2017 FAR Book Update

Page numbers refer to 2017 FAR textbook pages. When new/edited text is shown along with old text, the new/edited text is highlighted in gray, unless noted otherwise. For those who prefer to purchase a new textbook due to the significant amount of changes, please visit https://www.rogercpareview.com/cpa-courses/textbooks.

Page 1-7

Lecture 1.04

Fair Value and the Option to Report Financial Assets and Financial Liabilities at Fair Value

ASC 820 does not allow, nor require, assets or liabilities be reported at fair value unless there is another requirement to do so. An entity is required to recognize various items at fair value, including the following:

- Investments in marketable debt or equity securities that are classified as either trading securities or available for sale securities are reported at fair value (mark-to-market) as of each balance sheet date.
  - Unrealized gains and losses on trading securities are recognized in the statement of income.
  - Unrealized gains and losses on available for sale securities are recognized in other comprehensive income.

- Investments in equity securities, except those required to be accounted for under the equity method, those that are required to be consolidated, and, when an appropriate election is made, those for which the market value is not readily determinable.

- With very few exceptions, assets acquired and liabilities assumed in a business combination are initially recognized at fair value, but are not adjusted to fair value in subsequent periods for presentation on the balance sheet, unless that asset or liability is being reported at fair value for some other reason.
The accounting literature defines fair value for certain items. In a business combination, for example:

- The fair value of cash is its face amount.
- The fair value of an investment in marketable securities is its market value.
- The fair value of accounts receivable is its net realizable value (NRV).
- The fair value of inventory is its net realizable value (NRV).
Revenue Recognition

Under IFRS, requirements for recognizing revenue were established in IAS 18. These requirements were modified by IFRS 15, issued in May of 2014, and effective on the CPA Exam January 1, 2018. Under IAS 18, the requirements apply to all transactions involving revenue from:

- The sale of goods
- The rendering of services
- The use of assets to earn interest, royalties, and dividends
GAAP

- LCNRV is used for most inventory, but not all – LIFO and retail method still use lower of cost or market (LCM).
- LIFO is allowed.
- Impairment losses may NOT be reversed.
IAS 11 – Construction Contracts (Revenue Recognition)

When the International Accounting Standards Board issued IFRS 15, Revenue from Contracts with Customers, it provided revenue recognition standards that superseded those of IAS 11. Under both GAAP and IFRS, construction contracts are considered contracts with customers and, under both sets of principles, this topic is included in accounting for revenue from contracts with customers. IFRS 15 is scheduled to be eligible for exam testing in 2017, making IAS 11 relevant until then. Under IAS 11:

IFRS requires:
- **Stage of completion** (percentage of completion) accounting when the outcome can be reasonably estimated,
- **Zero profit** (cost recovery) accounting when the outcome cannot be reasonably estimated.

IFRS does not allow:
- Use of the completed contract method.

GAAP
Percentage of completion is used if certain criteria are met, otherwise use completed contract method.
GAAP

- Deferred tax asset valuation allowances are used to reduce benefits to amount “more likely than not” to be realized.
- On B/S deferred tax assets and liabilities are non-current only.
- Use future enacted tax rate
IAS 18 – Revenue Recognition

Under IFRS, revenues are recognized in accordance with IFRS 15, Revenues from Contracts with Customers. Under US GAAP, revenue is recognized in accordance with ASU 2014-09, with various amendments, which is also Revenue from Contracts with Customers. With few exceptions that are not worth noting, the standards are essentially the same. Requirements for recognizing revenue were established in IAS 18. The requirements apply to all transactions involving revenue from:

- The sale of goods
- The rendering of services
- The use of assets to earn interest, royalties, and dividends

Effective in 2017, and earlier for those entities so choosing, IFRS 15, Revenue from Contracts with Customers, will supersede this pronouncement.

Revenue is measured at the **fair value of consideration received** or receivable.

Revenues from the **sale of goods** occur when 5 criteria have been met:

- Significant risks and rewards of ownership transferred to the buyer.
- The selling entity does not retain managerial involvement associated with ownership of the asset.
- The amount can be reliably measured.
- Economic benefits are likely to flow to the entity.
- Costs incurred and to be incurred in relation to the transaction can be reliably measured.

