WILEY CPA EXAM REVIEW

Focus Notes

Financial Accounting and Reporting

FOURTH EDITION

Less Antman

• concepts  • problem-solving  • terms  • rules and criteria

JOHN WILEY & SONS, INC.
FOURTH EDITION

Less Antman

• concepts           • problem-solving           • terms • rules and criteria
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<th>Page</th>
</tr>
</thead>
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**Preface**

This publication is a comprehensive, yet simplified study program. It provides a review of all the basic skills and concepts tested on the CPA exam, and teaches important strategies to take the exam faster and more accurately. This tool allows you to take control of the CPA exam.

This simplified and focused approach to studying for the CPA exam can be used:

- As a handy and convenient reference manual
- To solve exam questions
- To reinforce material being studied

Included is all of the information necessary to obtain a passing score on the CPA exam in a concise and easy-to-use format. Due to the wide variety of information covered on the exam, a number of techniques are included:

- Acronyms and mnemonics to help candidates learn and remember a variety of rules and checklists
- Formulas and equations that simplify complex calculations required on the exam
• Simplified outlines of key concepts without the details that encumber or distract from learning the essential elements
• Techniques that can be applied to problem solving or essay writing, such as preparing a multiple-step income statement, determining who will prevail in a legal conflict, or developing an audit program
• Pro forma statements, reports, and schedules that make it easy to prepare these items by simply filling in the blanks
• Proven techniques to help you become a smarter, sharper, and more accurate test taker

This publication may also be useful to university students enrolled in Intermediate, Advanced and Cost Accounting, Auditing, Business Law, and Federal Income Tax classes.

Good Luck on the Exam,
Less Antman, CPA
About the Author

Less Antman, CPA has been preparing individuals for the CPA exam since 1979. For many years, he taught CPA review classes on a full-time basis for various programs, including Mark’s CPA Review Course and Kaplan CPA Review. He currently operates his own CPA review program in the state of California, under the name Antman CPA Review, located in Arcadia, California. He has taught more than 5,000 totally live CPA review classes, more than any other CPA review instructor in the United States, and his written materials have been used in several different instructor-based CPA review programs.
## Objectives of Financial Reporting

Financial statements are designed to meet the objectives of financial reporting:

<table>
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<th>Information Type</th>
<th>Objective</th>
</tr>
</thead>
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<td>Direct Information</td>
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</tr>
<tr>
<td>Statement of Earnings and Comprehensive Income</td>
<td>Direct Information</td>
<td>Entity Performance</td>
</tr>
<tr>
<td>Statement of Cash Flows</td>
<td>Direct Information</td>
<td>Entity Cash Flows</td>
</tr>
<tr>
<td>Financial Statements Taken As a Whole</td>
<td>Indirect Information</td>
<td>Management &amp; Performance</td>
</tr>
</tbody>
</table>
Qualitative Characteristics of Accounting Information

Primary Qualitative Characteristics

Ingredients

Secondary Qualitative Characteristics

Usefulness

Relevance

Predictive value

Feedback value

Timeliness

Reliability

Representational faithfulness

Verifiability

Neutrality

Consistency & Comparability

Focus on

Basic Concepts - Module 7
Elements of Financial Statements

Assets - Liabilities = Equity

Equity = Contributions by owners - Distributions to owners = Comprehensive Income

Comprehensive Income = Revenues - Expenses + Gains - Losses

Comprehensive Income = Net income ± Adjustments to stockholders' equity
Basic Rules & Concepts

Consistency
Realization
Conservatism
Recognition
Allocation
Matching
Full disclosure

You’ll get more credit (CR) if you CRAM your essays FULL of these rules and concepts
Revenue Recognition

Accrual method
Collection reasonably assured
Degree of uncollectibility estimable

Installment sale
Collection not reasonably assured

Cost recovery
Collection not reasonably assured
No basis for determining whether or not collectible

Installment Sales Method

Installment receivable balance × Gross profit percentage = Deferred gross profit (balance sheet)
Cash collections × Gross profit percentage = Realized gross profit (income statement)

Cost Recovery Method

All collections applied to cost before any profit or interest income is recognized
Converting from Cash Basis to Accrual Basis

**Revenues**

Cash (amount received) \( xx \)
Increase in accounts receivable (given) \( xx \)  
  - Decrease in accounts receivable (given) \( xx \)
  - **Revenues** (plug) \( xx \)

**Cost of Sales**

Cost of sales (plug) \( xx \)
Increase in inventory (given) \( xx \)
Decrease in accounts payable (given) \( xx \)  
  - Decrease in inventory (given) \( xx \)
  - Increase in accounts payable (given) \( xx \)
  - Cash (payments for merchandise) \( xx \)
Expenses

Expense (plug) xx
Increase in prepaid expenses (given) xx
Decrease in accrued expenses (given) xx
  Decrease in prepaid expenses (given) xx
  Increase in accrued expenses (given) xx
  Cash (amount paid for expense) xx

Balance Sheet

Current Assets
Cash
Trading securities
Current securities available for sale
Accounts receivable
Inventories
Prepaid expenses
Current deferred tax asset

Current Liabilities
Short-term debt
Accounts payable
Accrued expenses
Current income taxes payable
Current deferred tax liability
Current portion of long-term debt
Unearned revenues
<table>
<thead>
<tr>
<th>Long-Term Investments</th>
<th>Long-Term Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Noncurrent securities available for sale</td>
<td>Long-term notes payable</td>
</tr>
<tr>
<td>Securities held to maturity</td>
<td>Bonds payable</td>
</tr>
<tr>
<td>Investments at cost or equity</td>
<td>Noncurrent deferred tax liability</td>
</tr>
<tr>
<td><strong>Property, Plant, &amp; Equipment</strong></td>
<td></td>
</tr>
<tr>
<td>Intangibles</td>
<td><strong>Stockholders' Equity</strong></td>
</tr>
<tr>
<td><strong>Other Assets</strong></td>
<td>Preferred stock</td>
</tr>
<tr>
<td>Deposits</td>
<td>Common stock</td>
</tr>
<tr>
<td>Deferred charges</td>
<td>Additional paid-in capital</td>
</tr>
<tr>
<td>Noncurrent deferred tax asset</td>
<td>Retained earnings</td>
</tr>
<tr>
<td></td>
<td>Accumulated other comprehensive income</td>
</tr>
</tbody>
</table>
Current Assets & Liabilities

**Assets**
- Economic resource
- Future benefit
- Control of company
- Past event or transaction

**Liabilities**
- Economic obligation
- Future sacrifice
- Beyond control of company
- Past event or transaction

**Current Assets**
- Converted into cash or used up
- Longer of:
  - One year
  - One accounting cycle

**Current Liabilities**
- Paid or settled
- Longer of:
  - One year
  - One accounting cycle

**OR** Requires use of current assets

---

Focus on
Financial Statements - Module 7
Special Disclosures

**Significant Accounting Policies**

Inventory method  
Depreciation method  
Criteria for classifying investments  
Method of accounting for long-term construction contracts

**Related-Party Transactions**

Exceptions:  
- Salary  
- Expense reimbursements  
- Ordinary transactions
### Reporting the Results of Operations

#### Preparing an Income Statement

**Multiple step**

- Revenues
- Cost of sales
  - Operating expenses
    - Selling expenses
    - G & A expenses
  - Operating income
+ Other income
+ Gains
- Other expenses
- Losses
= Income before taxes
- Income tax expense
= Income from continuing operations

**Single step**

- Revenues
+ Other income
+ Gains
= Total revenues
- Costs and expenses
  - Cost of sales
  - Selling expenses
  - G & A expenses
  - Other expenses
  - Losses
= Income from continuing operations
**Computing Net Income**

Income from continuing operations (either approach)

± Discontinued operations

± Extraordinary items

= Net income

(Cumulative changes section was eliminated by SFAS 154)
## Errors Affecting Income

<table>
<thead>
<tr>
<th>Error (ending balance)</th>
<th>Current stmt</th>
<th>Prior stmt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset overstated</td>
<td>Overstated</td>
<td>No effect</td>
</tr>
<tr>
<td>Asset understated</td>
<td>Understated</td>
<td>No effect</td>
</tr>
<tr>
<td>Liability overstated</td>
<td>Understated</td>
<td>No effect</td>
</tr>
<tr>
<td>Liability understated</td>
<td>Overstated</td>
<td>No effect</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Error (beginning balance – ending balance is correct)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset overstated</td>
</tr>
<tr>
<td>Asset understated</td>
</tr>
<tr>
<td>Liability overstated</td>
</tr>
<tr>
<td>Liability understated</td>
</tr>
</tbody>
</table>
**Errors Affecting Income (continued)**

Error (beginning balance – ending balance is not correct)

<table>
<thead>
<tr>
<th>Description</th>
<th>Effect</th>
<th>Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset overstated</td>
<td>No effect</td>
<td>Overstated</td>
</tr>
<tr>
<td>Asset understated</td>
<td>No effect</td>
<td>Understated</td>
</tr>
<tr>
<td>Liability overstated</td>
<td>No effect</td>
<td>Understated</td>
</tr>
<tr>
<td>Liability understated</td>
<td>No effect</td>
<td>Overstated</td>
</tr>
</tbody>
</table>
Extraordinary Items

Classification as extraordinary – 2 requirements (both must apply)
  • Unusual in nature
  • Infrequent of occurrence

One or neither applies – component of income from continuing operations

Extraordinary

Negative goodwill on consolidation resulted from purchase (always)
Acts of nature (usually)

Not Extraordinary

Gains or losses on sales of investments or prop, plant, & equip
Gains or losses due to changes in foreign currency exchange rates
Write-offs of inventory or receivables
Effects of major strikes or changes in value of investments
Change in Accounting Principle

Use retrospective application of new principle:

1) Calculate revised balance of asset or liability as of beginning of period as if new principle had always been in use.

2) Compare balance to amount reported under old method.

3) Multiply difference by 100% minus tax rate.

4) Result is treated on books as prior period adjustment to beginning retained earnings.

5) All previous periods being presented in comparative statements restated to new principle.

6) Beginning balance of earliest presented statement of retained earnings adjusted for all effects going back before that date.
Change in Accounting Principle (continued)

Journal entry:
Asset or liability xxx
  Retained earnings xxx
  Current or deferred tax liability (asset) xxx

Or
Retained earnings xxx
Current or deferred tax liability (asset) xxx
Asset or liability xxx
Special Changes

Changes in accounting principle are handled using the prospective method under limited circumstances. No calculation is made of prior period effects and the new principle is simply applied starting at the beginning of the current year when the following changes in principle occur:

- Changes in the method of depreciation, amortization, or depletion
- Changes whose effect on prior periods is impractical to determine (e.g. changes to LIFO when records don’t allow computation of earlier LIFO cost bases)

(Note: the method of handling changes in accounting principle described here under SFAS 154 replaces earlier approaches, which applied the cumulative method to most changes in accounting principle. SFAS 154 abolished the use of the cumulative method.)
Change in Estimate

- No retrospective application
- Change applied as of beginning of current period
- Applied in current and future periods
**Error Corrections**

Applies to:
- Change from unacceptable principle to acceptable principle
- Errors in prior period financial statements

When error occurred:
Discontinued Operations

When components of a business are disposed of, their results are reported in discontinued operations:

- Component – An asset group whose activities can be distinguished from the remainder of the entity both operationally and for financial reporting purposes.
- Disposal – Either the assets have already been disposed of or they are being held for sale and the entity is actively searching for a buyer and believes a sale is probable at a price that can be reasonably estimated.

All activities related to the component are reported in discontinued operations, including those occurring prior to the commitment to dispose and in prior periods being presented for comparative purposes.
Reporting Discontinued Operations

Lower section of the income statement:

- After income from continuing operations
- Before extraordinary items

Reported amount each year includes all activities related to the component from operations as well as gains and losses on disposal, net of income tax effects

- Expected gains and losses from operations in future periods are not reported until the future period in which they occur.

Impairment loss is included in the current period when the fair market value of the component is believed to be lower than carrying amount based on the anticipated sales price of the component in future period.
Reporting Comprehensive Income

Statement of Comprehensive Income required as one of financial statements

- May be part of Income statement
- May be separate statement
- Begin with net income
- Add or subtract items of other comprehensive income

Other comprehensive income includes:

- Current year’s unrealized gains or losses on securities available for sale
- Current year’s foreign currency translation adjustments
- Current year’s increase or decrease in an additional pension liability in excess of unamortized prior service cost
- Current year’s unrealized gains or losses resulting from changes in market values of certain derivatives being used as cash flow hedges.
Accounting for Changing Prices

Accounting at Current Cost

Assets & liabilities reported at current amounts

Income statement items adjusted to current amounts
  • Inventory reported at replacement cost
  • Cost of sales = Number of units sold × Average current cost of units during period
  • Differences in inventory & cost of sales treated as holding gains or losses
  • Depreciation & amortization – Computed using same method & life based on current cost
Accounting for Changes in Price Level

Purchasing power gains & losses relate only to **monetary** items

- Monetary assets – money or claim to receive money such as cash & net receivables
- Monetary liabilities – obligations to pay specific amounts of money

Company may be monetary creditor or debtor

- Monetary creditor – monetary assets > monetary liabilities
- Monetary debtor – monetary liabilities > monetary assets

In periods of rising prices

- Monetary creditor will experience purchasing power loss
- Monetary debtor will experience purchasing power gain
Inventories

Goods In Transit

- Seller: Add to physical count, FOB shipping point, FOB destination
- Buyer: Add to physical count

Seller's Place of Business → Common Carrier → Buyer's Place of Business
**Inventory Cost**

Purchase price  
+ Freight in  
+ Costs incurred in preparing for sale  
= Inventory cost

**Goods on Consignment**

Consignee — Exclude from physical count  
Consignor — Add to physical count (at cost )

Cost of goods on consignment =  
Inventory cost  
+ Cost of shipping to consignee

Abnormal costs expensed in current period instead of being included in inventory:

- Idle facility expense
- Wasted materials in production
- Double freight when items returned and redelivered
Cost of Goods Sold

Beginning inventory
+ Net purchases
= Cost of goods available for sale
– Ending inventory
= Cost of goods sold

Inventory Errors

<table>
<thead>
<tr>
<th></th>
<th>Beg. RE</th>
<th>COGS</th>
<th>Gross Profit</th>
<th>End RE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning – overstated</td>
<td>Over</td>
<td>Over</td>
<td>Under</td>
<td>No effect</td>
</tr>
<tr>
<td>Beginning – understated</td>
<td>Under</td>
<td>Under</td>
<td>Over</td>
<td>No effect</td>
</tr>
<tr>
<td>Ending – overstated</td>
<td>No effect</td>
<td>Under</td>
<td>Over</td>
<td>Over</td>
</tr>
<tr>
<td>Ending – understated</td>
<td>No effect</td>
<td>Over</td>
<td>Under</td>
<td>Under</td>
</tr>
</tbody>
</table>
**Periodic Versus Perpetual**

<table>
<thead>
<tr>
<th></th>
<th>Periodic</th>
<th>Perpetual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buy merchandise:</td>
<td>Purchases</td>
<td>Inventory</td>
</tr>
<tr>
<td></td>
<td>Accounts payable</td>
<td>Accounts payable</td>
</tr>
<tr>
<td>Sell merchandise</td>
<td>Accounts receivable</td>
<td>Accounts receivable</td>
</tr>
<tr>
<td></td>
<td>Sales</td>
<td>Sales</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Cost of goods sold</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Inventory</td>
</tr>
<tr>
<td>Record cost of</td>
<td>Ending inventory (count)</td>
<td></td>
</tr>
<tr>
<td>goods sold</td>
<td>Cost of goods sold (plug)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Purchases (net amount)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Beginning inventory (balance)</td>
<td></td>
</tr>
</tbody>
</table>

