognition of non-exchange revenues depends upon their classification.

DERIVED TAX REVENUES

a. Derived Tax Revenues

(1) Derived (non-exchange) tax revenues represent taxes imposed on or derived from exchange transactions such as commercial sales (sales taxes), taxpayer income (income taxes), etc.

(2) Revenues are recognized when measurable and available.

IMPOSED NON-EXCHANGE REVENUES

b. Imposed Non-Exchange Revenues

(1) Imposed non-exchange revenues represent taxes imposed on non-exchange transactions (fines) or wealth (property taxes).

(2) Receivables are recorded when the government has an enforceable legal claim (i.e., when property taxes are levied). Revenue is recognized subject to the availability criterion. Revenue can generally be recognized with their use is required or first permitted.

c. Government Mandated Non-Exchange Transactions

GOVERNMENT MANDATED NON-EXCHANGE TRANSACTIONS

(1) Government mandated non-exchange transactions represent instances in which a higher level of government (e.g., a state) provides funds and mandates certain activities by another level of government (e.g., a county) such as environmental clean up, etc.

(2) Revenues are recognized when eligibility requirements are met and the revenues are both measurable and available. Eligibility requirements may specify the characteristics (e.g., must be a county with a landfill, etc.) and allowable costs (e.g., expenditures to implement recycling programs, etc.) of the organization.

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d. Voluntary Non-Exchange Transactions

VOLUNTARY NON-EXCHANGE TRANSACTIONS

(1) Voluntary non-exchange transactions represent instances in which the government receives resources and does not provide equal value (e.g., grants agreements).

(2) Revenues are recognized when grant restrictions have been met and when resources are measurable and available.

PASS KEY

The following items are deemed measurable and available at the time the related event occurs:

Billed/Recorded (= Revenue)

- Real estate taxes (due)
- Fines and penalties

Received (= Revenue)

- Income taxes
- Sales taxes

Earned (= Revenue)

Deferred revenue when collected.

- Real estate taxes paid in advance
- Restricted grants (earned when spent)

Journal entry to record accrual of real property taxes levied and provide for the estimated amount of uncollectible accounts:

DR	Real property taxes receivable — current	$1,800,000	
CR	Revenues		$1,620,000
CR	Allowance for uncollectible taxes receivable		180,000

Note: When recording receivables, there may be an allowance account but not an uncollectible accounts or "bad debt" expense. The recording of the allowance reduces revenue to the measurable and available amount.

Journal entry to record the collection of property taxes:

DR	Cash	$1,458,000	
CR	Real property taxes receivable — current		$1,458,000

Journal entry to reclassify receivables to delinquent:

DR	Property taxes receivable — delinquent	$342,000	
CR	Property taxes receivable — current		$342,000

Journal entry to reclassify current allowance for uncollectible taxes to delinquent and adjust revenues to accrue available amounts.

DR	Revenues	$162,000	
DR	Allowance for uncollectible taxes — current	$180,000	
CR	Allowance for uncollectible taxes — delinquent		$342,000

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2. Expenditures

GOVERNMENTAL FUND EXPENDITURES

There is no need to differentiate between operating expenditures and capital expenditures in governmental fund types. Both capital purchases and operating expenditures are considered spending of funds and are treated as expenditures.

EXAMPLE	Police cars and police officers' salaries are both "expenditures" that are treated equally in achieving the primary reporting focus (emphasis) or "financial flow" of operating data (flow of financial resources), as opposed to "capital maintenance" (depreciation accounting) or "income" determination, which are both emphasized in commercial accounting.

There is no capital asset set up on the fund's books, and there is no asset to depreciate. Capital purchases are recorded as government-wide governmental capital assets for government-wide reporting. Note that all items are expenditures: prepaids, inventory, fixed assets, bond issue costs, and debt incurrence. There is NO ACCRUAL of any expenditure (i.e., no matching principle).

Journal entry to record the purchase of a capital item (e.g., equipment)

DR	Expenditure	$25,000	
CR	Vouchers payable or cash		$25,000

PASS KEY

The timing of the expenditure is when the voucher payable is recorded. The modified accrual method does not delay the expenditure until the cash payment is made.

PURCHASE METHOD

a. Alternatives for Expenditure Recognition

(1) Purchase Method

(a) Expenditure current assets when purchased:

(1) Supplies

(2) Prepaids (insurance)

(3) Inventory

(b) Reverse (set-up as a current asset) for items not used during period (still on hand).

CONSUMPTION METHOD

(2) Consumption Method

(a) Set-up as a current asset when purchased:

(1) Supplies

(2) Prepaids (insurance)

(3) Inventory

(b) Expenditure items as consumed (by periodic physical count).

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	Purchase	Consumption
Buying item	**DR** Expenditure **CR** Vouchers payable	**DR** Supplies inventory **CR** Vouchers payable
Use of item	No entry	**DR** Expenditure **CR** Supplies inventory
On-hand at year end	**DR** Supplies inventory **CR** Reserve for supplies	No entry*

* Regardless of the method used, inventory asset amounts must be balanced with a fund balance reserve to ensure that the unreserved fund balance represents available resources. The purchase method assumes adjustment at year-end while the consumption method, as presented, assumes perpetual inventory maintenance along with related adjustments to fund balance reserves such that no entry is specifically required at year-end.

b. Transfers Between Funds

INTERFUND TRANSFERS

Although not an expenditure, transfers out represent the use of financial resources. Transfers usually represent budget transactions that move revenues recorded in one fund to defray expenditures incurred in another fund as determined by local budget ordinance. The journal entry below describes a transfer that will take place from the general fund to the debt service fund. Interfund transfers must be authorized and may occur throughout the period.

Journal entry to record routine transfer between funds:

DR	Interfund transfer to debt service fund	$10,000	
CR	Cash (from the general fund)		$10,000

(1) The debt service fund will record a corresponding journal entry.

(2) The interfund transfer to debt service fund is closed to unreserved fund balance at the end of the period.

(3) Be aware that there are several different types of interfund transfers. These will be discussed later.

c. Classification of Governmental Expenditures

EXPENDITURE CLASSIFICATION

Expenditures of governmental funds are first classified according to the appropriate fund. Within the fund, the expenditures can be further classified using one of several methods.

(1) Function or Program

FUNCTIONAL CLASSIFICATION OF EXPENDITURES

Function or program classification provides information on the overall purpose of the expenditures. Function groups expenditures into the major services of the governmental entity. Program groups expenditures into activities, operations, or organizational units that are directed to the attainment of specific purposes or objectives. Both function and program are broad classifications. Examples of functions include public safety, highways, education, health and welfare, and general governmental services. Examples of program include programs for the elderly, drug addiction, and education.

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(2) Organizational Unit

Organization unit corresponds to the organizational structure of the governmental entity. An organizational unit may be responsible for carrying out several programs. Examples of organization units include the police and fire departments. Organization units roll up into functional presentations. For example, the police and fire departments combine to form the public safety function.

(3) Activity

By classifying expenditures by specific activity, economy and efficiency of operations can be measured. Measurement standards such as expenditure per unit of work can be determined. In addition, this classification serves as a basis for budget preparation. The activity can be an event, a task, or a unit of work with a specific purpose.

(4) Character

Classification by character refers to determining the basis of the fiscal period the expenditures are presumed to benefit. The major classifications by character are:

(a) Current expenditures, which benefit the current fiscal period;

(b) Capital outlays, which are presumed to benefit both the present and future fiscal periods;

(c) Debt service, which benefits prior fiscal periods as well as current and future periods; and

(d) Inter-governmental, where one governmental unit transfers resources to another.

(5) Object Classes

Classification by object classifies the expenditure according to the type of items purchased or services obtained. Examples are personnel services, supplies, and principal and interest payments for debt service expenditures.

3. Fixed Assets (Purchased, Constructed, and Leased)

Fixed assets are often not expected to contribute to the generation of revenue. The acquiring of a fixed asset, therefore, is not capitalized on the fund's books. Instead, it is considered an expenditure of the funds. The fixed assets are reported on the government-wide financial statements.

EXAMPLE

A governmental fund purchases a new police car for $25,000.

Governmental fund journal entry to record the purchase of the police car:

DR	Expenditure	$25,000	
CR	Vouchers payable (or cash)		$25,000

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PASS KEY

- Governmental funds (GRaSPP) use modified accrual and will "expenditure" fixed asset acquisition consistent with the current financial resources measurement focus. The fixed assets are reported on the government-wide financial statement.
- Proprietary and fiduciary funds (SE-PAPI) use full accrual and will capitalize fixed asset acquisitions and depreciate them consistent with the economic resources measurement focus.

4. Debts (Long-Term)

LONG-TERM DEBT ACCOUNTING GOVERNMENTAL FUNDS

Proceeds from long-term debts are recorded in the governmental funds as "Other Financing Sources." The governmental funds do not record or carry the long-term debt. The long-term debt is recorded on the government-wide financial statements.

EXAMPLE

A governmental unit receives the proceeds of a bond issue of $1,000,000.

Governmental fund journal entry to record the receipt of the proceeds:

DR	Cash	$1,000,000	
CR	Other financing sources		$1,000,000

PASS KEY

- Governmental funds (GRaSPP) use modified accrual and will record proceeds from long-term debt as "other financing sources" (statement of revenues, expenditures, and changes in fund balance/not the balance sheet) consistent with the current financial resources measurement focus. The debt service fund will pay the currently due interest and principal.
- Proprietary and fiduciary funds (SE-PAPI) use full accrual, record the long-term debt consistent with the economic resources measurement focus, and will directly pay the interest and principal.

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General Fund **R**evenue (Special) Fund **A**nd **S**ervice (Debt) Fund **P**rojects (Capital) Fund **P**ermanent Fund	Modified Accrual	Budget: Activity: **Encumbrances:**	Book on opposite side as control Revenue—measurable and available Expenditures—all spending Assets—expenditured Debts—other financing sources **Reserve funds for purchase orders**

E. ENCUMBRANCES

ENCUMBRANCE ACCOUNTING

Open purchase orders represent an encumbrance or reduction of the appropriations of a government. In order for governmental managers to effectively monitor the degree to which they have used their budgetary appropriations, governmental accounting systems must reflect not only the expenditures but also the obligations to spend (purchase orders). This is done to prevent overspending of appropriations. Subsidiary ledgers are used to record the details of budgetary accounts, encumbrances, and other general ledger accounts that require detail.

1. An encumbrance should not be viewed as a GAAP expenditure. Similarly, the reserve for encumbrances is not a liability. The reserve for encumbrance account (sometimes titled "budgetary fund balance reserved for encumbrance") acts as a restriction of the fund balance.

EXAMPLE

Encumbrances

Assume that Progressive Township has budgeted or appropriated $100,000 for the purchase of two sanitation trucks at the beginning of the year. Then assume that a purchase order is issued to purchase the two sanitation trucks at an estimated cost of $45,000 each.

Journal entry to set up the encumbrance and reserve for encumbrance in budgetary accounts in the general fund:

DR	Encumbrances	$90,000	
CR	Reserve for encumbrances		$90,000

The invoice is received for one of the trucks, at an actual cost of $44,000. The entry to the encumbrances account is reversed and the actual expenditure is recorded. Assume that the second truck is backordered.

Journal entry to reverse estimated encumbrances in budgetary accounts:

DR	Reserve for encumbrances	$45,000	
CR	Encumbrances		$45,000

Journal entry to record the actual expenditures of $44,000:

DR	Expenditures	$44,000	
CR	Vouchers payable (or cash)		$44,000

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2. Encumbrances are often recorded for budgetary control purposes, especially in the general and special revenue funds. Encumbrances are not generally used for recurring expenditures, such as salaries. They are more commonly used for purchases, which require the use of a purchase order by the government's policy.

PASS KEY

Historically, the examiners have frequently asked the timing of debits and credits to the encumbrance account and debits and credits to the reserve for encumbrance account. Remember that the planned obligations of the government (appropriations) are recorded as credits. All other uses of the appropriation are debits. All you need to remember is simply to net the natural balances of the appropriations, expenditure and encumbrance accounts together to arrive at the management objective of this accounting: unexpended appropriations.

The following schedule shows the manner in which the journal entries from the outline would produce management information debits are shown without brackets, and credits are shown in brackets. Notice how the activity in the Budget, Activity and Encumbrance columns are independently maintained by the accounting entries. Also notice how the unexpended appropriation fluctuates first with the encumbrance (10,000) and then with the recording of the actual transaction (11,000).

Transaction	**B**udget (Appropriations)	**A**ctivity Expenditure	**E**ncumbrance Encumbrance	Unexpended Appropriation @SUM
1	(100,000)	-	-	(100,000)
2	-	-	90,000	90,000
Subtotal	**(100,000)**	**-**	**90,000**	**(10,000)**
3			(45,000)	(45,000)
4		44,000		44,000
Total	**$ (100,000)**	**$ 44,000**	**$ 45,000**	**$ (11,000)**

3. If an encumbrance (purchase order) is still outstanding at year-end and appropriations do not lapse (i.e., government will honor outstanding purchase orders), reverse the above journal entry and establish a "fund balance reserved for encumbrances."

ENCUMBRANCE ACCOUNTING YEAR-END

Outstanding encumbrances at year-end will be carried forward as a reserve of fund balance with a corresponding reduction of unreserved fund balance, if the appropriations do not lapse.

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EXAMPLE

Encumbrances Continued

Journal entry to close outstanding encumbrances at year end and reserve the fund balance:

DR	Reserved for encumbrance	$45,000	
CR	Encumbrances		$45,000

To close budgetary accounts related to outstanding purchase orders.

&

DR	Unreserved fund balance (year end surplus)	$45,000	
CR	Fund balance reserved for encumbrances		$45,000

To record reservation of fund balance relative to outstanding prior year purchase orders.

PASS KEY

Transaction	Budget (Appropriations)	Activity Expenditures	Encumbrance Encumbrance	Unexpended Appropriation @ SUM	Cash	Fund Balance Unreserved	Fund Balance Reserved
1	(100,000)			100,000	100,000	(100,000)	
2			90,000	(90,000)			
3			(45,000)	45,000			
4		44,000		(44,000)	(44,000)	44,000	
Subtotal	(100,000)	44,000	45,000	11,000			
5	100,000	(44,000)	(45,000)	(11,000)			
Subtotal	-0-	-0-	-0-	-0-	56,000	(56,000)	
6						45,000	(45,000)
Total	-0-	-0-	-0-	-0-	$56,000	(11,000)	(45,000)

4. In the following year, the use (spending/expenditure) of these amounts will not be recorded as an expenditure for comparison to the following year's budget; rather, it will be recorded as an expenditure of the prior year.

PRIOR YEAR EXPENDITURES

EXAMPLE

Encumbrances Continued

Journal entry to record the receipt of last year's item and pay for it:

DR	Expenditure – prior year	$45,000	
CR	Vouchers payable (or cash)		$45,000

PASS KEY

The outstanding encumbrance at year-end is treated as a reserve of the fund balance. In the following year, when the item is received and paid, it is not reported as an expenditure in the budget and actual comparison schedules since it is not a charge against current period appropriations.

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EXAMPLE

A county's balances in the general fund included the following:

Appropriations	$745,000
Encumbrances	37,250
Expenditures	298,000
Vouchers payable	55,875

What is the remaining amount available for use by the county?

a. $353,875 c. $409,750
b. $391,125 d. $447,000

Solution: Choice "c" is correct. Appropriations is a budgetary account. This account represents the governmental unit's approved spending (in this case $745,000). Expenditures represent the actual incurring of bills, whether paid in cash or recorded as vouchers payable. Encumbrances are the restrictions of the fund balance for purchase orders. Vouchers payable represent expenditures not yet paid.

Budget: Appropriations	$745,000
Activity: Expenditures	- 298,000
Encumbrances:	- 37,250
Remaining available appropriations	$409,750

PASS KEY

Remember to close the budget, activity and encumbrances (BAE-BAE) separately. Do not try to net them. The rule is:

(B)	Budget is booked →	(B)	Budget is closed for same amount
(A)	Activity is booked →	(A)	Activity is closed for actual amount
(E)	Encumbrances are booked →	(E)	Encumbrance is reversed for same amount

PASS KEY

Encumbrance accounting provides the final dimension to both fiscal accountability and current financial resources measurement focus. Throughout the year, the use of encumbrances helps monitor the degree to which appropriations have been used. At year-end, encumbrances serve to reduce unrestricted and unreserved fund balances to determine the degree of spendable available resources that can be carried forward into the next spending cycle.

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GOVERNMENTAL FUNDS

I. GENERAL FUND

General Fund **R**evenue (Special) Fund **A**nd **S**ervice (Debt) Fund **P**rojects (Capital) Fund **P**ermanent Fund	Modified Accrual	Budget:	Book on opposite side as control
		Activity:	Revenue—measurable and available Expenditures—all spending Assets—expenditured Debts—other financing sources
		Encumbrances:	Reserve funds for purchase orders

A. OVERVIEW

1. Purpose

The general fund is created at beginning of the governmental unit, and it exists throughout the life of that unit. The general fund accounts for the general activities of a government that are not accounted for by any other fund.

2. Examples

General fund activities include the administrative and general services of the government.

B. REVENUE SOURCES

The general fund usually has the largest share of revenues in a governmental unit. Sources of general fund revenues frequently include all of the earnings types contemplated by governmental reporting models:

1. Taxes

General fund revenues in local government often include property taxes as the primary revenue source. Franchise and public service taxes are often recorded in the general fund.

2. Public Safety and Regulation

General fund revenues in local government often include fees and fines (police department, building inspectors, etc. fine individuals for infractions, charge fees for inspections, etc.). General fund revenues also include license and permit revenues (police and fire or building department licenses for buildings and permits for activities).

3. Intergovernmental

Shared or grant revenues from other governments may appear in the general fund.

4. Charges for Services

Exchange revenues that support general fund activities may appear in the general fund. The government may elect to use a governmental model instead of proprietary funds for services supported by charges.

5. Other Revenues

General fund revenues include investment earnings as well as miscellaneous earnings.

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C. EXPENDITURE TYPES

The general fund usually has the largest share of expenditures in a governmental unit. Sources of general fund expenditures frequently include most of the current functional expenditure types contemplated by governmental reporting models:

1. General Government

General government activities often include the administrative functions of the government such as the city manager, finance, etc.

2. Public Safety

Public safety activities often include the police department, fire department, jail, and building inspections department.

3. Culture and Recreation

Culture and recreation activities include parks, libraries, etc.

D. UNIQUE ACCOUNTING ISSUES

1. Current Resources Measurement Focus

The assets and liabilities of the general fund consist of "current" items. There are no fixed assets in the general fund because capital outlay items are treated as expenditures.

a. Fixed Asset Accounting

Fixed assets purchased with governmental fund resources are only reported in the government-wide financial statements.

b. Reconciling Items

The current financial resources measurement focus precludes recording non-current items and thereby creates reconciling items between the governmental fund financial statements and the government-wide financial statements.

2. Other Characteristics

a. Modified Accrual and Budgetary Accounting

The general fund uses the modified accrual basis of accounting, and formally records its budget in its accounting system.

b. Major Fund Status

There is only one general fund per reporting entity and it is always reported as a major fund.

c. Internal Financing

The general fund automatically finances other funds by:

(1) Making a loan (e.g., to special revenue fund for financing a special assessment).

(2) Making a contribution of equity or revenue (called an "interfund transfer"), to a debt service fund or internal service fund.

(3) Making up a deficit in an enterprise fund.

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d. Default Classification

The general fund is an operating "catch-all" fund for items not accounted for in other funds, such as:

(1) Major and miscellaneous revenues and

(2) Major and miscellaneous expenditures.

e. Special Revenue funds

The special revenue fund is similar to the general fund in that special activities not accounted for in any other fund are accounted for in the numerous special revenue funds set up for those special purposes.

E. FINANCIAL STATEMENTS

1. Fund Financial Statements

a. Balance sheet (Current Assets = Current Liabilities + Fund Balance)

b. Statement of Revenues, Expenditures, and Changes in Fund Balance

2. Required Supplementary Information

a. Budgetary Comparison Schedule

3. Balance Sheet Illustration

The following is an illustration of a balance sheet for the general fund of a governmental unit.

Progressive Township **Balance Sheet** **General Fund** **December 31, 20X1**	
ASSETS	
Cash	800,000
Receivables	162,000
Due from other funds	450,000
Receivables from other governments	620,000
Inventories	55,000
Total assets	2,087,000
LIABILITIES AND FUND BALANCES	
Liabilities:	
Accounts payable	250,000
Due to other funds	50,000
Payable to other governments	65,000
Deferred revenue	95,000
Total liabilities	460,000
Fund balances:	
Reserved for:	
Inventories	55,000
Encumbrances	45,000
Unreserved and reported in:	
General fund	1,527,000
Total fund balances	1,627,000
Total liabilities and fund balance	**2,087,000**

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4. Statement of Revenues, Expenditures, and Changes in Fund Balance Illustration

The following is an example of the statement of revenues, expenditures, and changes in fund balance for the general fund of a governmental unit:

Progressive Township
Statement of Revenues, Expenditures, and Changes in Fund Balance
General Fund
For the Year Ended December 31, 20X1

REVENUES	
Property taxes	1,620,000
Fees and fines	120,000
Interest earnings	55,000
Total Revenues	1,795,000
EXPENDITURES	
Current:	
General government	450,000
Public safety	1,000,000
Culture and recreation	80,000
Other functional classifications	200,000
Capital outlay	25,000
Total expenditures	1,755,000
Excess (deficiency) of revenues over expenditures	40,000
OTHER FINANCING SOURCES (USES)	
Transfers in	85,000
Transfers out	(14,000)
Total other financing sources and uses	71,000
Net change in fund balances	111,000
Fund balances-beginning	1,516,000
Fund balances-ending	1,627,000

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II. SPECIAL REVENUE FUND

General Fund **Revenue (Special) Fund** **A**nd **S**ervice (Debt) Fund **P**rojects (Capital) Fund **P**ermanent Fund	Modified Accrual	Budget:	Book on opposite side as control
		Activity:	Revenue—measurable and available Expenditures—all spending Assets—expenditured Debts—other financing sources
		Encumbrances:	Reserve funds for purchase orders

SPECIAL REVENUE FUND

A. OVERVIEW

1. Purpose

Special revenue funds account for revenues and expenditures that are legally restricted for specific purposes. If intent is to recover less than 50% of expenses by a tax on users, then it is properly accounted in the special revenue fund. Intent controls the accounting, regardless of future realization. The life of the special revenue fund may be limited or unlimited.

2. Examples

Examples of special revenue funds include:

a. Sales tax fund (e.g., to operate park and tourist facility)

b. Gasoline tax fund (e.g., to operate and maintain streets)

c. Funds to account for specific fees

(1) Special fees (e.g., to operate school programs)

(2) Admission fees (e.g., to operate museums)

(3) Parking fees (e.g., to operate traffic court)

d. Grant funds

(1) State grants (state juvenile rehabilitation fund to operate a youth center)

(2) Federal grant funds (Federal financial assistance programs)

B. REVENUE SOURCES

Special revenue funds account for revenues legally restricted for specific purposes and are often classified as either intergovernmental revenue or fees

1. Intergovernmental Revenues

Revenues are often from a single intergovernmental source or a fee. Examples include:

a. Specific taxes and shared taxes,

b. Grants

2. Fees

a. Fees,

b. Other earmarked revenue sources.

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C. EXPENDITURE TYPES

1. Character

The character of special revenue fund expenditures includes:

a. Current operating expenditures (e.g., street maintenance),

b. Capital outlays (e.g., highway construction -not special assessments), or

c. Both.

2. Function

Functional expenditures for special revenue funds should be consistent with the purpose of the revenue.

D. UNIQUE ACCOUNTING ISSUES

1. Expendable Trusts

Expendable trust activities (e.g., scholarship and endowment funds) represent funding whose principal and income may be expended in the course of their designated operations so that they are depleted by the end of their designated lives. Expendable trusts are accounted for as special revenue funds under GASB 34.

a. Basis of Accounting

Expendable trust activities are accounted for in the same manner as the governmental funds, which use "modified accrual" accounting.

b. Character of Expenditures

Expendable trust activities may include capital outlay expenses, depending on the character of the endowment.

c. Donations

When a donation is received by an expendable trust, cash or current asset is debited, and revenue is credited. Donations may be:

(1) Donor/grantor restricted (principal and interest) or

(2) Government restricted.

(a) Forfeiture act – illegal activities

2. Grants

When a grant is received, the recipient government monitors and/or determines eligibility.

(1) Recognize revenues and expenditures equally based on payments of the grantor.

PASS KEY

The rule of thumb for use of the correct fund is:

- Monitoring = special revenue fund
- Nonmonitoring = agency trust fund

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E. FINANCIAL STATEMENTS

SPECIAL REVENUE FUND FINANCIAL STATEMENTS

1. Statement of Revenues, Expenditures, and Changes in Fund Balance

The following is an example of the statement of revenues, expenditures, and changes in fund balance for the special revenue fund of a governmental unit.

2. Financial Statement Assumptions

This financial statement assumes a specific tax (a convention development tax), which is collected and remitted to the government through another government. (We will see that the sample financial statements assume revenues recorded in this fund have been pledged to debt payments and are largely transferred out to another fund to support those debt payments.)

Progressive Township
Statement of Revenues, Expenditures, and Changes in Fund Balance
Convention Development Tax
For the Year Ended December 31, 20X1

REVENUES	
Intergovernmental	375,000
Interest earnings	18,000
Total Revenues	393,000
EXPENDITURES	
Current:	
Culture and recreation	17,500
Total expenditures	17,500
Excess (deficiency) of revenues over expenditures	375,500
OTHER FINANCING SOURCES (USES)	
Transfers out	(250,000)
Total other financing sources and uses	(250,000)
Net change in fund balances	125,500
Fund balances-beginning	58,500
Fund balances-ending	184,000

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III. DEBT SERVICE FUND

General Fund **R**evenue (Special) Fund **A**nd **Service (Debt) Fund** **P**rojects (Capital) Fund **P**ermanent Fund	Modified Accrual	Budget:	Book on opposite side as control
		Activity:	Revenue—measurable and available Expenditures—all spending Assets—expenditured Debts—other financing sources
		Encumbrances:	N/A*

* Fund balance is entirely reserved for debt service.

A. OVERVIEW

1. Purpose

The debt service fund is created to account for the accumulation of resources (cash and investments) and the payment of currently due interest and principal on "long-term general obligation debt" (which is generally "serial bond debt") by setting aside cash and cash equivalents.

a. The debt service fund pays off the debt of the GRaSPP funds.

b. The debt service fund does NOT pay off the debt of the SE-PAPI funds.

2. Examples

a. Central City Development Debt Service Fund

b. Community Redevelopment Debt Service Fund

c. Convention Center Development Bond Debt Service Fund

d. General Revenue Bond Debt Service Fund

B. REVENUE AND OTHER FINANCING SOURCES

The debt service fund's resources for new debt are frequently derived from allocated portions of property taxes and transfers from other funds. Refinanced debt generally results in proceeds from general obligation refunding bonds (including premiums) approved by taxpayers.

1. Journalizing Fund Establishment (Other Financing Sources)

For example, assume independently of all other recorded transactions, that the general fund transferred $10,000 cash to the debt service fund.

Journal entry to record transfer from general fund:

DR	Cash	$10,000	
CR	Interfund transfers from the general fund		$10,000

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2. Journalizing Mandatory Transfer (Other Financing Sources)

Drawing from the example of the bond issuance for the construction of a new government building described in the next section (the capital projects fund), an $80,000 premium included in the bond proceeds was transferred to the debt service fund as required by the bond indenture.

Journal entry to record transfer from capital projects fund:

DR	Cash		$80,000	
CR		Interfund transfers from the capital projects fund		$80,000

3. Journalizing Mandatory Transfer (Other Financing Sources)

Interest revenue of $40,000 was transferred from the capital projects fund as required by the bond indenture (see capital projects example which follows).