For transactions involving **rendering of services**:

- When the outcome can be reliably estimated, revenue is recognized based on the stage of completion (percentage-of-completion).
- When the outcome cannot be reliably estimated, revenue is recognized to the extent of recoverable expenses recognized (cost recovery).

Revenues from **interest, royalties, and dividends** are recognized when the amounts can be reliably estimated and economic benefits are likely to flow to the entity.

- Interest is recognized applying the effective interest method.
- Royalties are recognized on the accrual basis.
- Dividends are recognized when the shareholders' right to receive payment is established.

**Disclosures** will include:

- Accounting policies adopted for recognizing revenues.
- Amount of revenue recognized in each significant category
  - Sale of goods
  - Rendering of services
  - Interest
  - Royalties
  - Dividends

Amount of revenue from exchange of goods and services in each category.
IFRS 15 – Revenue from Contracts with Customers

IFRS requires that revenue be recognized applying a 5-step process, which will be effective for CPA Exam testing in 2017.

1. Identify the contracts with customers
2. Identify all performance obligations within each contract
3. Determine the total consideration from the contract
4. Allocate the total consideration among all performance obligations
5. Recognize revenues when each performance obligation is satisfied or, in some cases, while performance obligations are being satisfied.

GAAP

GAAP now recognizes revenues in accordance with the joint pronouncement, Revenue from Contracts with Customers, resulting in only negligible differences.

Revenue recognition should be similar under GAAP in 2018 for public entities and later for nonpublic entities, although the FASB has indicated that the effective dates will be postponed for 1 year.
Delete Inventory and Long-Term Constructions Contracts from chart. GAAP and IFRS are now essentially the same in the areas, with the exception that GAAP still uses LCM for certain types of inventory.

Under Income Taxes, under both GAAP and IFRS, all deferred taxes are classified as noncurrent. Delete row if present.
Balance Sheet Example - Roger Company
GAAP BALANCE SHEET/Statement of Financial Position
December 31, 20X7

Assets
Current Assets
- Cash and cash equivalents (unrestricted and restricted)
- Temporary term investments (trading securities)
- Receivables (NRV)
  o Tax and other refunds
  o Receivables from affiliates and employees and overpayments to creditors
  o Accounts receivable, net of allowance for bad debts
  o Current portions of installments receivable and notes receivable
- Inventories (LCM)
  o Raw materials
  o Work-in-process
  o Finished goods
- Prepaid expenses (such as insurance and rent)
  o Current deferred tax asset

Total Current Assets

Noncurrent Investments
- Nonmarketable securities (such as equity method securities)
- Long-term investments in marketable debt securities
  o Available for sale
  o Held to maturity

Property, Plant, and Equipment (Fixed Assets)
- Land, buildings, and improvements
- Machinery and equipment, leased assets
- Less accumulated depreciation

Intangible Assets (net of amortization)
- Goodwill
- Other identifiable intangibles (such as patents, trademarks, and copyrights)

Other Assets
- Deposits, unamortized BIC
- Noncurrent receivables (including noncurrent portions of installments receivable and notes receivable)
- Noncurrent deferred tax asset
- Equipment to be disposed of

Total Noncurrent Assets

Total Assets

Liabilities and Stockholders’ Equity
Current Liabilities
- Short-term notes payable
- Accounts payable
- Accrued expenses (such as salaries and wages, interest, and utilities)
- Estimated current liabilities (such as warranty expense)
- Taxes payable (such as income taxes, collected sales taxes, and withheld payroll taxes)
  o Current deferred tax liability

Total Current Liabilities

Noncurrent Liabilities
- Notes payable (net of current portion)
- Bonds payable
- Noncurrent deferred tax liability
- Other noncurrent liabilities (such as noncurrent portions of capital lease obligations and warranty obligations)
- Deferred liabilities (such as liabilities under pension plans, post-employment plans, and post retirement plans)

Total Noncurrent Liabilities

Stockholders’ Equity
- Contributed capital (APIC)
  o Preferred stock
  o Common stock (net of T/S at par)
  o Additional paid-in capital (APIC)
- Noncontrolling interest
- Earned capital
  o Retained earnings (appropriated and unappropriated)
  o Accumulated other comprehensive income (OCI) - (DENT)

Subtract
- Treasury stock at cost

Total Liabilities & Equity
Lecture 2.04

IFRS STATEMENT OF FINANCIAL POSITION

Normally, assets are reported as current and noncurrent, and liabilities are reported as current and noncurrent on the Statement of Financial Position (balance sheet). If a liquidity presentation provides more relevant and reliable information, then balance sheet items may be reported based on their liquidity without segregation.