FIFO – Same under either method
LIFO – Different amounts for periodic and perpetual
Average – Different amounts for periodic and perpetual
Periodic – Weighted-average
Inventory Valuation Methods

<table>
<thead>
<tr>
<th></th>
<th>Ending Inventory</th>
<th>Cost of Goods Sold</th>
<th>Gross Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Periods of rising prices:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FIFO</td>
<td>Highest</td>
<td>Lowest</td>
<td>Highest</td>
</tr>
<tr>
<td>LIFO</td>
<td>Lowest</td>
<td>Highest</td>
<td>Lowest</td>
</tr>
<tr>
<td>Periods of falling prices:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FIFO</td>
<td>Lowest</td>
<td>Highest</td>
<td>Lowest</td>
</tr>
<tr>
<td>LIFO</td>
<td>Highest</td>
<td>Lowest</td>
<td>Highest</td>
</tr>
</tbody>
</table>
**Applying LIFO**

Step 1 – Determine ending quantity

Step 2 – Compare to previous period’s ending quantity

Step 3 – Increases – Add new layer

Step 4 – Small decreases (less than most recent layer) – Reduce most recent layer

Step 5 – Large decreases (more than most recent layer) – Eliminate most recent layer or layers and decrease next most recent layer

Step 6 – Apply appropriate unit price to each layer

For each layer:

\[
\text{Inventory Value} = \text{Quantity} \times \text{Price per unit}
\]
## Application of LIFO

### Information given:

<table>
<thead>
<tr>
<th>Year</th>
<th>Ending Quantity</th>
<th>Price per unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>10,000 units</td>
<td>$5.00</td>
</tr>
<tr>
<td>Year 2</td>
<td>12,000 units</td>
<td>$5.50</td>
</tr>
<tr>
<td>Year 3</td>
<td>15,000 units</td>
<td>$6.00</td>
</tr>
<tr>
<td>Year 4</td>
<td>13,500 units</td>
<td>$6.50</td>
</tr>
<tr>
<td>Year 5</td>
<td>11,200 units</td>
<td>$7.00</td>
</tr>
<tr>
<td>Year 6</td>
<td>13,200 units</td>
<td>$7.50</td>
</tr>
</tbody>
</table>

### Information applied:

#### Year 1:

<table>
<thead>
<tr>
<th>Base layer</th>
<th>Ending Quantity</th>
<th>Price per unit</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>10,000 units</td>
<td>$5.00</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>10,000 units</strong></td>
<td><strong>$50,000</strong></td>
</tr>
</tbody>
</table>

---

Focus on Inventories - Module 8
**Application of LIFO (continued)**

**Year 2:**

<table>
<thead>
<tr>
<th>Layer</th>
<th>Units</th>
<th>Cost</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 2 layer</td>
<td>2,000</td>
<td>$5.50</td>
<td>$11,000</td>
</tr>
<tr>
<td>Base layer</td>
<td>10,000</td>
<td>$5.00</td>
<td>$50,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>12,000 units</strong></td>
<td></td>
<td><strong>$61,000</strong></td>
</tr>
</tbody>
</table>

**Year 3:**

<table>
<thead>
<tr>
<th>Layer</th>
<th>Units</th>
<th>Cost</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 3 layer</td>
<td>3,000</td>
<td>$6.00</td>
<td>$18,000</td>
</tr>
<tr>
<td>Year 2 layer</td>
<td>2,000</td>
<td>$5.50</td>
<td>$11,000</td>
</tr>
<tr>
<td>Base layer</td>
<td>10,000</td>
<td>$5.00</td>
<td>$50,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>15,000 units</strong></td>
<td></td>
<td><strong>$79,000</strong></td>
</tr>
</tbody>
</table>
### Application of LIFO (continued)

**Year 4:**

<table>
<thead>
<tr>
<th>Layer</th>
<th>Units</th>
<th>Cost</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 3 layer</td>
<td>1,500</td>
<td>$6.00</td>
<td>$9,000</td>
</tr>
<tr>
<td>Year 2 layer</td>
<td>2,000</td>
<td>$5.50</td>
<td>$11,000</td>
</tr>
<tr>
<td>Base layer</td>
<td>10,000</td>
<td>$5.00</td>
<td>$50,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>13,500</td>
<td></td>
<td>$70,000</td>
</tr>
</tbody>
</table>

**Year 5:**

<table>
<thead>
<tr>
<th>Layer</th>
<th>Units</th>
<th>Cost</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 2 layer</td>
<td>1,200</td>
<td>$5.50</td>
<td>$6,600</td>
</tr>
<tr>
<td>Base layer</td>
<td>10,000</td>
<td>$5.00</td>
<td>$50,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>11,200</td>
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<td>$56,600</td>
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</tbody>
</table>
**Application of LIFO (continued)**

Year 6:

<table>
<thead>
<tr>
<th>Layer</th>
<th>Units</th>
<th>Cost per Unit</th>
<th>Total Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 3 layer</td>
<td>2,000</td>
<td>$7.50</td>
<td>$15,000</td>
</tr>
<tr>
<td>Year 2 layer</td>
<td>1,200</td>
<td>$5.50</td>
<td>$6,600</td>
</tr>
<tr>
<td>Base layer</td>
<td>10,000</td>
<td>$5.00</td>
<td>$50,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>13,200</td>
<td></td>
<td><strong>$71,600</strong></td>
</tr>
</tbody>
</table>
Dollar Value LIFO

Less cumbersome than LIFO for inventory consisting of many items
Combines inventory into pools
Increases in some items within a pool offset decreases in others

Applying Dollar-Value LIFO

Step 1 – Determine ending inventory at current year’s prices
Step 2 – Divide by current price level index to convert to base year prices
Step 3 – Compare to previous period’s ending inventory at base year prices
Step 4 – Increases – Add new layer at base year prices
Step 5 – Small decreases (less than most recent layer) – Reduce most recent layer
Step 6 – Large decreases (more than most recent layer) – Eliminate most recent layer or layers and decrease next most recent layer
Step 7 – Apply appropriate unit price to each layer

For each layer:

\[
\text{Inventory amount at base year prices} \times \text{Price index} = \text{Inventory amount Dollar Value LIFO}
\]
# Application of Dollar-Value LIFO

Information given:

<table>
<thead>
<tr>
<th>Year</th>
<th>Ending Inventory at Current Prices</th>
<th>Price level index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$200,000</td>
<td>100</td>
</tr>
<tr>
<td>Year 2</td>
<td>243,800</td>
<td>106</td>
</tr>
<tr>
<td>Year 3</td>
<td>275,000</td>
<td>110</td>
</tr>
<tr>
<td>Year 4</td>
<td>255,200</td>
<td>116</td>
</tr>
</tbody>
</table>

Information applied:

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Base year prices</th>
<th>Index</th>
<th>Dollar Value LIFO</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base layer</td>
<td>$200,000</td>
<td>100</td>
<td>$200,000</td>
</tr>
<tr>
<td>Total</td>
<td>$200,000</td>
<td></td>
<td>$200,000</td>
</tr>
</tbody>
</table>
Application of Dollar-Value LIFO (continued)

Year 2:
$243,800 ÷ 1.06 = $230,000 (at base year prices)

<table>
<thead>
<tr>
<th></th>
<th>Base year prices</th>
<th>Index</th>
<th>Dollar Value LIFO</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 2 layer</td>
<td>$30,000</td>
<td>106</td>
<td>$31,800</td>
</tr>
<tr>
<td>Base layer</td>
<td>$200,000</td>
<td>100</td>
<td>$200,000</td>
</tr>
<tr>
<td>Total</td>
<td>$230,000</td>
<td></td>
<td>$231,800</td>
</tr>
</tbody>
</table>
Application of Dollar-Value LIFO (continued)

Year 3:
$275,000 ÷ 1.10 = $250,000 (at base year prices)

<table>
<thead>
<tr>
<th></th>
<th>Base year prices</th>
<th>Index</th>
<th>Dollar Value LIFO</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 3 layer</td>
<td>$20,000</td>
<td>110</td>
<td>$22,000</td>
</tr>
<tr>
<td>Year 2 layer</td>
<td>$30,000</td>
<td>106</td>
<td>$31,800</td>
</tr>
<tr>
<td>Base layer</td>
<td>$200,000</td>
<td>100</td>
<td>$200,000</td>
</tr>
<tr>
<td>Total</td>
<td>$250,000</td>
<td></td>
<td>$253,800</td>
</tr>
</tbody>
</table>
**Application of Dollar-Value LIFO (continued)**

**Year 4:**

$255,200 \div 1.16 = $220,000 \text{ (at base year prices)}

<table>
<thead>
<tr>
<th>Base year prices</th>
<th>Index</th>
<th>Dollar Value LIFO</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 2 layer</td>
<td>$20,000</td>
<td>106</td>
</tr>
<tr>
<td>Base layer</td>
<td>$200,000</td>
<td>100</td>
</tr>
<tr>
<td>Total</td>
<td>$220,000</td>
<td></td>
</tr>
</tbody>
</table>
Dollar Value LIFO – Calculating a Price Level Index

**Simplified LIFO** – Company uses a published index

**Double Extension Method** – Cumulative index
   - Compare current year to base year
     - Ending inventory at current year’s prices
     - Ending inventory at base year prices

**Link Chain** Method – Annual index
   - Compare current year to previous year
     - Ending inventory at current year’s prices
     - Ending inventory at previous year’s prices
**Lower of Cost or Market**

Inventory = lower of cost or market

- Market Value Equals
- Replacement Cost

Ceiling = Net realizable value (Sales price – Cost of disposal)

Too high, use ceiling

Floor = Net realizable value – normal profit

Too low, use floor

Just right, use replacement cost
Gross Profit Method for Estimating Inventory

If gross profit is **percentage of sales**:

- Sales \(100\%\)
- Cost of sales
- Gross profit

To find cost of sales:

\[
\text{Sales} \times (100\% - \text{Gross profit }\%)
\]

Beginning inventory

\[
\begin{align*}
\text{Beginning inventory} & + \text{Net purchases} \\
& = \text{Cost of goods available}
\end{align*}
\]

\[
\begin{align*}
\text{Cost of goods available} & - \text{Cost of sales} \\
& = \text{Ending inventory}
\end{align*}
\]

If gross profit is **percentage of cost**:

- Sales
- Cost of sales \(100\%\)
- Gross profit

Sales + (100\% + \text{Gross profit }\%)
### Conventional Retail (Lower of Cost or Market)

<table>
<thead>
<tr>
<th>Cost</th>
<th>Retail</th>
<th>C/R%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning inventory</td>
<td>xx</td>
<td>xx</td>
</tr>
<tr>
<td>+ Net purchases</td>
<td>xx</td>
<td>xx</td>
</tr>
<tr>
<td>+ Freight in</td>
<td>xx</td>
<td>xx</td>
</tr>
<tr>
<td>+ Net markups</td>
<td>xx</td>
<td>xx</td>
</tr>
<tr>
<td>= Cost of goods available for sale</td>
<td>xx</td>
<td>xx</td>
</tr>
<tr>
<td>- Sales (retail)</td>
<td>xx</td>
<td>xx</td>
</tr>
<tr>
<td></td>
<td>Net markdowns</td>
<td>xx</td>
</tr>
<tr>
<td></td>
<td>Employee discounts</td>
<td>xx</td>
</tr>
<tr>
<td></td>
<td>Spoilage (retail)</td>
<td>xx</td>
</tr>
<tr>
<td>= Ending inventory at retail</td>
<td>xx</td>
<td>xx</td>
</tr>
<tr>
<td>× Cost to retail percentage</td>
<td></td>
<td></td>
</tr>
<tr>
<td>= Ending inventory at approximate lower of cost or market</td>
<td>xx</td>
<td>xx</td>
</tr>
</tbody>
</table>
Long-Term Construction Contracts

Percentage of Completion

Use when:

- Estimates of costs are reasonably dependable
- Estimates of progress toward completion

Reporting profit

- Recognized proportionately during contract
- Added to construction in process

Balance sheet amount

- Current asset – excess of costs and estimated profits over billings
- Current liability – excess of billings over costs and estimated profits
Calculating profit:

Step 1 – Total profit

<table>
<thead>
<tr>
<th></th>
<th>xxx</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract price</td>
<td></td>
</tr>
<tr>
<td>Total estimated cost</td>
<td></td>
</tr>
<tr>
<td>Cost incurred to date</td>
<td>xxx</td>
</tr>
<tr>
<td>Estimated cost to complete</td>
<td>+ xxx</td>
</tr>
<tr>
<td>Total estimated cost</td>
<td>– xxx</td>
</tr>
<tr>
<td>Total estimated profit</td>
<td>= xxx</td>
</tr>
</tbody>
</table>

Step 2 – % of completion (Cost to cost method)

Costs incurred to date (1) ÷ Total estimated cost (2) = % of completion (4)

Step 3 – Profit to date

% of completion (4) × Total estimated profit (3) = Estimated profit to date (5)

Step 4 – Current period’s profit

Estimated profit to date (5) – Profit previously recognized = Current period’s profit
Recognizing Losses

When loss expected:

Estimated loss \( xxx \)

+ Profit recognized to date \( xxx \)

= Amount of loss to recognize \( xxx \)
Completed Contract

Income statement amount
- Profit recognized in period of completion
- Loss recognized in earliest period estimable

Balance sheet amount
- Current assets – excess of costs over billings
- Current liabilities – excess of billings over costs
Property, Plant, & Equipment

General Rule:
Capitalized amount = Cost of asset + Costs incurred in preparing it for its intended use
  Cost of asset = FMV of asset received or
  Cash paid + FMV of assets given

Gifts:
  Asset (FMV) xx
  Income xx

Other capitalized costs for assets acquired by gift or purchase:
  Shipping
  Insurance during shipping
  Installation
  Testing
**Land and Building**

Total cost:
- Purchase price
- Delinquent taxes assumed
- Legal fees
- Title insurance

Allocation to land and building – *Relative Fair Market Value Method*

\[
\text{FMV of land} + \frac{\text{FMV of building}}{\text{Total FMV}} = \text{Total FMV}
\]

**Land** = FMV of land + Total FMV × Total Cost

**Building** = FMV of building ÷ Total FMV × Total Cost
Capitalization of Interest

Capitalize on:
- Assets constructed for company’s use
- Assets manufactured for resale resulting from special order

Do not capitalize on:
- Inventory manufactured in the ordinary course of business

Interest capitalized:
- Interest on debt incurred for construction of asset
- Interest on other debt that could be avoided by repayment of debt

Computed on:
- Weighted-average accumulated expenditures
Costs Incurred After Acquisition

Capitalize if:

- **Bigger** – the cost makes the asset bigger, such as an addition to a building
- **Better** – the cost makes the asset better, such as an improvement that makes an asset perform more efficiently
- **Longer** – the cost makes the asset last longer, it extends the useful life

Do not capitalize:

  Repairs and maintenance
Depreciation and Depletion

Basic Terms:

- **Straight-line rate** = 100% ÷ Useful life (in years)
- **Book value** = Cost – Accumulated depreciation
- **Depreciable basis** = Cost – Salvage value

Selection of Method:

- Use **straight-line** when benefit from asset is uniform over life
- Use **accelerated** when:
  - Asset more productive in earlier years
  - Costs of maintenance increase in later years
  - Risk of obsolescence is high
- Use **units-of-production** when usefulness decreases with use
### Straight-Line