Journal entry to record transfer from capital projects fund:

DR	Cash		$40,000	
CR		Interfund transfers from the capital projects fund		$40,000

4. Journalizing Investment Income (Revenue)

Any income from the investment of resources is recorded as revenue, as follows:

DR	Cash		$36,000	
CR		Revenue — Investment income		$36,000

C. EXPENDITURE

The debt service fund makes actual expenditures associated with the principal and interest on general obligation long-term debt. When the interest payment is legally due, the debt service fund recognizes principal and interest expenditures.

1. Journalizing Interest Expenditures

Assume the semi annual interest payment associated with the bond issue is due ($2,000,000 at 3% x 6/12).

a. Journal entry to record payment of interest:

DR	Expenditures		$30,000	
CR		Cash (matured interest payable)		$30,000

b. Encumbrances

Encumbrance accounts are not used. Interest payments are considered expenditures.

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2. Journalizing Principal Expenditures

When the face amount of the bonds is due, the debt service fund would make the entry below using the cash that had been transferred from other funds, especially the general fund and the capital projects fund.

Journal entry to record the payment of principal on the bonds:

DR	Expenditures	$250,000	
CR	Cash (matured principal payable)		$250,000

To the debt service fund, both interest payments and principal payments are considered expenditures.

3. Expenditure Accrual

a. Expenditure Timing

Principal and interest expenditures should be recorded when they are legally payable per the bond agreement. There is no profit motive; therefore, there is no need to apply the matching principle.

(1) No allocation between interest and principal, both are expenditures.

(2) There is no accrual of interest expenditures or interest payable.

b. Treatment of Premiums and Discounts

(1) Bond premiums and discounts are treated as a component of bond proceeds at the time of bond issuance.

(2) There is no amortization of a premium or a discount.

D. UNIQUE ACCOUNTING ISSUES

1. Debt Service Fund Requirement

a. Legal Mandate

Debt service funds are required only when legally mandated and/or when resources are being accumulated for general long-term debt principal and interest payments maturing in future years.

b. Repayment of Other Governmental Debt

The general fund may pay interest and principal directly from the general fund to the bondholders, instead of directly to the debt service fund if the use of a debt service fund is not mandated.

2. Asset Balances

The operations of this fund are similar to a commercial accounting "sinking fund," which buys investments, earns interest, and eventually pays off the debt with accumulated investments.

3. Debt Balances

The full face value (less current installments) of the general obligation debt is not reported in this fund. Debt service fund expenditures are used to pay only "currently payable" principal and interest.

a. Current Balances

The balance and interest payable in the debt service fund represent currently due installments only.

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b. Illustration

City of M
DEBT SERVICE FUND
BALANCE SHEET
as of December 31, 20X3

Assets	
Cash and cash equivalents	$XXX
Due from capital projects and other funds	XXX
Investments	XXX
Interest receivables on investments	XXX
Total assets	$XXX
Liabilities	
Matured bonds payable	$XXX
Matured interest payable	XXX
Total liabilities	$XXX
Fund Balance	
Reserved for debt service retirement	XXX
Total liabilities and fund balance	$XXX

Note: There are no unreserved fund balance accounts.

4. Closing Entries

The debt service fund closing journal entry illustrated below, assumes a budget with estimated revenues of $36,000, appropriations of $30,000, and a fund balance of $6,000 established at the beginning of the year. This entry is similar to that of the general fund shown previously except there are no encumbrances.

a. The Budget is Closed at Year-End

Journal entry to close the budget (reverse for same amount):

DR	Budgetary fund balance	$ 6,000	
DR	Appropriations control	30,000	
CR	Estimated revenues control		$36,000

b. The Activity is Closed at Year-End

Journal entry to close activity for the actual amount:

DR	Bond issue proceeds	$ 80,000	
DR	Transfers from the special revenue fund	250,000	
DR	Transfers from the capital projects fund	40,000	
DR	Other revenues	36,000	
CR	Fund balance, reserved for debt service		126,000
CR	Expenditures – interest		30,000
CR	Expenditures – principal		$250,000

c. Encumbrances – N/A

Encumbrances are not applicable, and are therefore not closed at year-end.

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5. Composition of Fund Balance

Bond issue proceeds and transfers are temporary or nominal accounts that are closed to fund balance at year-end, consistent with other accounts reported in the funds operating statement. The fund balance consists of:

Beginning reserved fund balance	$384,000
Revenue	36,000
Expenditures—Interest	(30,000)
Expenditures—Principal	(250,000)
Subtotal	140,000
Bond issue proceeds	80,000
Transfer from special revenue fund	250,000
Transfer from capital projects fund	40,000
Ending reserved fund balance	$510,000

E. FINANCIAL STATEMENTS

1. Balance Sheet

The balance sheet displays the assets accumulated for the repayment of Convention Center Bonds payable from Convention Development Taxes recorded in the special revenue fund illustrated above. No currently payable debt is displayed (as illustrated above).

Progressive Township
Balance Sheet
Convention Center Bonds
December 31, 20X1

ASSETS	
Cash	450,000
Due from other funds	60,000
Total assets	510,000
LIABILITIES AND FUND BALANCES	
Liabilities:	
Accounts payable	-
Total liabilities	-
Fund balances:	
Reserved for:	
Debt Service	510,000
Total fund balances	510,000
Total liabilities and fund balance	**510,000**

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2. The Statement of Revenues, Expenditures, and Changes in Fund Balance

The statement of revenues, expenditures, and changes in fund balance for a debt service fund typically includes investment income, expenditures for debt service and transfers from other funds to support debt service obligations.

Progressive Township
Statement of Revenues, Expenditures, and Changes in Fund Balance
Convention Center Bonds
For the Year Ended December 31, 20X1

REVENUES	
Interest earnings	36,000
Total Revenues	36,000
EXPENDITURES	
Debt service:	
Principal	250,000
Interest and other charges	30,000
Total expenditures	280,000
Excess (deficiency) of revenues over expenditures	(244,000)
OTHER FINANCING SOURCES (USES)	
Transfers in	370,000
Total other financing sources and uses	370,000
Net change in fund balances	126,000
Fund balances-beginning	384,000
Fund balances-ending	510,000

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IV. CAPITAL PROJECTS FUND

General Fund **R**evenue (Special) Fund **A**nd **S**ervice (Debt) Fund **Projects (Capital) Fund** **P**ermanent Fund	Modified Accrual	Budget:	Book on opposite side as control
		Activity:	Revenue—measurable and available Expenditures—all spending Assets—expenditured Debts—other financing sources
		Encumbrances:	Reserve funds for purchase orders

A. OVERVIEW

1. Purpose

Capital projects funds are established for the construction or purchase or leasing of significant fixed assets, (used by governmental funds ("GRASPP") only, not by proprietary or fiduciary fund ("SE-PAPI"). The life of the capital projects fund is short and is limited to a construction period of 1 to 3 years.

2. Examples

a. Convention Center Construction Fund

b. Municipal Stadium Construction Fund

c. County Courthouse Construction Fund

d. Construction fund accounting for a special assessment project (such as streets and street lights benefiting only those certain property owners who will pay for them)

B. "REVENUES" AND "OTHER FINANCING SOURCES"

Capital projects funds are generally funded by bond proceeds that are to be used to complete a particular project. The project may also be purely funded by a transfer from another fund, specific tax revenues or capital grants. Investment earnings may also appear in this fund although the disposition of those earnings may be either to retain them in the fund for the benefit of the project or to immediately transfer them to a debt service fund for the benefit of the bond holders.

1. Investment Earnings

Unexpended capital projects resources are typically invested. Earnings recorded in the fund and then handled in a manner prescribed by law. The Concept Example below displays the treatment of $40,000 in earnings.

2. Tax Revenues

Tax revenues specifically identified for construction would be classified as tax revenues of a capital projects fund and recorded in a manner identical to tax revenues in the general fund.

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3. Capital Grants

Capital grants received in advance are often recorded as a liability and displayed as earned as they are expended. Government grants may be restricted and are reported as "revenues" when earned (e.g., grant money expended by recipient fund) or may be unrestricted, and recognized immediately.

a. Journal entry to record unrestricted government grant:

DR	Cash	$XXX	
CR	Revenue		$XXX

b. Journal entry to record restricted government grants (revenue when spent):

DR	Cash	$XXX	
CR	Deferred revenue		$XXX

c. Journal entries to recognize revenue restricted (when spent) by a cost reimbursement contract:

DR	Expenditure	$XXX	
CR	Vouchers payable/cash		$XXX
&			
DR	Deferred revenue	$XXX	
CR	Revenue		$XXX

4. General fund (or special revenue fund) transfers, which are reported as "other financing sources."

a. Journal entry to record a general or a special revenue fund transfer:

DR	Cash (or due from "other" fund)	$XXX	
CR	Other financing sources (transfers in)		$XXX

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5. Special Assessments

Special assessments are defined as taxes or fees levied against property owners who will directly benefit from the project (e.g., sidewalks and street lights). Accounting for special assessment transactions depends on the degree to which the governmental unit is responsible or potentially liable for debt often associated with the assessment.

a. Primarily or Potentially Liable

When the governmental unit is primarily or potentially liable for the special assessment debt, the governmental unit should:

(1) Account for the capital project and debt related transactions through the appropriate governmental or proprietary fund.

(2) When accounted for in a governmental fund, debt proceeds associated with special assessments for which the governmental unit is either primarily or potentially liable should be classified as "contribution from property owners" on the operating statement to distinguish it from bond proceeds.

(3) Assets and liabilities should be reported in the government-wide financial statements under the governmental or business-type activities column as appropriate.

b. Not Primarily or Potentially Liable

When the governmental unit is not primarily or potentially liable:

(1) Transactions should be reported in an agency fund, and

(2) Assets and liabilities should be excluded from government-wide presentations.

PASS KEY

When the governmental unit is not liable, the agency fund will account for special assessments.

6. Bond Issue Proceeds

The amount of net bond issue proceeds is presented on the statement of revenues, expenditures and other financing sources and uses as other financing sources.

a. Bond Premium or Discount

Premiums and discounts associated with bond proceeds are included in bond proceeds and receive no additional accounting after the year in which they are received.

b. Reconciling Items

The treatment of bond issue proceeds as a resource inflow on fund financial statements (by virtue of using a measurement focus that does not recognize non-current items) creates reconciling items between the governmental fund financial statements and the government-wide financials.

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EXAMPLE: Capital Projects Bond Issue

Assume that a bond issue for $2,000,000 was authorized to build a new convention center (a general government building). The bond was issued for $2,080,000. Assume the government has been directed to use the premium for the protection of the bondholders.

Journal entry to record the bond proceeds in the capital projects fund:

DR	Cash	$2,080,000	
CR	Other financing sources—bond issue proceeds		$2,000,000
CR	Other financing sources—premium on bonds		80,000

If the sale of the bonds resulted in a premium, as above, the amount of the premium is immediately transferred to the debt service fund, which is used to account for interest and principal payments on the bonds.

Journal entry to transfer the bond issue premium to debt service fund:

DR	Interfund transfer debt service	$80,000	
CR	Cash		$80,000

Note: If the bonds had been sold at a discount, either the project would have to be reduced by the amount of the discount or the amount could be transferred in from another source.

If the project is delayed, the proceeds from the bond issue may be invested. Assume that the $2,000,000 is invested in a CD that earned $40,000. The earnings are usually transferred to the debt service fund.

Journal entry to record investment in CD:

DR	Investment in CD	$2,000,000	
CR	Cash		$2,000,000

Journal entry to record interest revenue earned on the investment:

DR	Cash	$40,000	
CR	Revenue — Interest income		$40,000

Journal entry to record the transfer to the debt service fund

DR	Interfund transfer to the debt service fund	$40,000	
CR	Cash		$40,000

The debt service fund would record entries for receipt of this money.

Had the cost of the building been less than the amount provided, the balance would remain in the capital projects fund until proper authorization was enacted for its disposition. On the other hand, if the bond proceeds are completely exhausted before completion of the building, construction would have to cease until new appropriations are authorized.

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C. EXPENDITURE AND ENCUMBRANCE TYPES

Capital Project Fund expenditures are usually entirely classified as capital outlay, one of the major character classifications (e.g., current, capital outlay, debt service, etc.). During construction, encumbrances are recorded as commitments are incurred. Vouchers are recorded when a liability is incurred and the expenditure is known. As vouchers are recorded, the encumbrance entry is reversed. Cash is credited and vouchers payable is debited as payments are made. (For illustration of journal entries, see the discussion of the general fund.)

EXAMPLE

Capital Project Encumbrances and Expenditures

1. Journal entry to record several contracts signed for construction:

DR	Encumbrances	$1,100,000	
CR	Reserved for encumbrances		$1,100,000

2. Journal Entries for one completed contract that is approved for payment

Journal entry to reverse the encumbrance for same amount:

DR	Reserved for encumbrances	$600,000	
CR	Encumbrances		$600,000

Journal entry to record purchased/constructed assets:

DR	Expenditures	$600,000	
CR	Vouchers payable (or cash)		$600,000

3. Journal entry to record capital lease equipment:

DR	Expenditures	$XXX	
CR	Other financing sources		$XXX

PASS KEY

Journal Entry Amount to Report Fixed Assets in Government-Wide Financial Statements

Manner Acquired	Amount Recorded
Purchase	Cost to buy
Construction	Cost to construct
Capital lease	P.V. lease payments
Donated	FMV
Forfeiture	Lower of cost (to acquire) or market

D. UNIQUE ACCOUNTING ISSUES

1. Asset Balances

The cumulative balance of the value of the constructed asset (inception to date construction in progress) is not displayed on the capital project fund balance sheet.

2. Liability Balances

a. Bond Liability

The bond liability is not recorded in the capital projects fund.

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b. Short-Term Borrowing (Current Liabilities)

Short-term borrowings might be necessary to start a project before either bond proceeds or other revenues are received. Often these borrowings are "bond anticipated notes" issued with the expectation that they will be repaid upon issuance of permanent long-term financing (bonds). The current debt related to this financing is displayed on the balance sheet and recorded as follows.

Journal entry to record the short-term borrowing:

DR	Cash	$XXX	
CR	Short-term note payable		$XXX

3. Closing Entries

At the end of the period, three closing entries are required in the capital projects fund. Assume the budget was $2,000,000, encumbrances were $500,000, and expenditures were $600,000 to illustrate year-end closings.

a. Budget is closed at year-end.

Journal entry to close the budget (reverse for same amount):

DR	Appropriations	$2,000,000	
CR	Estimated revenue		$2,000,000

b. Actual activity is closed at year-end.

Journal entry to close activity (for the actual amount):

DR	Other financing sources - bond issue proceeds	$2,000,000	
DR	Investment revenue	40,000	
DR	Other financing sources – bond premium	80,000	
CR	Expenditures		$600,000
CR	Interfund transfers to debt service, investment revenue		40,000
CR	Interfund transfer to debt service, bond premium		80,000
CR	Unreserved fund balance		1,400,000

c. Encumbrances are closed at year-end.

Journal entry to close/reverse encumbrances for the same amount:

DR	Fund balance reserved for encumbrances	$500,000	
CR	Encumbrances		$500,000

Outstanding encumbrances at year-end should be carried forward as a reserve of fund balance with a corresponding reduction of unreserved fund balance in actual or "real" accounts.

Journal entry to record outstanding encumbrances:

DR	Unreserved fund balance	$500,000	
CR	Fund balance reserved for encumbrances		$500,000

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4. Composition of Unreserved Fund Balance

Note that the unreserved fund balance consists of:

Beginning fund balance, unreserved	$ 100,000
Proceeds from the bond issue	2,080,000
Interest income	40,000
Expenditures	(600,000)
Encumbrances (fund balance reserved)	(500,000)
Interfund transfer to debt service	(120,000)
Ending fund balance, unreserved	$1,000,000

E. FINANCIAL STATEMENTS

The financial statements for the capital projects fund are similar to those already shown for the general fund. Accounts used by individual funds may differ. Some of the common capital projects accounts appear below

1. Balance Sheet

Progressive Township
Balance Sheet
Convention Center Construction
December 31, 20X1

ASSETS	
Cash and Investments	2,100,000
Total assets	**2,100,000**
LIABILITIES AND FUND BALANCES	
Liabilities:	
Accounts payable	600,000
Total liabilities	600,000
Fund balances:	
Reserved for:	
Encumbrances	500,000
Unreserved and reported in:	
Capital projects funds	1,000,000
Total fund balances	1,500,000
Total liabilities and fund balance	**2,100,000**

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2. Statement of Revenues, Expenditures, and Changes in Fund Balance

Progressive Township Statement of Revenues, Expenditures, and Changes in Fund Balance Convention Center Construction For the Year Ended December 31, 20X1	
REVENUES	
Interest earnings	40,000
Total Revenues	40,000
EXPENDITURES	
Capital outlay	600,000
Total expenditures	600,000
Excess (deficiency) of revenues over expenditures	(560,000)
OTHER FINANCING SOURCES (USES)	
Proceeds of long-term capital-related debt	2,080,000
Transfers out	(120,000)
Total other financing sources and uses	1,960,000
Net change in fund balances	1,400,000
Fund balances-beginning	100,000
Fund balances-ending	1,500,000

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PASS KEY

The previous discussion described the accounting that Progressive Township would do to pledge tax revenues to the payment of debt service relative to bonds whose proceeds were used for the construction of a convention center. The following condensed financial statements show the relationship between the special revenue, debt service, and capital projects funds.

Progressive Township
Selected Statements of Revenues, Expenditures, and Changes in Fund Balance
Convention Center Funding, Debt and Construction
For the Year Ended December 31, 20X1

	Convention Development Tax	Convention Center Bonds	Convention Center Construction	Total Governmental Funds
REVENUES				
Property taxes	-	-	-	-
Fees and fines	-	-	-	-
Intergovernmental	375,000	-	-	375,000
Charges for services	-	-	-	-
Interest earnings	18,000	36,000	40,000	94,000
Total Revenues	393,000	36,000	40,000	469,000
EXPENDITURES				
Current:				
General government	-	-	-	-
Public safety	-	-	-	-
Culture and recreation	17,500	-	-	17,500
Other functional classifications	-	-	-	-
Debt service:				
Principal	-	250,000	-	250,000
Interest and other charges	-	30,000	-	30,000
Capital outlay	-	-	600,000	600,000
Total expenditures	17,500	280,000	600,000	897,500
Excess (deficiency) of revenues over expenditures	375,500	(244,000)	(560,000)	(428,500)
OTHER FINANCING SOURCES (USES)				
Proceeds of long-term capital-related debt	-	-	2,080,000	2,080,000
Transfers in	-	370,000	-	370,000
Transfers out	(250,000)	-	(120,000)	(370,000)
Total other financing sources and uses	(250,000)	370,000	1,960,000	2,080,000
Net change in fund balances	125,500	126,000	1,400,000	1,651,500
Fund balances-beginning	58,500	384,000	100,000	542,500
Fund balances-ending	184,000	510,000	1,500,000	2,194,000

Examiners have frequently asked candidates not only about the journal entries related to multiple funds involved in a single initiative, but also about the manner in which those same transactions are displayed in the funds involved. The statements above show the individual funds from pages F8-34, F8-40 and F8-48 and their relationship. Note the Special Revenue Fund has operating expenditures, the Debt Service Fund has debt service expenditures and the Capital Projects fund has capital outlay expenditures. Note also that other financing sources and uses include debt proceeds and transfers and that, among these various funds associated with this event, transfers in and out are equal.

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V. PERMANENT FUNDS

General Fund **R**evenue (Special) Fund **A**nd **S**ervice (Debt) Fund **P**rojects (Capital) Fund **Permanent Fund**	Modified Accrual	Budget:	Book on opposite side as control
		Activity:	Revenue—measurable and available Expenditures—all spending Assets—expenditured Debts—other financing sources
		Encumbrances:	N/A

PERMANENT FUNDS

A. OVERVIEW

1. Purpose

Permanent funds should be used to report resources that are legally restricted to the extent that only earnings, and not principal, may be used for the purposes that support the reporting government's programs (i.e., that is for the benefit of the public).

2. Examples

A public cemetery perpetual care fund is an example of a permanent fund. These funds are the equivalent of nonexpendable trusts and may also be used for endowments that are governed by a formal trust agreement with the donor.

B. REVENUE SOURCES

Revenues may include investment earnings from the trust.

C. EXPENDITURE TYPES

Expenditures related to the operating purpose of the fund (e.g. cemetery maintenance)

D. UNIQUE ACCOUNTING ISSUES

Accounting and Financial Reporting for Certain Investments and for External Investment Pools (GASB 31) provides investment valuation guidance. Investments generally are required to be accounted for at fair value for governmental investments.

Permanent funds otherwise use governmental fund accounting principles.

PASS KEY

Two of the governmental funds (GRaSPP) do not record encumbrances:

- Debt service fund
- Permanent fund

PASS KEY

The easy way to determine where public-restricted funds are recorded is:

Fund	Available for Public Spending
• Special revenue fund	Principal and interest
• Permanent fund	Interest only

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PROPRIETARY FUNDS

I. INTERNAL SERVICE FUND

Service (Internal) Fund **E**nterprise Fund **P**ension Trust **A**gency Trust **P**rivate Purpose Trust **I**nvestment Trust	Full Accrual	• Balance Sheet — Statement of Net Assets • Income Statement — Statement of Revenues and Expenses • Statement of Cash Flows • Footnotes

A. OVERVIEW

1. Purpose

Internal service funds are established to finance and account for services and supplies provided exclusively to other departments within a government unit or to other governmental units, typically on a cost-reimbursement basis.

2. Examples

a. Central janitorial departments

b. Central garages and motor pools

c. Central printing and duplicating services

d. Central purchasing and stores departments

e. Central repair shops

f. Central computer processing department

g. Self insurance

B. REVENUE SOURCES

1. Restricted Grant Revenues: recognized as revenues in the year monies are spent.

2. Operating Revenues (billings for services provided): recognized when earned.

Journal entry to record billings for services rendered to other funds:

DR	Cash (or due from other fund)	$XXX	
CR	Billings to other departments (operating revenue)		$XXX

3. Non-Operating Revenues

Non-operating revenues, such as interest earnings, are segregated from operating revenues for financial statement display.

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C. EXPENSE TYPES

1. Operating Expenses

Normal and customary operating expenses related to the delivery of services appear in the internal service funds.

a. Expenses are typically displayed by object.

b. Expenses are recorded when incurred.

2. Non-Operating Expenses

Non-operating expenses, such as interest expense, are segregated from operating expenses for financial statement display.

D. UNIQUE ACCOUNTING ISSUES

1. Accounting

a. Accrual Accounting

Proprietary funds must be accounted for in the same manner as a privately owned commercial business and must utilize, whenever possible, those accounting and reporting principles and procedures recommended for private for-profit entities. Capital is to be maintained and is nonexpendable.

(1) Recording Long-Term Liabilities and Fixed Assets

Long-term liabilities and fixed assets are recorded in the internal service funds.

(2) Depreciation

Fixed assets are recorded and depreciated in the internal service funds.

b. Budgetary Accounts and Encumbrances (N/A)

Neither budgetary accounts nor encumbrances are recorded in internal service funds. Typically, the user department has budgeted for department costs (i.e., appropriations and encumbrances where appropriate).

c. Net Assets

Net Assets are classified in a manner consistent with other proprietary funds and display three categories of equity: unrestricted, invested in capital assets net of related debt, and restricted for debt service.

2. Reporting

Major fund reporting requirements (covered later) do not apply to internal service funds.

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3. Establishing an Internal Service Fund

a. Contributions from other funds, such as the general fund or an enterprise fund. The start of an internal service fund would be recorded as an interfund transfer.

Journal entry to record other fund contributions (a non-reciprocal transfer):

DR	Cash		$XXX	
CR		Interfund transfer		$XXX

b. Sale of "general obligation bonds," or capital leases.

Journal entry to record the sale of general obligation bonds:

DR	Cash		$XXX	
CR		Long-term bond payable		$XXX

c. Long-term advances from other funds to be repaid from the earnings to the service (revolving) fund.

Journal entry to record a long-term payable to another fund:

DR	Cash		$XXX	
CR		Due to other fund		$XXX

4. Self-Insurance Funds

When a government elects to establish self-insurance funds, the internal service fund is the appropriate fund. When other funds transfer resources related to the actuarially determined liability, the transfer is recorded as an expenditure/expense. Self-insurance "premiums" paid by benefiting funds represent user charges.

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E. FINANCIAL STATEMENTS

1. Statement of Net Assets

INTERNAL SERVICE FUND FINANCIAL STATEMENTS

An example of the Statement of Net Assets follows. Internal Service Funds also require presentation of a Statement of Revenues, Expenses, and Changes in Net Assets as well as a Statement of Cash Flows.

Progressive Township
Statement of Net Assets
Central Reproduction
December 31, 20X1

ASSETS	
Current Assets:	
Cash	50,000
Receivables	25,000
Due from other funds	50,000
Due from other governments	
Inventories	35,000
Total current assets	160,000
Noncurrent assets:	
Restricted cash and cash equivalents	-
Capital assets:	
Land	50,000
Buildings and equipment	150,000
Less: accumulated depreciation	(40,000)
Total noncurrent assets	160,000
Total assets	320,000
LIABILITIES	
Current liabilities:	
Accounts payable	13,000
Compensated absences	16,000
Bonds, notes and loans payable	30,000
Total current liabilities	59,000
Noncurrent liabilities:	
Compensated absences	28,000
Bonds, notes and loans payable	70,000
Total noncurrent liabilities	98,000
Total liabilities	157,000
NET ASSETS	
Invested in capital assets, net of related debt	60,000
Unrestricted	103,000
Total net assets	163,000

2. Reconciling Item

Internal service funds are frequently combined with governmental funds for purposes of displaying governmental activities in the government-wide financial statements since they are often set up to primarily service the governmental funds of the government. Internal service fund net assets and changes in net assets are used as reconciling items between the total governmental funds and the government-wide financial statements.

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II. ENTERPRISE FUND

Service (Internal) Fund **Enterprise Fund** **P**ension Trust **A**gency Trust **P**rivate Purpose Trust **I**nvestment Trust	Full Accrual	• Balance Sheet — Statement of Net Assets • Income Statement — Statement of Revenues and Expenses • Statement of Cash Flows • Footnotes

A. OVERVIEW

1. Purpose

Enterprise funds are used to account for operations that are financed and operated in a manner similar to private business enterprise. Activities are required to be reported as enterprise funds if any one of the following criteria are met:

a. The activity is financed with debt that is secured solely by a pledge of the net revenue from fees and charges.

b. Laws and regulations require that the cost of providing services be recovered through fees.

c. The pricing policies of the activity establish fees and charges designed to recover its costs.

2. Examples

a. Public utilities (water companies and electric companies)

b. Public hospitals (although governmental models may also be used)

c. Public universities (although governmental models may also be used)

d. Other commercial activities, such as:

(1) Public transportation systems

(2) Airports

(3) Public benefit corporations

(4) Dock and wharf facilities

(5) Off-street parking lots and garages

(6) Public housing

(7) Golf courses and swimming pools

(8) Lotteries

B. REVENUE SOURCES

Revenues for Enterprise (and all proprietary funds) must be presented by major source and distinguished between operating and non-operating. Classification of transactions as operating or not should be consistent with transaction classification in the Statement of Cash Flows.

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1. Operating Revenues

Operating revenues (and operating expenses) are defined by the main purposes of the fund. Examples of operating revenues include:

a. Charges for Services

(1) Water & Sewer billings (in a public utility)

(2) Greens fees (in Golf Course)

b. Miscellaneous Operating Revenues

2. Non-Operating Revenues

Non-operating revenues are earnings or non-exchange transactions (such as taxes and certain fees and charges) and interest

a. Shared Revenues (Non-Operating Revenue)

Shared revenues are revenues (e.g., from gasoline or sales taxes) collected by one government (e.g., state) and shared on a predetermined basis with another (e.g., local) government. They are non-operating revenues of the local government.

b. Interest and Investment Income

Transfers in (e.g., from the general fund) are other financial sources that will affect the results of operations. The accounting for revenues is the same as in commercial (GAAP) accounting.