Annual depreciation =

\[ \text{Depreciable basis} \times \text{Straight-line rate} \]

Partial year =

\[ \frac{\text{Annual depreciation}}{\text{Portion of year}} \times \text{Straight-line rate} \]

### Double-Declining Balance

Annual depreciation =

\[ \text{Book value} \times \text{Straight-line rate} \times 2 \]

Partial year =

\[ \frac{\text{Book value}}{\text{Portion of year}} \times \text{Straight-line rate} \times 2 \]
**Sum-of-the-Years’-Digits**

Annual depreciation = 

\[
\text{Depreciable basis} \times \text{Fraction} = 1^{\text{st}} \text{ Year} \quad 2^{\text{nd}} \text{ Year} \quad 3^{\text{rd}} \text{ Year}
\]

\[
\text{Numerator} = \begin{array}{c}
n \\ n-1 \\ n-2 \\ \frac{n(n+1)}{2} \\
\end{array}
\]

\[
\text{Denominator} = \begin{array}{c}
n(n+1) + 2 \\ n(n+1) + 2 \\ n(n+1) + 2 \\ \frac{n(n+1)}{2} \\
\end{array}
\]

Partial year:

1\text{st} year = 1\text{st} year’s depreciation × portion of year

2\text{nd} year = Remainder of 1\text{st} year’s depreciation

+ 2\text{nd} year’s depreciation × portion of year

3rd year = Remainder of 2\text{nd} year’s depreciation

+ 3\text{rd} year’s depreciation × portion of year
**Units-of-Production**

Depreciation rate = **Depreciable basis ÷ Total estimated units to be produced (hours)**

Annual depreciation =

  - Depreciation rate
  - \( \times \) Number of units produced (hours used)

**Group or Composite**

Based on straight-line

Gains or losses not recognized on disposal

  - Cash (proceeds) \( xx \)
  - Accumulated depreciation (plug) \( xx \)
  - Asset (original cost) \( xx \)
**Impairment**

Occurs if undiscounted future cash flow less than asset carrying amount from events such as:

- A decrease in the market value of the asset
- An adverse action or assessment by a regulator
- An operating or cash flow loss associated with a revenue producing asset

When an impairment loss occurs:

Asset is written down to fair market value (or discounted net cash flow):

\[
\begin{align*}
\text{Loss due to impairment} & \quad xx \\
\text{Accumulated depreciation} & \quad xx
\end{align*}
\]

Note that test for impairment (future cash flow) is different from write-down amount (net realizable value)
Application of Impairment Rules

Example 1:

Asset carrying value – $1,000,000
Undiscounted future cash flow expected from asset – $900,000
Fair market value of asset – $600,000

Impairment exists – $900,000 expected cash flow less than $1,000,000 carrying amount

Write asset down by $400,000 ($1,000,000 reduced to $600,000)

Example 2:

Asset carrying value – $800,000
Undiscounted future cash flow expected from asset – $900,000
Fair market value of asset – $600,000

No impairment adjustment – $900,000 expected cash flow exceeds $800,000 carrying amount
Disposal of Property, Plant, & Equipment

Cash (proceeds) xx
Accumulated depreciation (balance) xx
Loss on disposal (plug) xx
  Gain on disposal (plug) xx
  Asset (original cost) xx

A disposal in involuntary conversion is recorded in the same manner as a sale.
**Nonmonetary Exchanges**

Cash (amount received)
Asset – New (FMV) xx
Accumulated depreciation (balance on old asset) xx
Loss on disposal (plug)
  Cash (amount paid)
  Gain on disposal (plug) xx
  Asset – Old (Original cost) xx

**FMV**

Use fair value of asset received or
Fair value of asset given
+ Cash paid
– Cash received
Exception

Applies to exchanges when:

- FMV is not determinable
- Exchange is only to facilitate subsequent sales to customers (e.g. ownership of inventory in one city is swapped for similar inventory in another to facilitate prompt delivery to customer in distant city)
- Transaction lacks commercial substance (risk, timing, and amount of future cash flows will not significantly change as a result of the transaction).

**Loss** – FMV of asset given < Carrying value of asset given

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (amount received)</td>
<td>xx</td>
</tr>
<tr>
<td>Asset – New (FMV)</td>
<td>xx</td>
</tr>
<tr>
<td>Loss on disposal (plug)</td>
<td>xx</td>
</tr>
<tr>
<td>Cash (amount paid)</td>
<td>xx</td>
</tr>
<tr>
<td>Asset – Old (carrying value)</td>
<td>xx</td>
</tr>
</tbody>
</table>
**Gain** – FMV of asset given > Carrying value of asset given

Gain recognized only when cash received

\[
\text{FMV of asset given} - \text{Carrying value of asset given} = \text{Total gain} \\
\times \text{Percentage} = \text{Gain recognized}
\]

\[
\text{Cash received} \quad \text{Total proceeds (Cash + FMV of asset received)}
\]

\[
\text{Cash (amount received)} \quad xx \\
\text{Asset—New (plug)} \quad xx \\
\text{Gain on disposal (computed amount)} \quad xx \\
\text{Asset—Old (carrying value)} \quad xx
\]
No gain recognized when cash paid or no cash involved

Asset – New (plug) xx
Accumulated depreciation (balance on old asset) xx
  Cash (amount paid) xx
  Asset – Old (original cost) xx
Intangibles

General Characteristics
Lack physical substance
Uncertain benefit period
Associated with legal rights

Initial Accounting
Capitalize costs of purchasing intangibles
Expense costs of developing intangibles internally
Capitalize costs of preparing for use
  Legal fees
  Registration fees
**Amortization**

Straight-line amortization

Amortized over **shorter** of:
- Legal life
- Useful life

Units of sales amortization used if greater than straight-line

Tested for impairment when events suggest undiscounted future cash flow will be less than carrying value of intangible – written down to fair market value

Intangibles with no clear legal or useful life (trademarks, perpetual franchises) tested annually for impairment and written down whenever fair market value is less than carrying value
**Goodwill**

**Acquisition**
- Must be part of (purchase) business combination
- Excess of purchase price over fair value of underlying net assets

**Internal costs**
- May incur development or maintenance costs
- All costs are expensed

**Amortization**
- No amortization recorded
- Test annually for impairment of value
- Goodwill written down whenever fair market value less than carrying value
Leasehold Improvements

Amortize over shorter of:
  • Useful life
  • Remaining term of lease

Patents

Legal costs of defending a patent
  • Successful – capitalize legal costs as addition to carrying value of patent
  • Unsuccessful – recognize legal costs as expense and consider writing down patent
Research and Development (R & D)

Research – aimed at discovery of new knowledge
    New product or process
    Improvement to existing product or process

Development – converting new knowledge into plan or design

R & D assets:
    Used for general R & D activities
        Capitalize
        Depreciate
        Charge to R & D expense
    Used for specific project
        Charge to R & D expense
Startup Costs
Costs associated with startup of organization should be immediately expensed

Franchises
Initial fee – generally capitalized and amortized
Subsequent payments – generally recognized as expense in period incurred

Software
Expense – cost up to technological feasibility
Capitalize and amortize – costs from technological feasibility to start of production
  • Coding and testing
  • Production of masters
Charge to inventory – costs incurred during production
Software (continued)

Time line:

- **Technological Feasibility**
  - Costs are recognized as expense

- **Beginning of Production**
  - Costs are capitalized

- Costs are charged to inventory
Amortization of capitalized software costs – larger of:

<table>
<thead>
<tr>
<th>Straight-line</th>
<th>or</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carrying value</td>
<td>Carrying value</td>
<td></td>
</tr>
<tr>
<td>Remaining useful life</td>
<td>Estimated remaining revenues</td>
<td></td>
</tr>
<tr>
<td>(Current period + future periods)</td>
<td>(Current revenues + future revenues)</td>
<td></td>
</tr>
</tbody>
</table>

**Additional amortization:**

Carrying value (after amortization) > Net realizable value (based on future revenues)

Excess is additional amortization
Bank Reconciliation

Bank balance

+ Deposits in transit
− Outstanding checks
± Errors made by bank
= Corrected balance

Book balance

Amounts collected by bank +
Unrecorded bank charges −
Errors made when recording transactions ±
Corrected balance =

Must be equal
**Accounts Receivable**

<table>
<thead>
<tr>
<th>Allowance Receivable</th>
<th>Allowance for Uncollectible Accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning balance</td>
<td>Beginning balance</td>
</tr>
<tr>
<td>Sales</td>
<td>Collections</td>
</tr>
<tr>
<td></td>
<td>Write-offs</td>
</tr>
<tr>
<td>Reinstatements</td>
<td>Write-offs</td>
</tr>
<tr>
<td>Ending balance</td>
<td>Reinstatements</td>
</tr>
</tbody>
</table>

**Net realizable value** = Accounts receivable – Allowance for Uncollectible Accounts
Uncollectible Accounts

**Income Statement Approach**
- Credit sales
- $\times$ % uncollectible (given)
- = Bad debt expense

**Balance Sheet Approach**
- Accounts receivable balance
- $\times$ Portion uncollectible
- = Ending balance in allowance

Allowance for Uncollectible Accounts

<table>
<thead>
<tr>
<th>beginning balance</th>
<th>Bad debt expense</th>
<th>reinstatements</th>
<th>ending balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>accounts written off</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Calculate expense and plug balance or calculate balance and plug expense

Focus on
Receivables – Module 10
Uncollectible Accounts

Allowance Methods - GAAP

Matching concept – Bad debt expense in period of sale
Measurement concept – Accounts receivable at net realizable value

Direct Write-off Method - Non-GAAP

Violates matching concept – Bad debt expense when account written off
Violates measurement concept – Accounts receivable overstated at gross amount
Notes Received for Cash

Calculating Payment
Principal amount ÷ Present value factor = Payment amount

Present value factor for annuity based on number of payments and interest rate

Allocating Payments
Payment amount – Interest = Principal reduction

Calculating Interest

- Beginning balance × Interest rate × Period up to payment = Interest up to payment
- Balance after principal reduction × Interest rate × Period up to payment to year-end = Interest for remainder of year

Add together for total interest
Notes Received for Goods or Services

Note Balance

Short-term: Amount = Face value

Long-term: Amount =
  Fair value of goods or services
  Present value of payments if fair value not known

Journal entry:

  Note receivable - Face amount (given) xxx
  Revenue - Calculated amount xxx
  Discount on note receivable (plug) xxx
Notes Received for Goods or Services

**Interest Income**

Face amount of note
- Unamortized discount
= Carrying value of note
× Interest rate
= Interest income

**Journal entry:**

Discount on note receivable xxx
Interest income xxx
Financing Receivables - Discounting

**Proceeds From Discounting**

Face amount

+ Interest income (Face × Interest rate × Term)
= Maturity value
– Discount (Maturity value × Discount rate × Remaining term)
= Proceeds
Financing Receivables

**Financing Without Recourse**
Treated as sale – referred to as factoring
- Cash
- Loss on sale (plug)
- Accounts receivable (balance)

**Financing With Recourse**
Treated as loan – may be referred to as assignment
- Cash - Proceeds (given)
- Note payable secured by receivables
- Accounts receivable assigned
- Accounts receivable (balance)
Financial Statement Analysis

Ratios Involving Current Assets & Liabilities

Working capital = current assets – current liabilities
Current ratio = current assets ÷ current liabilities
Quick ratio = quick assets ÷ current liabilities

Quick assets – current assets readily convertible into cash
- Cash
- Accounts receivable
- Investments in trading securities
**Ratios Involving Receivables**

Accounts receivable turnover = \( \frac{\text{Credit sales}}{\text{Average accounts receivable}} \)

Days to collect accounts receivable = \( \frac{365}{\text{Accounts receivable turnover}} \)

or

Days to collect accounts receivable = \( \frac{\text{Average accounts receivable}}{\text{Average sales/day}} \)

Average sales/day = \( \frac{\text{Credit sales}}{365} \)

**Ratios Involving Inventories**

Inventory turnover = \( \frac{\text{Cost of sales}}{\text{Average inventory}} \)

Days sales in inventory = \( \frac{365}{\text{Inventory turnover}} \)

or

Days sales in inventory = \( \frac{\text{Average inventory}}{\text{Average inventory sold/day}} \)

Average inventory sold/day = \( \frac{\text{Cost of sales}}{365} \)
Other Ratios

Operating cycle = Days to collect accounts receivable + Days sales in inventory
Debt to total assets = Total debt ÷ Total assets
Debt to equity = Total debt ÷ Total stockholders’ equity
Return on assets = Net income ÷ Average total assets
### Accounts Payable

<table>
<thead>
<tr>
<th>Purchase shipment terms</th>
<th>Payable already recorded</th>
<th>Payable not already recorded</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shipping point</td>
<td>No adjustment</td>
<td>Adjust – add</td>
</tr>
<tr>
<td>Destination</td>
<td>Adjust – deduct</td>
<td>No adjustment</td>
</tr>
</tbody>
</table>
Contingencies

Loss Contingencies

Probable – Accrue & disclose
  • Not estimable – Disclose only
  • Estimable within range – Accrue minimum of range
Reasonably possible – Disclose only
Remote – Neither accrued nor disclosed

Gain Contingencies

Never accrue (until realization occurs or is assured beyond reasonable doubt)
May disclose
Estimated & Accrued Amounts

Money 1\textsuperscript{st} – Goods or services 2\textsuperscript{nd}
- Expenses – prepaid
- Revenues – unearned

Goods or services 1\textsuperscript{st} – Money 2\textsuperscript{nd}
- Expenses – accrued
- Revenues – receivable
**Revenue Items**

Calculate amount earned or amount collected

1) Determine changes in accrual items:

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue receivable</td>
<td>Increase</td>
<td>Decrease</td>
</tr>
<tr>
<td>Unearned revenue</td>
<td>Decrease</td>
<td>Increase</td>
</tr>
</tbody>
</table>

2) Prepare journal entry

- Cash xxx
- Revenue receivable xxx or xxx
- Unearned revenue xxx or xxx
- Revenues xxx

3) If amount collected is given, that is the debit to cash and the amount required to balance the entry is the amount earned. If the amount earned is given, that is the credit to revenues and the amount required to balance the entry is the amount collected.
**Expense Items**

Calculate amount incurred or amount paid

1) Determine changes in accrual items:

<table>
<thead>
<tr>
<th>Item</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepaid expense</td>
<td>Increase</td>
<td>Decrease</td>
</tr>
<tr>
<td>Accrued expense</td>
<td>Decrease</td>
<td>Increase</td>
</tr>
</tbody>
</table>

2) Prepare journal entry

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expense</td>
<td>xxx</td>
</tr>
<tr>
<td>Prepaid expense</td>
<td>xxx or</td>
</tr>
<tr>
<td>Accrued expense</td>
<td>xxx or</td>
</tr>
<tr>
<td>Cash</td>
<td>xxx</td>
</tr>
</tbody>
</table>

3) If amount paid is given, that is the credit to cash and the amount required to balance the entry is the amount incurred. If the amount incurred is given, that is the debit to expense and the amount required to balance the entry is the amount paid.
Insurance
Prepaid insurance (end of year)
   Total premiums paid × Months remaining / Total # of months
Insurance expense
   Prepaid insurance (beginning) + Premiums paid – Prepaid insurance (ending)

Royalties
Royalty income for current year
1st payment – includes royalties earned in latter part of previous period early in current period
   • Include payment
   • Deduct royalties from previous period
2nd payment – received for royalties earned during current period
   • Include entire payment
Additional royalties
   • Add royalties earned for latter part of current period
**Service Contract**

Service contract revenues – fees received uniformly during period

- Fees received
  - × % earned in 1st period
  - × 50%

Deferred service contract revenues

- Fees received
  - service contract revenues
**Coupons**

**Discounts on merchandise**
- Number of coupons not expired
  - × % expected to be redeemed

  × Cost per coupon (face + service fee)

  – Amount already paid

  = Liability

**Premiums (Prizes)**
- Number of units sold
  - × % expected to be redeemed

  + number required per prize

  – Prizes already sent

  × Cost per prize

  = Liability
**Warranties**

**Warranty expense**

\[
\text{Sales} \times \% \text{ of warranty costs} = \text{Expense for period}
\]

**Warranty liability**

\[
\begin{array}{c|c|c|c|}
\text{Estimated warranty liability} & \text{Beg. bal.} & \text{Expense} & \text{End bal.} \\
\hline
\text{Payments} & & & \\
\end{array}
\]
**Compensated Absences**

Four conditions:
- Past services of employees
- Amounts vest or accumulate
- Probable
- Estimable

When all conditions met:

<table>
<thead>
<tr>
<th></th>
<th>Vest</th>
<th>Accumulate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vacation pay</td>
<td>Must accrue</td>
<td>Must accrue</td>
</tr>
<tr>
<td>Sick pay</td>
<td>Must accrue</td>
<td>May accrue</td>
</tr>
</tbody>
</table>
Miscellaneous Liabilities

Refinancing Liabilities

To exclude from current liabilities – 2 requirements:
  • Company intends to refinance on a long-term basis
  • Company can demonstrate ability to refinance

The ability to refinance can be demonstrated in either of 2 ways:
  • Refinance on long-term basis after balance sheet date but before issuance
  • Enter into firm agreement with lender having ability to provide long-term financing
Accounting for Leases

Lessees Reporting

Rights & risks of ownership transfer from lessor to lessee?