C. EXPENSE TYPES

1. Operating Expenses

Operating expenses are generally classified by object to include such major categories as Personal services, Utilities, and Depreciation.

2. Non-Operating Expenses

Non-operating expenses most commonly include interest expense.

D. UNIQUE ACCOUNTING ISSUES

1. Accrual Accounting

Proprietary funds must be accounted for in the same manner as a privately owned commercial business and must utilize, whenever possible, those accounting and reporting principles and procedures recommended for private for-profit entities.

a. Recording Long-Term Liabilities and Fixed Assets

(1) Fixed assets are recorded in the enterprise funds.

(2) The enterprise fund carries the following bonds (i.e., long-term debt)

(a) Revenue bonds backed only by the proprietary fund,

(b) Revenue bonds backed by proprietary fund with general obligation backing, and

(c) General obligation bonds paid with proprietary fund revenues.

b. Depreciation

Fixed assets are recorded and depreciated in the enterprise funds.

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c. Net Assets

Net assets is comprised of three parts:

1. Invested in capital assets, net of related debt
2. Restricted for debt service, and
3. Unrestricted.

PASS KEY

The CPA Examiners have tested candidates' recall that governmental funds (GRaSPP) use modified accrual (BAE-BAE) and that proprietary and fiduciary funds (SE-PAPI) use full accrual accounting. Therefore, "SE-PAPI" funds do **not** record **budgets** nor do these funds record **encumbrances**.

2. Reporting, Statement of Revenues, Expenses, and Changes in Fund Net Assets

a. Revenue Valuation

Revenues are reported either net of discounts and allowance with appropriate disclosure of allowance amounts or reported gross with related discount or allowance amounts reported on the face of the financial statement.

b. Contributed Capital

Revenues from capital contributions or additions to endowments are displayed separately after non-operating revenues and expenses. Contributed capital is not shown on the face of the Balance Sheet.

c. Special and Extraordinary Items

Special items represent items that are either unusual or infrequent while extraordinary items represent items that are unusual and infrequent (consistent with commercial accounting). Special and extraordinary items are reported separately after non-operating revenues and expenses

d. Transfers

Interfund transfers are displayed after contributions and special and extraordinary items.

PASS KEY

In case you forget the order of presentation of line items on a proprietary fund Statement of Revenues, Expenses, and Changes in Fund Net Assets, remember INCASET and you'll be encased in knowledge:

I Income (0perating)
N Non-Operating Income and Expense
C Capital Contributions and
A Additions to endowments
S Special Items (Unusual or Infrequent)
E Extraordinary items
T Transfers

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3. Establishing an Enterprise Fund

a. Capital Contributions

Capital contributions will be reported as a separate category of revenue reported below the non-operating revenue and expense section of the operating statement. Capital contributions are not identified as a separate component of net assets.

Journal entry to record contributions: (Non Reciprocal Interfund Activity)

DR	Cash		$X,XXX	
CR		Interfund transfers		$X,XXX

Equity transfers from other funds would be recorded as interfund transfers.

b. Long-Term Debt (or Capital Lease)

The enterprise fund will carry long-term debt, which is backed by the proprietary fund or paid with revenues.

Journal entry to issue of "general obligation bond" to be paid from proprietary fund revenues:

DR	Cash		$X,XXX	
CR		Long-term bond payable		$X,XXX

4. Municipal Landfills (The Dump)

Municipal landfill accounting is governed by "Accounting for Municipal Solid Waste Landfill Closure (MSWLF) and Postclosure Care Costs (GASB 18)"

GASB 18 refers to Environmental Protection Agency (EPA) rules and establishes standards of accounting and reporting for MSWLF closure and postclosure costs required to be incurred by federal, state, or local laws or regulations as a condition for the right to operate in the current period.

a. Reporting and Disclosure

The estimated total current cost of MSWLF closure and postclosure care should be disclosed as "estimated total current cost of MSWLF closure and postclosure care to be recognized," regardless of their capital or operating nature or the effective date of the regulations requiring the care.

b. Cost components

The estimated total current cost of MSWLF closure and postclosure care, based upon applicable federal state or local laws or regulations, should include the:

(1) Cost of equipment expected to be installed and facilities expected to be constructed near or after the date that the MSWLF stops accepting solid waste and during the post closure period. This equipment should be limited to items that, once installed or constructed, will be exclusively used for the MSWLF.

(2) Cost of a gas monitoring and collection system.

(3) Cost of final cover (capping) expected to be applied near or after the date that the MSWLF stops accepting solid waste.

(4) This estimate should be adjusted annually. Under proprietary fund reporting, a portion of this estimated cost is recognized as an expense and as a liability, based on usage, each period the MSWLF is operating. All costs are recognized as of the date of closure.

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c. Equipment Purchases

Purchases of equipment anticipated by the liability accrual reduce the liability and do not increase assets.

E. FINANCIAL STATEMENTS

1. Statement of Net Assets

Progressive Township
Statement of Net Assets
Water and Sewer Fund
December 31, 20X1

ASSETS	
Current Assets:	
Cash	650,000
Receivables	500,000
Due from other governments	100,000
Inventories	85,000
Total current assets	1,335,000
Noncurrent assets:	
Restricted cash and cash equivalents	750,000
Capital assets:	
Land	700,000
Buildings and equipment	1,800,000
Less: accumulated depreciation	(750,000)
Total noncurrent assets	2,500,000
Total assets	3,835,000
LIABILITIES	
Current liabilities:	
Accounts payable	350,000
Due to other funds	450,000
Compensated absences	75,000
Bonds, notes and loans payable	150,000
Total current liabilities	1,025,000
Noncurrent liabilities:	
Compensated absences	300,000
Bonds, notes and loans payable	1,300,000
Total noncurrent liabilities	1,600,000
Total liabilities	2,625,000
NET ASSETS	
Invested in capital assets, net of related debt	300,000
Restricted for debt service	750,000
Unrestricted	160,000
Total net assets	1,210,000

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2. Statement of Revenues, Expenses, and Changes in Fund Net Assets

Progressive Township
Statement of Revenues, Expenses, and Changes in Fund Net Assets
Water and Sewer Fund
December 31, 20X1

Operating revenues	
Charges for services	1,500,000
Miscellaneous	250,000
Total operating revenues	**1,750,000**
Operating expenses	
Personal services	975,000
Contracted services	85,000
Other operating expenses	300,000
Depreciation expense	270,000
Total operating expenses	**1,630,000**
Operating income (loss)	**120,000**
Nonoperating revenues (expenses)	
Interest and investment revenue	60,000
Interest expense	(100,000)
Total nonoperating revenue (expenses)	**(40,000)**
Income (loss) before contributions and transfers	**80,000**
Capital contributions	300,000
Change in net assets	**380,000**
Total net assets - beginning	830,000
Total net assets - ending	**1,210,000**

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3. Statement of Cash Flows

Progressive Township
Statement of Cash Flows
Water and Sewer Fund
December 31, 20X1

CASH FLOWS FROM OPERATING ACTIVITIES	
Receipts from customers	1,510,000
Payments to suppliers	(432,500)
Payments to employees	(1,008,000)
Internal activity - payments to other funds	-
Other receipts (payments)	337,750
Net cash provided by operating activities	407,250
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES	
Operating subsidies and transfers to other funds	-
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES	
Proceeds from capital debt	605,000
Capital Contributions	300,000
Purchases of capital assets	(980,000)
Principal paid on capital debt	(97,500)
Interest paid on capital debt	(100,000)
Net cash (used) by capital and related financing activities	(272,500)
CASH FLOWS FROM INVESTING ACTIVITIES	
Proceeds from sales and maturities of investments	(318,750)
Interest and dividends	60,000
Net cash provided by investing activities	(258,750)
Net (decrease) increase in cash and cash equivalents	(124,000)
Balances - beginning of the year	774,000
Balances - end of the year	650,000
Reconciliation of operating income (loss) to net cash provided (used) by operating activities:	
Operating income (loss)	120,000
Adjustments to reconcile operating income to net cash provided (used) by operating activities:	
Depreciation expense	270,000
Changes in assets and liabilities	
Receivables, net	(240,000)
Inventories	(34,000)
Accounts and other payables	122,500
Accrued expenses	168,750
Net cash provided by operating activities	407,250

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PENSION FUNDS

FIDUCIARY FUNDS

I. PENSION (AND OTHER EMPLOYEE BENEFIT) TRUST

Service (Internal) Fund **E**nterprise Fund **Pension Trust** **A**gency Trust **P**rivate Purpose Trust **I**nvestment Trust	Full Accrual	• Balance Sheet (Statement of Plan Net Assets) • Income Statement (Statement of Changes in Plan Net Assets) • Statement of Cash Flows (Not required) • Footnotes

A. OVERVIEW

1. Purpose

Pension (and Other Employee Benefit) Trust funds account for government sponsored defined benefit and defined contribution plans and other employee benefits such as post retirement health care benefits.

2. Examples

a. Employee Retirement Plan

b. Deferred Compensation Plan

B. REVENUE (ADDITION) SOURCES

1. Employer & Employee Contributions—Restricted Account

a. Resources received are credited to the account "employee contributions—restricted." This account appears in the net assets section of the pension trust fund balance sheet and is disclosed in the footnotes.

Journal entry to record the receipt of money from other funds (additions, not revenue, nor "other financing sources"):

DR	Cash		$XXX	
CR		Additions: employer contribution - restricted		$XXX

2. Other Fund Transferring Money to this Fund:

a. Journal entry of a GRASPP fund, which uses modified accrual (expenditures, not "other uses," "transfers"):

DR	Expenditures		$XXX	
CR		Cash		$XXX

b. Journal entry of a SE-PAPI fund, which uses full accrual (expenses, not "transfers"):

DR	Expenses		$XXX	
CR		Cash		$XXX

3. Income from Investments

Income from investments is recorded as revenue and is closed to the proper employee restricted accounts at year-end.

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C. EXPENSE (DEDUCTION) TYPES

Expenses of pension trust funds frequently include benefits payments, refunds and administrative expense.

D. UNIQUE ACCOUNTING ISSUES

1. Accounting

a. Full Accrual

Pension trust funds and public employee retirement systems (PERS) use the accrual basis of accounting (i.e., no budget and no encumbrances are used).

b. Basis of Accounting

Pension funds use the economic resources measurement focus.

(1) Pension (and other employee benefit) trusts capitalize fixed assets and record related depreciation expense.

(2) Pension (and other employee benefit) trusts carry long-term debt and pay both principal and interest.

2. Net Asset Accounting

The net assets may include reserves for both employer and employee contributions, as well as any actuarial deficiency for the employer's contributions. Net assets are typically reported in a single line item titled "Net Assets: Held in trust for pension benefits and other purposes."

DR	Reserve for employer's contributions	$XXX	
DR	Actuarial deficiency in reserve	XXX	
DR	Reserve for employees' contributions	XXX	
CR	Pension net assets		$XXX

3. Deferred Compensation Plans for "Other-Than-Enterprise-Fund" Employees

a. Defined

IRC Sec. 457 deferred compensation plans are similar to 403(b) and 401(k) defined contribution plans.

b. Accounting

IRC Sec. 457 deferred compensation plans that are reported in the fiduciary funds should be reported as pension (and other employee benefit) trust funds. Furthermore, the investment held by these plans are to be reported (according to GASB 31), at fair value where readily determinable.

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E. FINANCIAL STATEMENTS (INCLUDING REQUIRED SUPPLEMENTARY INFORMATION AND NOTE DISCLOSURES)

PENSION FUND FINANCIAL STATEMENTS

GASB 25 requires that pension plan assets generally be measured using the accrual basis of accounting applied on a fair value basis; however, pension benefit obligations should be recognized when "due and payable." The statement covers measurement and reporting for defined benefit plans and disclosure for defined contribution plans.

1. Statement of Plan Fiduciary Net Assets

The statement of plan net assets is prepared on an accrual basis and reports the plan's assets, liabilities, and net assets.

a. Asset Valuation

For the most part, the plan's net assets (investments) are reported on a fair value basis. This statement identifies the major assets of the plan.

b. Liabilities and Net Asset Determination

Reported liabilities should be subtracted from the total assets, and the difference should be reported as "net assets held in trust for pension benefits." This statement does not report the required actuarial liability. Instead, it is reported in the schedule of funding progress.

Progressive Township
Statement of Fiduciary Net Assets
Employee Retirement Plan
December 31, 20X1

ASSETS	
Cash	1,000,000
Receivables:	
Interest and dividends	70,000
Other receivables	25,000
Total receivables	95,000
Investments at fair value:	
U.S. government obligations	1,000,000
Corporate bonds	1,000,000
Corporate stock	2,000,000
Total investments	4,000,000
Total assets	5,095,000
LIABILITIES	
Accounts payable	30,000
Refunds payable and others	14,600
Total liabilities	44,600
NET ASSETS	
Held in trust for pension benefits and other purposes	5,050,400

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2. Statement of Changes in Plan Net Assets

The statement of plan net assets reports the net increase or decrease in net plan assets from the beginning of the year until the end of the year.

a. Additions

Additions in net assets include contributions received from employees and employers; net appreciation (or depreciation) of the fair value of the plan assets, including realized and unrealized gains and losses; and premiums and discounts on debt securities, which should not be amortized as part of investment income.

b. Deductions

Deductions from net assets include pension benefit payments to retirees and beneficiaries and administrative expenses.

Progressive Township
Statement of Changes In Fiduciary Net Assets
Employee Retirement Plan
December 31, 20X1

ADDITIONS	
Contributions	
Employer	471,250
Plan members	157,100
Total contributions	628,350
Investment earnings:	
Net increase (decrease)	
in fair value of investments	200,000
Interest	130,000
Dividends	60,000
Total investment earnings	390,000
Less investment expense	40,000
Net investment earnings	350,000
Total additions	**978,350**
DEDUCTIONS	
Benefits	157,100
Refunds of contributions	62,850
Administrative expenses	4,900
Total deductions	**224,850**
Change in net assets	**753,500**
Net assets - beginning of the year	**4,296,900**
Net assets - end of the year	**5,050,400**

3. Statement of Cash Flows

The Statement of Cash Flows is not required.

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PASS KEY

The fiduciary and proprietary funds both use full accrual accounting. One significant difference between the fiduciary and proprietary funds is:

- Fiduciary funds – cash flow statement is not required
- Proprietary funds – cash flow statement is required

4. Notes to the Financial Statements Include:

PENSION FUND DISCLOSURES

a. A plan description.

b. A summary of significant accounting policies.

c. Contributions and reserves including funding policy, required contribution rates under the funding policy, description of terms or long-term contracts, and balances in legally required reserves.

d. Risk concentrations (i.e., identifications of investment that represent 5% or more of the net assets of the pension plan).

5. Required Supplementary Information

Required supplementary information, which consists of a schedule of funding progress and a schedule of employer contributions (for the past six consecutive fiscal years of the plan) and notes to support the two schedules. The measurement of pension plan information should be based on an actuarial valuation that is performed at least biennially. The computation is based on the following components:

a. Benefits to be included, which are based on the actuarial present value of total projected benefits.

b. Actuarial assumptions.

c. Economic assumptions, which establish the discount rate and the projected salary increase assumption.

d. Actuarial cost method.

e. Actuarial value of assets, and market-related values (basically same as fair value, but without short-term fluctuations).

f. Annual required contributions, which include employer's normal costs and a provision that amortizes the unfunded actuarial accrued liability.

g. Contribution deficiencies or excess contributions.

6. Other Post Employment Benefit (OPEB) Plans

Specific reporting for defined benefit OPEBs (such as life time health care) are described by GASB 43. Reporting requirements (financial statements and multi year schedules included in RSI) are nearly identical to pension reporting. Actuarial valuations in RSI are required biennially for plans with over 200 participants and triennially for plans with less than 200 participants.

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II. AGENCY TRUST FUND

AGENCY FUNDS

Service (Internal) Fund **E**nterprise Fund **P**ension Trust **Agency Trust** **P**rivate Purpose Trust **I**nvestment Trust	Full Accrual	• Balance Sheet—Statement of Fiduciary Net Assets • Income Statement—N/A • Statement of Cash Flows—N/A • Footnotes—When necessary

A. OVERVIEW

1. Purpose

An agency fund collects cash to be held temporarily for an authorized recipient to whom it will be later disbursed. This recipient may be another fund or some individual or firm or even government outside of the government.

2. Examples

a. Tax Collection Funds

b. Clearance Funds

c. Special Assessments

B. REVENUE SOURCES

Revenues are not recognized in agency funds

C. EXPENSE TYPES

Expenses are not recognized in agency funds

D. UNIQUE ACCOUNTING ISSUES

1. Tax Collection Funds

Tax collection funds exist when one local government collects a tax for an overlapping governmental unit and remits the amount collected, less administrative charges, to the recipient unit

a. Sales tax agency fund,

b. Payroll withholding agency fund, and

c. Real estate taxes agency fund.

EXAMPLE

Journal entry to record the county collections and retaining of a fee (%):

DR	Cash		$1,000,000	
CR		Due to other units (towns)		$950,000
CR		Due to county general fund		50,000

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2. Clearance Funds

Clearance funds are used to accumulate a variety of revenues from different sources and apportion them to various operating funds in accordance with a statutory formula or procedure.

a. Cash Conduit Arrangements (no monitoring)

(1) Pass through grants

(2) Food stamps

(3) Traffic citations

(4) Alimony, child support and other court ordered payments

PASS KEY

If a governmental unit has monitoring and/or determines eligibility, then the special revenue fund is used.

3. Special Assessments

a. When the governmental unit "is not otherwise obligated" for the debt (i.e., not primarily or potentially liable), the receivables and debt service transaction are appropriately accounted for in the agency fund.

PASS KEY

If a governmental unit has liability, accounting is made through the capital projects and debt service funds.

E. FINANCIAL STATEMENTS

AGENCY FUND FINANCIAL STATEMENTS

Agency funds do not use a statement of revenues and expenses. A statement of changes in assets and liabilities is prepared. Agency funds record no fund balance because current assets must equal current liabilities.

Statement of Fiduciary Net Assets

1. Current Assets = Current Liabilities
2. Agency funds "usually" have no year-end balance, as monies are periodically transferred to clear the fund.
3. The following example displays a sample statement of fiduciary net assets.

Progressive Township
Statement of Fiduciary Net Assets
Agency Fund
December 31, 20X1

ASSETS	
Cash	1,000,000
Total assets	1,000,000
LIABILITIES	
Accounts payable	1,000,000
Total liabilities	1,000,000

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III. PRIVATE PURPOSE TRUST

PRIVATE PURPOSE FUNDS

Service (Internal) Fund **E**nterprise Fund **P**ension Trust **A**gency Trust **Private Purpose Trust** **I**nvestment Trust	Full Accrual	• Balance Sheet — Statement of Net Assets • Income Statement— Statement of Changes in Net Assets • Statement of Cash Flows—Not Required • Footnotes

A. OVERVIEW

1. Purpose

The private purpose trust fund is the designated fund for reporting all other trust arrangements under which principal and income are for the benefit of one of the following:

a. Specific individuals

b. Private organizations

c. Other governments

2. Examples

a. Escheat Property Fund

b. Other Trusts

The private purpose trust accounts for fiduciary transactions that relate to specific private rather than general public purposes other than:

(1) Public employee retirement systems or

(2) Investment pools held on behalf of other governments.

B. REVENUE SOURCES

The income from the principal of a private purpose trust may be placed with another fund.

Assume the principal of a private purpose trust fund is invested and the income received is transferred to a general fund.

1. General Fund

Journal entry to record the transfer of income to the general fund:

DR	Due from private purpose trust	$500	
CR	Transfer from the private purpose trust		$500

Journal entry to record the transfer of cash to the general fund:

DR	Cash	$500	
CR	Due from the private purpose trust		$500

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2. Private Purpose Trust

Journal entry to record obligation to transfer income to general fund:

DR	Interfund transfer to the general fund	$500	
CR	Due to the general fund		$500

Journal entry to record transfer of funds to the general fund:

DR	Due to the general fund	$500	
CR	Cash		$500

C. EXPENSE TYPES

1. Expenses

Expenses relate to the specific purpose of the trust and may relate to benefits or administrative charges.

2. Capital Gains (Losses)

Capital gains and losses are recorded as adjustments to fund principal and not to income, unless the grantor specified otherwise.

D. UNIQUE ACCOUNTING ISSUES

Escheat property is property that reverts to a governmental entity in the absence of legal claimants or heirs at the time the estate is settled. Escheat property generally should be reported as an asset in the governmental or proprietary fund to which the property ultimately escheats. Escheat property held for individuals, private organizations or other governments should be reported in a private purpose trust fund.

1. Revenue is reduced and a fund liability is reported to the extent property will probably be reclaimed.
2. Transfers to other funds are "operating transfers."
3. Advances to/from occur if assets are less than the liability to future claimants.

PASS KEY

To determine the correct fund to account for restricted funds, use the following chart:

Fund	Use	Spending
• Special revenue fund	Public	Interest and principal (expendable)
• Permanent fund	Public	Interest only (nonexpendable)
• Private purpose fund	Private	Interest and/or principal (expendable)

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IV. INVESTMENT TRUST FUNDS

Service (Internal) Fund **E**nterprise Fund **P**ension Trust **A**gency Trust **P**rivate Purpose Trust **Investment Trust**	Full Accrual	• Balance Sheet (Statement of Fiduciary Net Assets) • Income Statement (Statement of Changes in Fiduciary Net Assets) • Statement of Cash Flows—Not Required • Footnotes

A. OVERVIEW

1. Purpose

Accounting and Financial Reporting for Certain Investments and for External Investment Pools (GASB 31) established that a governmental entity that sponsors one or more external investment pools (sponsoring government) should report the external portion of each pool as a separate investment trust fund.

2. Example

a. Investment Trust Fund

B. REVENUE (ADDITION) SOURCES

Additions in net assets include contributions; net appreciation (or depreciation) of the fair value of the plan assets, including realized and unrealized gains and losses; and premiums and discounts on debt securities, which should not be amortized as part of investment income.

C. EXPENSE (DEDUCTION) TYPES

Deductions from net assets include payments to beneficiaries and administrative expenses.

D. UNIQUE ACCOUNTING ISSUES

1. Basis of Accounting and Measurement Focus

The investment trust funds are required to use the economic resources measurement focus and the accrual basis of accounting to report transactions and balances.

2. Asset Valuation

For the most part, the plan's net assets (investments) are reported on a fair value basis.

E. FINANCIAL STATEMENTS

1. Statement of Fiduciary Net Assets

The statement of fiduciary net assets is prepared on the accrual basis and reports the plan's assets, liabilities, and net assets. The statement identifies the major assets of the plan. Reported liabilities should be subtracted from the total assets, and the difference reported as "net assets held in investment trust."

2. Statement of Changes in Fiduciary Net Assets

The statement of changes in fiduciary net assets reports the net increase or decrease in net plan assets from the beginning of the year until the end of the year.

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MATRIX OF FINANCIAL STATEMENTS REQUIRED FOR VARIOUS FUNDS

		Governmental					Proprietary		Fiduciary			
		G	R	S	P	P	S	E	P	A	P	I
		GENERAL	REVENUE (SPECIAL)	SERVICE (DEBT)	PROJECTS (CAPITAL)	PERMANENT	SERVICE (INTERNAL)	ENTERPRISE	PENSION	AGENCY	PRIVATE PURPOSE	INVESTMENT
BALANCE SHEET	• Balance Sheet Current Assets Current Liabilities Fund Balance	X	X	X	X	X						
	• Statement of Net Assets Assets Liabilities Net Assets						X	X				
	• Statement of Fiduciary Net Assets Assets Liabilities Net Assets								X	X	X	X
INCOME STATEMENT	• Statement of Revenues, Expenditures, and Changes in Fund Balance Revenue Expenditures Other Financing Sources (Uses)	X	X	X	X	X						
	• Statement of Revenues, Expenses, and Changes in Fund Net Assets Operating Revenue Operating Expenses Non-operating Revenue and Expenses						X	X				
	• Statement of Changes in Fiduciary Net Assets Additions Deductions								X	–	X	X
CASH FLOWS	• Statement of Cash Flows Operating Investing Capital Financing Non-capital Financing						X	X				
	METHODS OF ACCOUNTING											
	• Full Accrual						X	X	X	X	X	X
	• Modified Accrual Budget Activity Encumbrances	X • • •	X • • •	X • • –	X • • •	X • • –						

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FINANCIAL ACCOUNTING & REPORTING 8
Class Questions Answer Worksheet

MC Question Number	First Choice Answer	Correct Answer	NOTES
1.			
2.			
3.			
4.			
5.			
6.			
7.			
8.			
9.			
10.			
11.			
12.			
13.			
14.			
15.			
16.			
17.			
18.			
19.			
20.			
21.			
22.			

Grade:

Multiple-choice Questions Correct / 22 = _____% Correct

Detailed explanations to the class questions are located in the back of this textbook.

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NOTES

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CLASS QUESTIONS

1. CPA-00888

Which of the following lead(s) to the use of fund accounting by a governmental organization?

	Financial Control	*Legal Restrictions*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

2. CPA-00892

Which of the following characteristics of service efforts and accomplishments is the most difficult to report for a governmental entity?

a. Comparability.
b. Timeliness.
c. Consistency.
d. Relevance.

3. CPA-00889

In complying with GASB #34, a government will present separate fund financial statements for its governmental and proprietary funds. The purpose of this presentation is to:

a. Demonstrate compliance with legal, regulatory or other budgetary compliance features of the government's administration of its finances.
b. Report additional and detailed information about the primary government.
c. Provide internal transfer pricing data regarding individual internal service funds.
d. Document the prioritization of general revenue allocations.

4. CPA-00891

The economic resources measurement focus and accrual basis of accounting would be most appropriate for which fund as used in the fund financial statements?

a. General Fund.
b. Permanent Fund.
c. Internal Service Fund.
d. Capital Projects Fund.

5. CPA-00890

Which funds would most appropriately use the current financial resources measurement focus and modified accrual basis of accounting in their fund financial statements:

	Governmental	*Proprietary*	*Fiduciary*
a.	Yes	No	Yes
b.	No	Yes	Yes
c.	Yes	No	No
d.	Yes	Yes	Yes

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6. CPA-00962

Ridge Township's governing body adopted its general fund budget for the year ended July 31, 1994, comprised of estimated revenues of $100,000 and appropriations of $80,000. Ridge formally integrates its budget into the accounting records.

To record the appropriations of $80,000, Ridge should:

a. Credit appropriations control.
b. Debit appropriations control.
c. Credit estimated expenditures control.
d. Debit estimated expenditures control.

7. CPA-00964

Ridge Township's governing body adopted its general fund budget for the year ended July 31, 1994, comprised of estimated revenues of $100,000 and appropriations of $80,000. Ridge formally integrates its budget into the accounting records.

To record the $20,000 budgeted excess of estimated revenues over appropriations, Ridge should:

a. Credit estimated excess revenues control.
b. Debit estimated excess revenues control.
c. Credit budgetary fund balance.
d. Debit budgetary fund balance.

8. CPA-04553

The budget of a governmental unit, for which the appropriations exceed the estimated revenues, was adopted and recorded in the general ledger at the beginning of the year. During the year, expenditures and encumbrances were less than appropriations; whereas revenues equaled estimated revenues. The budgetary fund balance account is:

a. Credited at the beginning of the year and debited at the end of the year.
b. Credited at the beginning of the year and not changed at the end of the year.
c. Debited at the beginning of the year and credited at the end of the year.
d. Debited at the beginning of the year and not changed at the end of the year.

9. CPA-00907

Both Curry City and the State have a general sales tax on all merchandise. Curry City's tax rate is 2 percent and the State's rate is 4 percent. Merchants are required by law to remit all sales tax collected each month to the State by the 15th of the following month. By law, the State has 45 days to process the collections and to make disbursements to the various jurisdictions for which it acts as an agent. Sales tax collected by merchants in Curry total $450,000 in May and $600,000 in June. Both merchants and the State make remittances in accordance with statutes. What amount of sales tax revenue for May and June is included in the June 30 year-end financial statements of the State and Curry?

	State	*Curry*
a.	$1,050,000	$0
b.	$1,050,000	$350,000
c.	$700,000	$350,000
d.	$300,000	$150,000

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10. CPA-00955

When a snowplow purchased by a governmental unit is received, it should be recorded in the general fund as a(an):

a. Encumbrance.
b. Expenditure.
c. Capital Asset.
d. Appropriation.

11. CPA-00940

Which account should Spring Township credit when it issues a purchase order for supplies?

a. Appropriations control.
b. Vouchers payable.
c. Encumbrance control.
d. Reserve for encumbrances.

12. CPA-00969

Elm City issued a purchase order for supplies with an estimated cost of $5,000. When the supplies were received, the accompanying invoice indicated an actual price of $4,950. What amount should Elm debit (credit) to the reserve for encumbrances after the supplies and invoice were received?

a. ($50)
b. $50
c. $4,950
d. $5,000

13. CPA-00935

The revenues control account of a governmental unit is increased when:

a. The encumbrance account is decreased.
b. Appropriations are recorded.
c. Property taxes are recorded.
d. The budget is recorded.

14. CPA-00908

When a purchase order is released, a commitment is made by a governmental unit to buy a computer to be manufactured to specifications for use in property tax administration. This commitment should be recorded in the general fund as a (an):

a. Appropriation.
b. Encumbrance.
c. Expenditure.
d. Fixed asset.

15. CPA-00996

Which of the following funds of a governmental unit uses the same basis of accounting as the special revenue fund?

a. Enterprise funds.
b. Internal service funds.
c. Private purpose fund.
d. Permanent fund.

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16. CPA-01000

The debt service fund of a governmental unit is used to account for the accumulation of resources for, and the payment of, principal and interest in connection with a:

	Fiduciary Fund	*Proprietary Fund*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

17. CPA-00997

It is inappropriate to record depreciation expense in a(an):

a. Enterprise fund.
b. Internal service fund.
c. Private purpose trust fund.
d. Capital projects fund.

18. CPA-01029

The billings for transportation services provided to other governmental units are recorded by the internal service fund as:

a. Transportation appropriations.
b. Operating revenues.
c. Interfund exchanges.
d. Inter-governmental transfers.

19. CPA-01032

Cy City's Municipal Solid Waste Landfill Enterprise Fund was established when a new landfill was opened January 3, 1994. The landfill is expected to close December 31, 2015. Cy's 1994 expenses would include a portion of which of the year 2016 expected disbursements?

I. Cost of a final cover to be applied to the landfill.
II. Cost of equipment to be installed to monitor methane gas buildup.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

20. CPA-01040

A state government had the following activities:

I.	State-operated lottery	$10,000,000
II.	State-operated hospital	3,000,000

Which of the above activities should be most likely accounted for in an enterprise fund?

a. Neither I nor II.
b. I only.
c. II only.
d. Both I and II.

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21. CPA-01067

Fish Road property owners in Sea County are responsible for special assessment debt that arose from a storm sewer project. If the property owners default, Sea has no obligation regarding debt service, although it does bill property owners for assessments and uses the monies it collects to pay debt holders. What fund type should Sea use to account for these collection and servicing activities?

a. Agency.
b. Debt service.
c. Private purpose funds.
d. Capital projects.

22. CPA-01082

Arlen City's accounts contained the following cash balances at December 31, 1992:

Under the Forfeiture Act-cash confiscated from illegal activities; disbursements can be used only for law enforcement activities	$300,000
Sales taxes collected by Arlen to be distributed to other governmental units	500,000

What amount of cash should Arlen report in its private purpose trust funds at December 31, 1992?

a. $0
b. $300,000
c. $500,000
d. $800,000

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NOTES

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Financial Accounting & Reporting 9

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Financial Accounting & Reporting 9

GOVERNMENTAL ACCOUNTING (PART B)

I. GOVERNMENTAL FINANCIAL REPORTING REQUIREMENTS OF GASB 34

A. OVERVIEW

1. Governmental Reporting Standards

The governmental reporting standards established by GASB 34 require presentation of basic financial statements and required supplementary information. Basic financial statements are defined as government-wide financial statements, fund financial statements, and notes to the financial statements. Supplementary information covers a wide range of information, including management's discussion and analysis and supporting schedules.

2. Accountability

Governmental reporting focuses on two important types of accountability:

a. Operational Accountability

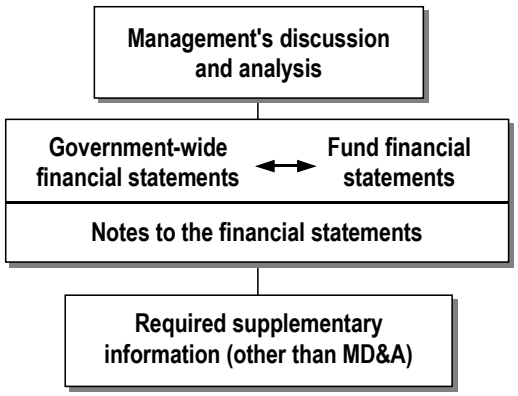
The focus of government-wide financial statements is to report the extent to which the government has met its operating objectives efficiently and effectively, using all resources available for that purpose, and the extent to which it can continue to meet its objectives for the future.

b. Fiscal Accountability

The focus of the fund financial statements is to demonstrate that the government entity's actions in the current period have complied with public decisions concerning the raising and spending of public funds in the short-term (usually one budgetary cycle or one year).

3. Integrated Approach

The integrated approach requires financial accounting and disclosure that not only shows operational and fiscal accountability but also shows the relationship between operational and fiscal accountability. Governmental financial data therefore, integrates the statements relative to complementary reporting objectives, as illustrated below:



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a. The integrated approach requires a reconciliation of the fund financial statements to the government-wide financial statements.

(1) This reconciliation may appear on the face of the fund financial statements or in the notes to the financial statements if summarized aggregated information does not fully disclose the relationship of operational and fiscal accountability.

(2) The purpose of the reconciliation is to link the two levels of financial reporting.

b. Major funds are the focus of the fund statements. Fund type summaries do not in and of themselves provide useful information. Major funds highlight the more significant components of governmental activities.

B. REPORTING FOR GENERAL PURPOSE GOVERNMENTAL UNITS (E.G., STATES, COUNTIES, CITIES, TOWNS, MUNICIPALITIES, AND VILLAGES)

1. Required

a. Management's Discussion and Analysis (MD&A) (required supplementary information)

b. Government-Wide Financial Statements

(1) Statement of Net Assets

(2) Statement of Activities

c. Fund Financial Statements (major funds shown individually, non-major funds shown in total)

(1) Governmental Funds

(a) Balance Sheet

(b) Statement of Revenues, Expenditures, and Changes in Fund Balances

(2) Proprietary Funds

(a) Statement of Net Assets (or Balance Sheet)

(b) Statement of Revenues, Expenses, and Changes in Fund Net Assets (or Fund Equity)

(c) Statement of Cash Flows

(3) Fiduciary Funds

(a) Statement of Fiduciary Net Assets

(b) Statement of Changes in Fiduciary Net Assets

d. Notes to Financial Statements

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e. Required Supplementary Information (RSI) other than Management's Discussion and Analysis

REQUIRED SUPPLEMENTARY INFORMATION RSI

(1) Pension

(a) Schedule of Funding Progress (for entities reporting pension trust funds)

(b) Schedule of Employer Contributions (for entities reporting pension trust funds)

(2) Budget

(a) Budgetary Comparison Schedules (originally adopted budget and comparison of final amended budget to actual)

(3) Infrastructure

(b) Information about Infrastructure Assets (for entities reported using the modified approach)

f. Other Supplementary Information (optional)

(1) Combining Statements for Non-major Funds

(2) Variance between originally adopted budget and final amended budget.

(3) Variance between final amended budget and actual.

2. Optional

a. Comprehensive Annual Financial Report

COMPREHENSIVE ANNUAL FINANCIAL REPORT CAFR

(1) Introductory Section (unaudited)

(a) Letter of Transmittal

(b) Organizational Chart

(c) List of Principal Officers

(2) Basic Financial Statements and Required Supplementary Information (audited)

(a) Management's Discussion and Analysis

(b) Government-wide Financial Statements

(c) Fund Financial Statements

(d) Notes to the Financial Statements

(e) Required Supplementary Information

(3) Statistical Section

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II. THE FINANCIAL REPORTING ENTITY

The financial reporting entity consists of the primary government (i.e., general purpose governmental units), organizations for which the primary government is financially accountable (i.e., special purpose governmental units), and certain other specially-defined organizations (i.e., component units).

GASB 34 establishes specific minimum reporting criteria for general purpose governmental units, special purpose governmental units, and component units.

A. GENERAL PURPOSE GOVERNMENTAL UNITS

The focus of the government-wide financial statements should be on the primary government.

1. Primary Government Defined

PRIMARY GOVERNMENT

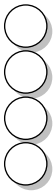
The primary government consists of all organizations that make up the legal government entity. The primary government is considered the nucleus of the financial reporting entity.

2. Primary Government Entities

a. State governments

b. General purpose local governments (e.g., a city or a county)

c. Special purpose local governments (e.g., a hospital authority or a school district) that meets all of the following criteria:



(1) Has a **s**eparately-**e**lected governing body

(2) Is **l**egally separate, and

(3) Is **f**iscally independent of other state and local governments.

3. A Primary Government Reports "By Itself" (i.e., it applies the "SELF" mnemonic above)

B. SPECIAL PURPOSE GOVERNMENTAL UNITS

Special purpose governmental units that are not primary governments are organizations that are financially accountable to a primary government. They are typically entities engaged in:

1. Governmental activities,
2. Business-type activities,
3. Fiduciary activities, and
4. Governmental and business-type activities.

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C. COMPONENT UNIT

COMPONENT UNIT

A component unit of the primary government is a legally separate organization for which the elected officials of the primary government are financially accountable. It may also be a separate organization, but its nature and the significance of its relationship with the primary government are such that exclusion of the unit's financial information would cause the primary government's financial statements to be misleading or incomplete.

1. Blended Presentation

BLENDED PRESENTATION

a. Some component units are so intertwined with the primary government that they are, in substance, the same as the primary government.

b. In these cases, blended presentation is preferred.

(1) The blended presentation combines financial information with the primary government.

(2) Financial information of the component units is not presented in separate columns.

c. The blended method is used in either of the following circumstances:

(1) A board of the component unit is substantively the same as that of the primary government.

(2) The component unit serves the primary government exclusively or almost exclusively.

2. Discrete Presentation (or separate presentation)

DISCRETE PRESENTATION

a. Financial statements of the reporting entity should provide an overview of the entity based on financial accountability.

b. Discrete presentation is used when the criteria for blended presentation are not met.

c. Most component units should use discrete presentation.

d. Discrete presentation displays component units in separate columns.

PASS KEY

Discrete presentation is the default method when the criteria for blended presentation have not been met.

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GOVERNMENTAL REPORTING SUMMARY

	Governmental Funds					Proprietary Funds		Fiduciary Funds			
Fund Structure	**G**	**R**	**S**	**P**	**P**	**S**	**E**	**P**	**A**	**P**	**I**
	General	Revenue (special)	Service (debt)	Projects (capital)	Permanent	Service (internal)	Enterprise	Pension	Agency	Private purpose	Investment
Fund accounting											
Basis of accounting Measurement focus Specialized accounting	Modified Accrual Current Financial Resource No Fixed Assets or LTD Budget / Activity / Encumbrances					Full Accrual Economic Resources None		Full Accrual Economic Resources None			
Accountability objective; *Government-wide reporting*	**Government-Wide Financial Statements** **Operational Accountability**										
Classifications	**Governmental Activities**					**Government Activities**	**Business Type Activities**	**Fiduciary Funds**			
Financial statements	Balance Sheet Income Statement					Balance Sheet Income Statement		Not Reported Not Reported			
Basis of accounting Measurement focus	Full Accrual Economic Resources					Full Accrual Economic Resources					
Accountability objective; *Fund reporting*	**Fund Financial Statements** **Fiscal Accountability**										
Classifications Accounting Budgetary reporting Specialized disclosures	**Major Funds** Fund Accounting Included in RSI (B v A + Adopted v Final) Reconciliation to Government-wide Financial Statements					**Major Funds** Fund Accounting N/A Reconciliation to Government-wide FS		**Major Funds** Fund Accounting N/A			

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III. THE FINANCIAL REPORTS

The following is an overview of the various items required in the government reporting model.

Management's Discussion & Analysis (MD&A)
Government-wide Financial Statements
Fund Financial Statements
Notes to Financial Statements
Required Supplementary Information
Other Supplementary Information

A. MANAGEMENT'S DISCUSSION AND ANALYSIS (REQUIRED SUPPLEMENTARY INFORMATION)

Management's discussion and analysis (MD&A) is a narrative that provides a brief, objective, and easily readable analysis of the government's financial activities based upon currently known facts, decisions, and conditions. It provides the financial management of the government with the opportunity to present both a short-term and a long-term analysis of activities. The following should be included:

1. A Description of the Financial Statements

a. An easily readable analysis of the government's financial activities based on currently known facts, decisions, and conditions.

b. Condensed financial statement information derived from the government-wide financial statements used to support the government's overall financial position and results of operations.

c. Analysis of overall financial position and results of operations including reasons for changes from the prior year.

d. Analysis of balances and transactions of individual funds including limitations on future uses of funds.

e. Analysis of significant variations between original and final budget.

f. A description of the significant assumptions and implications of use of the modified approach for accounting for infrastructure.

2. The Identity of the Primary Government and Discrete Component Units

3. Economic Conditions and Outlook

A description of the impact of the economy on the financial statements.

4. Major Initiatives

This section describes capital asset and long-term debt activity during the year.

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Management's Discussion & Analysis (MD&A)	
Government-wide Financial Statements	**Statement of Net Assets** Statement of Activities
Fund Financial Statements	
Notes to Financial Statements	
Required Supplementary Information	
Other Supplementary Information	

B. GOVERNMENT-WIDE FINANCIAL STATEMENTS

GOVERNMENT-WIDE FINANCIAL STATEMENTS

There are two statements included in a set of government-wide financial statements: the Statement of Net Assets and the Statement of Activities. These statements aggregate information for all governmental and all business-type activities. GASB 34 requires the use of the economic resources measurement focus and the full accrual basis of accounting for both statements. Government-wide financial statements include all assets and liabilities over which a government has control or responsibility; therefore, fiduciary funds are excluded and the component units are included.

1. Statement of Net Assets (This is a consolidated statement.)

NET ASSET FORMAT

a. Net Assets Format

Assets
<Liabilities>
Net Assets

b. Three Components of Net Assets

COMPONENTS OF NET ASSETS

Net assets are divided into each of three components as applicable.

(1) Invested in Capital Assets, Net of Related Debt

This component of net assets groups all capital assets (including infrastructure) and is then reduced by accumulated depreciation and the outstanding balances of the debt that are attributable to the acquisition, construction, or improvement of those assets.

(2) Restricted Net Assets

Restricted net assets are assets subject to external restrictions imposed by creditors, grantors, contributors, laws or regulations of other governments, and restrictions imposed by law through constitutional provisions or legislation.

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(3) Unrestricted Net Assets

Unrestricted net assets represent the balance of the net assets of the governmental entity.

(a) These net assets are internally designated, which means that they are not included in restricted assets. These reserves are controlled by management and can be modified or removed.

(b) As restrictions are satisfied or terminated (i.e., expired), restricted net assets should be reclassified as unrestricted.

c. Capital Assets—Capitalization and Depreciation

(1) Capitalized Assets

The GASB 34 reporting model requires that capital assets, including infrastructure assets, be included in the government-wide financial statements. The cost of capital assets should include all ancillary charges necessary to place the asset into its intended location and condition of intended use. Capitalization of construction period interest is not required for capital assets used in governmental activities.

The term infrastructure asset refers to streets, bridges, gutters, and other assets of the government. Prior to GASB 34, recording assets of this character was optional. Since implementation of GASB 34, infrastructure assets are recorded as general capital assets. They are only reported on the government-wide financial statements because of the incompatibility of recording these assets at the fund level with the governmental fund measurement focus and the fact that it would be difficult to allocate general assets to the individual funds.

(2) Depreciation

(a) Required Approach

Depreciation expense that can be specifically identified with a functional category should be included in the direct expenses of that function.

(b) Modified Approach

Infrastructure assets that are part of a network or subsystem of a network (hereafter referred to as eligible infrastructure assets) are not required to be depreciated provided the features of the two requirements (in b.1. and b.2., below) are met. Under the modified approach, infrastructure expenditures are typically reported as expenses, unless the outlays result in additions or improvements, in which case they would be capitalized.

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(1) (Requirement One) The government's asset management system meets certain conditions:

(a) Inventory of eligible infrastructure assets is up-to-date.

(b) A summarized condition assessment of the eligible infrastructure assets is performed and the results use a measurement scale.

(c) Each year an estimate is made of the amount necessary to maintain and preserve the eligible infrastructure assets at the condition level established and disclosed by the government.

(2) (Requirement Two) The government documentation should include data on asset preservation:

(a) A complete condition assessment of eligible infrastructure assets must be performed in a consistent manner at least every three years.

(b) Information that the results of the three most recently completed condition assessments provide reasonable assurance that the eligible infrastructure assets are being presented approximately at (or above) the condition level established and disclosed by the government.

(c) Reporting Requirements

Two schedules must be presented as required supplementary information as derived from the asset management system and documentation:

(1) A schedule reporting the condition of the government's infrastructure, and

(2) A comparison schedule of needed and actual expenditures to maintain the government's infrastructure.

(d) Accounting Changes (change in estimates)

(1) A change from the depreciation (required approach) to the modified approach should be treated as a change in accounting estimate.

(2) A change from the modified approach to the depreciation approach should also be treated as a change in accounting estimate.

(3) Impairment

Governments are required to determine if impairment of an asset has occurred. Insurance recoveries are netted against the loss.

(a) Physical Damage

Measured using the restoration cost approach. The estimated cost to restore the asset is used to write down historical cost.

(b) Enactment of Laws or Obsolescence

Measured using the service units approach. The estimated productive units before and after the impairment are used to quantify the impairment write off.

(c) Duration of Use Reduce

Measured using the service units approach.

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d. Artwork and Historical Treasures

Governments should capitalize works of art, historical treasures, and similar assets at their historical cost or fair value at date of donation (estimated if necessary) whether they are held as individual items or in a collection. Governments are encouraged, but not required, to capitalize a collection (and all additions to that collection), whether donated or purchased, when that collection meets all of the following conditions:

(1) The collection is held for public exhibition, education, or research in furtherance of public service, rather than financial gain.

(2) The collection is protected, kept unencumbered, cared for, and preserved.

(3) The collection is subject to an organizational policy that requires the proceeds from sales of collection items to be used to acquire other items for collections.

e. Elimination

Elimination of interfund activities within major activity categories displayed for government-wide presentations should be prepared to avoid "grossing up" balances of assets and liabilities.

(1) Interfund receivables and payables should be eliminated except for the net residual balances of amounts due and payable between governmental activities and business-type activities.

(2) Receivables and payables to fiduciary funds should be treated like assets and liabilities derived from external sources.

f. Internal Service Funds

Activity resulting from internal service funds should be reported in the governmental activities column unless the government's enterprise funds are the primary recipient of internal service fund services.

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Progressive Township
Statement of Net Assets
December 31, 20X1

	Primary Government			
	Governmental Activities	Business-type Activities	Total	Component Units
ASSETS				
Cash	4,000,000	2,000,000	6,000,000	520,000
Receivables	940,000	670,000	1,610,000	–
Internal balances	450,000	(450,000)	–	–
Inventories	96,000	127,500	223,500	–
Capital assets	2,827,000	2,975,000	5,802,000	–
Total assets	**8,313,000**	**5,322,500**	**13,635,500**	**520,000**
LIABILITIES				
Accounts payable	1,104,000	400,000	1,504,000	130,000
Deferred revenue	95,000	–	95,000	–
Non-current liabilities				–
Due within one year	46,000	337,500	383,500	–
Due in more than one year	3,518,000	2,750,000	6,268,000	–
Total liabilities	**4,763,000**	**3,487,500**	**8,250,500**	**130,000**
NET ASSETS				
Invested in capital assets net of related debt	1,227,000	450,000	1,677,000	–
Restricted				
Capital projects	1,074,000	–	1,074,000	–
Debt service	668,000	1,200,000	1,868,000	–
Unrestricted	581,000	185,000	766,000	390,000
Total net assets	**3,550,000**	**1,835,000**	**5,385,000**	**390,000**

PASS KEY

The government-wide financial statement includes all assets and liabilities over which a government has control or responsibility. It is important to note that:

- Fiduciary funds (PAPI) are not included
- Component units are included

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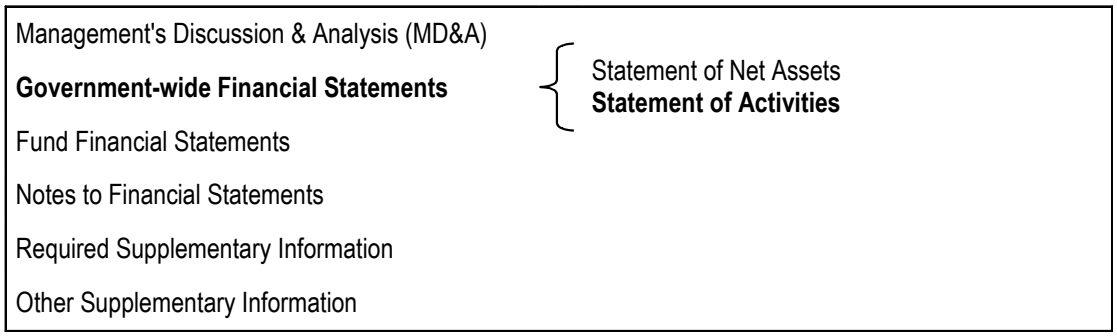

2. Statement of Activities

The use of the full accrual method is required for the reporting of revenue and expenses. This is a consolidated statement.

a. Program Approach

The net program cost format provides cost information about the primary functions of the government and indicates each program's dependence on general revenues of the government.

b. Functions/Programs

The net expense or revenue for each function or program is classified into one of these categories:

(1) Primary Government Governmental Activities

(2) Primary Government Business-type Activities

(3) Component Units

c. Expenses

Expenses are reported by function on the full accrual basis. This category represents expenses directly associated with each of the functions or programs listed.

d. Program Revenue

Program revenues are revenues directly associated with the function or program on the full accrual basis.

(1) Exchange revenue is recognized when goods or services are transferred. Revenue recognition is similar to commercial business enterprises.

(2) Non-exchange revenue (GASB 33: Accounting and Financial Reporting for Non-exchange Transactions) involves transactions in which a government gives (or receives) value without directly receiving (or giving) equal value in exchange.

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(a) Revenue Recognition Criteria (non-exchange revenue)

(1) Required Recipient Characteristics

The recipient must possess the characteristics required by the provider.

(2) Time requirements

Any provider required time restrictions set by the provider must be fulfilled.

(3) Reimbursement Requirement

Certain grants are recognized after the recipient has expended funds that are eligible for reimbursement.

(4) Contingency Requirement

Recognition is permitted after the removal or passage of the contingency.

CATEGORIES OF NON-EXCHANGE REVENUES

(b) Category Types

(1) Charges for Services

(i) Revenues based on exchange or exchange-like transactions including:

- Charges for services to customers or applicants who directly benefit from goods or services (e.g., water and sewer fees, licenses, building permits, etc.)
- Charges for services to other governments (e.g., charges to housing prisoners, etc.)
- Fines and forfeitures

(2) Operating Grants and Contributions

(i) Mandatory and voluntary non-exchange transactions with other governments, organizations or individuals that are restricted for use in a particular program.

- Grant revenues in support of specific programs

(3) Capital Grants and Contributions

(i) Mandatory and voluntary non-exchange transactions with other governments, organizations or individuals that are restricted for use in a particular program.

- Grant revenues in support of specific programs

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e. Net (Expense) Revenue and Changes in Net Assets

The net expense or revenue is presented in three categories and a total column:

(1) Primary Government Governmental Activities Column

(2) Primary Government Business-type Activities Column

(3) Total Column (1 and 2)

(4) Component Units Column

f. General Revenues

General revenues are presented separately in the same three categories and a total column as above.

g. Special Items

Special items are reported separately. Special items are unusual or infrequent (but not both) and are within the control of management.

h. Change in Net Assets

The general revenues are deducted from net (expenses) revenues. The net difference is combined with beginning net assets to arrive at ending net assets.

i. Eliminations

Elimination of internal transactions that artificially "double up" on activity should be prepared. Interfund services, such as water and other utilities, should not be eliminated. Internal activity associated with blended component units should be reclassified as interfund activity (covered later). Internal activity associated with discretely presented component units should be reported as external transactions.

j. Internal Service Funds

Activity resulting from internal service funds should be reported in the governmental activities column unless the government's enterprise funds are the primary recipient of internal service fund services.

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Progressive Township
Statement of Activities
For the Year Ended December 31, 20X1

			Program Revenues			Net (Expenses) Revenues and Changes in Net Assets Primary Government			Component Units
Functions/Programs	Expenses	Indirect Expense Allocation	Charges for Services	Operating Grants and Contributions	Capital Grants and Contributions	Governmental Activities	Business-type Activities	Total	Total
Primary government:									
Governmental activities:									
General government	563,000	–	215,000	–	–	(348,000)	–	(348,000)	–
Public safety	1,025,000	–	78,000	–	–	(947,000)	–	(947,000)	–
Culture and recreation	107,500	–	–	–	–	(107,500)	–	(107,500)	–
Other functional classifications	2,147,000	–	–	1,360,000	–	(787,000)	–	(787,000)	–
Interest on long-term debt	246,000	–	–	–	–	(246,000)	–	(246,000)	–
Total governmental activities	4,088,500	–	293,000	1,360,000	–	(2,435,500)	–	(2,435,500)	–
Business-type activities:									
Water	692,000		700,000	–	–	–	8,000	8,000	–
Sewer	1,038,000		1,050,000	–	300,000	–	312,000	312,000	–
Parking facilities	465,000		650,000	–	–	–	185,000	185,000	–
Total business-type activities	2,195,000		2,400,000	–	300,000	–	505,000	505,000	–
Total primary government	6,283,500		2,693,000	1,360,000	300,000	(2,435,500)	505,000	(1,930,500)	–
Component units:									
Landfill	300,000		500,000	–	–	–	–	–	200,000
Public school system	1,000,000		100,000	–	–	–	–	–	(900,000)
Total component units	1,300,000		600,000	–	–	–	–	–	(700,000)
General revenues									
Taxes:									
Property taxes						1,620,000	–	1,620,000	1,000,000
Franchise taxes						835,000	–	835,000	–
Investment earnings						195,000	60,000	255,000	–
Transfers						81,000	–	81,000	–
Total general revenues, special items, and transfers						2,731,000	60,000	2,791,000	1,000,000
Change in net assets						295,500	565,000	860,500	300,000
Net assets-beginning						3,254,500	1,270,000	4,524,500	90,000
Net assets-ending						3,550,000	1,835,000	5,385,000	390,000

PASS KEY

To remember the categories of program revenue, just recall that the government can "SOC" away these revenues:

- Services (charges for)
- Operating grants and contributions
- Capital grants and contributions

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Notes to Financial Statements	Fiduciary Funds	Statement of Fiduciary Net Assets Statement of Changes in Fid. Net Assets
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Other Supplementary Information		

C. FUND FINANCIAL STATEMENTS

1. Required Fund Financial Statements

Financial statements are required for the governmental, proprietary, and fiduciary funds.