Yes → Capital lease

No → Operating lease
Transfer of rights & risks of ownership – At least 1 of 4 criteria

Actual transfer
- Title transfers to lessee by end of term
- Lease contains bargain purchase option

Transfer in substance
- Lease term ≥ 75% of useful life
- Present value of min lease payments ≥ 90% of fair market value

To calculate present value – lessee uses lower of:
- Incremental borrowing rate
- Rate implicit in lease (if known)
Capital Leases

Inception of lease

Journal entry to record lease:

\[
\begin{align*}
\text{Leased asset} & \quad xxx \\
\text{Lease obligation} & \quad xxx
\end{align*}
\]

Amount of asset & liability = PV of minimum lease payments:

- Payments beginning at inception result in annuity due
- Payments beginning at end of first year result in ordinary annuity
- Payments include bargain purchase option or guaranteed residual value (lump sum at end of lease)
**Lease payments**

Payment at inception:
- Lease obligation xxx
- Cash xxx

Subsequent payments:
- Interest expense xxx
- Lease obligation xxx
- Cash xxx

Interest amount:
- Balance in lease obligation
  - Interest rate (used to calculate PV)
  - Time since last payment (usually 1 year)
  = Interest amount
Periodic Expenses – Depreciation

Actual transfer (1 of first 2 criteria)
- Life = useful life of property
- Salvage value taken into consideration

Transfer in substance (1 of latter 2 criteria)
- Life = shorter of useful life or lease term
- No salvage value

Periodic Expenses – Executory costs
Consist of insurance, maintenance, & taxes
Recognized as expense when incurred
Balance Sheet Presentation

Leased asset
• Reported as P, P, & E
• Reported net of accumulated depreciation

Lease obligation
• Current liability = Principal payments due in subsequent period
• Noncurrent liability = Remainder

Disclosures
• Amount of assets recorded under capital leases
• Minimum lease payments for each of next 5 years and in aggregate
• Description of leasing activities
Lessor Reporting

Rights & risks of ownership transfer from lessor to lessee?

Yes
Additional criteria

No
Operating lease

Transfer of rights & risks of ownership - At least 1 of 4 criteria

• Same criteria as lessee
• To calculate present value – lessor uses rate implicit in lease
**Additional Criteria**

- Collectibility of lease payments reasonably predictable
- No significant uncertainties as to costs to be incurred in connection with lease

Are both additional criteria met?

- Yes
  - Sales-type or direct-financing lease
- No
  - Operating lease
Sales-Type & Direct-Financing Leases

Inception of lease

Journal entry to record lease:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivable</td>
<td>xxx</td>
</tr>
<tr>
<td>Accumulated depreciation (if any)</td>
<td>xxx</td>
</tr>
<tr>
<td>Asset</td>
<td>xxx</td>
</tr>
<tr>
<td>Gain (if any)</td>
<td>xxx</td>
</tr>
</tbody>
</table>

**Receivable** = fair value of property & present value of lease payments (rate implicit in lease)

**Asset & accum dep** – To remove carrying value of asset from lessor’s books

**Gain**

- If amount needed to balance the entry, it is a gain or loss and this is a sales-type lease
- If the entry balances without a gain or loss, this is a direct financing lease
Collections

At inception of lease:

Cash \( \text{xxx} \)
Receivable \( \text{xxx} \)

Subsequent collections:

Cash \( \text{xxx} \)
Interest income (formula) \( \text{xxx} \)
Receivable \( \text{xxx} \)

Interest amount:

Balance of receivable
\( \times \) Interest rate (implicit in lease)
\( \times \) Time since last payment (usually 1 year)
= Interest amount
Balance Sheet Presentation

Receivable

• Current asset – Principal collections due within one year
• Noncurrent asset – Remainder
Operating Leases

Lessor Accounting
Rent revenue
Various expenses (depreciation on asset, taxes, insurance, & maintenance)

Lessee Accounting
Rent expense
Miscellaneous expenses (taxes, insurance, & maintenance)

Rent revenue or expense
- Recognized uniformly over lease
- Total of rents over term of lease ÷ Number of periods = Rent per period
**Sale-Leaseback Transactions**

**Minor Leaseback**
Leaseback ≤ 10% of fair value of property sold
- Sale and leaseback recognized as separate transactions
- Gain or loss on sale

**Other Leasebacks**
Seller-lessee retains significant portion of property
- Some or all of gain deferred
- Deferred amount limited to present value of leaseback payments
- Deferred amount spread over lease
- Remainder recognized in period of sale
Bonds

Issuance – Interest date

Cash (present value approach) xxx
Discount or premium (plug) xxx or xxx
Bonds payable (face amount) xxx

Issuance – Between interest dates

Cash (sales price approach + interest amount) xxx
Discount or premium (plug) xxx or xxx
Interest payable (interest amount) xxx
Bonds payable (face) xxx
**Proceeds**

Present value approach
- Present value of principal (lump sum) at yield rate
- Present value of interest (ordinary annuity) at yield rate

Sales price approach
- Sales price given as percentage of face amount
- Multiplied by face to give proceeds amount

**Interest**

Bond issued between interest dates

Calculated amount
- Face amount of bonds
- × Stated rate
- × Portion of year since previous interest date
= Interest amount
**Bond Interest**

*Effective interest method - GAAP*

<table>
<thead>
<tr>
<th>Interest payable</th>
<th>Interest expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>Face amount</td>
<td>Carrying value</td>
</tr>
<tr>
<td>× Stated rate</td>
<td>× Yield rate</td>
</tr>
<tr>
<td>× Portion of year since previous interest date</td>
<td>× Portion of year since previous interest date</td>
</tr>
<tr>
<td>= Interest payable</td>
<td>= Interest expense</td>
</tr>
</tbody>
</table>

Difference

Amortization of discount or premium
**Straight-line method – Not GAAP**

Interest payable
- Face amount
- × Stated rate
- × Portion of year since previous interest date
= Interest payable

Amortization
- Premium or discount
- ÷ Months in bond term
= Amortization per month
- interest date
- × Months since last interest date
= Amortization

Interest expense = interest payable ± amortization

- + Amortization of discount
- – Amortization of premium
**Recording Interest Expense:**

<table>
<thead>
<tr>
<th>Description</th>
<th>xxx</th>
<th>or</th>
<th>xxx</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bond premium or discount (amortization)</td>
<td>xxx</td>
<td>or</td>
<td>xxx</td>
</tr>
<tr>
<td>Cash or interest payable</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
**Bond Issue Costs**

Recorded as asset

- Deferred charge
- Amortized (straight-line) over term of bond
- Not considered part of carrying value

**Bond Retirement**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bond payable (face amount)</td>
<td>xxx</td>
</tr>
<tr>
<td>Bond premium or discount (balance)</td>
<td>xxx or xxx</td>
</tr>
<tr>
<td>Gain or loss (plug)</td>
<td>xxx or xxx</td>
</tr>
<tr>
<td>Bond issue costs (balance)</td>
<td>xxx</td>
</tr>
<tr>
<td>Cash (amount paid)</td>
<td>xxx</td>
</tr>
</tbody>
</table>

Gain or loss is extraordinary if retirement is determined to be both unusual and infrequent
Convertible Bonds

Recorded as bonds that are not convertible

Upon conversion:

<table>
<thead>
<tr>
<th><strong>Book Value Method</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds payable (face)</td>
<td>xx</td>
</tr>
<tr>
<td>Prem or disc (bal)</td>
<td>xx or xx</td>
</tr>
<tr>
<td>Com stk (par)</td>
<td>xx</td>
</tr>
<tr>
<td>APIC (diff)</td>
<td>xx</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Market Value Method</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds payable (face)</td>
<td>xx</td>
</tr>
<tr>
<td>Prem or disc (bal)</td>
<td>xx or xx</td>
</tr>
<tr>
<td>Com stk (par)</td>
<td>xx</td>
</tr>
<tr>
<td>APIC (computed)</td>
<td>xx</td>
</tr>
<tr>
<td>Gain or loss (diff)</td>
<td>xx or xx</td>
</tr>
</tbody>
</table>

**Book value method**
- Issuance price of stock = Carrying value of bonds
- No gain or loss

**Market value method**
- Issue price of stock = Fair market value
- Gain or loss recognized
Detachable Warrants

Allocate proceeds using relative fair value method

Fair value of bonds (without warrants) + Fair value of warrants (without bonds) = Total fair value

Bonds = Proceeds × Value of bonds/total value

Warrants = Proceeds × Value of warrants/total value

Record issuance:

\[
\begin{align*}
\text{Cash (total proceeds)} & \quad xx \\
\text{Discount or premium (plug**)} & \quad xx \text{ or } xx \\
\text{APIC (amount allocated to warrants)} & \quad xx \\
\text{Bonds payable (face amount)} & \quad xx \\
\end{align*}
\]

\[
** \quad \text{Bonds payable} - \text{Discount or plus premium} = \text{Amount allocated to bonds}
\]
Disclosures

A bond issuer should disclose:

- The face amount of bonds
- The nature and terms of the bonds including a discussion of credit and market risk, cash requirements, and related accounting policies
- The fair value of the bonds at the balance sheet date, indicated as a reasonable estimate of fair value
Troubled Debt Restructuring

Transfer property to creditor

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability (amount forgiven)</td>
<td>xxx</td>
</tr>
<tr>
<td>Gain or loss on disposal</td>
<td>xxx or xxx</td>
</tr>
<tr>
<td>Asset (carrying value)</td>
<td>xxx</td>
</tr>
<tr>
<td>Extraordinary gain on restructure</td>
<td>xxx</td>
</tr>
</tbody>
</table>

Gain (or loss) on disposal = Fair value of asset – Carrying value of asset
Gain on restructure = Carrying value of debt – Fair value of asset

Issuance of equity

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability (amount forgiven)</td>
<td>xxx</td>
</tr>
<tr>
<td>Common stock (par value)</td>
<td>xxx</td>
</tr>
<tr>
<td>APIC (based on fair value)</td>
<td>xxx</td>
</tr>
<tr>
<td>Gain on restructure</td>
<td>xxx</td>
</tr>
</tbody>
</table>

APIC = Fair value of stock issued – Par value of stock issued
Gain on restructure = Fair value of stock – Carrying value of debt
Modification of Terms

Total payments under new terms:

- If $\geq$ carrying value of debt – no adjustment made
- If $<$ carrying value of debt – difference is gain

Treatment of restructuring gain

Reported in ordinary income unless it is determined that the restructuring is both unusual and infrequent.
Bankruptcy

Order of distribution:

1) Fully secured creditors
   • Receive payment in full
   • Excess of fair value of asset over debt added to remaining available money

2) Partially secured creditors
   • Receive payment equal to fair value of collateral
   • Difference considered unsecured debt

3) Unsecured creditors
   • All receive partial payment
   • \( \frac{\text{Remaining available money}}{\text{Total of unsecured claims}} = \text{Ratio} \)
   • Ratio multiplied by each claim to determine payment
Pension Plans

Pension Expense

Service cost
+ Interest
– Actual return on plan assets
± Amortization of prior service cost
± Gains or losses to extent recognized
= Pension expense
**Service cost** – Increase in plan’s projected benefit obligation (PBO) resulting from services performed by employees

**Interest** – Beginning PBO × discount (interest) rate

**Actual return on plan assets** – Increase in plan assets after eliminating contributions and adding back distributions

**Gains or losses** – 2 components
  - Difference between actual return and expected return
  - Amortization of accumulated amount when beginning balance > greater of 10% of beginning PBO or 10% of market related value of beginning plan assets
Accrued or Prepaid Pension Expense

When expense > payments – difference is accrued pension expense
When expense < payments – difference is prepaid pension expense
Either accrued or prepaid pension expense will appear on balance sheet.