2. Major Fund Reporting Criteria

GASB 34 emphasizes reporting by major fund rather than fund type. Reporting by major fund provides more meaningful information. Major funds are specifically defined, as follows:

a. Major Fund Rules—Two Criteria (both must be met):

(1) 10% or more of the corresponding total revenues, expenditures/expenses, assets or liabilities of:

(a) All governmental funds

OR

(b) Enterprise funds

AND

(2) 5% or more of revenues, expenditures/expenses, assets or liabilities of:

(a) All governmental funds

AND

(b) All enterprise funds

b. Government officials may elect to report a fund as major if they believe that the public interest is served by the reporting, regardless of the quantitative criteria.

PASS KEY

When determining if a fund qualifies as a major fund, remember that aggregate fund balance/ equity is not used in either test.

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3. Reconciliation of Governmental Fund Financial Statements to Government-wide Financial Statements

RECONCILIATION OF FUND FINANCIALS TO GOVERNMENT-WIDE FINANCIAL STATEMENTS

Financial statement presentation for governments requires a reconciliation of the equity presented on the balance sheet and the increase/decrease in equity presented in the operating statement from the governmental fund perspective to the government-wide financial statements.

The differences between governmental fund and government-wide financial statements are the result of differences in the measurement focus and basis of accounting used by each presentation.

a. Measurement Focus Differences

Reconciliation of governmental fund financial statements to the government-wide financial statements involves elimination of the impact of using the current financial resources measurement focus for governmental fund financial statements instead of the economic resources measurement focus used in government-wide financials.

Generally this involves adjustment of capital asset and long-term debt accounts. Loan proceeds (net of principal payments on debt) must be eliminated from resources inflows on the governmental fund operating statement and the related long-term debt must be added to the balance sheet. Current period capital expenditures (net of depreciation expense) must be eliminated from resource outflows on the governmental fund operating statement and the related capital assets (net of accumulated depreciation) must be added to the balance sheet.

b. Basis of Accounting Differences

Reconciliation of governmental fund financial statements to the government-wide financial statements involves elimination of the impact of using the modified accrual basis of accounting in governmental fund financial statements instead of the full accrual basis of accounting used in government-wide financial statements.

Generally this involves increasing revenues to show revenues earned rather than only those measurable and available and recognizing expenses when incurred rather than expenditures of current resources.

c. Application to Financial Statements

The impact of measurement focus and basis of accounting differences must be considered in reconciling two features of financial statement presentation.

The financial statements must reconcile:

(1) The differences in the fund balances of governmental funds and net assets in the government-wide financial statements, and

(2) The differences in the net change in fund balances of governmental funds and the change in net assets for governmental activities.

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Use the following mnemonic to prepare the reconciliation:

Balance Sheet	Statement of Revenues, Expenditures, and Changes in Fund Balance
(G) GRASPP- Fund Balance	(G) GRASPP-Net Change in Fund Balance
(A) Assets (non-current)	(O) Other Financing Sources
(L) Liabilities (non-current)	(E) Expenditure – Capital Outlay (net of depreciation)
(S) Service (Internal) Fund Net Assets	(S) Service (Internal) Fund Net Income
(B) Basis of Accounting	(B) Basis of Accounting
(A) Accrued	(A) Additional Accrued
(R) Revenues and	(R) Revenues and
(E) Expenses	(E) Expenses

Reconciliation of the fund balance of governmental fund balance sheets to net assets of government-wide balance sheets requires you to:

(1) Consider the difference in measurement focus:

(a) Add non-current assets.

(b) Add internal service fund net assets.

(c) Subtract non-current liabilities.

(2) Consider the difference in basis of accounting:

(a) Adjust for accrual of revenue accounted for on the full accrual basis of accounting rather than the modified accrual basis of accounting.

(b) Adjust for accrual of expenses accounted for on the full accrual basis of accounting rather than the expenditures accrued on the modified accrual basis of accounting.

d. Reconciliation of the change in fund balance displayed in the governmental fund statement revenues, expenditures, and changes in fund balances to the change in net assets displayed in the governmental activities column of the government-wide statement of activities requires that you:

(1) Consider the difference in measurement focus

(a) Add capital outlay (not accounted for as an expense, net of depreciation expense).

(b) Subtract debt proceeds (not accounted for as a revenue).

(c) Add Internal Service Fund changes in net assets accounted for in the proprietary funds.

(2) Consider the difference in basis of accounting:

(a) Adjust for accrual of revenue accounted for on the full accrual basis of accounting rather than the modified accrual basis of accounting.

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(b) Adjust for accrual of expenses accounted for on the full accrual basis of accounting rather than the expenditures accrued on the modified accrual basis of accounting.

EXAMPLES

EXAMPLE 1

Fund balances of Progressive Township's Governmental Funds totaled $6,555,000 for the year ended December 31, 20X1. Subsidiary accounting records for the township include the following information:

Capital assets used in governmental activities	$2,000,000
Accumulated depreciation on capital assets used in governmental activities	500,000
Long-term debt obligations issued to finance governmental projects	2,500,000
Internal Service Fund Net Assets	200,000
Proprietary Fund Net Assets	7,500,000
Fiduciary Fund Net Assets	650,000

Net assets displayed in the governmental activities column of the government-wide financial statements would be:

a. $5,755,000 c. $13,255,000
b. $7,755,000 d. $13,905,000

Solution: Choice "a" is correct. Net Assets displayed in the government-wide financial statements eliminate the effect of the financial resources measurement focus and modified accrual basis of accounting used to determine Fund Balance in the governmental fund financial statements.

The Fund Balances of Progressive Township's Governmental Fund Balances reconcile to the Net Assets displayed in the Governmental Activities column of the Government-wide Financial Statements as follows:

G	Governmental Fund Balances	$6,555,000
	Capital assets used in governmental activities	2,000,000
A	Accumulated depreciation on capital assets used in governmental activities	(500,000)
L	Long-term debt obligations issued to finance governmental projects	(2,500,000)
S	Internal Service Fund Net Assets	200,000
	Net Assets of Governmental Activities	$5,755,000

Choices "b", "c", and "d" are incorrect per above.

EXAMPLE 2

Progressive Township is preparing the reconciliation between the amount reported as "Net Change in Fund Balances" for all governmental funds to the amount reported as the "Change in Net Assets" for governmental activities on the town's government-wide financial statements for the year ended December 31, 20X1.

Progressive Township reported the following transactions on their governmental fund financial statements.

Net change in Fund Balance	$600,000
Capital Outlay Expenditures	250,000
Debt Service Expenditure – Principal	100,000
Debt Service Expenditure – Interest	85,000
Proceeds from Issuance of Long-term Debt	500,000
Net Revenue from Enterprise Funds	1,800,000
Net Revenue from Internal Service Funds	53,000

The town's subsidiary records also displayed the following information:

Depreciation expense on capital assets used in governmental activities	45,000

What amount would Progressive Township be reporting as the Change in Net Assets for Governmental Activities on the government-wide financial statements?

a. $503,000 c. $652,000
b. $458,000 d. $373,000

Solution: Choice "b" is correct. The Change in Net Assets displayed in the government-wide financial statements eliminates the effect of the financial resources measurement focus and modified accrual basis of accounting used to determine the Net Change in Fund Balance in the governmental fund financial statements.

The Net Change in Fund Balance of Progressive Township's Governmental Funds reconcile to the Change in Net Assets displayed in the Governmental Activities column of the Government-wide Financial Statements as follows:

G	Net change in Fund Balance	$600,000
O	Proceeds from Issuance of Long-term Debt	(500,000)
E	Capital Outlay Expenditures	250,000
S	Net Revenue from Internal Service Funds	53,000
	Debt Service Expenditure – Principal	100,000
BARE	Depreciation expense on capital assets used in governmental activities	(45,000)
	Change in Net Assets, Governmental Activities	$458,000

Choices "a", "c", and "d" are incorrect per above.

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4. Governmental Funds

GRASPP

a. Balance Sheet

Progressive
Balance Sheet
Governmental Funds
December 31, 20X1

	General Fund	HUD Programs	Convention Development Tax	Convention Center Bonds	Convention Center Construction	Other Governmental Funds	Total Governmental Funds
ASSETS							
Cash	800,000	80,000	250,000	450,000	2,100,000	270,000	3,950,000
Receivables	162,000	–	–	–	–	–	162,000
Due from other funds	450,000	–	–	60,000	–	–	510,000
Receivables from other governments	620,000	–	50,000	–	–	83,000	753,000
Inventories	55,000	–	–	–	–	6,000	61,000
Total assets	**2,087,000**	**80,000**	**300,000**	**510,000**	**2,100,000**	**359,000**	**5,436,000**
LIABILITIES AND FUND BALANCES							
Liabilities:							
Accounts payable	250,000	20,000	56,000	–	600,000	100,000	1,026,000
Due to other funds	50,000	–	60,000	–	–	–	110,000
Payable to other governments	65,000	–	–	–	–	–	65,000
Deferred revenue	95,000	–	–	–	–	–	95,000
Total liabilities	460,000	20,000	116,000	–	600,000	100,000	1,296,000
Fund balances:							
Reserved for:							
Inventories	55,000	–	–	–	–	6,000	61,000
Encumbrances	45,000	–	16,000	–	500,000	28,000	589,000
Debt Service	–	–	–	510,000	–	158,000	668,000
Unreserved and reported in:							
General fund	1,527,000	–	–	–	–	–	1,527,000
Special revenue funds	–	60,000	168,000	–	–	(7,000)	221,000
Capital projects funds	–	–	–	–	1,000,000	74,000	1,074,000
Total fund balances	1,627,000	60,000	184,000	510,000	1,500,000	259,000	4,140,000
Total liabilities and fund balances	**2,087,000**	**80,000**	**300,000**	**510,000**	**2,100,000**	**359,000**	**5,436,000**

Total Governmental Fund Balances	4,140,000
Capital assets used in governmental activities that are not reported in fund financial statements	2,667,000
Other long-term assets not available to defray the cost of current expenses and are not reported in fund financial statements	–
Long-term liabilities including bonds payable not recorded in fund financial statements	(3,420,000)
Internal Service Fund used for governmental activities	163,000
Net assets from governmental activities	3,550,000

Note: This simplified example assumes no differences between fund financials and government-wide financials pertaining to the basis of accounting.

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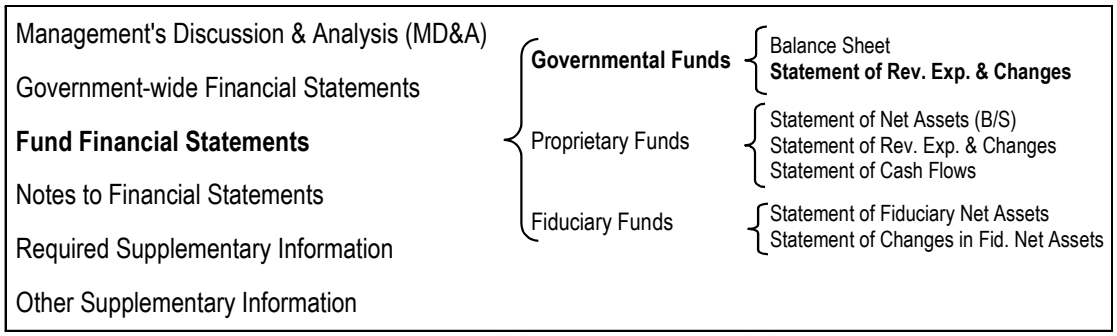

b. Statement of Revenue, Expenditures, and Changes in Fund Balance

Progressive Township
Statement of Revenues, Expenditures, and Changes in Fund Balance
Governmental Funds
For the Year Ended December 31, 20X1

	General Fund	HUD Programs	Convention Development Tax	Convention Center Bonds	Convention Center Construction	Other Governmental Funds	Total Governmental Funds
REVENUES							
Property taxes	1,620,000	–	–	–	–	–	1,620,000
Fees and fines	120,000	–	–	–	–	–	120,000
Intergovernmental	–	960,000	375,000	–	–	860,000	2,195,000
Charges for services	–	–	–	–	–	78,000	78,000
Interest earnings	55,000	–	18,000	36,000	40,000	40,000	189,000
Total Revenues	1,795,000	960,000	393,000	36,000	40,000	978,000	4,202,000
EXPENDITURES							
Current:							
General government	450,000	–	–	–	–	–	450,000
Public safety	1,000,000	–	–	–	–	–	1,000,000
Culture and recreation	80,000	–	17,500	–	–	–	97,500
Other functional classifications	200,000	940,000	–	–	–	957,000	2,097,000
Debt service:							
Principal	–	–	–	250,000	–	110,000	360,000
Interest and other charges	–	–	–	30,000	–	211,000	241,000
Capital outlay	25,000	–	–	–	600,000	162,000	787,000
Total expenditures	1,755,000	940,000	17,500	280,000	600,000	1,440,000	5,032,500
Excess (deficiency) of revenues over expenditures	40,000	20,000	375,500	(244,000)	(560,000)	(462,000)	(830,500)
OTHER FINANCING SOURCES (USES)							
Proceeds of long-term capital-related debt	–	–	–	–	2,080,000	–	2,080,000
Transfers in	85,000	–	–	370,000	–	10,000	465,000
Transfers out	(14,000)	–	(250,000)	–	(120,000)	–	(384,000)
Total other financing sources and uses	71,000	–	(250,000)	370,000	1,960,000	10,000	2,161,000
Net change in fund balances	111,000	20,000	125,500	126,000	1,400,000	(452,000)	1,330,500
Fund balances-beginning	1,516,000	40,000	58,500	384,000	100,000	711,000	2,809,500
Fund balances-ending	1,627,000	60,000	184,000	510,000	1,500,000	259,000	4,140,000

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c. Reconciliation of the Statement of Revenue, Expenditures, and Changes in Fund Balances

Reconciliation of activity by fund type to the government-wide financial statements can be presented on either the face of the financial statements or the notes to the financial statements.

Progressive Township
Reconciliation of Governmental Fund Operating Statements and the Statement of Activities
December 31, 20X1

Net change in fund balances - total governmental funds		1,330,500
Bond proceeds reflected as debt in excess of payments		
Bond proceeds	(2,080,000)	
Payments	360,000	
		(1,720,000)
Capital Outlay expense in excess of depreciation		
Capital Outlay	787,000	
Depreciation Expense		
General Government	(35,000)	
Public Safety	(25,000)	
Culture and Recreation	(10,000)	
Other Functional Classifications	(50,000)	
		667,000
Revenues in the Statement of Activities that do not provide current financial resources and are not reported in the funds		–*
Net revenue (expense) of Internal Service Funds		18,000
Change in Net Assets of Governmental Activities		295,500

* *Note:* Our example includes the significant assumption that no reconciliation items result from different bases of accounting.

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SE-PAPI

5. Proprietary Funds

a. Statement of Net Assets

Progressive Township
Statement of Net Assets
Proprietary Funds
December 31, 20X1

	Business-type Activities Enterprise Funds			Governmental Activities
	Water and Sewer	Parking Facilities	Totals	Internal Service Funds
ASSETS				
Current Assets:				
Cash	650,000	150,000	800,000	50,000
Receivables	500,000	20,000	520,000	25,000
Due from other funds	-	-	-	50,000
Due from other governments	100,000	50,000	150,000	-
Inventories	85,000	42,500	127,500	35,000
Total current assets	1,335,000	262,500	1,597,500	160,000
Non-current assets:				
Restricted cash and cash equivalents	750,000	450,000	1,200,000	-
Capital assets:				
Land	700,000	400,000	1,100,000	50,000
Buildings and equipment	1,800,000	1,200,000	3,000,000	150,000
Less: accumulated depreciation	(750,000)	(375,000)	(1,125,000)	(40,000)
Total non-current assets	2,500,000	1,675,000	4,175,000	160,000
Total assets	3,835,000	1,937,500	5,772,500	320,000
LIABILITIES				
Current liabilities:				
Accounts payable	350,000	50,000	400,000	13,000
Due to other funds	450,000	-	450,000	-
Compensated absences	75,000	37,500	112,500	16,000
Bonds, notes, and loans payable	150,000	75,000	225,000	30,000
Total current liabilities	1,025,000	162,500	1,187,500	59,000
Non-current liabilities:				
Compensated absences	300,000	150,000	450,000	28,000
Bonds, notes, and loans payable	1,300,000	1,000,000	2,300,000	70,000
Total non-current liabilities	1,600,000	1,150,000	2,750,000	98,000
Total liabilities	2,625,000	1,312,500	3,937,500	157,000
NET ASSETS				
Invested in capital assets, net of related debt	300,000	150,000	450,000	60,000
Restricted for debt service	750,000	450,000	1,200,000	-
Unrestricted	160,000	25,000	185,000	103,000
Total net assets	1,210,000	625,000	1,835,000	163,000

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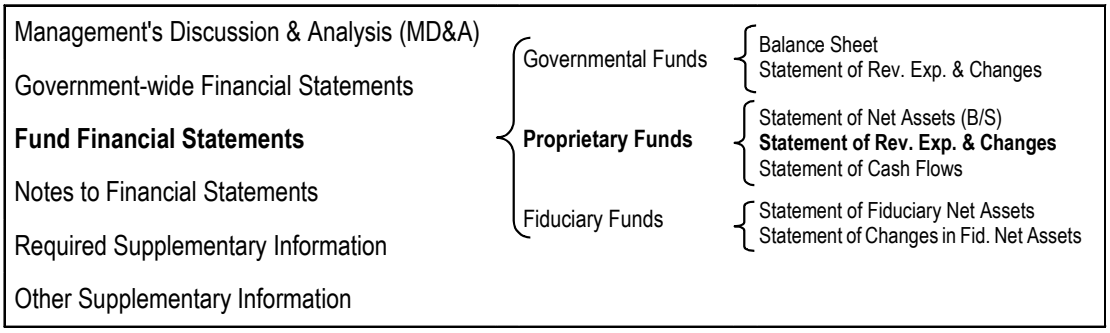

b. Statement of Revenues, Expenses, and Changes in Fund Net Assets

Progressive Township
Statement of Revenues, Expenses, and Changes in Fund Net Assets
Proprietary Funds
December 31, 20X1

	Business-type Activities-Enterprise Funds			Governmental Activities
	Water and Sewer	Parking Facilities	Totals	Internal Service Funds
Operating revenues				
Charges for services	1,500,000	600,000	2,100,000	95,000
Miscellaneous	250,000	50,000	300,000	-
Total operating revenues	**1,750,000**	**650,000**	**2,400,000**	**95,000**
Operating expenses				
Personal services	975,000	150,000	1,125,000	55,000
Contracted services	85,000	35,000	120,000	5,000
Other operating expenses	300,000	30,000	330,000	10,000
Insurance claims and expenses	-	-	-	-
Depreciation expense	270,000	200,000	470,000	8,000
Total operating expenses	**1,630,000**	**415,000**	**2,045,000**	**78,000**
Operating income (loss)	**120,000**	**235,000**	**355,000**	**17,000**
Non-operating revenues (expenses)				
Interest and investment revenue	60,000	-	60,000	6,000
Interest expense	(100,000)	(50,000)	(150,000)	(5,000)
Total non-operating revenue (expenses)	**(40,000)**	**(50,000)**	**(90,000)**	**1,000**
Income (loss) before contributions and transfers	**80,000**	**185,000**	**265,000**	**18,000**
Capital contributions	300,000	-	300,000	-
Transfers	-	-	-	-
Change in net assets	**380,000**	**185,000**	**565,000**	**18,000**
Total net assets - beginning	830,000	440,000	1,270,000	145,000
Total net assets - ending	**1,210,000**	**625,000**	**1,835,000**	**163,000**

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c. Statement of Cash Flows

(1) The statement of cash flows is prepared in a similar manner as the commercial enterprise version, with the following six differences:

(a) The direct method is required (indirect method is not permitted).

(b) A reconciliation of operating income (not net income) to net cash provided by operations is required.

(c) There are four categories (instead of the three categories in commercial accounting):

(1) Operating activities

(2) Investing activities

(3) Capital and related financing activities

(4) Non-capital financing activities

(d) Interest income/cash receipts are reported as "investing activities" (not as operating activities).

(e) Interest expense/cash payments are either:

(1) Capital and related financing or

(2) Non-capital financing.

(f) Capital asset purchases are reported as "financing activities" (not as investing activities).

(2) Components of the four categories include such transactions as:

(a) Operating activities

(1) Cash inflows from sales of goods and services

(2) Cash outflows to suppliers or employees

(3) Cash inflows from interfund transfers or reimbursements

(4) Cash transactions not meeting the definition of the other categories

(b) Investing activities

(1) Cash inflows and outflows associated with loans to others

(2) Cash inflows and outflows associated with equity transactions

(c) Capital and related financing activities

(1) Cash flows from issuing debt associated with capital assets

(2) Cash inflows from capital grants

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(3) Cash inflows from contribution activity associated with capital assets

(4) Cash activity related to special assessments associated with capital assets

(d) Non-capital financing activities

(1) Cash receipts from grants or subsides

(2) Cash received from property taxes (not restricted for capital use)

Progressive Township
Statement of Cash Flows
Proprietary Funds
December 31, 20X1

	Business-type Activities-Enterprise Funds			Governmental Activities
	Water and Sewer	Parking Facilities	Totals	Internal Service Funds
CASH FLOWS FROM OPERATING ACTIVITIES				
Receipts from customers	1,510,000	528,500	2,038,500	78,000
Payments to suppliers	(432,500)	(151,375)	(583,875)	(73,000)
Payments to employees	(1,008,000)	(352,800)	(1,360,800)	(1,650)
Internal activity-payments to other funds	-	-	-	(3,375)
Other receipts (payments)	337,750	484,775	822,525	13,025
Net cash provided by operating activities	407,250	509,100	916,350	13,000
CASH FLOWS FROM NON-CAPITAL FINANCING ACTIVITIES				
Operating subsidies and transfers to other funds	-	-	-	-
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES				
Proceeds from capital debt	605,000	211,750	816,750	35,000
Capital contributions	300,000	-	300,000	-
Purchases of capital assets	(980,000)	(425,000)	(1,405,000)	(50,000)
Principal paid on capital debt	(97,500)	(34,125)	(131,625)	(6,500)
Interest paid on capital debt	(100,000)	(50,000)	(150,000)	(5,000)
Net cash (used) by capital and related financing activities	(272,500)	(297,375)	(569,875)	(26,500)
CASH FLOWS FROM INVESTING ACTIVITIES				
Proceeds from sales and maturities of investments	(318,750)	(112,000)	(430,750)	-
Interest and dividends	60,000	-	60,000	6,000
Net cash provided by investing activities	(258,750)	(112,000)	(370,750)	6,000
Net increase (decrease) in cash and cash equivalents	(124,000)	99,725	(24,275)	(7,500)
Balances - beginning of the year	774,000	50,275	824,275	57,500
Balances - end of the year	650,000	150,000	800,000	50,000
Reconciliation of operating income (loss) to net cash provided (used) by operating activities				
Operating income (loss)	120,000	235,000	355,000	17,000
Adjustments to reconcile operating income to net cash provided (used) by operating activities:				
Depreciation expense	270,000	200,000	470,000	8,000
Change in assets and liabilities				
Receivables, net	(240,000)	(84,000)	(324,000)	(18,000)
Inventories	(34,000)	(11,900)	(45,900)	(3,000)
Accounts and other payables	122,500	110,000	232,500	4,000
Accrued expenses	168,750	60,000	228,750	5,000
Net cash provided by operating activities	407,250	509,100	916,350	13,000

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Other Supplementary Information		

SE-**PAPI**

6. Fiduciary Funds

a. Statement of Fiduciary Net Assets

Progressive Township
Statement of Fiduciary Net Assets
Fiduciary Funds
December 31, 20X1

	Employee Pension Retirement Plan	Agency Funds	Private-Purpose Trusts
ASSETS			
Cash	1,000,000	1,000,000	4,000
Receivables:			
Interest and dividends	70,000	-	-
Other receivables	25,000	-	1,000
Total receivables	95,000	-	1,000
Investments at fair value:			
U.S. government obligations	1,000,000	-	40,000
Corporate bonds	1,000,000	-	-
Corporate stock	2,000,000	-	-
Total investments	4,000,000	-	40,000
Total assets	5,095,000	1,000,000	45,000
LIABILITIES			
Accounts payable	30,000	1,000,000	3,000
Refunds payable and others	14,600	-	-
Total liabilities	44,600	1,000,000	3,000
NET ASSETS			
Held in trust for pension benefits and other purposes	5,050,400		42,000

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Management's Discussion & Analysis (MD&A)		
Government-wide Financial Statements	Governmental Funds	Balance Sheet Statement of Rev. Exp. & Changes
Fund Financial Statements	Proprietary Funds	Statement of Net Assets (B/S) Statement of Rev. Exp. & Changes Statement of Cash Flows
Notes to Financial Statements	**Fiduciary Funds**	Statement of Fiduciary Net Assets **Statement of Changes in Fid. Net Assets**
Required Supplementary Information		
Other Supplementary Information		

b. Statement of Changes in Fiduciary Net Assets

Progressive Township
Statement of Changes In Fiduciary Net Assets
Fiduciary Funds
December 31, 20X1

	Employee Retirement Plan	Private-Purpose Trusts
ADDITIONS		
Contributions		
Employer	471,250	-
Plan members	157,100	-
Total contributions	628,350	-
Investment earnings:		
Net increase (decrease) in fair value of investments	200,000	-
Interest	130,000	3,200
Dividends	60,000	-
Total investment earnings	390,000	3,200
Less investment expense	40,000	-
Net investment earnings	350,000	3,200
Total additions	**978,350**	**3,200**
DEDUCTIONS		
Benefits	157,100	5,200
Refunds of contributions	62,850	-
Administrative expenses	4,900	1,000
Total deductions	**224,850**	**6,200**
Change in net assets	**753,500**	**(3,000)**
Net assets - beginning of the year	**4,296,900**	**45,000**
Net assets - end of the year	**5,050,400**	**42,000**

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Management's Discussion & Analysis (MD&A)
Government-wide Financial Statements
Fund Financial Statements
Notes to Financial Statements
Required Supplementary Information
Other Supplementary Information

D. NOTES TO THE FINANCIAL STATEMENTS

NOTES TO FINANCIAL STATEMENTS

1. Notes to the financial statements are essential to fair presentation and considered integral to the financial statements. Notes should focus on the primary government, specifically:
   a. Governmental activities,
   b. Business-type activities,
   c. Major funds,
   d. Non-major funds in the aggregate, and
   e. Additional information regarding discretely presented component units.
2. Generic governmental disclosures should include:
   a. A description of government-wide activities noting the exclusion of fiduciary funds,
   b. Policies relating to elimination of internal activity,
   c. Description of the modified approach for reporting infrastructure, if used, and
   d. Segment information on enterprise funds meeting the following definition of a segment:
      (1) Enterprise represents an identifiable activity.
      (2) Enterprise has one or more debt issues outstanding with revenue streams pledged in support of that debt.
      (3) Enterprise is accounted for separately.
3. Specific governmental disclosures (GASB #38):
   a. Description of activities for:
      (1) Major funds
      (2) Internal service funds
      (3) Fiduciary funds

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b. The length of time used to define "available" in determining revenue recognition under the modified accrual basis (measurable and available).

c. Actions taken to correct material non-compliance with finance-related or legal compliance.

d. A schedule of short-term debt and the purpose for which the short-term debt was issued.

e. Analysis of interfund account balances by:

   (1) Maturity (current and non-current)

   (2) Purpose

   (3) Individual major fund

   (4) Non-major funds in the aggregate

   (5) Internal service fund

   (6) Fiduciary fund types

f. Analysis of accounts receivable and accounts payable by:

   (1) Maturity (current and non-current)

   (2) Type:

      (a) Accounts receivable (taxes and special assessments)

      (b) Accounts payable (vendors, salaries and benefits)

   (3) Activity and fund:

      (a) Governmental activities (GRASP) and internal service

      (b) Business-type activities (enterprise funds)

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Management's Discussion & Analysis (MD&A)
Government-wide Financial Statements
Fund Financial Statements
Notes to Financial Statements
Required Supplementary Information
Other Supplementary Information

REQUIRED SUPPLEMENTARY INFORMATION

E. REQUIRED SUPPLEMENTARY INFORMATION (OTHER THAN MD & A)

Required supplementary information includes information that precedes the financial statements (the MD&A) and information included after the basic financial statements. Significant information that follows the basic financial statements include:

1. Budgetary Information

a. Budgetary comparison schedules that show the original budget, the final amended budget, and actual amounts.

b. Computation of variances is optional. Computation of differences between original and final amended budget is optional.

c. Budgetary comparison may use either GAAP or budgetary formats, or basis of accounting, but must include a reconciliation to GAAP.

d. Budgetary comparisons may be presented as part of the basic financial statements at the election of the government.

e. Financial statements prepared in accordance with the provisions of GASB 34 possibly include budget versus actual comparisons including display of the originally adopted budget and the changes that resulted in the final amended budget.

f. Budgetary comparison schedules may be presented as required supplementary information or in the basic financial statements for the general fund and for each major special revenue fund that has a legally adopted annual budget.

g. Notes to required supplementary information should disclose excess of expenditure over appropriations in individual funds presented in the budgetary comparison.

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h. Budgetary Comparison Schedule

Budgetary comparison schedules should be prepared for the general fund and all special revenue funds that require a budget.

Progressive Township
Budgetary Comparison Schedule
General Fund
For the Year Ended December 31, 20X1

	Budgeted Amounts		Actual Amounts	Variance with Final Budget Positive
	Original	Final	(Budgetary Basis)	(Negative)
Budgetary fund balance, January 1	2,975,000	1,516,000	1,516,000	-
Resources (inflows)				
Property taxes	1,500,000	1,530,000	1,620,000	90,000
Fees and fines	100,000	100,000	120,000	20,000
Inter-governmental	260,000	260,000	-	(260,000)
Charges for services	100,000	100,000	-	(100,000)
Interest earnings	40,000	40,000	55,000	15,000
Proceeds of long-term capital-related debt			-	-
Transfers from other funds	85,000	85,000	85,000	-
Amounts available for appropriation	2,085,000	2,115,000	1,880,000	(235,000)
Charges to appropriations (outflows)				
General government				
Legal	29,250	29,250	45,000	(15,750)
Mayor, city council and city manager	146,250	146,250	225,000	(78,750)
Finance and accounting	102,375	102,375	157,500	(55,125)
City clerk and elections	14,625	14,625	22,500	(7,875)
Public safety				
Police department	760,500	785,500	600,000	185,500
Fire department	253,500	253,500	200,000	53,500
Emergency medical services	190,125	190,125	150,000	40,125
Building inspections	63,375	63,375	50,000	13,375
Culture and recreation				
Library	3,900	3,900	4,000	(100)
Leisure services	74,100	74,100	76,000	(1,900)
Other functional classifications				
Public works administration	23,400	23,400	40,000	(16,600)
Street maintenance	29,250	29,250	50,000	(20,750)
Traffic operations	58,500	58,500	100,000	(41,500)
Miscellaneous	5,850	5,850	10,000	(4,150)
Contingency	165,000	165,000		165,000
Transfers to other funds	4,000	4,000	14,000	(10,000)
Capital Outlay	30,000	30,000	25,000	5,000
Total Charges to appropriations	1,954,000	1,979,000	1,769,000	210,000
Budgetary Fund Balance, December 31	3,106,000	1,652,000	1,627,000	(25,000)

Note: Model assumes budget was developed on a GAAP basis, optional variance data included.

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2. Infrastructure Information

a. Modified approach for reporting infrastructure assumes significant required supplementary disclosures derived from the items described in the section titled Capital Assets.

b. Required supplementary information for all eligible infrastructure assets reported using the modified approach should include schedules that disclose:

(i) Assessed condition of infrastructure, and

(ii) Estimated annual amount to maintain and preserve infrastructure for each of the past five years,

Additional disclosures for infrastructure would include:

(i) The basis for condition measurement, and

(ii) The condition level at which the government plans to maintain its infrastructure.

3. Pension Information

Full pension reporting requires presentation of 6 (six) years of data.

a. Schedule of Funding Progress

Relevant information such as actual valuation date, actual value of plan assets, unfunded actuarial liability, funded ratio (assets divided by liabilities), and annual covered payroll.

b. Schedule of Employer Contributions

Relevant information such as the Annual Required Contribution (ARC), the percentage of ARC recognized in the financial statements, and required contributions from other entities.

c. Notes to Schedule

Information disclosures such as identification of actuarial methods; factors that influence valuation, such as benefit changes, etc.

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Management's Discussion & Analysis (MD&A)

Government-wide Financial Statements

Fund Financial Statements

Notes to Financial Statements

Required Supplementary Information

Other Supplementary Information

F. OTHER SUPPLEMENTARY INFORMATION (OPTIONAL)

1. Combining statements for non-major funds.
2. Variance between originally adopted budget and final amended budget.
3. Variance between final amended budget and actual.

Progressive Township
Balance Sheet
Non-major Governmental Funds
December 31, 20X1

	Special Revenue Funds		Debt Service Funds		Capital Projects Fund	Permanent Fund	Total Nonmajor Governmental Funds
	Gas Tax	Headstart	East Bridge	Police Dept Bonds	East Bridge	Inmate Commissary	
ASSETS							
Cash	10,000	5,000	66,500	100,000	88,000	500	270,000
Receivables from other governments	65,000	18,000	-	-	-	-	83,000
Inventories	-	-	-	-	-	6,000	6,000
Total assets	**75,000**	**23,000**	**66,500**	**100,000**	**88,000**	**6,500**	**359,000**
LIABILITIES AND FUND BALANCES							
Liabilities:							
Accounts payable	65,000	12,000	8,500	-	14,000	500	100,000
Total liabilities	65,000	12,000	8,500	-	14,000	500	100,000
Fund balances:							
Reserved for:							
Inventories	-	-	-	-	-	6,000	6,000
Encumbrances	25,000	3,000	-	-	-	-	28,000
Debt Service	-	-	58,000	100,000	-	-	158,000
Unreserved and reported in:							
Special revenue funds	(15,000)	8,000	-	-	-	-	(7,000)
Capital projects funds	-	-	-	-	74,000	-	74,000
Total fund balances	10,000	11,000	58,000	100,000	74,000	6,000	259,000
Total liabilities and fund balance	**75,000**	**23,000**	**66,500**	**100,000**	**88,000**	**6,500**	**359,000**

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Progressive Township
Statement of Revenues, Expenditures, and Changes in Fund Balance
Nonmajor Governmental Funds
For the Year Ended December 31, 20X1

	Special Revenue Funds		Debt Service Funds		Capital Projects Fund	Permanent Fund	Total Non-major Governmental Funds
	Gas Tax	Headstart	East Bridge	Police Dept Bonds	East Bridge	Inmate Commissary	
REVENUES							
Inter-governmental	410,000	400,000	-	-	50,000	-	860,000
Charges for services	-	-	-	-	-	78,000	78,000
Interest earnings	-	-	20,000	15,000	5,000	-	40,000
Total Revenues	410,000	400,000	20,000	15,000	55,000	78,000	978,000
EXPENDITURES							
Current:							
Other functional classifications	485,000	395,000	-	-	-	77,000	957,000
Debt service:							
Principal	-	-	45,000	65,000	-	-	110,000
Interest and other charges	-	-	83,000	128,000	-	-	211,000
Capital outlay	-	-			162,000	-	162,000
Total expenditures	485,000	395,000	128,000	193,000	162,000	77,000	1,440,000
Excess (deficiency) of revenues over expenditures	(75,000)	5,000	(108,000)	(178,000)	(107,000)	1,000	(462,000)
OTHER FINANCING SOURCES (USES)							
Transfers in	-	-	-	10,000	-	-	10,000
Total other financing sources and uses	-	-	-	10,000	-	-	10,000
Net change in fund balances	(75,000)	5,000	(108,000)	(168,000)	(107,000)	1,000	(452,000)
Fund balances-beginning	85,000	6,000	166,000	268,000	181,000	5,000	711,000
Fund balances-ending	10,000	11,000	58,000	100,000	74,000	6,000	259,000

IV. INTERFUND ACTIVITY

Interfund activity represents the flow of resources between funds and between the primary government and its component units. The accounting associated with interfund activity can be classified as follows:

(i) Reciprocal interfund activity

(ii) Non-reciprocal interfund activity

Interfund activity is subject to specific requirements related to financial statement display and disclosure.

A. RECIPROCAL INTERFUND ACTIVITY

RECIPROCAL INTERFUND ACTIVITY

Reciprocal interfund activity includes exchange-type transactions between funds.

1. Interfund Loans

Interfund loans represent temporary extensions of credit to other funds that are expected to be repaid and are accounted for as interfund receivables and payables (due from/due to).

a. Unrealizable balances are reclassified as transfers.

2. Interfund Services Provided and Used

Interfund services represent sales and purchases between funds at external pricing. Examples include sales of water and sewer services by an enterprise fund to the city and internal service fund activities. Transactions of this type are accounted for as revenues and expenses/expenditures.

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B. NON-RECIPROCAL INTERFUND ACTIVITY

Generally non-reciprocal interfund activity represents non-exchange transactions between funds.

1. Interfund Transfers

Flows of assets between funds without the exchange of equivalent value represent interfund transfers. Payments in lieu of taxes made by a Proprietary Fund to the General Fund or the budgeted transfer of pledged revenues from a Special Revenue Fund to a Debt Service Fund to meet bond covenant requirements are examples of interfund transfers. Transfers are normally displayed as other financing sources and uses after non-operating revenues and expenses.

2. Interfund Reimbursements

Payments of expenses made by one fund on behalf of another fund are accounted for as reimbursements. The expenditure originally made is reimbursed by the fund actually responsible for the disbursement. Interfund reimbursement serve to reclassify the expenditure or expense associated with the original transaction to the fund ultimately responsible for the obligation satisfied. Interfund reimbursements are not displayed as interfund transactions.

C. FINANCIAL STATEMENT DISPLAY AND DISCLOSURE

The display and disclosure of interfund activities is meant to isolate meaningful relationships without needlessly grossing up transactions.

1. Financial Statement Displays

a. Within the governmental activities column of the government-wide financial statements.

Activity within a particular column displayed on the financial statements should be eliminated.

b. Within the business-type activities column of the government-wide financial statements.

Activity within a particular column displayed on the financial statements should be eliminated.

c. Between the governmental activities and business-type activities displayed on the government-wide financial statements.

The internal balances should be displayed as an internal balance on the face of each financial statement and aligned with the each other to eliminate for purposes of total primary government financial statements (see example, page F9-14).

d. Between the primary government and its fiduciary funds.

The transaction should be reported as if between external parties.

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2. Financial Statement Disclosures

a. Interfund Loans and Transfers

Disclosure of interfund loans and transfers will include:

(1) Due to/from by individual major fund

(2) Due to/from non-major funds in the aggregate

(3) Due to/from internal service funds in the aggregate

(4) The purpose/description of each loan or transfer

b. Interfund Loans

Disclosures specific to loans include:

(1) Any amounts not expected to be repaid within a year

c. Interfund Transfers

Disclosures specific to transfers include:

(1) Any transfers that do not occur on a routine basis

(2) Transfers that are not consistent with the activities of the fund making the transfer.

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NOT-FOR-PROFIT ORGANIZATIONS

The CPA Examination tests the external reporting requirements and unique accounting issues faced by not-for-profit organizations. Often the accounting issues material to not-for-profit organizations relate to revenue recognition or the classification of resource inflows. From time to time the examination also tests the application of not-for-profit accounting principles to the various industries that are commonly organized as not-for-profit corporations.

I. GENERAL OVERVIEW: NOT-FOR-PROFIT ORGANIZATIONS

A. CHARACTERISTICS OF NOT-FOR-PROFIT ORGANIZATIONS

Not-for-profit entities are defined by the FASB as entities that have the following characteristics:

1. Their revenues come from contributions.
2. Their operating purpose does not include profit, although there is nothing to preclude the generation of a profit.
3. Their ownership interests are unlike business enterprises.

B. INDUSTRIES THAT FREQUENTLY INCLUDE ORGANIZATIONS THAT USE NOT-FOR-PROFIT ACCOUNTING

Not-for-profit entities are generally divided into four separate categories related to various industries:

1. Health Care Organizations

a. Hospitals
b. Nursing homes
c. Hospices

2. Educational Institutions

a. Colleges and universities
b. Other schools

3. Voluntary Health and Welfare Organizations

a. United Way
b. Red Cross
c. March of Dimes

4. Other Private (not governmental) Not-for-Profit Organizations

a. Cemetery organizations
b. Fraternal organizations
c. Labor unions
d. Museums, libraries, and performing arts organizations
e. Professional organizations (e.g., the AICPA)

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C. USERS OF NOT-FOR-PROFIT FINANCIAL STATEMENTS AND THEIR NEEDS

1. The FASB identifies users of not-for-profit financial statements as including donors, members, creditors, and others who provide resources to the not-for-profit entity (e.g., the government via grants, etc.)
2. The FASB recognizes that users of not-for-profit financial statements have common interests. These common interests include the ability to assess:
   a. The services the organization provides,
   b. The organization's ability to continue to provide those services, and
   c. The method the organization's managers use to discharge their stewardship responsibility.
3. The FASB identifies the information that should be provided in not-for-profit organization financial statements in order to meet these common interests:
   a. The amount and nature of an organization's assets, liabilities, and net assets (Statement of Financial Position).
   b. The effects of events and circumstances that change the amount and nature of net assets (Statement of Activities).
   c. The amount and kinds of inflows and outflows of economic resources occurring within a period (Statement of Activities).
   d. The relationship between the inflows and outflows (Statement of Activities).
   e. How an organization obtains and spends cash (Statement of Cash Flows).
   f. The service efforts of an organization (Statement of Functional Expenses).

D. FULL ACCRUAL BASIS OF ACCOUNTING

Generally accepted accounting principles require that not-for-profit organizations report on the full accrual basis of accounting.

The primary reporting emphasis is placed on disclosing the sources of the institution's resources and how they were expended, rather than on the periodic determination of net income. The overall emphasis for not-for-profit financial statements is on basic information for the organization as a whole.

PASS KEY

The study of not-for-profit accounting focuses on several key issues. Consider these themes:

- ***Classification*** of net assets as unrestricted, temporarily restricted and permanently restricted;
- Revenue ***recognition*** concepts related to unconditional pledges and support;
- Distinguishing between restricted revenue and conditional pledges; and
- Distinguishing between restricted revenues and the absence of ***variance power.***

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II. GENERAL OVERVIEW: FINANCIAL REPORTING STANDARDS APPLICABLE TO NOT-FOR-PROFIT ORGANIZATIONS

A. FINANCIAL ACCOUNTING STATEMENT 117 GOVERNS EXTERNAL REPORTING FOR PRIVATE NOT-FOR-PROFIT ORGANIZATIONS

1. All types of private not-for-profit organizations are required to have consistent external reporting, making it easier to compare the performance of different not-for-profit organizations.
2. Fund accounting is not used for external financial reporting (however, disclosure of funds is not prohibited).
    a. Separate funds may be maintained for internal purposes.
3. External financial statements must focus on the basic information for the organization as a whole.
4. Governmental not-for-profits (for example, a state university) are not affected by FASB 117.

B. REQUIRED FINANCIAL STATEMENTS

1. Statement of Financial Position, which is the not-for-profit version of the balance sheet,
2. Statement of Activities, which is the not-for-profit version of the income statement and statement of retained earnings,
3. Statement of Cash Flows, and
4. Statement of Functional Expenses, which is required for voluntary health and welfare organizations, and encouraged for other organizations.

III. STATEMENT OF FINANCIAL POSITION

A. COMPONENTS OF THE STATEMENT OF FINANCIAL POSITION

The not-for-profit statement of financial position is divided into three major components:

1. Assets,
2. Liabilities, and
3. Net assets (equity). (This is not called funds, fund balances, or retained earnings.)

B. SEQUENCE OF ACCOUNT DISPLAY FOR ASSETS AND LIABILITIES

1. Relative liquidity should be disclosed in the same way it is in commercial accounting:
    a. Assets and liabilities should be classified as current or non-current, and
    b. Assets should be sequenced by nearness to cash and liabilities sequenced by nearness to maturity.

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C. ELEMENTS OF THE STATEMENT OF FINANCIAL POSITION

The statement of financial position must include total assets, total liabilities, unrestricted net assets, temporarily restricted net assets, permanently restricted net assets, and total net assets.

D. NET ASSETS (RESTRICTED & UNRESTRICTED)

NET ASSET CLASSIFICATIONS

The components of net assets of not-for-profit organizations are classified in one of three possible ways: unrestricted, temporarily restricted, or permanently restricted net assets.

1. Unrestricted Net Assets

Unrestricted net assets are available to finance general operations of the particular organization, and may be expended at the discretion of the governing board.

(a) They are net assets that are not permanently restricted or temporarily restricted by donor-imposed stipulations.

(b) Internal board designated funds are considered unrestricted.

2. Temporarily Restricted Net Assets

Temporarily restricted net assets are similar to permanently restricted net assets except the donor-imposed stipulations either expire by passage of time or can be fulfilled and removed by actions of the organization.

(a) Temporarily restricted net assets should not be displayed as a deficit;

(b) Any over-expenditure of temporarily restricted net assets should be classified as a reduction of unrestricted net assets.

3. Permanently Restricted Net Assets

Permanently restricted net assets result from contributions and other inflows of assets whose use is limited by donor-imposed stipulations that *neither* expire by passage of time *nor* can be fulfilled or otherwise removed by actions of the organization.

(a) They can also result from the reclassification from (or to) other classes of net assets as a consequence of donor-imposed stipulations.

PASS KEY

Internal board designated funds are considered unrestricted, not restricted. Many prior CPA exam questions provide incorrect responses to questions that suggest internal board-designated funds should be restricted.

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Not-for-Profit Organization
STATEMENTS OF FINANCIAL POSITION
December 31, 20X1 and 20X0
(in thousands)

	20X1	*20X0*
Assets:		
Cash and cash equivalents	$ 75	$ 460
Accounts and interest receivable	2,130	1,670
Inventories and prepaid expenses	610	1,000
Contributions receivable	3,025	2,700
Short-term investments	1,400	1,000
Assets restricted to investment in land, buildings, and equipment	5,120	4,560
Land, buildings & equipment	61,700	63,590
Long-term investments	218,070	203,500
Total assets	$292,220	$278,480
Liabilities and net assets:		
Liabilities		
Accounts payable	$ 2,570	$ 1,050
Refundable advance	—	650
Grants payable	875	1,300
Notes payable	—	1,140
Annuities obligations	1,685	1,700
Long-term debt	5,500	6,500
Total liabilities	10,630	12,340
Net assets:		
Unrestricted	115,228	103,670
Temporarily restricted	24,342	25,470
Permanently restricted	142,020	137,000
Total net assets	281,590	266,140
Total liabilities and net assets	$292,220	$278,480

PASS KEY

It is important to remember that not-for-profits have different categories for net assets than governmental fund accounting.

Not-For-Profit Net Asset Categories	Governmental Net Asset Categories
• Permanently restricted	• Invested
• Unrestricted	• Restricted
• Temporarily restricted	• Unrestricted

Remember: Not-for-profits "put" their net assets in these categories.

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IV. STATEMENT OF ACTIVITIES

A. ELEMENTS OF THE STATEMENT OF ACTIVITIES

The not-for-profit statement of activities reports revenues and expenses (shown gross), gains and losses (often shown net) (investment income is an example), and reclassification between classes of net assets (for example, from temporarily restricted to unrestricted, once the restrictions have been removed).

1. Four required elements presented in the Statement of Activities:
   a. Change in total net assets,
   b. Change in unrestricted net assets,
   c. Change in temporarily restricted net assets, and
   d. Change in permanently restricted net assets.

B. CLASSIFICATION OF REVENUE, GAINS, AND OTHER SUPPORT

CLASSIFICATION OF CHANGES IN NET ASSETS

Contributions, pledges, and gifts are classified into one of the following three categories according to the existence or absence of donor-imposed restrictions:

1. Unrestricted

Unrestricted, which is free of donor restrictions on usage. If no restrictions are specified by the donor, the gift is considered unrestricted.

2. Temporarily Restricted

Temporarily restricted, which is generally one of the following types:

a. Purpose, which means the money must be spent as the donor stipulates (i.e., cancer research, youth education, etc.).

b. Time, which means the assets are restricted until a fixed period passes (e.g., a gift of a CD that must be held until maturity and then can be spent as the organization wishes).

c. Acquisition of plant, which means the assets are restricted until land is purchased and/or a facility is built.

3. Permanently Restricted

Permanently restricted, which are contributions with restrictions that can never be removed (e.g., an endowment fund where the corpus must be retained and income can be used by the NFP in accordance with the donor's stipulations).

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C. TIMING OF RECLASSIFICATION OF RESTRICTIONS

1. Contributions with donor-imposed restrictions are recorded as restricted revenue in the period in which they are received. They increase temporarily or permanently restricted net assets.
2. When a donor restriction is satisfied, a reclassification is reported on the statement of activities. Reclassifications are items that simultaneously increase one net asset class and decrease another.
3. Donor-imposed restrictions that are met in the same period they are received may be recorded as unrestricted support (contribution revenue), provided that the organization discloses and consistently applies this accounting policy.
4. Support that results in permanently restricted net assets ordinarily are not reclassified, as they were permanently restricted by the donor.
5. Revenue, gains, and other support that result in unrestricted net assets ordinarily do not become restricted.

D. EXPENSE CLASSIFICATION IN THE STATEMENT OF ACTIVITIES

Expenses are reported as decreases in unrestricted net assets. Detail functional classification must be presented either on the face of the financials or the notes to the financial statements. Expenses are categorized as:

1. Program Services

Program services (expenses), which are the activities for which the organization is chartered. Examples are:

a. Universities – education and research
b. Hospitals – patient care and education
c. Union – labor negotiations and training
d. Day Care – child care

2. Support Services

Supporting services, which include everything not classified as a program service. Examples are:

a. Fund-raising
b. Administration
c. Management and general
d. Membership development

3. Combined Costs

Not-for-profit organizations that combine fund-raising efforts with educational (or program) services, should allocate the combined cost between functions.

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Not-for-Profit Organization
STATEMENT OF ACTIVITIES
For Year Ended December 31, 20X1
(in thousands)

	Unrestricted	*Temporarily Restricted*	*Permanently Restricted*	*Total*
Revenues, gains, and other support:				
Contributions	$ 8,640	$ 8,110	$ 280	$ 17,030
Fees	5,400			5,400
Income on long-term investments	5,600	2,580	120	8,300
Other investment income	850			850
Net unrealized and realized gains on long-term investments	8,228	2,952	4,620	15,800
Other	150			150
Net assets released from restrictions:				
Satisfaction of program restrictions	11,990	(11,990)		—
Satisfaction of equipment acquisition restrictions	1,500	(1,500)		—
Expiration of time restrictions	1,250	(1,250)		—
Total revenues, gains, and other support	43,608	(1,098)	5,020	47,530
Expenses and losses:				
Program A	13,100			13,100
Program B	8,540			8,540
Program C	5,760			5,760
Management and general	2,420			2,420
Fund raising	2,150			2,150
Total expenses	31,970			31,970
Fire loss	80			80
Actuarial loss on annuity obligations	—	30		30
Total expenses and losses	32,050	30		32,080
Changes in net assets	11,558	(1,128)	5,020	15,450
Net assets at beginning of year	103,670	25,470	137,000	266,140
Net assets at end of year	$ 115,228	$ 24,342	$ 142,020	$ 281,590

V. STATEMENT OF CASH FLOWS

A Statement of Cash Flows is required for all not-for-profit organizations. FAS 95 is applicable to not-for-profit organizations, the commercial format is followed, and either the direct or the indirect method may be used.

A. CLASSIFICATION OF SOURCES AND USES OF CASH

1. Operating Activities

a. Include applicable agency transactions.

b. When using the direct method, operating activities should be reported by major class of gross receipts (including contributions, program income, and interest income or dividend income from investments).

c. Include receipts of unrestricted resources designated by the governing body to be used for long-lived assets.

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2. Financing Activities

Cash flows from financing activities include the cash transactions related to borrowing that are typically found in commercial statements of cash flows but also include cash transactions related to certain restricted contributions. Cash flows from financing activities may be segregated on the face of the financial statement as follows:

a. Proceeds from Restricted Contributions

Cash received with donor-imposed restrictions limiting its use to long-term purposes such as increases to an endowment, purchases of assets or annuity agreements is displayed as a financing activity. Disbursements of these restricted contributions for either temporary investments or the purpose for which they were intended are classified as investing activity.

b. Other Financing Activities

Other financing activities include receipts and disbursements associated with borrowing, disbursements associated with split interest agreements, and receipts of dividends and interest restricted to reinvestment.

PASS KEY

Contributions of unrestricted revenue later earmarked (board designated) for construction or purchase of long-lived assets are classified as "Operating" on the Statement of Cash Flows.

3. Investing Activities

a. Include proceeds from the sale of works of art or purchases of works of art.

b. Include investment in equipment.

c. Include proceeds from the sale of assets that were received in prior periods and whose sale proceeds were restricted to investment in equipment.

4. Cash and Cash Equivalents

a. Exclude donor-restricted securities that may otherwise meet the cash equivalent definition in commercial accounting.

PASS KEY

Note that in not-for-profit reporting, the statement of cash flows has the three typical commercial classifications: operating activities, financing activities, and investing activities.

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Not-for-Profit Organization
STATEMENT OF CASH FLOWS
For Year Ended December 31, 20X1
(in thousands)

Cash flows from operating activities:			
Change in net assets		$ 15,450	
Adjustments to reconcile change in net assets to net cash used by operating activities:			
Depreciation		3,200	
Fire loss		80	
Actuarial loss on annuity obligations		30	
Increase in accounts and interest receivable		(460)	
Decrease in inventories and prepaid expenses		390	
Increase in contributions receivable		(325)	
Increase in accounts payable		1,520	
Decrease in refundable advance		(650)	
Decrease in grants payable		(425)	
Contributions restricted for long-term investment		(2,740)	
Interest and dividends restricted for long-term investment		(300)	
Net unrealized and realized gains on long-term investments		(15,800)	
Net cash used by operating activities			$ (30)
Cash flows from investing activities:			
Insurance proceeds from fire loss on building		250	
Purchase of equipment		(1,500)	
Proceeds from sale of investments		76,100	
Purchase of investments		(74,900)	
Net cash used by investing activities			(50)
Cash flows from financing activities:			
Proceeds from contributions restricted for:			
Investment in endowment	$ 200		
Investment in term endowment	70		
Investment in plant	1,210		
Investment subject to annuity agreements	200		
		1,680	
Other financing activities:			
Interest and dividends restricted for reinvestment	300		
Payments of annuity obligations	(145)		
Payments on notes payable	(1,140)		
Payments on long-term debt	(1,000)		
		(1,985)	
Net cash used by financing activities			(305)
Net decrease in cash and cash equivalents			(385)
Cash and cash equivalents at beginning of year			460
Cash and cash equivalents at end of year			$ 75

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VI. STATEMENT OF FUNCTIONAL EXPENSES

A. STATEMENT OF FUNCTIONAL EXPENSES

The Statement of Functional Expenses is mandatory for Voluntary Health and Welfare Organizations but optional (and encouraged) for all other not-for-profit organizations.