Additional Pension Liability

Minimum liability reported when:

Accumulated benefit obligation (ABO) > Fair value of plan assets

ABO
– Fair value of plan assets
= Minimum liability
**Additional Pension Liability**

Additional pension liability will be reported when minimum liability > accrued pension expense

Minimum liability
- Balance in accrued pension expense or
+ Balance in prepaid pension expense
= Additional pension liability

To record additional pension liability

Deferred pension asset (limited to balance in unamortized prior service cost) xxx
Stockholders’ equity account – part of accumulated other comprehensive income (plug) xxx
Additional pension liability xxx
Disclosures

- Description of funding policies and types of assets held
- Pension expense for the period
- Fair value of plan assets
- Reconciliation of funded status with accrued or prepaid pension expense reported on the balance sheet
Postretirement Benefits

Types of Benefits

Company pays for:
- Health care
- Tuition assistance
- Legal services
- Life insurance
- Day care
- Housing subsidies

Individuals covered:
- Retired employees
- Beneficiaries
- Covered dependents
Postretirement Benefit Expense

Service cost
+ Interest
– Actual return on plan assets
± Amortization of prior service cost
± Gains or losses to extent recognized
= Postretirement benefit expense
Accounting for Income Taxes

**Income Tax Expense**

Taxable income = Pretax accounting income

- No temporary differences
- Income tax expense = Current income tax expense
- No deferred tax effect

Taxable income ≠ Pretax accounting income

- Temporary differences
- Income tax expense = Current income tax expense ± Deferred income taxes
**Current Income Tax**

Current income tax expense  =  Taxable income  ×  Current tax rate

Current tax liability  =  Current income tax expense  –  Estimated payments

Taxable income:

- Pretax accounting income (financial statement income)
- ± Permanent differences
- ± Changes in cumulative amounts of temporary differences
- = Taxable income
Permanent & Temporary Differences

Permanent differences
- Nontaxable income (interest income on municipal bonds) & nondeductible expenses (premiums on officers' life insurance)
- No income tax effect

Temporary differences
- Carrying values of assets or liabilities ≠ tax bases
- May be taxable temporary differences (TTD) or deductible temporary differences (DTD)

Assets
- Financial statement basis > tax basis = TTD
- Financial statement basis < tax basis = DTD

Liabilities
- Financial statement basis > tax basis = DTD
- Financial statement basis < tax basis = TTD
Deferred Tax Assets & Liabilities

TTD × Enacted future tax rate = Deferred tax liability

DTD × Enacted future tax rate = Deferred tax asset

Selecting appropriate rate:

1) Determine future period when temporary difference will have tax effect (period of reversal)
2) Determine enacted tax rate for that period

**Deferred Tax Asset Valuation Allowance**

May apply to any deferred tax asset

- Is it more likely than not that some or all of deferred tax asset will not be realized
- Consider tax planning strategies

Valuation allowance = portion of deferred tax asset that will not be realized
**Deferred Income Tax Expense or Benefit**

1) Calculate balances of deferred tax liabilities and assets and valuation allowances
2) Combine into single net amount
3) Compare to combined amount at beginning of period
   - Increase in net liability amount = deferred income tax expense
   - Decrease in net asset amount = deferred income tax expense
   - Increase in net asset amount = deferred income tax benefit
   - Decrease in net liability amount = deferred income tax benefit
**Balance Sheet Presentation**

Identify current and noncurrent deferred tax assets, liabilities, and valuation allowances

Current – TTD or DTD relates to asset or liability classified as current

Noncurrent – TTD or DTD relates to asset or liability classified as noncurrent

TTD or DTD does not relate to specific asset or liability (such as result of net operating loss carryforward) – classify as current or noncurrent depending on period of tax effect

1) Combine current deferred tax assets, liabilities, and valuation allowances into single amount
2) Report as current deferred tax asset or liability
3) Combine noncurrent deferred tax assets, liabilities, and valuation allowances into single amount
4) Report as noncurrent deferred tax asset or liability
Stockholders’ Equity

Issuance of Common Stock

*Stock issued for cash, property, or services:*

Journal entry:

Cash, property, or expense (fair value) xxx
Common stock (par or stated value) xxx
APIC (difference) xxx
Common Stock Subscribed

Subscription – Journal entry:

- Cash (down payment) xxx
- Subscriptions receivable (balance) xxx
  - Common stock subscribed (par or stated value) xxx
  - APIC (difference) xxx

Collection and issuance of shares – Journal entries:

- Cash (balance) xxx
  - Subscriptions receivable xxx
- Common stock subscribed (par or stated value) xxx
  - Common stock (par or stated value) xxx
### Treasury Stock

**Acquisition of shares:**

<table>
<thead>
<tr>
<th>Cost Method</th>
<th>Par Value Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>TS (cost) xx</td>
<td>TS (par value) xx</td>
</tr>
<tr>
<td>Cash xx</td>
<td>APIC (original amount) xx</td>
</tr>
<tr>
<td>RE (difference) xx</td>
<td>RE (difference) xx</td>
</tr>
<tr>
<td>or</td>
<td>or</td>
</tr>
<tr>
<td>APIC from TS (difference) xx</td>
<td></td>
</tr>
<tr>
<td>Cash (cost) xx</td>
<td>Cash (cost) xx</td>
</tr>
</tbody>
</table>
### Sale – more than cost:

<table>
<thead>
<tr>
<th>Cost Method</th>
<th>Par Value Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (proceeds)</td>
<td>xx</td>
</tr>
<tr>
<td>TS (cost)</td>
<td>xx</td>
</tr>
<tr>
<td>APIC from TS</td>
<td>xx</td>
</tr>
</tbody>
</table>

### Sale – less than cost:

<table>
<thead>
<tr>
<th>Cost Method</th>
<th>Par Value Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (proceeds)</td>
<td>xx</td>
</tr>
<tr>
<td>APIC from TS (difference up to balance)</td>
<td>xx</td>
</tr>
<tr>
<td>RE (remainder of difference)</td>
<td>xx</td>
</tr>
<tr>
<td>TS (cost)</td>
<td>xx</td>
</tr>
</tbody>
</table>
Characteristics of Preferred Stock

Preference over common stock
- Receive dividends prior to common stockholders
- Paid before common on liquidation

Cumulative preferred stock
- Unpaid dividends accumulated as dividends in arrears
- Paid in subsequent periods prior to payment of current dividends to common or preferred
- Not considered liability until declared

Participating preferred stock
- Receive current dividends prior to common stockholders
- Receive additional dividends, in proportion to common stockholders, in periods of high dividends
Equity Instruments With Characteristics of Liabilities

Financial instruments shares should be classified as liabilities on the balance sheet, even when they appear to be in the form of equity, when any of these characteristics apply:

- Preferred shares have a mandatory redemption date payable in cash
- An obligation exists to repurchase shares through the transfer of assets to the shareholder.
- Shares are convertible to other shares when the exchange rate is based on a fixed monetary value of issuer shares or is tied to variations in the fixed value of something other than the issuer’s shares.

Note that convertible shares whose conversion rate is not adjusted for changes in values do not fall into this category (e.g. preferred stock convertible at a fixed 10 for 1 ratio to the common stock would not be a liability)
Dividends

Cash Dividends

Recorded when declared
1) Dividends in arrears to preferred stockholders if cumulative
2) Normal current dividend to preferred stockholders
3) Comparable current dividend to common stockholders
4) Remainder
   • Allocated between common and preferred shares if preferred stock is participating
   • Paid to common stockholders if preferred stock is nonparticipating

Property Dividends

Journal entry
Retained earnings (fmv of property) xxx
Gain (or loss) xxx or xxx
Asset (carrying value of property) xxx
Liquidating Dividends

Journal entry
- Retained earnings (balance) \( \text{xxx} \)
- APIC (plug) \( \text{xxx} \)
- Cash or Dividends payable \( \text{xxx} \)

Stock Dividends

Journal entry - Normal stock dividend – usually 20% or less
- Retained earnings (fmv of stock issued) \( \text{xxx} \)
  - Common stock (par or stated value) \( \text{xxx} \)
  - APIC (difference) \( \text{xxx} \)

Journal entry – Large stock dividend – usually more than 25% – referred to as stock split affected in the form of a stock dividend
- Retained earnings (par or stated value) \( \text{xxx} \)
  - Common stock (par or stated value) \( \text{xxx} \)
Preferred Stock – Special Issuances

Preferred with Detachable Warrants

Cash (proceeds) xxx
  APIC from warrants (amount allocated) xxx
  Preferred stock (par) xxx
  APIC from preferred stock (difference) xxx

Amount allocated to warrants using relative fair value method:
  Fair value of warrants
  + Fair value of stock
  = Total fair value

Allocation:
  • Fair value of warrants ÷ Total fair value × Proceeds = Amount allocated to warrants
  • Fair value of stock ÷ Total fair value × Proceeds = Amount allocated to stock
Convertible Preferred Stock

Journal entry – Issuance

Cash (proceeds) xxx
Preferred stock (par) xxx
APIC from preferred stock (difference) xxx

Journal entry – Conversion

Preferred stock (par) xxx
APIC from preferred stock (original amount) xxx
Common stock (par or stated value) xxx
APIC (difference) xxx
Retained Earnings

Appropriations
Set up to disclose to financial statement users future commitments that are not subject to accrual.

Journal entry:

\[
\begin{align*}
\text{Retained earnings} & \quad xxx \\
\text{Retained earnings appropriated for…} & \quad xxx
\end{align*}
\]

When the commitment is met, accrued, or avoided, the appropriation is reversed.

Journal entry:

\[
\begin{align*}
\text{Retained earnings appropriated for…} & \quad xxx \\
\text{Retained earnings} & \quad xxx
\end{align*}
\]
Prior Period Adjustments

Made to correct errors in financial statements of prior periods

Adjustment to beginning retained earnings
  • Equal to net amount of errors from periods prior to earliest period presented
  • Reduced by tax effect

Presented on statement of retained earnings
  • Unadjusted beginning balance reported
  • Increased or decreased for prior period adjustment
  • Result is adjusted beginning balance
### Statement of Retained Earnings

Beginning retained earnings, as previously reported

\[ \pm \text{ Prior period adjustments} \]
\[ = \text{ Beginning retained earnings, as adjusted} \]
\[ + \text{ Net income for period} \]
\[ - \text{ Dividends} \]
\[ - \text{ Appropriations} \]
\[ + \text{ Appropriations eliminated} \]
\[ = \text{ Ending retained earnings} \]
Stock Options Plans

Noncompensatory Plans

Noncompensatory when:

- All employees participate
- Participation uniform among employees
- Option period limited to reasonable time
- Discount below market price limited to reasonable amount
Compensatory Plans

Journal entry

<table>
<thead>
<tr>
<th>Account</th>
<th>xxx</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred compensation</td>
<td>xxx</td>
</tr>
<tr>
<td>APIC – Options</td>
<td>xxx</td>
</tr>
</tbody>
</table>

Options must be accounted for using FMV at date of grant based on:

- Market price of options with similar characteristics
- Option pricing model
  - Binomial distribution model
  - Black-Scholes model
- Intrinsic value (stock price – exercise price) only used when FMV cannot be determined at grant date and must be replaced by FMV as soon as estimate is available

Compensation recognized over service period
Stock Appreciation Rights

Calculating liability

- Stock price
  - Amount specified in stock appreciation rights
  = Amount per share
  × # of stock appreciation rights
  = Total liability
  × Portion of service period elapsed
  = Liability on balance sheet date

Amount needed to increase or decrease liability is recognized as compensation expense
Quasi Reorganizations

Journal entry:

Common stock (reduction in par value) xxx
APIC (plug) xxx or xxx
  Retained earnings (eliminate deficit) xxx
  Assets (eliminate overstatements) xxx
Book Value Per Share

Calculation:

Total stockholders’ equity

- Preferred stock (par value or liquidation preference)
- Dividends in arrears on cumulative preferred stock

= Stockholders’ equity attributable to common stockholders

÷ Common shares outstanding at balance sheet date

= Book value per common share
Disclosure of Information About Capital Structure

Rights & privileges of various debt & equity securities outstanding

- Number of shares of common and preferred stock authorized, issued, & outstanding
- Dividend & liquidation preferences
- Participation rights
- Call prices & dates
- Conversion or exercise prices or rates & pertinent dates
- Sinking fund requirements
- Unusual voting rights
- Significant terms of contracts to issue additional shares
### Reporting Stockholders’ Equity

6% cumulative preferred stock, $100 par value, 200,000 shares authorized, 120,000 shares issued and outstanding  $ 12,000,000

Common stock, $10 par value, 1,500,000 shares authorized, 1,150,000 shares issued and 1,090,000 shares outstanding  11,500,000

Additional paid-in capital  3,650,000

27,150,000

Retained Earnings:
- Unappropriated  $ 6,925,000
- Retained earnings appropriated for plant expansion  1,400,000  8,325,000

Accumulated other comprehensive income:
- Accumulated unrealized gain due to increase
  - In value of marketable securities available for sale  750,000
  - Accumulated translation adjustment  (515,000)  235,000

Accumulated translation adjustment  (515,000)  35,710,000

Less: Treasury stock, 60,000 shares at cost  780,000

Total Stockholders’ Equity  $ 34,930,000
Earnings Per Share

Reporting Earnings Per Share

Simple capital structure
- No potentially dilutive securities outstanding
- Present basic EPS only

Complex capital structure
- Potentially dilutive securities outstanding
- Dual presentation of EPS – basic EPS & diluted EPS

Potentially dilutive securities - Securities that can be converted into common shares
- Convertible bonds and convertible preferred stock
- Options, rights, and warrants
Basic EPS

**Numerator - Income Available to Common Stockholders**

- Income from continuing operations
- Dividends declared on noncumulative preferred stock
- Current dividends on cumulative preferred stock (whether or not declared)
- Income from continuing operations available to common stockholders
± Discontinued operations
± Extraordinary items
= Net income available to common stockholders

**Denominator**

Weighted-average common shares outstanding on the balance sheet date
**Diluted EPS**

Adjust numerator & denominator for dilutive securities
- Assume conversion into common shares
- Dilutive if EPS decreases

**Convertible Preferred Stock**

Dilutive if basic EPS is greater than preferred dividend per share of common stock obtainable:
- Add preferred dividends back to numerator
- Add common shares that preferred would be converted into to denominator

**Convertible Bonds**

Dilutive if basic EPS is greater than interest, net of tax, per share of common stock obtainable:
- Add interest, net of tax, to numerator
- Add common shares that bonds would be converted into to denominator
Options, Rights, & Warrants

Dilutive when market price exceeds exercise price (proceeds from exercise)

The **treasury stock method** is applied

\[
\text{Number of options} \times \text{Exercise price} = \text{Proceeds from exercise} \\
\div \text{Average market price of stock during period} = \text{Shares reacquired with proceeds} \\
\Rightarrow \text{Number of options} - \text{Shares reacquired} = \text{Increase in denominator}
\]

Calculation done on quarter-by-quarter basis
Presentation of EPS Information

**Income Statement**

Simple capital structure – Basic EPS only
- Income from continuing operations
- Net income

Complex capital structure – Basic & Diluted EPS
- Income from continuing operations
- Net income

**Additional Disclosures (income statement or notes)**
- Discontinued operations
- Extraordinary items
## Methods of Reporting Investments

<table>
<thead>
<tr>
<th>Method</th>
<th>Conditions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidation</td>
<td>Majority owned (&gt; 50%)</td>
</tr>
<tr>
<td>Equity</td>
<td>Less than majority owned&lt;br&gt;Ability to exercise significant influence&lt;br&gt;Ownership generally ≥ 20%</td>
</tr>
<tr>
<td>Cost</td>
<td>Less than majority owned&lt;br&gt;Unable to exercise significant influence&lt;br&gt;Ownership generally &lt; 20%&lt;br&gt;Not an investment in marketable securities</td>
</tr>
<tr>
<td>Special Rules</td>
<td>Less than majority owned&lt;br&gt;Unable to exercise significant influence&lt;br&gt;Ownership generally &lt; 20%&lt;br&gt;Investment in marketable securities (FASB #115)</td>
</tr>
</tbody>
</table>
Equity Method

Carrying Value of Investment

Cost
+ Earnings
– Dividends
= Carrying value of investment

Earnings

Income reported by investee
× % of ownership
= Unadjusted amount
• Adjustments
= Investor’s share of investee’s earnings
Equity Method

Adjustments to Earnings

1) Compare initial investment to FMV of underlying net assets
2) Portion of excess may be due to inventory
   Deduct from income in the first year (unless inventory not sold during year)
3) Portion of excess may be due to depreciable asset
   Divide by useful life and deduct from income each year
4) Portion of excess may be due to land
   No adjustment (unless land sold during year)
5) Remainder of excess attributed to goodwill
   Test each year for impairment and deduct from income if it has occurred
Equity Method

Application of Equity Method

Information given:
Investment 25%
Cost $400,000
Book value of investee’s underlying net assets $900,000
Undervalued assets:
  - Inventory 100,000
  - Building (20 yrs) 400,000
  - Land 200,000
Investee’s unadjusted income $225,000
Dividends $40,000
Application of Equity Method (continued)

Information Applied

Value of investment – $400,000 ÷ 25% $1,600,000
Book value of underlying net assets $900,000
Difference $700,000