1. The total amount of each functional expense should be clearly disclosed in the statement of activities and/ or the footnotes.
2. The Statement of Functional Expenses analyzes expenses by their natural expense classification (e.g., salaries, rent, utilities).

B. FUNCTIONAL CLASSIFICATION OF EXPENSES

In order to assess an organization's service efforts, including the cost of its services and how it uses its resources, expenses, which are decreases in unrestricted net assets, should be classified and grouped by the functions of the particular organization. The most common groups of functional classifications are (1) program support services, (2) fund-raising, and (3) management and general.

1. Program Support Expenses

Program support expenses are expenses that are directly related to the organization's program. For example, if an organization's program was cancer research then only those expenses directly related to the actual research on cancer should be classified as program support expenses.

2. Fund-Raising Expenses

Fund-raising expenses should also be classified functionally and be separately disclosed in the financial statements. They include the costs of transmitting appeals to the public and the salaries of personnel connected with fund-raising campaigns.

3. Management and General

Management and general costs include expenses for the overall direction of the organization, general record keeping, business management, budgeting, general board activities, and related purposes.

4. Multiple Cost Items

If a cost relates to several categories and/or classifications, allocate the cost on any reasonable basis.

VII. GENERAL COMMENTS: SPECIFIC ACCOUNTING ISSUES RELATED TO REVENUE RECOGNITION FOR NOT-FOR-PROFIT ORGANIZATIONS

A. FINANCIAL ACCOUNTING STATEMENT 116

Financial Accounting Statement 116 governs the recognition of most contributions received and contributions made.

1. Resource inflows in not-for-profit organizations are generally classified in the financial statements as either revenue or other support.
2. Revenues typically represent exchange transactions in which the not-for-profit organization earns resources in exchange for a service performed (e.g., fees).

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3. Other support typically represents operating income that is donated (contributed) or provided in some way that is anticipated as part of the central ongoing activities of the organization.

4. Identifying and accounting for these transactions appropriately is a significant feature of not-for-profit accounting.

B. FINANCIAL ACCOUNTING STATEMENT 136

Financial Accounting Statement 136 governs the treatment of asset transfers between related not-for-profit organizations.

1. General principles regarding recognition and classification are consistent with FAS 116, but include specific criteria in different circumstances.

2. Related not-for-profit organizations include separate fund-raising organizations created to benefit other not-for-profit organizations (such as foundations) or organizations involved with community-wide fund-raising appeals (such as the United Way).

3. Receipts of a foundation or a community-wide fund-raising organization that are specifically intended for another beneficiary organization may represent a liability rather than revenue. Accounting by the beneficiary organization is also affected.

VIII. ACCOUNTING FOR CONTRIBUTIONS RECEIVED AND CONTRIBUTIONS MADE

A. CONTRIBUTIONS AND RECOGNITION

1. Contributions—Defined

A contribution is defined as an unconditional transfer of cash or assets (collection is certain) to a new owner (title passes) in a manner which is voluntary (the donor is under no obligation to donate) and is non-reciprocal (the donor gets nothing in exchange).

2. Recognition

Contribution recognition considers whether collection is conditional or unconditional. Collectibility and recognition issues are separate from restricted classification issues.

a. Cash Contributions

Cash contributions should be recognized as revenues or gains in the period in which they are received, and they should be measured at their fair value at the date of the gift.

b. Unconditional Promises

An unconditional promise to give (also known as a pledge) is a contribution, and is recorded as revenue at its fair market value when the promise is made. An unconditional promise may be written or verbal. However, verbal pledges should be documented by the organization internally and may be more difficult to collect.

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c. Conditional Promises

A conditional promise to give (or pledge) is a transaction that depends on an occurrence of a future and uncertain event. Recognition does not occur until the conditions are substantially met (or when it can be determined that the chances of not meeting the conditions are remote) and the promise becomes unconditional.

(1) Good faith deposits that accompany a conditional promise are accounted for as a refundable advance in the liability section of the statement of financial position.

d. Multi-Year Pledges

Multi-year pledges are recorded at the net present value at the date the pledge is made.

(1) Future collections are considered temporarily restricted revenues and net assets (time-restricted).

(2) The difference between the previously recorded present value and the current amount collected is considered contribution revenue, not interest income.

e. Allowance for Uncollectible Pledges

An allowance for uncollectible pledges should be recorded in accordance with commercial accounting principles for accounts receivable.

f. Split Interest Agreements

Split interest agreements represent donor contributions of trusts or other arrangements under which the not-for-profit organization receives benefits that are shared with other beneficiaries.

(1) Examples included:

(a) Charitable lead trust

(b) Perpetual trust held by a third party

(c) Charitable remainder trust

(d) Charitable gift annuity

(e) Pooled life income fund

(2) During the term of the agreement, changes in the value of split interest agreements should be recognized for:

(a) Amortization of discounts, and

(b) Re-valuations.

(3) Assets and liabilities recognized under split interest agreements should be disclosed separately from other assets and liabilities in the Statement of Financial Position.

(4) Contribution revenues and changes in the value of split interest agreements should be disclosed as separate line items in the Statement of Activities (or the related notes).

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(5) Split interest contributions should be:

(a) Measured at their fair values at the date of acquisition,

(b) Estimated based on the present value of the estimated future distributions, and

(c) Displayed as temporarily restricted (unless there is a permanent restriction established by the donor).

PASS KEY

Do not confuse the net asset classification concept of unrestricted and restricted with the revenue recognition concept of conditional and unconditional. Unconditional pledges are assured of collection and may be either recognized as restricted or unrestricted. Conditional pledges are still subject to important contingencies and are not recorded as revenue, but rather as liabilities.

B. SPECIALIZED SUPPORT TRANSACTIONS

Not-for-profit organizations receive support in both donated cash as well as services and non-monetary items. Special criteria apply to the recognition and valuation of these transactions.

1. Donated Services

DONATED SERVICES

Donated services received by a not-for-profit organization are generally not recorded because of the difficulty in placing a monetary value on donated services (and the absence of control over them). However, donated services should be recorded as contribution revenue and expense at fair value if the services meet the following criteria:

(i) They create or enhance a non-financial asset (e.g., land, building, inventory, etc.), or

(ii) They require specialized skills that the provider possesses and would otherwise have been purchased by the organization (i.e., attorney, accountant, and doctor services, etc.).

Contributions of services are recognized "some" of the time:

a. **S**pecialized skills are required and possessed by the donor

b. **O**therwise needed by the organization

c. **M**easurable

d. **E**asily (at fair value)

DR	Expense or asset	$XXX	
CR	Contributions—Non-operating revenue		$XXX

Disclosure in the notes to the financial statements should include the nature and extent of contributed services received for the period and the amount recognized as revenues.

Costs of soliciting contributed services are considered fund raising expenses regardless of whether services meet recognition criteria.

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PASS KEY

Expenses associated with solicitations of contributions of volunteer assistance are classified as fund-raising expenses regardless of whether the volunteer assistance meets the "SOME" criteria for in-kind recognition.

EXAMPLE

A storm damaged the roof of a new building owned by K-9 Shelters, a not-for-profit organization. A supporter of K-9, a professional roofer, repaired the roof at no charge. In K-9's statement of activities, the damage and repair of the roof should

a. Be reported by note disclosure only.
b. Be reported as an increase in both expenses and contributions.
c. Be reported as an increase in both net assets and contributions.
d. Not be reported.

Solution: Choice "b" is correct. Donated services are recognized if the services received either (1) create or enhance non-financial assets, or (2) require specialized skills, are provided by individuals possessing those skills, and would typically need to be purchased if not provided by donation. Both of these conditions are met so the following entry would be made to record the damage and repair of the roof:

Expense	$XXX	
Contribution		$XXX

SFAS 116 para. 9

2. Donated Collection Items

Donated collection items are contributed works of art or historical treasures. They are not required to be recorded by the recipient not-for-profit organization if all of the following requirements are met:

a. The item is part of a collection, which is held for public viewing, exhibition, education, or research (and not for investment or financial gain),

b. The collection is cared for, preserved, and protected by the organization, and

c. The organization has a policy that requires any proceeds from the sale of donated items to be reinvested in other collection items.

Note: If the preceding requirements are not met, the donation must be recognized as an asset and revenue.

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3. Donated Materials

If significant in amount, donated materials should be recorded at their fair value on the date of receipt if the fair value can be objectively determined.

DR	Asset	$XXX	
CR	Contribution—support		$XXX

Donated materials that merely pass through the organization to an ultimate beneficiary, such as used clothing, should not be recorded, unless the amounts involved are substantial. In that event, the donated materials should be recorded as a contribution with an offsetting entry to expenses, and such substantial amounts should be appropriately disclosed in the financial statements.

DR	Expense	$XXX	
CR	Unrestricted contributions—supplies		$XXX

When donated items are sold at greater than FMV, the amount received in excess of FMV is considered contribution revenue.

C. RECORDING PROMISES TO CONTRIBUTE AND OTHER SUPPORT TRANSACTIONS

1. Unrestricted Contributions

Unconditional promises to contribute in the future are reported as restricted support (implied time restriction), at the present value of the estimated future cash flows using a discount rate commensurate with the risks involved even if their ultimate use is unrestricted. An example of an appropriate discount rate on short-term promises resulting from current fund-raising activities would be the collection rate from past campaigns. If the unconditional promises are expected to be collected or paid in less than one year, they may be measured at net realizable value since that amount is a reasonable estimate of fair value.

UNRESTRICTED PLEDGES (WITH IMPLIED TIME RESTRICTION):

DR	Pledge Receivable	$XXX	
CR	Allowance for doubtful accounts		$XXX
CR	Contributed revenue—temporarily restricted revenue		$XXX

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EXAMPLE

The League, a not-for-profit organization, received the following pledges:

Unrestricted	$200,000
Restricted for capital additions	150,000

All pledges are legally enforceable; however, the League's experience indicates that 10% of all pledges prove to be uncollectible. What amount should the League report as pledges receivable, net of any required allowance account?

a. $135,000
b. $180,000
c. $315,000
d. $350,000

Solution: Choice "c" is correct. In a not-for-profit organization, if the pledges are legally enforceable, they are recorded in the accounts. Net pledges receivable are gross pledges receivable ($350,000) less allowance for uncollectible (10% x $350,000), or $315,000. The unrestricted pledges, net of allowance, are credited to Support-Private gifts, while the restricted pledges, net of allowance, are credited to Restricted Net Assets. SOP 78-10, SFAS 117

2. Restricted Contributions

A contribution may be restricted by the donor. Donor-imposed restrictions limit the use of contributed assets. They are recognized as revenues or gains in the period received and as assets, decreases of liabilities, or expenses depending on the form of the benefits received. Restricted contributions are segregated into those with temporary restrictions or with permanent restrictions and are reported as such in the financial statements.

RESTRICTED NET ASSETS

DR	Pledge receivable	$XXX	
CR	Allowance for doubtful accounts		$XXX
CR	Restricted revenue (temp. restricted net assets)		$XXX

Later: After receivable is collected and when money is spent on restricted purpose

RESTRICTED NET ASSETS

DR	Reclassification: Satisfaction of restriction	$XXX	
CR	Cash/restricted net assets		$XXX

UNRESTRICTED NET ASSETS

DR	Cash/Unrestricted net assets	$XXX	
CR	Reclassification: Satisfaction of restriction		$XXX
DR	Operating expense	$XXX	
CR	Cash/Unrestricted net assets		$XXX

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D. DISTINGUISHING CONTRIBUTIONS FROM OTHER TRANSACTIONS

Other than contributions, not-for-profit organizations can receive resources, which may be classified as revenue or liabilities. These resources are derived from three other transactions mentioned in the FAS 117:

1. Agency Transactions

AGENCY TRANSACTIONS

a. Agency transactions consist of resources received by the not-for-profit over which the not-for-profit has little or no discretion or variance power.

b. The ability to use assets in any way the not-for-profit deems appropriate is called variance power.

c. Agency transactions are accounted for as an asset and a liability.

PASS KEY

Receipts that are restricted by a donor for specific purposes are displayed as restricted revenues and an increase in restricted net assets. Receipts that are restricted by a donor for specific beneficiaries are displayed as liabilities since the organization has no variance power.

2. Gifts In-kind

IN-KIND

a. Non-cash contributions to a not-for-profit are called gifts in-kind.

b. Gifts in-kind are measured at their fair market values.

c. Gifts in-kind that are donated as part of a fund-raising appeal are valued at FMV when received and revalued upon their sale as part of the fund-raising appeal. The difference between the fair value at the time of donation and the value at the time of sale is accounted for as an additional contribution.

3. Exchange Transactions

EXCHANGE TRANSACTIONS

a. Reciprocal transfers in which each party receives and sacrifices something of approximately equal value are termed exchange transactions.

b. The cost of premiums (e.g., calendars, coffee mugs, tote bags, etc.) given to potential donors as part of a fund-raising appeal is classified as a fund-raising expense.

c. The cost of premiums given to acknowledge donations is also classified as a fund-raising expense.

d. Generally, the difference between the fair value of dues or other purchases and the amount transferred is classified as a contribution.

e. Exchange transactions are classified as unrestricted revenues and net assets, even in circumstances in which resource providers place limitations on the use of the resources.

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PASS KEY

The general rule, for CPA Examination questions, for exchange transaction contributions is:

Amount Transferred
< Fair Value Dues/Purchase >
Contribution Revenue

IX. TRANSFERS OF ASSETS TO A NOT-FOR-PROFIT ORGANIZATION OR CHARITABLE TRUST THAT RAISES OR HOLDS CONTRIBUTIONS FOR OTHERS

Statement of Financial Accounting Standards No. 136 describes the accounting for asset transfers to other not-for-profit organizations, such as foundations, and the circumstances under which those transfers should be accounted for as (1) contribution revenue, (2) a liability, or (3) an equity transaction. Much of this specialized accounting represents an application of the ideas previously covered, primarily using the concept of variance power to determine if the accounting for an asset transfer should be recognized as either contribution revenue or a liability. New ideas presented in this pronouncement represent an extension of equity method accounting techniques to not-for-profits in the event that legally separate entities are in fact financially interrelated.

A. DEFINITIONS

1. Financially interrelated organizations are defined as organizations related by **both** of the following characteristics:

   a. One organization has the ability to influence the operating and financial decisions of the other, and

   b. One organization has an ongoing economic interest in the net assets of the other.

      Residual rights are created in this instance that increase or decrease as the value of net assets change.

B. GENERAL PRINCIPLES: RECIPIENT ACCOUNTING

1. Without Variance Power

An organization that accepts assets from a donor and agrees to use or manage them on behalf of a specified beneficiary **without variance power** accounts for assets received as follows:

a. Assets are valued at fair value.

b. Assets are recognized as a **liability** to the beneficiary.

DR	Asset		XXX	
CR		Refundable advance		XXX

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c. Assets transferred to recipient organizations are not contributions and are accounted for as liabilities when **any one** of the following conditions are met:

(1) The resource provider can change the beneficiary.

(2) The resource provider's asset transfer is conditional or otherwise revocable or repayable.

(3) The resource provider controls the recipient organization and specifies an unaffiliated beneficiary.

(4) The resource provider specifies itself or affiliate as the beneficiary and does not qualify for equity accounting.

2. Granted Variance Power

An organization that accepts assets from a donor and agrees to use or manage them on behalf of beneficiary but **is granted variance power**, the unilateral authority to redirect assets to another beneficiary, follows donee accounting.

a. Assets are valued at fair value.

b. Assets are recognized as **contribution revenue** when received and expensed when distributed to the beneficiary.

DR	Asset		XXX	
CR		Contribution revenue		XXX

3. Financially Interrelated – Granted Variance Power

An organization **financially interrelated** with a beneficiary that accepts assets from a donor and agrees to use or manage them on behalf of beneficiary but **is granted variance power** follows donee accounting.

a. Assets are valued at fair value.

b. Assets are recognized as **contribution revenue** when received and expensed when distributed to the beneficiary.

DR	Asset		XXX	
CR		Contribution revenue		XXX

C. GENERAL PRINCIPLES: BENEFICIARY ACCOUNTING

1. Recognition Rule

Specified beneficiaries recognize their rights to assets held by others (the recipient) unless the recipient is explicitly granted variance power.

2. Recognized Rights

Rights, when recognized, will be recorded as any one of the following:

a. An interest in the net assets of the recipient,

b. A beneficial interest, or

c. A receivable and contribution revenue.

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3. Recognized Interest – Financially Interrelated

Beneficiaries recognize an interest in the net assets of the recipient when the organizations are financially interrelated.

a. The interest in the net assets of the recipient is adjusted for the beneficiary's share of the change.

DR	Interest in net assets	XXX	
CR	Equity transaction (Statement of Activities)		XXX

4. Recognized Beneficial Interest—Pools of Assets

Beneficiaries recognize a beneficial interest in an unconditional right to receive specified cash flows from pools of assets

a. Measurements and remeasurements serve to present assets at fair value using discounting or other techniques.

DR	Beneficial interest	XXX	
CR	Contribution revenue		XXX

5. Recognized Receivable and Contribution Revenue

In cases that do not involve recognition of net assets or beneficial interests, the beneficiary recognizes a receivable and contribution revenue consistent with treatment of all other unconditional promises to give.

DR	Receivable	XXX	
CR	Contribution revenue		XXX

D. RECIPIENT ACCOUNTING, ASSETS RECOGNIZED AS EQUITY

Assets transferred to recipient organizations are not contributions and are accounted for as an equity transaction when **all** of the following conditions are met:

1. The resource provider specifies itself or an affiliate as the beneficiary.
2. The resource provider and the recipient are financially interrelated.
3. The resource provider does not expect payment of the transferred assets.

E. EQUITY TRANSACTION REPORTING—Resource Provider Accounting

1. A resource provider that specifies itself as a beneficiary reports an equity transaction as an interest in the net asset of the recipient organization.
2. A resource provider that specifies an affiliate as its beneficiary reports an equity transaction as a separate line item on its statement of activities.
   a. The affiliate will report an interest in the recipient organization.
   b. The recipient organization will report an equity transaction as a separate line item in its statement of activities.

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F. DISCLOSURES BY RESOURCE PROVIDERS

Organizations (not-for-profit resource providers) that transfer assets to a recipient organization and specify either themselves or an affiliate as the beneficiary disclose the following.

1. Identity of the recipient organization.
2. Whether variance power was granted and the terms of the variance power, if applicable.
3. Terms under which assets will be distributed to the resource provider.
4. Aggregate amount recognized in the statement of financial position as transfers and the character of the transfer recognition as either:
   a. An interest in net assets, or
   b. Another asset (refundable advance or other)

   Organizations that disclose the ratio of fund-raising expenses to amounts raised will also disclose the methodology used to compute that ratio.

CONCEPT EXAMPLE

Farleigh Stated University, a private not-for-profit institute of higher learning, established the Farleigh Stated Foundation, Inc., a not-for-profit corporation, to raise funds for the university and to account for and manage the investments of the university. The university establishes an agreement with the foundation to accept transfer of the investments and agrees to return both principal and interest on the investments to the university upon request by the university and approval of the foundation's board. The university fully anticipates that no reasonable request will be denied.

How should the university and the foundation account for this transaction?

Farleigh Stated University
The university has made a donation to a not-for-profit organization and made itself the beneficiary. The university would:

- Take the investments on their statement of financial position;
- Record a beneficial interest (an asset) in the assets of the foundation; and
- Disclose the nature of the agreement and aggregate amount displayed on the statement of financial position related to the transaction.

Farleigh Stated University Foundation, Inc.
The foundation has received a donation in which the resource provider, the university, has named itself as the beneficiary. The foundation does not have variance power related to these investments since they are obligated to return the assets to the university. The foundation would:

- Record the investments at fair market value on their statement of financial position;
- Record a liability due to Farleigh Stated University for the full amount of the investments;
- Present appropriate disclosures.

Note that this is not an equity transaction. The transaction did not meet all three of the criteria required for equity treatment. Although the resource provider did name itself as a beneficiary and the university and foundation may be financially interrelated, the university fully anticipates return of both principal and interest.

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X. OTHER ACCOUNTING ISSUES

A. INVESTMENTS IN SECURITIES

1. Fair Value

All debt securities and those equity securities that have readily determinable fair values are measured at fair value in the statement of financial position.

2. Gains and Losses (Realized and Unrealized)

Gains and losses on investments are reported in the statement of activities as increases or decreases in unrestricted net assets unless the use of the investment is restricted, either temporarily or permanently, by explicit donor stipulations or by law. Allocate pooled investment gains and losses equitably.

a. Market Losses on Permanently Restricted Net Assets

(1) Typically, revenues and gains from permanently restricted net assets are identified for specific uses by the donor and are classified as temporarily restricted.

(2) Losses on investments of a donor-restricted permanent fund first go to reduce temporarily restricted net assets to the extent that previously recognized gains have not been earned or used in the temporarily restricted category and are then applied to unrestricted net assets.

(3) Calculated amounts that reduce temporarily restricted and unrestricted net assets in the event of a loss on endowment funds is generally done on a fund by fund basis rather than in the aggregation for all endowment funds.

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EXAMPLE

Crisis Outreach, Inc., a not-for-profit voluntary health and welfare organization received a $500,000 permanent endowment. The donor stipulated that the income must be used for a mental health program. The endowment fund reported $60,000 net decrease in market value and $30,000 investment income. The organization spent $45,000 on the mental health program during the year. What amount of change in temporarily restricted net assets should the organization report?

a. $75,000 decrease.
b. $15,000 decrease.
c. $0
d. $425,000 increase.

RULE: Generally, losses on the investments of a donor-restricted endowment fund serve to reduce temporarily restricted net assets to the extent that donor-imposed temporary restrictions on net appreciation (cumulative losses minus gains) of the fund have not been met before the loss occurs. Any remaining loss reduces unrestricted net assets.

Choice "c" is correct. The change in temporarily restricted net assets is comprised of the increase in temporarily restricted net assets related to investment earnings and the amounts released from temporary restrictions. Losses in excess of satisfaction of donor-restricted stipulations are treated as unrestricted as follows.

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Mental Health Program				
Investment Income		30,000		
Release restriction	30,000	(30,000)		
Expenses	(45,000)	0		
Subtotal	(15,000)	0		
Investments				
Losses	(60,000)			
Beginning of year	0	0	500,000	500,000
End of year	(75,000)	0	500,000	425,000

The decline in fair value of the assets of the endowment fund first reduces the temporarily restricted net assets and then reduces unrestricted net assets.

3. Derivatives

A not-for-profit organization should recognize the change in fair value of all derivatives in the period of the change. Not-for-profits are not permitted to use special hedge accounting rules.

4. Dividends, Interest, and Other Investment Income

Investment income (e.g., dividends and interest) is reported in the period earned as increases in unrestricted net assets unless the use of the investment is restricted, either temporarily or permanently, by explicit donor stipulations or by law. Allocate pooled investment income equitably.

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5. Donor's Stipulation

The nature of the donor's stipulation determines how to recognize both gains and losses and investment income. Donor-restricted investment income is reported as an increase in temporarily or permanently restricted net assets, depending on the donor's stipulation. Gains and losses that are limited to specific uses by donor stipulations may be reported as increases in unrestricted net assets *if* the stipulations are met in the same reporting period as the gains and income are recognized.

B. BASIS OF ASSETS

1. Purchased fixed assets are carried at cost, as required by GAAP.
2. Fixed assets donated to the NFP are recorded at FMV at the date of the gift.
3. Depreciation is recorded in accordance with GAAP for non-governmental not-for-profit organizations.
   a. However, works of art and historical treasures are not depreciated.

C. SPECIAL FUNDS USED IN NOT-FOR-PROFIT INTERNAL ACCOUNTING

1. Fund Accounting

Fund accounting is only appropriate for internal reporting of private not-for-profit organizations and external reporting of governmental not-for-profit organizations (such as city hospitals, state universities, etc.). Funds can be disclosed in the notes, however, for external financial statements of private not-for-profit organizations.

2. Endowment Fund

An endowment fund (consisting of permanently restricted net assets) is used to account for donated assets, the principal of which must be retained intact.

a. Permanent Endowment

(1) Income is expendable as directed by the donor and recorded based on donor restrictions. Corpus (principal) is not permitted to be spent.

(2) The accounting is the same as a "Permanent Trust Fund" in governmental accounting.

b. Term Endowment

Term endowments consist of assets that must be held for a specified term, in accordance with the donor's stipulations. They are reported as temporarily restricted net assets.

c. Quasi-endowment

A quasi-endowment fund is used when the internal governing board of an institution (not the donor) has determined that funds are to be retained and invested for specified (other than loan or plant) purposes. They are appropriations of unrestricted net assets.

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EXAMPLE

On December 30, 1994, Leigh Museum, a not-for-profit organization, received a $7,000,000 donation of Day Co. shares with donor stipulated requirements as follows:

- Shares valued at $5,000,000 are to be sold with the proceeds used to erect a public viewing building.
- Shares valued at $2,000,000 are to be retained with the dividends used to support current operations.

Leigh elected early adoption of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations.* As a consequence of the receipt of the Day shares, how much should Leigh report as temporarily restricted net assets on its 1994 statement of financial position?

a. $0
b. $2,000,000
c. $5,000,000
d. $7,000,000

Solution: Choice "c" is correct. The shares valued at $5,000,000, which are designated for sale with proceeds used to erect a building would be classed as a temporarily restricted net asset. The shares valued at $2,000,000 would be classed as a permanently restricted net asset, since they are to be retained by the organization and the dividends used to support current operations. SFAS 117 para. 15

XI. NOT-FOR-PROFIT SPECIFIC INDUSTRY APPLICATIONS

Specific industries have transactions that are unique to those industries. Accounting for those transactions occurs within the context of the overarching accounting and reporting considerations of not-for-profit accounting. Prior to the implementation of SFAS 116 and SFAS 117, significant attention was paid to the nuances of each industry. Prior CPA exam history provides a number of questions related to these topics. For that reason we provide specific industry applications of not-for-profit accounting principles.

A. COLLEGES AND UNIVERSITIES (INSTITUTIONS OF HIGHER LEARNING)

1. General

COLLEGES AND UNIVERSITIES

The primary objective in financial reporting for colleges and universities is accounting for the resources received by the institution and for the uses of these resources in accordance with any restrictions that are imposed.

General goals usually include accounting for costs expended for (1) instruction, (2) acquisition of capital assets, (3) research, and (4) acquisition of goods and services.

Accounting and reporting for transactions in not-for-profit colleges and universities follows general principles; however, there are some unique applications that are tested from time to time.

2. Revenues and Expenses

a. Revenues

Revenues consist of all increases in unrestricted net assets and *all restricted* resources that were actually *expended* during the period, such as:

(1) Student tuition and fees. These should be reported at gross amount. Scholarships, tuition waivers, and similar reductions are considered either expenditures or a separately displayed allowance reducing revenue.

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(2) Government aid, grants, and contracts.

(3) Gifts and private grants.

(4) Endowment income.

(5) Sales and services of educational departments, such as publications and testing services.

(6) Revenues of auxiliary enterprises, such as food service, residence halls, campus store, and athletics.

PASS KEY

Many prior CPA Examination questions have required students to compute gross revenue from tuition and fees:

Assessed Student Tuition and Fees
< Cancelled Classes >
Gross Revenue from Tuition and Fees

b. Restricted Revenues and Gains

Restricted revenues and gains, whether permanently or temporarily restricted, are reported in the statement of activities. They are reported as changes in temporarily or permanently restricted net assets.

c. Expenses

Expenses are decreases in unrestricted net assets and may include such items as:

(1) Scholarship and Fellowship

(2) Maintenance and Operation

(3) Administration and Institutional

(4) Research

(5) Teaching

(6) Public Service Programs

(7) Auxiliary Enterprises

(8) Libraries

(9) Student Services

d. Gains and Losses

Gains and losses on investments and other assets, classified as unrestricted, temporarily restricted, or permanently restricted, are reported in the statement of activities.