Reconciliation of difference

<table>
<thead>
<tr>
<th>Item</th>
<th>Book Value</th>
<th>% of Ownership</th>
<th>Carrying Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$100,000</td>
<td>20%</td>
<td>$100,000</td>
</tr>
<tr>
<td>Building</td>
<td>400,000</td>
<td></td>
<td>20,000</td>
</tr>
<tr>
<td>Land</td>
<td>200,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$700,000</td>
<td></td>
<td>$120,000</td>
</tr>
</tbody>
</table>

Earnings

Income reported by investee $225,000

• Adjustments (120,000)

= Adjusted amount 105,000

× % of ownership 25%

= Investor’s share $26,250

Earnings adjustment

Income reported by investee $225,000 × 25% $56,250

= Earnings 26,250

− Dividends ($40,000 × 25%) 10,000

= Carrying value $416,250

Carrying value

Cost $400,000

+ Earnings 26,250

− Dividends 10,000

= Carrying value $416,250
Changes to and from the Equity Method

Equity Method to Cost Method

- No longer able to exercise significant influence
- Usually associated with sale of portion of investment
- Apply equity method to date of change
- Apply cost method from date of change

Cost Method to Equity Method

- Now able to exercise significant influence
- Usually associated with additional purchase
- Apply equity method retroactively
- Affects retained earnings and investment for prior periods
## Marketable Securities

<table>
<thead>
<tr>
<th>Types of securities in classification</th>
<th>Trading Securities</th>
<th>Available for Sale</th>
<th>Held to Maturity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance sheet classification</td>
<td>Debt or equity</td>
<td>Debt or equity</td>
<td>Debt only</td>
</tr>
<tr>
<td>Carrying amount on balance sheet</td>
<td>Current</td>
<td>Current or noncurrent</td>
<td>Noncurrent until maturity</td>
</tr>
<tr>
<td>Unrealized gains and losses</td>
<td>Income statement</td>
<td>Equity section of balance sheet *</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Realized gains and losses</td>
<td>Income statement</td>
<td>Income statement</td>
<td>Should not occur</td>
</tr>
</tbody>
</table>

* Excluded from net income – included in comprehensive income
Life Insurance

Payment of premium:

- Cash surrender value of life insurance (increase in value) xxx
- Insurance expense (plug) xxx
- Cash (premium amount) xxx

Death of insured:

- Cash (face of policy) xxx
- Cash surrender value of life insurance (balance) xxx
- Gain (difference) xxx
**Statement of Cash Flows**

**Purpose of Statement**
Summarizes sources and uses of cash and *cash equivalents*
Classifies cash flows into operating, investing, and financing activities

**Cash Equivalents**
Easily converted into cash (liquid)
Original maturity $\leq$ 3 months
Format of Statement

Cash provided or (used) by **operating** activities
± Cash provided or (used) by **investing** activities
± Cash provided or (used) by **financing** activities
= Net increase or (decrease) in cash & cash equivalents
+ Beginning balance
= Ending balance
### Operating Activities

**Direct Method – Top to bottom**

- Collections from customers
- Interest & dividends received
- Proceeds from sale of trading securities
- Other operating cash inflows
- Payments for merchandise
- Payments for expense
- Payments for interest
- Payments for income taxes
- Payments to acquire trading securities
- Other operating cash outflows

\[
\text{Must be equal}
\]

**Direct Method – Top to bottom**

- Net income
- Noncash revenues
- Noncash expenses
- Gains on sales of investments
- Losses on sales of investments
- Gains on sales of plant assets
- Losses on sales of plant assets
- Increases in current assets
- Decreases in current assets
- Decreases in current liabilities
- Increases in current liabilities

\[
= \text{Cash flows from operating activities}
\]

\[
\text{Cash flows from operating activities} =
\]

**Focus on**

Statement of Cash Flows – Module 15 168
## Components of Direct Method

<table>
<thead>
<tr>
<th>Component</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Collections from customers</td>
<td>xxx</td>
</tr>
<tr>
<td>Increase in accounts receivable (given)</td>
<td>xxx</td>
</tr>
<tr>
<td>Decrease in accounts receivable (given)</td>
<td>xxx</td>
</tr>
<tr>
<td>Sales (given)</td>
<td>xxx</td>
</tr>
<tr>
<td>Increase in inventory (given)</td>
<td>xxx</td>
</tr>
<tr>
<td>Decrease in accounts payable (given)</td>
<td>xxx</td>
</tr>
<tr>
<td>Cost of sales (given)</td>
<td>xxx</td>
</tr>
<tr>
<td>Decrease in inventory (given)</td>
<td>xxx</td>
</tr>
<tr>
<td>Increase in accounts payable (given)</td>
<td>xxx</td>
</tr>
<tr>
<td>Payments for merchandise (plug)</td>
<td>xxx</td>
</tr>
</tbody>
</table>
Adjustments Under Indirect Method

Increase in accumulated depreciation
+ Accumulated depreciation on assets sold
= Addition to income for depreciation expense

Equity in earnings from equity method investment
– Dividends received from equity method investee
= Reduction to income for equity in earnings (should equal increase in investment)
Investing Activities

Principal collections on loans receivable
+ Proceeds from sale of investments (except trading securities)
+ Proceeds from sale of plant assets
  – Loans made
  – Payments to acquire investments (except trading securities)
  – Payments to acquire plant assets
= Cash flows from investing activities
Financing Activities

Proceeds from borrowings
+ Proceeds from issuing stock
– Debt principal payments
– Payments to reacquire stock
– Payments for dividends

= Cash flows from financing activities
Other Disclosures

With direct method:
   Reconciliation of net income to cash flows from operating activities (indirect method)

With indirect method:
   Payments for interest
   Payments for income taxes

With all cash flow statements:
   Schedule of noncash investing and financing activities
Business Combinations

Consolidation is required whenever the entity has control over another entity.

- Investor is identified as parent and investee as subsidiary in control situations
- Ownership of majority of voting stock generally indicates control
- Consolidation is required even if control situation is temporary
- Consolidation is not appropriate when a majority shareholder doesn’t have effective control:
  - Company is in bankruptcy or reorganization
  - Foreign exchange controls limit power to keep control of subsidiary assets
- All consolidations are accounted for as purchases
Accounting for a Purchase

**Combination – Records combined**

- Assets (at fair market values) xxx
- Goodwill (plug)
  - Liabilities (at fair market values) xxx
  - Stockholders’ equity (2 steps) * xxx
  - OR
    - Cash (amount paid) xxx

* Credit common stock for par value of shares issued and credit APIC for difference between fair value and par value of shares issued

**Combination – Records not combined**

- Investment (fair value of net assets) xxx
- Stockholders’ equity (same 2 steps) xxx
- OR
  - Cash (amount paid) xxx
**Earnings**

Consolidated net income:

- Parent’s net income
- + Subsidiary’s net income from date of acquisition
- ± Effects of intercompany transactions
  - Depreciation on difference between fair value and carrying value of sub’s assets
  - Impairment losses on goodwill (if applicable)
- = Consolidated net income
Retained Earnings – Year of Combination

- Beginning retained earnings – Parent’s beginning balance
  + Consolidated net income
  – Parent’s dividends for entire period
  = Ending retained earnings
Consolidations

Eliminate the Investment

Example 1 – Date of combination – no goodwill or minority interest

- Inventory (excess of fair value over carrying value) xxx
- Land (excess of fair value over carrying value) xxx
- Depreciable assets (excess of fair value over Carrying value) xxx
- Common stock (sub’s balance) xxx
- APIC (sub’s balance) xxx
- Retained earnings (sub’s balance) xxx
- Investment xxx
Example 2 – Date of combination – no goodwill with minority interest

Inventory (excess of fair value over carrying value) xxx
Land (excess of fair value over carrying value) xxx
Depreciable assets (excess of fair value over carrying value) xxx
Common stock (sub’s balance) xxx
APIC (sub’s balance) xxx
Retained earnings (sub’s balance) xxx
 Minority interest (sub’s total stockholders’ equity × minority interest percentage) xxx
Investment xxx
### Example 3 – Date of combination – goodwill and minority interest

<table>
<thead>
<tr>
<th>Category</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory (excess of fair value over carrying value)</td>
<td>xxx</td>
</tr>
<tr>
<td>Land (excess of fair value over carrying value)</td>
<td>xxx</td>
</tr>
<tr>
<td>Depreciable assets (excess of fair value over carrying value)</td>
<td>xxx</td>
</tr>
<tr>
<td><strong>Goodwill (plug)</strong></td>
<td>xxx</td>
</tr>
<tr>
<td>Common stock (sub’s balance)</td>
<td>xxx</td>
</tr>
<tr>
<td>APIC (sub’s balance)</td>
<td>xxx</td>
</tr>
<tr>
<td>Retained earnings (sub’s balance)</td>
<td>xxx</td>
</tr>
<tr>
<td>Minority interest (sub’s total stockholders’ equity × minority interest percentage)</td>
<td>xxx</td>
</tr>
<tr>
<td>Investment</td>
<td>xxx</td>
</tr>
</tbody>
</table>

Calculating goodwill – 4 steps
1) Determine amount paid for acquisition
2) Compare to book value of sub’s underlying net assets
3) Subtract difference between fair values and book values of sub’s assets
4) Remainder is goodwill
Additional entries – after date of acquisition

• Debit cost of sales instead of inventory for fair market value adjustment
• Recognize depreciation on excess of fair value over carrying value of depreciable assets
• Recognize impairment of goodwill (if FMV of goodwill is less than carrying amount)
Eliminating Entries

Intercompany Sales of Inventory

Eliminate gross amount of intercompany sales

- Sales xxx
- Cost of sales xxx

Eliminate intercompany profit included in ending inventory

- Cost of sales xxx
- Inventory xxx

Eliminate unpaid portion of intercompany sales

- Accounts payable xxx
- Accounts receivable xxx
Intercompany Sales of Property, Plant, & Equipment

Eliminate intercompany gain or loss

- Gain on sale (amount recognized) xxx
- Depreciable asset xxx

Adjust depreciation

- Accumulated depreciation (amount of gain divided by remaining useful life) xxx
- Depreciation expense xxx

Intercompany Bond Holdings

Eliminate intercompany investment in bonds

- Bonds payable (face amount of bonds acquired) xxx
- Bond premium or discount (amount related to Intercompany bonds) xxx or xxx
  - Gain or loss on retirement (plug) xxx or xxx
  - Investment in bonds (carrying value) xxx
Investments in Derivative Securities

Derivatives – Derive their value from other assets. Examples:

- Stock option – value based on underlying stock price
- Commodity futures contract – value based on underlying commodity price

Initially recorded at cost (or allocated amount) – Reported on balance sheet at fair value

- Trading security – unrealized gains and losses on income statement
- Available for sale security – unrealized gains and losses reported as other comprehensive income in stockholders’ equity
Characteristics of Derivatives

Settlement in cash or assets easily convertible to cash (such as marketable securities)

Underlying index on which value of derivative is based (usually the price of some asset)

No net investment at time of creation:
- Futures-based derivative involves no payments at all when derivative created
  - Such a derivative must be settled on settlement date in all cases
- Options-based derivative involves small premium payment when derivative created
  - Option holder has right not to settle derivative if results would be unfavorable
  - Payment of premium when derivative created is price of this option.
Use of Derivatives

Speculative – Attempt to profit from favorable change in underlying index
  - Gain or loss on change in fair value reported in ordinary income

Fair Value Hedge – Attempt to offset risk of existing asset, liability, or commitment
  - Hedge must move in opposite direction to offsetting item
  - Movement must be between 80% and 125% of offsetting item to be effective hedge
  - Gain or loss on change in derivative reported in ordinary income
    - Should approximately offset loss or gain on item being hedged

Cash Flow Hedge – Attempt to offset risk associated with future expected transactions
  - Gain or loss excluded from ordinary income until offsetting future event affects income
    - Reported as part of other comprehensive income until that time
Financial Instruments

Risk of loss:
Market risk – Losses due to fluctuations in market place
Credit risk – Losses due to nonperformance of other party
Concentration of credit risk – Several instruments have common characteristics resulting in similar risks

Required Disclosures
• Off-balance-sheet credit risk – credit risk that is not already reflected as an accrued contingency
• Concentration of credit risk
Segment Reporting

Definition of Segments

Segments identified using management approach:

- Component earns revenue and incurs expenses
- Separate information is available
- Component is evaluated regularly by top management
Reportable Segments - 3 Tests

Revenue test – Segment revenues ≥ 10% of total revenues

Asset test – Segment identifiable assets ≥ 10% of total assets

Profit or loss test
- Combine profits for all profitable segments
- Combine losses for all losing segments
- Select larger amount
- Segments profit or loss ≥ 10% of larger amount
Disclosures for Reportable Segments

Segment profit or loss
- Segment revenues include intersegment sales
- Deduct traceable operating expenses and allocated indirect operating expenses
- Do not deduct general corporate expenses

Segment revenues
Segment assets
Interest revenue & expense
Depreciation, depletion, & amortization
Other items


Partnership

Admitting a Partner

Calculating the Contribution – No Goodwill or Bonus

Partnership equity (before new partner’s contribution)
\[ \div 100\% – \text{new partner’s percentage} \]
\[ = \text{Total capital after contribution} \]
\[ \times \text{New partner’s percentage} \]
\[ = \text{Amount to be contributed} \]

Journal entry:

Cash \[ xxx \]

New partner’s equity \[ xxx \]
Excess Contribution by New Partner – Bonus Method

Partnership equity (before new partner’s contribution) + New partner’s contribution = Total capital after contribution

× New partner’s percentage = New partner’s capital – New partner’s capital = Bonus to existing partners

Journal entry:

Cash (new partner’s contribution) xxx
Capital, new partner (amount calculated) xxx
Capital, existing partners (bonus amount) xxx

Bonus is allocated to existing partners using their P & L percentages
Excess Contribution by New Partner – Goodwill Method

- New partner’s contribution
- ÷ New partner’s percentage
= Total capital after contribution
- Total capital of partnership (existing capital + contribution)
= Goodwill to existing partners

Journal entry:

<table>
<thead>
<tr>
<th>Account</th>
<th>xxx</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (new partner’s contribution)</td>
<td></td>
</tr>
<tr>
<td>Capital, new partner (new partner’s contribution)</td>
<td></td>
</tr>
<tr>
<td>Goodwill (amount calculated)</td>
<td></td>
</tr>
<tr>
<td>Capital, existing partners</td>
<td></td>
</tr>
</tbody>
</table>

Goodwill is allocated to existing partners using their P & L percentages.
**Contribution Below New Partner’s Capital – Bonus Method**

- Partnership equity (before new partner’s contribution)
- + New partner’s contribution
- = Total capital after contribution
- × New partner’s percentage
- = New partner’s capital
- – New partner’s contribution
- = Bonus to new partner

Journal entry:

- Cash (new partner’s contribution) xxx
- Capital, existing partners (bonus amount) xxx
- Capital, new partner (amount calculated) xxx

Bonus is allocated to existing partners using their P & L percentages
Contribution Below New Partner’s Capital – Goodwill Method

Partnership equity (before new partner’s contribution)
÷ 100% - new partner’s percentage
= Total capital after contribution
× New partner’s percentage
= New partner’s capital
– New partner’s contribution
= Goodwill

Journal entry:
Cash (new partner’s contribution) xxx
Goodwill (amount calculated) xxx
    Capital, new partner (total) xxx
Retiring a Partner

Payment Exceeds Partner’s Balance – Bonus Method

- Capital, retiring partner (existing balance) xxx
- Capital, remaining partners (difference – bonus) xxx
- Cash (amount paid) xxx

Bonus is allocated to existing partners using their P & L percentages
Payment Exceeds Partner’s Balance – Goodwill Method

Amount paid to retiring partner
÷ Retiring partner’s percentage
= Value of partnership on date of retirement
– Partnership equity before retirement
= Goodwill

Journal entries:

Goodwill (amount calculated) xxx
Capital, all partners xxx

Goodwill is allocated according to the partners’ P & L percentages

Capital, retiring partner xxx
Cash (amount paid to retiring partner) xxx
**Partnership Liquidation – 5 steps**

1) Combine each partner’s capital account with loans to or from that partner
2) Allocate gain or loss on assets sold to partners
3) Assume remaining assets are total loss – allocate to partners
4) Eliminate any partner’s negative balance by allocating to remaining partners using their P & L percentages
5) Resulting balances will be amounts to be distributed to remaining partners
Foreign Currency

Foreign Currency Transactions

Receivable or payable

- Record at spot rate
- Adjust to new spot rate on each financial statement date

Journal entry:

Receivable or payable xxx
   Foreign currency transaction gain xxx

OR

Foreign currency transaction loss xxx
   Receivable or payable xxx

Gain or loss = Change in spot rate × Receivable or payable (in foreign currency)
Forward Exchange Contracts

All gains and losses measured using forward rate – rate expected to be in effect when settled

Hedge – Protection against change in exchange rate related to existing receivable or payable

- Change in forward rate results in gain or loss on hedge
- This will approximately offset loss or gain on change in spot rate on receivable or payable

Special hedge contracts:

- Hedge of foreign currency investment – gains or losses reported in equity – excluded from net income but included in comprehensive income
- Hedge of foreign commitment – gain or loss deferred and offset against transaction

Speculative contracts – Entered into in anticipation of change in rate

- Change in forward rate results in gain or loss
**Foreign Currency Financial Statements**

*Conversion to U.S. $:*

- Local currency → Functional currency → Reporting currency (US $)
  - Remeasurement
  - Translation

**Functional Currency** – Currency of primary economic environment in which entity operates.

1) Functional currency = local currency
   - Translate from local currency to U.S. $

2) Functional currency = U.S. $
   - Remeasure from local currency to U.S. $

3) Functional currency neither local currency nor U.S. $
   - Remeasure from local currency to functional currency
   - Translate from functional currency to U.S. $
### Remeasurement and Translation

#### Remeasurement

**Historical rate:**
- Nonmonetary assets and liabilities
- Contributed capital accounts
- Revenue and expense accounts

**Current rate:**
- All other items

**Difference:**
- Remeasurement gain or loss
- Reported on income statement

#### Translation

**Rate at balance sheet date:**
- Assets and liabilities

**Rate in effect on transaction date**
- (or weighted-average rate for period):

**Revenues and expenses**
- Gains and losses

**Difference:**
- Translation gain or loss
- Component of stockholders’ equity
- Excluded from net income
- Included in comprehensive income
Interim Financial Statements

General Rules

1) Revenues & expenses recognized in interim period earned or incurred
2) Same principles as applied to annual financial statements
Special Rules

Inventory Losses

Expected to recover within annual period
- Not recognized in interim period
- Offset against recovery in subsequent interim period
- Recognized when clear that recovery will not occur

Not expected to recover within annual period
- Recognized in interim period
- Recovery in subsequent interim period recognized

Income Taxes

Estimate of rate that applies to annual period
Other Items

Property taxes – allocated among interim periods

Repairs & maintenance
  • Generally recognized in interim period when incurred (including major repairs)
  • Allocated to current & subsequent interim periods when future benefit results

Disposal of a segment – recognized in interim period in which it occurs

Extraordinary item – recognized in interim period in which it occurs
Personal Financial Statements

Basic Statements

Statement of Financial Condition

Statement of Changes in Net Worth
Principles Applied

Assets & liabilities – Reported at fair market values
Business interests – Reported as single amount

Real estate
  • When operated as business – reported net of mortgage
  • When not operated as business – asset and mortgage reported separately

Retirement plans
  • Contributions & earnings on contributions by employee included
  • Contributions & earnings on contributions by employer included to extent vested
Principles Applied (continued)

Life insurance – Cash surrender value minus borrowings against policy

Income taxes – 2 components
  • Income taxes on individual’s income for year to date
  • Tax effect on difference between tax basis and fair values of assets and liabilities

Other liabilities
  • Current payoff amount, if available
  • Otherwise, present value of future payments
Governmental Accounting

Objective of governmental accounting & reporting – **accountability**
- Provide useful information
- Benefit wide range of users

Governmental financial information should:
- Demonstrate operations within legal restraints imposed by citizens
- Communicate compliance with laws & regulations related to raising & spending money
- Demonstrate **interperiod equity** – current period expenditures financed with current revenues

To demonstrate full accountability for all activities, information must include:
- Cost of services
- Sufficiency of revenues for services provided
- Financial position
Funds
Government comprised of funds – self-balancing sets of accounts – 3 categories

- Governmental
- Proprietary
- Fiduciary

Methods of Accounting
Funds of a governmental unit use two methods of accounting

- Most funds use modified accrual accounting
- Some funds use accrual accounting

Modified Accrual Accounting
Differs from accrual accounting:

- Focus of financial reporting is financial position & flow of resources
- Revenues are recognized when they become available & measurable
- Expenditures are recorded when goods or services are obtained
- Expenditures classified by object, function, or character
Financial Statements of Governmental Units

General purpose financial statements – referred to as Comprehensive Annual Financial Report (CAFR) – 5 components

- Management discussions & analysis – Presented before financial statements
- Government-wide financial statements
- Fund financial statements
- Notes to financial statements
- Required supplementary information – Presented after financial statements and notes

Users should be able to distinguish between primary government & component units – component units may be blended when either:

- Governing body of component is essentially the same as that of the primary government
- The component provides services almost exclusively for the primary government

Most component units will be discretely presented
Management Discussion & Analysis (MD & A)

Introduces basic financial statements & provides analytical overview of government's financial activities

Should include:

• Condensed comparison of current year financial information to prior year
• Analysis of overall financial position and results of operations
• Analysis of balances and transactions in individual funds
• Analysis of significant budget variances
• Description of capital assets and long-term debt activity during the period
• Currently known facts, decisions, or conditions expected to affect financial position or results of operations
Government-Wide Financial Statements

Consist of:

- Statement of Net Assets
- Statement of Activities

Report on overall government

- Do not display information about individual funds
- Exclude fiduciary activities or component units that are fiduciary
- Distinction made between primary government and discretely presented component units
- Distinction made between government-type activities and business-type activities of primary government
- Government-type activities include governmental funds & internal service funds
- Business-type activities include enterprise funds only
Characteristics of Government-Wide Financial Statements

Use economic measurement focus for all assets, liabilities, revenues, expenses, gains, & losses

Apply accrual basis of accounting

Revenues from exchanges or exchange-like transactions recognized in period of exchange

Revenues from nonexchange transactions:

- **Derived tax revenues** imposed on exchange transactions recognized as asset & revenues when exchange occurs
- **Imposed nonexchange revenues** imposed on nongovernment agencies recognized as asset when government has enforceable claim & as revenues when use of resources required or permitted
- **Government-mandated nonexchange transactions** provided by one level of government for another recognized as asset & revenue (or liability & expense) when all eligibility requirements met
- **Voluntary nonexchange transactions** recognized similarly to government-mandated nonexchange transactions
Statement of Net Assets

Presents assets & liabilities

- Assets & liabilities in order of liquidity
- Current & noncurrent portions of liabilities reported
- Assets – Liabilities = Net assets

3 categories of net assets

- **Net assets invested in capital assets, net of related debt** – All capital assets, including restricted assets, net of depreciation & reduced by bonds, mortgages, notes, & other borrowings
- **Restricted net assets** – Assets with externally imposed restrictions on use distinguishing major categories of restrictions
- **Unrestricted net assets** – Remainder
Format of Statement of Net Assets

Assets, liabilities, & net assets reported for primary government

- Separate columns for government-type activities & business-type activities
- Amounts combined in total column

Assets, liabilities, & net assets also reported for component units

- Amounts reported similarly as those for primary government
- Column is not combined with totals for primary government
Statement of Activities

Self-financing activities distinguished from those drawing from general revenues

For each government function

- Net expense or revenue
- Relative burden

Governmental activities presented by function

Business-type activities presented by business segment

Items reported separately after net expenses of government’s functions:

- General revenues
- Contributions to term & permanent endowments
- Contributions to permanent fund principal
- Special items – those that are unusual or infrequent
- Extraordinary items – those that are unusual and infrequent
- Transfers
**Items on Statement of Activities**

Depreciation – indirect expense charged to function with asset

- Allocated among functions for shared assets
- Not required to be allocated to functions for general capital assets
- Not allocated to functions for general infrastructure assets

Revenues classified into categories

- Amounts received from users or beneficiaries of a program always **program revenues**
- Amounts received from parties outside citizenry are **general revenues** if unrestricted or program revenues if restricted to specific programs
- Amounts received from taxpayers always general revenues
- Amounts generated by the government usually general revenues
- Contributions to term & permanent endowments, contributions to permanent fund principal, special & extraordinary items, & transfers reported separately
**Format of Statement of Activities**

Information for each program or function reported separately:

- Expenses
- Charges for services
- Operating grants & contributions
- Capital grants & contributions

Difference between expenses & revenues reported for each program:

- Equal to change in net assets
- Separated into columns for governmental activities and business-type activities
- Combined into a total column

Remaining items (general revenues, grants & contributions, special & extraordinary items, & transfers) reported separately below functions & programs:

- Divided into governmental activities & business-type activities with total column
- Provides change in net assets & ending net assets with same amounts as Statement of Net Assets
- Separate column for component units not combined into total
Additional Characteristics of Government-Wide Financial Statements

Internal Amounts

- Eliminated to avoid doubling up
- Interfund receivables & payables eliminated
- Amounts due between government-type & business-type activities presented as offsetting internal balances

Capital assets include the following:

- Land, land improvements, & easements
- Buildings & building improvements
- Vehicles, machinery, & equipment
- Works of art & historical treasures
- Infrastructure
- All other tangible & intangible assets with initial useful lives > a single period
Accounting for Capital Assets & Infrastructure

Capital assets reported at historical cost
- Includes capitalized interest & costs of getting asset ready for intended use
- Depreciated over useful lives
- Inexhaustible assets not depreciated
- Infrastructure assets may be depreciated under modified approach

Infrastructure includes:
- Capital assets with longer lives than most capital assets that are normally stationary
- Roads, bridges, tunnels, drainage systems, water & sewer systems, dams, & lighting systems

Eligible infrastructure assets not depreciated
- Must be part of network or subsystem maintained & preserved at established condition levels
- Additions & improvements increasing capacity or efficiency capitalized
- Other expenditures expensed
Fund Financial Statements

**Governmental funds** include:
- General fund
- Special revenue funds
- Capital projects funds
- Debt service funds
- Permanent funds

**Proprietary funds** include:
- Enterprise funds
- Internal service funds

**Fiduciary funds** include:
- Pension & other employee benefit trust funds
- Investment trust funds
- Private purpose trust funds
- Agency funds
**Financial Statements of Governmental Funds**

Statements of governmental funds
- Balance sheet
- Statement of revenues, expenditures, and changes in fund balances

Focus is to report sources, uses, & balances of current financial resources
- Apply modified accrual accounting
- Capital assets & long-term debt not reported as assets or liabilities

Reports include separate columns for each major governmental fund and single column for total of all nonmajor funds:
- General fund is always major
- Others major if assets, liabilities, revenues, expenditures meet the 5% and 10% tests:
  - Fund at least 5% of “total” column in government-wide financial statements
  - Fund at least 10% of “government-type” column in government-wide financial statements.
**Balance Sheet**

Reports assets, liabilities, & fund balances
- Reported separately for each major governmental fund
- Fund balances segregated into reserved & unreserved

Total fund balances reconciled to net assets of governmental activities in government-wide financial statements
Statement of Revenues, Expenditures, & Changes in Fund Balances

Reports inflows, outflows, and balances of current financial resources
- Reported separately for each major governmental fund
- Revenues classified by major source
- Expenditures classified by function

Format of statement:
  
  Revenues
  - Expenditures
  = Excess (deficiency) of revenues over expenditures
  ± Other financing sources and uses
  ± Special and extraordinary items
  = Net change in fund balances
  ± Fund balances – beginning of period
  = Fund balances – end of period

Change in fund balances reconciled to change in net assets of governmental activities in government-wide financial statements
Financial Statements of Proprietary Funds

Statements of proprietary funds
- Statement of net assets
- Statement of Revenues, Expenses, and Changes in Fund Net Assets
- Statement of Cash Flows

Preparation of statements
- Emphasis is measurement of economic resources
- Prepared under accrual basis of accounting

Reports include separate column for each enterprise fund meeting 5% and 10% tests:
- Fund at least 5% of “total” column in government-wide financial statements
- Fund at least 10% of “business-type” column in government-wide financial statements.
- Total of non-major enterprise funds in a single column
- Total of all internal service funds in a single column
Statement of Net Assets
Prepared in classified format
- Current & noncurrent assets & liabilities distinguished
- Net assets reported in same categories as used in government-wide financial statements
Statement of Revenues, Expenses, & Changes in Fund Net Assets

Amounts should be the same as net assets & changes in net assets shown for business-type activities in government-wide financial statements

- Revenues reported by major source
- Operating & nonoperating revenues & expenses distinguished
- Nonoperating revenues & expenses reported after operating income

Format of statement of revenues, expenses, & changes in fund net assets

Operating revenues (listed by source)
- Operating expenses (listed by category)
= Operating income or loss
± Nonoperating revenues & expenses
= Income before other revenues, expenses, gains, losses, & transfers
± Capital contributions, additions to permanent & term endowments, special & extraordinary items, & transfers
= Increase or decrease in net assets
+ Net assets – beginning of period
= Net assets – end of period
Statement of Cash Flows
Shows sources & uses of cash by major classification
  • Operating activities reported using direct method
  • Noncapital financing activities
  • Capital & related financing activities
  • Investing activities

Operating income reconciled to cash flows from operating activities (indirect method)
Financial Statements of Fiduciary Funds

Statements of fiduciary funds
- Statement of Net Assets
- Statement of Changes in Fiduciary Net Assets

Focus of fiduciary financial statements
- Emphasis on measurement of economic resources
- Prepared using accrual basis of accounting

Report includes separate column for each major fiduciary fund and column for total of all non-major fiduciary funds.
- Selection of major funds based on judgment of entity management
- No 5% and 10% tests since fiduciary funds weren’t included in government-wide financial statements
Notes to Government Financial Statements

Intended to provide information needed for fair presentation of financial statements

Notes will include:

- Summary of significant accounting policies
- Disclosure about capital assets & long-term liabilities
- Disclosure about major classes of capital assets
- Disclosure about donor-restricted endowments
- Segment information
Required Supplementary Information

Presented in addition to MD & A

Consists of:

- Schedule of Funding Progress for all Pension Trust Funds
- Schedule of Employer Contributions to all Pension Trust Funds
- Budgetary comparison schedules for governmental funds (reporting basis is same as that chosen by legislative body for budget, and not necessarily that used for financial statements)
- Information about infrastructure reported under the modified approach
- Claims development information for any public entity risk pools
Governmental Funds

A governmental unit maintains 5 types of governmental funds

- General fund – all activities not accounted for in another fund
- Special revenue funds – account for revenues earmarked to finance specific activities
- Capital projects funds – account for construction of fixed assets
- Debt service fund – accumulates resources for payment of general obligation debts of other governmental funds
- Permanent funds – account for resources that are legally restricted
General Fund Accounting