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Sample Educational Institution
Statement of Activities
Year Ended June 30, 20X1
(IN THOUSANDS)

	Unrestricted	*Temporarily Restricted*	*Permanently Restricted*	*Total*
REVENUE, GAINS, AND OTHER SUPPORT				
Tuition and fees	$ 4,860	$ -	$ -	$ 4,860
Less: Institutional aid and scholarships	(1,260)	-	-	(1,260)
Net tuition and fees	3,600	-	-	3,600
Contributions	1,300	300	80	1,680
Income and realized gains on investments, net	1,200	425	-	1,625
Auxiliary enterprises	1,050	-	-	1,050
Government grants	225	209	-	434
Other	40	-	-	40
Unrealized gains on investments	125	-	-	125
Net assets released from restrictions	130	(130)	-	-
Total revenue, gains, and other support	7,670	804	80	8,554
EXPENSES				
Program expenses:				
Educational and general				
Instruction	3,220	-	-	3,220
Research	1,180	-	-	1,180
Public services	520	-	-	520
Academic support	450	-	-	450
Student services	390	-	-	390
Financial aid	540	-	-	540
Total educational and general expense	6,300	-	-	6,300
Auxiliary enterprises	710	-	-	710
Total program expenses	7,010	-	-	7,010
Supporting services:				
Management and general	582	-	-	582
Fund-raising	130	-	-	130
Total supporting services	712	-	-	712
Total expenses	7,722	-	-	7,722
CHANGE IN NET ASSETS	(52)	804	80	832
NET ASSETS AT BEGINNING OF YEAR	4,350	2,790	1,040	8,180
NET ASSETS AT END OF YEAR	$ 4,298	$ 3,594	$ 1,120	$ 9,012

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B. HEALTH CARE ORGANIZATIONS

Health care organizations are similar to commercial entities as is evidenced by their profit-oriented nature. Private not-for-profit health care organizations also record depreciation in the same manner as other for-profit entities. Even though the AICPA Audit Guide, *Health Care Organizations* encompasses many more health care entities than hospitals, the primary focus here is on hospitals.

Accounting and reporting for transactions in not-for-profit healthcare organizations follow general principles, however, there are some unique applications that are tested from time to time.

1. Revenue

Revenues of a health care organization are increases in unrestricted net assets and are reported by their source.

a. Patient Service Revenue

Patient service revenue should be accounted for on the accrual basis at established standard rates (usual and customary fees), even if the full amount is not expected to be collected. Although patient service revenue is accounted for on a gross basis, deductions are made from gross revenue for reporting purpose. Central transactions include medical services such as doctors, surgery, recovery room, and room and board.

(1) Charity Care

Charity care is defined as health care services that are provided but never expected to result in cash flows to the hospital.

(a) Management's policy for providing charity care (as well as the level of charity care provided) should be disclosed in the financial statements.

(b) Charity care is not recorded as a receivable or as revenue.

(c) Charity care is not recorded as a bad debt expense.

(2) Deductions

Deductions from patient service revenue to arrive at "net patient service revenue" include the following for uncompensated services:

(a) Contractual adjustments for third-party payments

(b) Policy discounts

(c) Administrative adjustments

(3) Premium Revenue for Capitation Agreements

Capitation revenues are the fixed amount per individual that is paid periodically, usually monthly, to a provider as compensation for providing health care services for that period.

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PASS KEY

Prior CPA Examination questions have required candidates to compute "Patient Service Revenue"; use this formula to answer these questions correctly:

Gross Patient Service Revenue
< Charitable Services >
Patient Service Revenue

b. Other Operating Revenue

Other operating revenue of a health care organization may include:

(1) Tuition from schools
(2) Revenues from educational programs
(3) Donated supplies and equipment
(4) Specific purpose grants
(5) Revenues from auxiliary activities
(6) Cafeteria revenue
(7) Parking fees
(8) Gift shop revenue
(9) Medical transcription fees

c. Non-operating Revenue and Support Gains and Losses

Non-operating revenue and gains and losses of a health care organization may include:

(1) Unrestricted interest and dividend income from investment activities
(2) Unrestricted gifts and bequests
(3) Unrestricted grants
(4) Unrestricted income from endowment funds
(5) Unrestricted income from board-designated funds
(6) Donated services

PASS KEY

Many prior CPA Examination questions have required candidates to identify which of the three categories of revenue a particular item of income is to be reported in:

I. Patient service revenue
II. Other operating revenue
III. Non-operating revenue

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2. Special Items Related to Not-for-Profit Healthcare Providers

a. Donated Supplies

Contributions of items that are not long-lived assets are recognized as revenue in the period received and as assets or a reduction of liabilities or expenses, depending on the form of the benefits received. For example, a donation of medical supplies over which the hospital has variance power should be recorded as a revenue and as an increase in supplies inventory or supplies expense. The donation is measured at fair value.

Journal Entry: To record the unrestricted donation of medical supplies

DR	Supplies inventory or expense	$XXX	
CR	Unrestricted contributions—other operating revenue		$XXX

3. Classification of Typical Hospital Expenses

Expenses are decreases in unrestricted net assets. The typical expenses of a health care organization are categorized by function and include:

a. Nursing services

b. Other professional services

c. General services

d. Administrative services

e. Bad debts

f. Depreciation

g. Interest

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Sample Hospital
Statement of Activities
Year Ended June 30, 20X1
(IN THOUSANDS)

	Unrestricted	*Temporarily Restricted*	*Permanently Restricted*	*Total*
REVENUE, GAINS, AND OTHER SUPPORT				
Net patient service revenue **	$ 5,324	$ –	$ –	$ 5,324
Contributions and gifts	895	420	–	1,315
Investment return designated for current operations	1,426	592	–	2,018
Other investment income	310	–	95	405
Federal grants and contracts	80	980	–	1,060
State grants	110	–	–	110
Private gifts and grants	55	–	–	55
Auxiliary enterprises	640	–	–	640
Other services	40	–	–	40
Net assets released from restrictions	1,786	(1,786)	–	–
Total revenue	10,666	206	95	10,967
EXPENSES				
Program expenses:				
Patient care	4,980	–	–	4,980
Research	2,290	–	–	2,290
Public services	530	–	–	530
Health education	594	–	–	594
Auxiliary enterprises	715	–	–	715
Total program expenses	9,109	–	–	9,109
Supporting services:				
Management and general	694	–	–	694
Fund-raising	183	–	–	183
Total supporting services	877	–	–	877
Total expenses	9,986	–	–	9,986
CHANGE IN NET ASSETS	680	206	95	981
NET ASSETS, BEGINNING OF YEAR	9,876	4,778	959	15,613
NET ASSETS, END OF YEAR	$ 10,556	$ 4,984	$ 1,054	$ 16,594

Revenue from health care services is reported **net of contractual adjustments and other adjustments.

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C. VOLUNTARY HEALTH AND WELFARE ORGANIZATIONS

VOLUNTARY HEALTH AND WELFARE ORGANIZATIONS

Voluntary health and welfare entities are non-profit organizations that obtain most of their operating funds by donations from the general public. The majority of these organizations use their resources to improve the overall health and welfare of a specific segment of society. Many of these voluntary groups focus their efforts on problems involving the health and welfare of indigent individuals (e.g., American Red Cross).

Accounting and reporting for transactions in voluntary health and welfare organizations follow general principles, however, there are some unique applications that are tested from time to time.

1. Basis of Accounting

When financial statements are presented in conformity with GAAP, the full accrual basis of accounting is required. The cash basis or modified accrual basis may be used only if the resulting financial statements do not materially differ from those prepared under the accrual method.

2. Income

To a large extent, voluntary health and welfare organizations depend upon contributions and pledges from the general public to support the activities of the organization.

(a) Contributions may be in cash or pledges (unconditional or conditional promises to contribute), and also may be unrestricted or restricted.

(b) Contributions collected by other organizations and earmarked for a voluntary health and welfare organization should be accounted for as receivables.

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EXAMPLE

Assume the following amounts are received:

Unrestricted pledges	$100,000
Restricted cash	25,000
Membership dues (paid in cash)	8,000
Unrestricted cash from a fund-raising party	15,000
Restricted pledges	30,000

Uncollectible pledges are estimated to be 1% of the gross amount.

Journal Entries: To record unrestricted and restricted funds

Unrestricted:

DR	Pledges receivable	$100,000	
DR	Cash	23,000	
CR	Public support—contributions		$99,000
CR	Estimated uncollectible pledges		1,000
CR	Public support—special events		15,000
CR	Revenue—membership dues		8,000

Restricted:

DR	Pledges receivable	$30,000	
DR	Cash	25,000	
CR	Estimated uncollectible pledges		300
CR	Public support—contributions		$54,700

3. Statement of Functional Expenses

This statement is simply a detailed schedule of the expenses of the voluntary health and welfare organization, divided into functional areas, such as program services and support services.

PASS KEY

Fund-raising expenses associated with fund-raising appeals must be shown separately on the face of the financial statements either as an expense or as a deduction from revenues. Fund-raising support may not be displayed as a simple net amount.

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Sample Voluntary Health and Welfare Organization
Statement of Activities
Year Ended December 31, 20X1
(IN THOUSANDS)

	Unrestricted	*Temporarily Restricted*	*Permanently Restricted*	*Year ended Dec 31, 20X1*	*Year ended Dec 31, 20X0*
SUPPORT AND REVENUE					
Support:					
Contributions	$ 3,764	$ 234	$ 2	$ 4,000	$ 4,126
Appropriations from affiliated organizations	275	-	-	275	308
Legacies and bequests	92	-	4	96	129
Special event revenues	285	-	-	285	255
Direct benefits to special event attendees	(181)	-	-	(181)	(163)
Total support	4,235	234	6	4,475	4,655
Revenue:					
Program revenue *					
Membership dues	17	-	-	17	12
Fees	30	-	-	30	36
Total program revenues	47	-	-	47	48
Investment income	298	10	25	333	94
Rental Income	12	-	-	12	11
Total revenues	357	10	25	392	153
NET ASSETS RELEASED FROM RESTRICTIONS	100	(100)	-	-	-
Total revenues and other support	4,692	144	31	4,867	4,808
EXPENSES					
Program expenses:					
Research	1,414	-	-	1,414	1,365
Public health and education	544	-	-	544	485
Professional education and training	618	-	-	618	516
Community services	578	-	-	578	486
Total program expenses	3,154	-	-	3,154	2,852
Supporting services:					
Management and general	574	-	-	574	638
Fund-raising	654	-	-	654	546
Total supporting services	1,228	-	-	1,228	1,184
Total expenses	4,382	-	-	4,382	4,036
CHANGE IN NET ASSETS	310	144	31	485	772
NET ASSETS AT BEGINNING OF YEAR	5,361	772	2,017	8,150	7,378
NET ASSETS AT END OF YEAR	$ 5,671	$ 916	$ 2,048	$ 8,635	$ 8,150

* Note: Other examples of program revenue would include "public agencies," "education," and "government fund program."

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Voluntary Health and Welfare Organization
Statement of Functional Expenses

Year Ended December 31, 20X1 with Comparative Totals for 20X0

	20X1									
	Program Expenses					Supporting Services*			Total Expenses	
	Research	Public Health Education	Professional Education & Training	Community Services	Total	Manage-ment and General	Fund Raising	Total	20X1	20X0
Salaries	$ 45	$ 291	$ 251	$ 269	$ 856	$ 331	$ 368	$ 699	$ 1,555	$ 1,433
Employee health and retirement benefits	4	14	14	14	46	22	15	37	83	75
Payroll taxes, etc.	2	16	13	14	45	18	18	36	81	75
Total salaries and related expenses	51	321	278	297	947	371	401	772	1,719	1,583
Professional fees and contract service payments	1	10	3	8	22	26	8	34	56	53
Supplies	2	13	13	13	41	18	17	35	76	71
Telephone and telegraph	2	13	10	11	36	15	23	38	74	68
Postage and shipping	2	17	13	9	41	13	30	43	84	80
Occupancy	5	26	22	25	78	30	27	57	135	126
Rental of equipment	1	24	14	4	43	3	16	19	62	58
Local transportation	3	22	20	22	67	23	30	53	120	113
Conferences, conventions, meetings	8	19	71	20	118	38	13	51	169	156
Printing and publications	4	56	43	11	114	14	64	78	192	184
Awards and grants	1,332	14	119	144	1,609	—	—	—	1,609	1,448
Miscellaneous	1	4	6	4	15	16	21	37	52	64
Total expense before depreciation	1,412	539	612	568	3,131	567	650	1,217	4,348	4,004
Depreciation on buildings and equipment	2	5	6	10	23	7	4	11	34	32
Total expenses	$1,414	$ 544	$ 618	$ 578	$3,154	$ 574	$ 654	$1,228	$4,382	$4,036

***Note:** Membership Administration could also have been a separate column under "Supporting Services."

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XII. SUMMARY COMPARISONS OF NON-PROFIT ORGANIZATIONS

A. SOURCES OF REVENUES OF NON-PROFIT ORGANIZATIONS

Colleges and Universities
Tuition and fees
Federal, state, or local grants and contracts and appropriations
Private gifts, grants, and contracts
Endowment income
Sales and service of educational activities (film rentals, testing services, etc.)
Sales and services of other activities (residence halls, food services, etc.)

Health Care Organizations
Patient service revenue (gross)
Less: Deductions (charity allowances, other allowances, etc.)
Net patient service revenue
Premium revenue
Other revenue, gains/losses:
Tuition from schools, specific-purpose grants, revenue from auxiliary enterprises, etc.
Unrestricted gifts and grants
Unrestricted income from endowment funds
Donated services

Voluntary Health and Welfare Organizations
REVENUE:
Membership dues
Investment income
Realized gains on investment activities
PUBLIC SUPPORT:
Public contributions
Special events
Legacies and bequests
Donated material and services

B. CLASSIFICATION OF EXPENSES OF NON-PROFIT ORGANIZATIONS

Colleges and Universities
Instruction
Academic instruction
Community education
Research
Institutes and centers
Project research
Public service
Community service
Conference and institutes
Extension service
Academic support
Computer services
Libraries
Student services
Admissions
Counseling
Financial aid
Health and infirmary
Intramural athletics
Student organizations
Registrar
Remedial instruction
Institutional support
Operation and maintenance of plant
Scholarships and Fellowships
Auxiliary enterprises

Health Care Organizations
Nursing services
Other professional services
General services
Fiscal services
Administrative services
Depreciation
Interest expense
Provision for bad debts

Voluntary Health and Welfare Organizations
PROGRAM SERVICES:
Research
Public education
Professional education and training
Community service
Other
SUPPORT SERVICES:
Management and general
Fund-raising

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APPENDIX
Internal Reporting for Not-for-Profit Organizations
(Fund Accounting)

I. GENERAL INFORMATION

(I) Fund accounting was eliminated for external reporting by FAS 117, in favor of accounting by classification of net assets.

(ii) GAAP permits not-for-profit organizations to continue to disclose information based upon internally maintained funds (i.e., fund accounting), provided the data regarding net assets (as required by FAS 117) is also presented.

II. SEVEN BASIC TYPES OF FUNDS USED BY NOT-FOR-PROFIT ORGANIZATIONS

The seven basic types of funds used by not-for-profit organizations are listed below. They may contain characteristics of unrestricted, temporarily restricted, or permanently restricted net assets.

A. UNRESTRICTED CURRENT (OR UNRESTRICTED OPERATING OF GENERAL) FUNDS

1. These funds are used to record a not-for-profit's activities that are supported by resources over which the governing boards have discretionary control.
2. The fund balances generally consist of unrestricted net assets.

B. RESTRICTED CURRENT (OR RESTRICTED OPERATING OR SPECIFIC-PURPOSE FUNDS)

1. These funds are used to record a not-for-profit's activities that are supported by resources whose use is limited by external parties to specific operating purposes.
2. The fund balances are generally temporarily restricted.

C. PLANT (OR LAND, BUILDING, AND EQUIPMENT) FUNDS

1. These funds are used to account for investments in plant or resources available for plant and equipment.
2. The fund balances can be any classification of net assets.

D. LOAN FUNDS

1. These funds are used to account for loans made to students, employees, and other constituents and the resources available for these purposes.
2. The fund balances represent amounts available to lend and can be any classification of net assets.

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E. ENDOWMENT FUNDS

1. These funds are used to account for assets whose income is used for the maintenance of the not-for-profit.
2. The fund balances can be any classification of net assets and are generally titled as follows:
    a. Permanent Endowment (permanently restricted)
    b. Term Endowment (temporarily restricted)
    c. Quasi-endowment (board designated or unrestricted)

F. ANNUITY AND LIFE INCOME (SPLIT INTEREST) FUNDS

1. These funds are used to account for resources provided by donors under various kinds of agreements in which the organization has a beneficial interest but is not the sole beneficiary.
2. The fund balances can be any classification of net assets, depending on the character of the donation associated with the annuity or life income fund.

G. AGENCY (OR CUSTODIAN) FUNDS

1. These funds are used to account for resources held by the entity as an agent for resource providers before those resources are transferred to third parties. The not-for-profit has little or no discretion over the use of those resources.
2. Agency transactions are not associated with any classification of net assets but are reflected as a liability.

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MATRIX OF FINANCIAL STATEMENTS REQUIRED FOR VARIOUS FUNDS

		Governmental					Proprietary		Fiduciary			
		G	R	S	P	P	S	E	P	A	P	I
		GENERAL	REVENUE (SPECIAL)	SERVICE (DEBT)	PROJECTS (CAPITAL)	PERMANENT	SERVICE (INTERNAL)	ENTERPRISE	PENSION	AGENCY	PRIVATE PURPOSE	INVESTMENT
BALANCE SHEET	• Balance Sheet Current Assets Current Liabilities Fund Balance	X	X	X	X	X						
	• Statement of Net Assets Assets Liabilities Net Assets						X	X				
	• Statement of Fiduciary Net Assets Assets Liabilities Net Assets								X	X	X	X
INCOME STATEMENT	• Statement of Revenues, Expenditures, and Changes in Fund Balance Revenue Expenditures Other Financing Sources (Uses)	X	X	X	X	X						
	• Statement of Revenues, Expenses, and Changes in Fund Net Assets Operating Revenue Operating Expenses Non-operating Revenue and Expenses						X	X				
	• Statement of Changes in Fiduciary Net Assets Additions Deductions								X	–	X	X
CASH FLOWS	• Statement of Cash Flows Operating Investing Capital Financing Non-capital Financing						X	X				
	METHODS OF ACCOUNTING											
	• Full Accrual						X	X	X	X	X	X
	• Modified Accrual Budget Activity Encumbrances	X ● ● ●	X ● ● ●	X ● ● –	X ● ● ●	X ● ● –						

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HOMEWORK READING

Governmental Accounting—Defining the Governmental Entity

GASB #39

"Defining Whether Certain Organizations Are Component Units," GASB #39 describes the circumstances under which not-for-profit organizations should be considered a component unit of a government. To address the issue of integration of not-for-profit and governmental organizations within a government's financial statements, the standard refines the criteria for the determination of component units beyond financial accountability to include consideration of the financial integration criteria applicable to not-for-profit organizations (developed in SFAS 136) and additional specific criteria.

I. ACCOUNTING ISSUE

Not-for-profit organizations that provide ongoing support to a primary government or to a component unit of that primary government may also be a component unit of the primary government. Example transactions include:

(i) Private foundations associated with State Universities

(ii) Private foundations associated with public health care facilities

II. CRITERIA FOR DISCRETE PRESENTATION

Legally separate, tax-exempt organizations should be reported as a discrete (separate column) component unit if they meet all of the following criteria:

A. Resources held by the tax-exempt organization are for the near-exclusive benefit of the primary government (benefit standard).

B. The primary government has access to a majority of the resources held by the tax-exempt organization (access standard).

C. Resources held by the tax-exempt organization are significant to the primary government (significance standard).

III. CRITERIA FOR OTHER COMPONENT UNIT PRESENTATION

Legally separate, tax-exempt organizations meeting the criteria of a financially integrated entity (SFAS 136) should be classified as a component unit of the primary government if their relationship to that government is so significant as to make the financial statements misleading without component unit treatment.

A. Financial Integration Criteria are described earlier in this lecture.

B. Presentation: Organizations meeting the more generalized criteria associated with financial integration should be presented on either a blended or discrete basis depending on the circumstance.

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EXAMPLE

State University Foundation, Inc. was created as a private tax-exempt not-for-profit organization to support State University, a governmentally organized and supported institute of higher learning. The criteria for State University Foundation, Inc. to be displayed as a discretely reported component unit within the financial statements of State University would include all but the following:

a. The State University must have access to a majority of the resources.

b. The State University Foundation must have been established and operate for the benefit of the State University.

c. The resources of State University Foundation, Inc. must be significant to State University.

d. The Board of Directors of the State University Foundation, Inc and the Board of Regents of State University must be fifty percent interlocking.

Solution: Choice "d" is correct. Classification of a private not-for-profit organization as component unit of a governmental organization with discrete presentation does not require overlapping governance.

Criteria for classification and presentation of a private not-for-profit organization as a discrete component unit of a primary government are all three of the following:

Benefit. The private organization must be for the near exclusive benefit of the primary government.

Access. The primary government must have access to the resources of the private not-for-profit organization.

Significance. Resources of the private not-for-profit organization must be significant to the primary government.

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FINANCIAL ACCOUNTING & REPORTING 9
Class Questions Answer Worksheet

MC Question Number	First Choice Answer	Correct Answer	NOTES
1.			
2.			
3.			
4.			
5.			
6.			
7.			
8.			
9.			
10.			
11.			
12.			
13.			
14.			
15.			
16.			

Grade:

Multiple-choice Questions Correct / 16 = _____% Correct

Detailed explanations to the class questions are located in the back of this textbook.

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NOTES

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CLASS QUESTIONS

1. CPA-00975

The statement of activities of the government-wide financial statements is designed primarily to provide information to assess which of the following?

a. Operational accountability.
b. Financial accountability.
c. Fiscal accountability.
d. Functional accountability.

2. CPA-00995

Which of the following statements about the statistical section of the Comprehensive Annual Financial Report (CAFR) of a governmental unit is true?

a. Statistical tables may not cover more than two fiscal years.
b. Statistical tables may not include non-accounting information.
c. The statistical section is not part of the basic financial statements.
d. The statistical section is an integral part of the basic financial statements.

3. CPA-01141

South City School District has a separately elected governing body that administers the public school system. The district's budget is subject to the approval of the city council. The district's financial activity should be reported in the City's financial statements by:

a. Blending only.
b. Discrete presentation.
c. Inclusion as a footnote only.
d. Either blending or inclusion as a footnote.

4. CPA-01044

A municipality preparing its basic financial statements and required supplementary information in accordance with GASB #34 would introduce the basic financial statements and provide analytical overview of the government's financial statements in:

a. A section titled Management's Discussion and Analysis only in the event that the basic financial statements are issued in connection with a public bond offering.
b. A section titled Management's Discussion and Analysis included as part of the city's required supplementary information following the financial statements.
c. A section titled Management's Discussion and Analysis included as part of the city's optional supplementary information immediately following the notes to the financial statements but before the required supplementary information.
d. A section titled Management's Discussion and Analysis included as part of the city's required supplementary information before the basic financial statements.

5. CPA-01171

The portion of special assessment debt maturing in 5 years, to be repaid from general resources of the government, should be reported in the:

a. General fund.
b. Government-wide statement of net assets.
c. Agency fund.
d. Capital projects fund.

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6. CPA-00960

Tree City reported a $1,500 net increase in fund balance for governmental funds. During the year, Tree purchased general capital assets of $9,000 and recorded depreciation expense of $3,000. What amount should Tree report as the change in net assets for governmental activities?

a. ($4,500)
b. $1,500
c. $7,500
d. $10,500

7. CPA-00989

Dogwood City's water enterprise fund received interest of $10,000 on long-term investments. How should this amount be reported on the Statement of Cash Flows?

a. Operating activities.
b. Non-capital financing activities.
c. Capital and related financing activities.
d. Investing activities.

8. CPA-00980

According to GASB 34, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments*, certain budgetary schedules are required supplementary information. What is the minimum budgetary information required to be reported in those schedules?

a. A schedule of unfavorable variances at the functional level.
b. A schedule showing the final appropriations budget and actual expenditures on a budgetary basis.
c. A schedule showing the original budget, the final appropriations budget, and actual inflows, outflows, and balances on a budgetary basis.
d. A schedule showing the proposed budget, the approved budget, the final amended budget, actual inflows and outflows on a budgetary basis, and variances between budget and actual.

9. CPA-01222

Pharm, a non-governmental not-for-profit organization, is preparing its year-end financial statements. Which of the following statements is required?

a. Statement of changes in financial position.
b. Statement of cash flows.
c. Statement of changes in fund balance.
d. Statement of revenue, expenses and changes in fund balance.

10. CPA-01220

Stanton College, a not-for-profit organization, received a building with no donor stipulations as to its use. Stanton does not have an accounting policy implying a time restriction on donated assets. What type of net assets should be increased when the building was received?

I. Unrestricted.
II. Temporarily restricted.
III. Permanently restricted.

a. I only.
b. II only.
c. III only.
d. II or III.

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11. CPA-01255

The Jackson Foundation, a not-for-profit organization, received contributions in 1996 as follows:

- Unrestricted cash contributions of $500,000.
- Cash contributions of $200,000 to be restricted to acquisition of property.

Jackson's statement of cash flows should include which of the following amounts?

	Operating activities	*Investing activities*	*Financing activities*
a.	$700,000	$0	$0
b.	$500,000	$200,000	$0
c.	$500,000	$0	$200,000
d.	$0	$500,000	$200,000

12. CPA-01212

State University received two contributions during the year that must be used to provide scholarships. Contribution A for $10,000 was collected during the year, and $8,000 was spent on scholarships. Contribution B is a pledge for $30,000 to be received next fiscal year. What amount of contribution revenue should the university report in its statement of activities?

a. $8,000
b. $10,000
c. $38,000
d. $40,000

13. CPA-01225

During 1997, Jones Foundation received the following support:

A cash contribution of $875,000 to be used at the board of directors' discretion;

A promise to contribute $500,000 in 1998 from a supporter who has made similar contributions in prior periods;

Contributed legal services with a value of $100,000, which Jones would have otherwise purchased.

At what amounts would Jones classify and record these transactions?

	Unrestricted revenue	*Temporarily restricted revenue*
a.	$1,375,000	$0
b.	$875,000	$500,000
c.	$975,000	$0
d.	$975,000	$500,000

14. CPA-01229

At the beginning of the year, the Baker Fund, a non-governmental not-for-profit corporation, received a $125,000 contribution restricted to youth activity programs. During the year, youth activities generated revenues of $89,000 and had program expenses of $95,000. What amount should Baker report as net assets released from restrictions for the current year?

a. $0
b. $6,000
c. $95,000
d. $125,000

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15. CPA-01257

In its fiscal year ended June 30, 1995, Barr College, a large private institution, received $100,000 designated by the donor for scholarships for superior students. On July 26, 1995, Barr selected the students and awarded the scholarships. How should the July 26 transaction be reported in Barr's statement of activities for the year ended June 30, 1996?

a. As both an increase and a decrease of $100,000 in unrestricted net assets.
b. As a decrease only in unrestricted net assets.
c. By footnote disclosure only.
d. Not reported.

16. CPA-01287

In April 1995, Delta Hospital purchased medicines from Field Pharmaceutical Co. at a cost of $5,000. However, Field notified Delta that the invoice was being canceled and that the medicines were being donated to Delta. Delta should record this donation of medicines as:

a. A memorandum entry only.
b. A $5,000 credit to non-operating expenses.
c. A $5,000 credit to operating expenses.
d. Other operating revenue.

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