A governmental unit will have one general fund

- Annual budget is recorded at the beginning of the year
- Revenues, expenditure, & other financing sources & uses are recorded during the year
- Adjustments are made at the balance sheet date
- Budgetary accounts are closed at year-end
**Beginning of Year**

Governmental unit adopts annual budget for general fund

Budget recorded with following entry:

- Estimated revenues control
- Estimated other financing sources
- Budgetary fund balance
- Appropriations
- Estimated other financing uses

Estimated revenues control = revenues expected to be collected during the year

Estimated other financing sources = estimate of proceeds from bond issues & operating transfers in

Budgetary fund balance = plug – amount required to balance the entry

Appropriations = expenditures expected during the year

Estimated other financing uses = expected operating transfers out
During the Year

Revenue cycle consists of billing certain revenues, such as property taxes, collecting billed revenues, writing off uncollectible billings, & collecting unbilled revenues

Billing of revenues:

<table>
<thead>
<tr>
<th>Account</th>
<th>xxx</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes receivable</td>
<td></td>
</tr>
<tr>
<td>Allowance for estimated uncollectible</td>
<td></td>
</tr>
<tr>
<td>Deferred revenues</td>
<td></td>
</tr>
<tr>
<td>Revenues control</td>
<td></td>
</tr>
</tbody>
</table>

Taxes receivable = amount billed

Allowance for estimated uncollectible taxes = billings expected to be uncollectible
- This amount may be adjusted upward or downward during the year
- Offsetting entry will be to revenues control

Deferred revenues = portion of billed taxes expected to be collected more than 60 days after close of current year

Revenues control = portion of billed taxes expected to be collected during the current year or within 60 days of close
During the Year (continued)

Collecting billed revenues:

- Cash xxx
- Taxes receivable xxx

Writing off uncollectible amounts:

- Allowance for estimated uncollectible taxes xxx
- Taxes receivable xxx

Collecting unbilled revenues:

- Cash xxx
- Revenues control xxx
**During the Year (continued)**

**Spending cycle** consists of ordering goods & services, receiving the goods & services, and paying for them.

**Ordering goods & services:**
- Encumbrances control (estimated cost) xxx
- Budgetary fund balance reserved for encumbrances xxx

**Receiving goods & services:**
- Budgetary fund balance reserved for encumbrances (estimated cost) xxx
- Encumbrances control xxx
- Expenditures control (actual cost) xxx
  - Vouchers payable xxx

**Payment:**
- Vouchers payable xxx
- Cash xxx
During the Year (continued)

Other financing sources & uses are recorded as the transactions occur:

- Proceeds of long-term debt issues are recorded as other financing sources when received
- Operating transfers to or from other funds are reported as other financing uses or sources as the funds are transferred
Adjustments at Balance Sheet Date

Closing entry – eliminating revenues, expenditures, & encumbrances:

- Revenues control xxx
- Unreserved fund balance (plug) xxx or xxx
  - Expenditures control xxx
  - Encumbrances control xxx

The remaining balance in the budgetary fund balance reserved for encumbrances is transferred to a nonbudgetary account:

- Budgetary fund balance reserved for encumbrances xxx
  - Fund balance reserved for encumbrances xxx

The governmental unit may decide to recognize inventory as an asset:

- Inventories (increase) xxx
  - Fund balance reserved for inventories xxx
  or
- Fund balance reserved for inventories xxx
  - Inventories (decrease) xxx
End of Year

Budget recorded in beginning of year is reversed:

- Appropriations xxx
- Estimated other financing uses xxx
- Budgetary fund balance xxx or xxx
  - Estimated revenues control xxx
  - Estimated other financing sources xxx
**Special Revenue Fund**

Used to account for revenues that must be used for a particular purpose

- Accounting identical to general fund

**Capital Projects Fund**

Used to account for construction of fixed assets

- Fund opened when project commences & closed when project complete
- Accounting similar to general fund

Differences in accounting for capital projects fund:

1) Budgetary entries generally not made
2) Expenditures generally made under contract
   - Credit contracts payable
   - Credit retention payable for deferred payments
Debt Service Fund

Used to account for funds accumulated to make principal & interest payments on general obligation debts

- Expenditures include principal & interest payable in current period
- Resources consist of amounts transferred from other funds (other financing sources) & earnings on investments (revenues)

Amounts used for interest payments separated from amounts used for principal payments

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
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</thead>
<tbody>
<tr>
<td>Cash for interest</td>
<td>xxx</td>
</tr>
<tr>
<td>Cash for principal</td>
<td>xxx</td>
</tr>
<tr>
<td>Other financing sources</td>
<td>xxx</td>
</tr>
</tbody>
</table>
Proprietary Funds

Account for governmental activities conducted similarly to business enterprises

Enterprise fund:
- Used to account for business-type activities
- Uses accrual basis accounting
- Earned income recognized as operating revenues
- Shared taxes reported as nonoperating revenues

Internal service fund:
- Used to account for services provided to other governmental departments on a fee or cost-reimbursement basis
- Resources come from billings to other funds
- Reported as operating revenues
Fiduciary Funds

Pension Trust Fund

Accounts for contributions made by government & employees using accrual accounting

Additional information in notes and supplementary information following notes will include:

- Description of plan and classes of employees covered
- Summary of significant accounting policies
- Information about contributions including description of how contributions are determined and required contribution rates of plan members
- Information about legally required reserves at reporting date
**Investment Trust Fund**
Accounts for assets received from other governments units to be invested on their behalf.

- Uses accrual accounting

**Private Purpose Trust Fund**
Accounts for resources held on behalf of private persons or organizations.

- Uses accrual accounting

**Agency Fund**
Accounts for money collected for various funds, other governments, or outsiders

- Includes only balance sheet accounts
- Assets always equal liabilities
- Uses modified accrual accounting
Interfund Transactions

Nonreciprocal transfers are transfers of resources from one fund to another without any receipts of goods or services, such as a transfer of money from the general fund to a capital projects fund.

Paying fund:
- Other financing uses control xxx
- Cash xxx

Receiving fund:
- Cash xxx
- Other financing sources control xxx
Interfund Transactions (continued)

**Reciprocal transfers** occur when one fund acquires goods or services from another in a transaction similar to one that would occur with outsiders.

**Paying fund:**
- Expenditures control or Expenses xxx
- Cash xxx

**Receiving fund:**
- Cash xxx
- Revenues control xxx

Reimbursements occur when one fund makes payments on behalf of another fund.

**Reimbursing fund:**
- Expenditures control or Expenses xxx
- Cash xxx

**Receiving fund:**
- Cash xxx
- Expenditures control or Expenses xxx
**Interfund Transactions (continued)**

**Loans** may be made one fund to another

Lending fund:
- Due from other fund (fund identified) xxx
- Cash xxx

Receiving fund:
- Cash xxx
- Due to other fund (fund identified) xxx
Solid Waste Landfill Operations

Environmental Protection Agency imposes requirements on solid waste landfills

- Procedures for closures
- Procedures for postclosure care

Procedures represent long-term obligations accounted for as long-term debt

- Costs to be incurred by governmental funds accounted for in general long-term debt account group
- Expenditures in governmental funds reduce general long-term debt account group balances
- Costs to be incurred by proprietary funds accounted for directly in funds
- Costs associated with closure and postclosure procedures accounted for during periods of operation
All not-for-profit organizations must prepare at least 3 financial statements.

Not-for-profit organizations include:
  - Hospitals
  - Colleges & universities
  - Voluntary health & welfare organizations (VHW)

Required financial statements for all types include:
  - Statement of Financial Position
  - Statement of Activities
  - Statement of Cash Flows

VHWs must also prepare a Statement of Functional Expenses.
Statement of Financial Position
Includes assets, liabilities, & net assets

- Unrestricted net assets – available for general use, including those set aside by board of trustees
- Temporarily restricted net assets – donated by outside party & restricted to specific purpose
- Permanently restricted net assets – donated by outside party & required to be invested with earnings restricted or unrestricted
**Statement of Financial Position (continued)**

Not-for-Profit Company  
Statement of Financial Position  
December 31, 20X2

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<thead>
<tr>
<th>Assets:</th>
<th>Liabilities:</th>
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<td>Cash</td>
<td>Accounts payable</td>
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<tr>
<td>Marketable securities</td>
<td>Notes payable</td>
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<td>Bonds payable</td>
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<tr>
<td>Inventory</td>
<td>Total liabilities</td>
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<tr>
<td>P, P, &amp; E</td>
<td>Unrestricted</td>
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<tr>
<td>Total assets</td>
<td>Temporarily restricted</td>
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<td>Permanently restricted</td>
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<td></td>
<td>Total net assets</td>
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<td></td>
<td>Total liabilities &amp; net assets</td>
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<th>40</th>
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<th>80</th>
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<td>Total net assets</td>
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<tr>
<td>Total liabilities &amp; net assets</td>
<td>640</td>
<td>250</td>
<td>390</td>
<td>640</td>
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</tr>
</tbody>
</table>
Statement of Activities for NPO

Similar to income statement

- Reports revenues, gains, expenses, & losses
- Also reports temporarily restricted assets released from restriction
- Categorized activities among unrestricted, temporarily restricted, & permanently restricted to provide change in net assets for each
- Change added to beginning balance to provide ending net assets for each category

Expenses classified by:

- Object – nature of item or service obtained
- Function – program or activity to which attributed
- Character – period or periods benefited from payments
**Statement of Activities (continued)**

Not-for-Profit Company

Statement of Activities
For Year Ended December 31, 20X2

<table>
<thead>
<tr>
<th> </th>
<th>Total</th>
<th>Unrestricted</th>
<th>Temporarily Restricted</th>
<th>Permanently Restricted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues &amp; gains</td>
<td>675</td>
<td>275</td>
<td>360</td>
<td>40</td>
</tr>
<tr>
<td>Donations</td>
<td>665</td>
<td>265</td>
<td>360</td>
<td>40</td>
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<tr>
<td>Investment income</td>
<td>10</td>
<td>10</td>
<td>0</td>
<td>0</td>
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<tr>
<td>Net assets released from restriction</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Research restrictions</td>
<td>100</td>
<td>(100)</td>
<td>0</td>
<td>0</td>
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<tr>
<td>Time restrictions</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Property restrictions</td>
<td>20</td>
<td>(20)</td>
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<tr>
<td>Total net assets released from restriction</td>
<td>120</td>
<td>(120)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Expenses &amp; losses</td>
<td>(355)</td>
<td>(10)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(10)</td>
<td>(10)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Program expenses</td>
<td>(190)</td>
<td>(190)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>General &amp; administrative</td>
<td>(85)</td>
<td>(85)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Salaries</td>
<td>(70)</td>
<td>(70)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total expenses &amp; losses</td>
<td>(355)</td>
<td>(10)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Change in net assets</td>
<td>320</td>
<td>40</td>
<td>240</td>
<td>40</td>
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<tr>
<td>Net assets at December 31, 20X1</td>
<td>70</td>
<td>5</td>
<td>65</td>
<td>0</td>
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<tr>
<td>Net assets at December 31, 20X2</td>
<td>390</td>
<td>45</td>
<td>305</td>
<td>40</td>
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</tbody>
</table>


**Statement of Cash Flows for NPO**

Similar to statement of cash flows under GAAP
- Special treatment for donated assets restricted for long-term purposes
- Classified as cash flows from financing activities

**Statement of Functional Expenses**

Classifies expenses into program services & support services
- Program services – expenses directly related to organization’s purpose
- Support services – expenses necessary, but not directly related to organization’s purpose such as fund-raising & administrative expenses

Expenses classified by (similar to statement of activities):
- Object
- Nature
- Character
**Contributions Made to and Received by Not-for-Profit Organizations**

In general, contributions are income to a not-for-profit organization

- Those that are part of the major, ongoing, & central operations are revenues
- Those that are not are gains

**Unrestricted cash donations:**

- Cash: xxx
- Donations (unrestricted funds): xxx

**Permanently restricted donations:**

- Cash: xxx
- Donations (permanently restricted funds): xxx

**Donated services:**

- Program expense (fair market value): xxx
- Donations (unrestricted funds): xxx
## Contributions Made to and Received by Not-for-Profit Organizations (continued)

Cash donations restricted for a specific purposes:

<table>
<thead>
<tr>
<th>When made:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>xxx</td>
</tr>
<tr>
<td>Donations (temporarily restricted funds)</td>
<td>xxx</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>When used:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Temporarily restricted net assets</td>
<td>xxx</td>
</tr>
<tr>
<td>Unrestricted net assets</td>
<td>xxx</td>
</tr>
<tr>
<td>Expense</td>
<td>xxx</td>
</tr>
<tr>
<td>Cash</td>
<td>xxx</td>
</tr>
</tbody>
</table>

Cash donated for purchase of property:

<table>
<thead>
<tr>
<th>When made:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>xxx</td>
</tr>
<tr>
<td>Donations (temporarily restricted funds)</td>
<td>xxx</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>When used:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Temporarily restricted net assets</td>
<td>xxx</td>
</tr>
<tr>
<td>Unrestricted net assets</td>
<td>xxx</td>
</tr>
<tr>
<td>Property</td>
<td>xxx</td>
</tr>
<tr>
<td>Cash</td>
<td>xxx</td>
</tr>
</tbody>
</table>
**Pledges**

Promises by outside parties to donate assets

- Recognized in period of pledge
- Allowance for uncollectible amount established
- Some or all may have time restriction – temporarily restricted
- Some or all may be unrestricted

<table>
<thead>
<tr>
<th>Pledges</th>
<th>xxx</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for uncollectible pledges</td>
<td>xxx</td>
</tr>
<tr>
<td>Donations (unrestricted funds)</td>
<td>xxx</td>
</tr>
<tr>
<td>Donations (temporarily restricted funds)</td>
<td>xxx</td>
</tr>
</tbody>
</table>
Other Donations

Donations of art, antiques, or artifacts not recognized if:

- Asset held for research or exhibition
- Asset preserved & unaltered
- Proceeds from sale of asset to be used to buy additional art, antiques, & artifacts

Donated assets to be held in trust

- Not recognized by not-for-profit organization
- Disclosed in footnotes to financial statements
Hospital Revenues

Patient service revenue recorded at gross value of services
- Billing may be less due to Medicare allowance or employee discount
- Difference recorded in allowance account
- Statement of activities will report net amount

Services provided for free due to charity not recognized as revenues

Special transactions:
- Bad debts recognized as expense on statement of activities, not reduction of revenues
- Miscellaneous revenues from cafeteria, gift shop, parking lot fees, & educational programs classified as other revenue
- Donated supplies reported as operating revenue & expense when used
- Donations of essential services and unrestricted donations are nonoperating revenues
College Tuition Revenues

Students may receive refunds or price breaks

**Refunds** to students reduce tuition revenues

**Price breaks** may result from scholarships or reductions for family members of faculty or staff

- Tuition recognized at gross amount
- Price break recognized as expense
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<td>Periodic Versus Perpetual</td>
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<td>Permanent &amp; Temporary Differences</td>
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<td>Personal Financial Statements</td>
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<td>Postretirement Benefits</td>
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<td>Preferred Stock</td>
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<td>Preferred Stock – Special Issuances</td>
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<td>Presentation of EPS Information</td>
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<td>Prior Period Adjustments</td>
<td>144</td>
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<td>Private Purpose Trust Fund</td>
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<td>Proprietary Funds</td>
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| Quasi-Reorganizations, 149 |
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