In a balance sheet segregated between current and noncurrent items, an asset is classified as current when:
1. The entity expects to realize the asset or to consume or sell it within 12 months or the normal operating cycle, or
2. The entity holds the asset primarily for the purpose of trading.

A liability is classified as current when:
1. The entity expects to settle the liability within the normal operating cycle
2. The liability will be settled within 12 months after the reporting period, or
3. The entity holds the liability for the purpose of trading

IFRS defines a financial instrument as any contract that gives results in a financial asset of one entity and a financial liability or equity instrument of another entity.

A financial asset is:
- Cash
- An equity instrument of another entity
- A contractual right:
  - To receive cash or another financial asset from another entity; or
  - To exchange financial assets or financial liabilities with another entity on potentially favorable terms
- A contract that will be settled in the entity's own equity instruments

A financial liability is:
- A contractual obligation:
  - To deliver cash or another financial asset to another entity; or
  - To exchange financial assets or financial liabilities with another entity on potentially unfavorable terms
- A contract that will be settle in the entity's own equity instruments

Financial assets are measured at amortized cost only if two conditions are met:
- The entity's business model is to hold the asset to collect scheduled cash flows
- The terms of the instrument call for cash flows that are exclusively payments of principal and interest on specified dates

All other financial assets are measured at fair value. In general, unrealized gains and losses are reported in profit or loss.
- Business model may involve both holding the instrument to collect cash flows and selling the financial instrument.
- When that is the case, the instrument is measured at fair value with unrealized gains and losses recognized in other comprehensive income.
In general, financial liabilities are measured at amortized cost, but may be measured at fair value, with unrealized gains or losses recognized in income, when it will result in more relevant information.

### IFRS Statement of Financial Position

<table>
<thead>
<tr>
<th>Assets</th>
<th>Notes</th>
<th>20X2</th>
<th>20X1</th>
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<tr>
<td><strong>Noncurrent assets</strong></td>
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<tr>
<td>Goodwill</td>
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<td>x,xxx</td>
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<tr>
<td>Other intangible assets</td>
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<td>x,xxx</td>
<td>x,xxx</td>
</tr>
<tr>
<td>Property, plant, and equipment</td>
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<td>x,xxx</td>
<td>x,xxx</td>
</tr>
<tr>
<td>Investments (such as equity method investments)</td>
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<td>x,xxx</td>
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<tr>
<td>Investment property</td>
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<tr>
<td>Biological Assets</td>
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<tr>
<td>Deferred tax assets</td>
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<td>x,xxx</td>
<td>x,xxx</td>
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<tr>
<td>Loans and other receivables (trade and other)</td>
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<tr>
<td><strong>Noncurrent assets</strong></td>
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<tr>
<td><strong>Current assets</strong></td>
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<tr>
<td>Inventories</td>
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<tr>
<td>Loans and other Receivables (trade and other)</td>
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<tr>
<td>Prepayments</td>
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<td>Current tax assets</td>
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<tr>
<td>Short-term financial assets and investments (derivatives)</td>
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<tr>
<td>Cash and cash equivalents</td>
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<tr>
<td><strong>Current assets</strong></td>
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<tr>
<td>Assets classified as held for sale</td>
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<tr>
<td><strong>Total assets</strong></td>
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</tr>
<tr>
<td><strong>Equity and liabilities</strong></td>
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<tr>
<td><strong>Equity</strong></td>
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<tr>
<td>Equity attributable to parent owners</td>
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<tr>
<td>Share capital</td>
<td>t</td>
<td>x,xxx</td>
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<tr>
<td>Share premium</td>
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<tr>
<td>Retained earnings</td>
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<tr>
<td>Reserves</td>
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<td>x,xxx</td>
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<tr>
<td>Accumulated other comprehensive income (DENT-R)</td>
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<td>x,xxx</td>
<td>x,xxx</td>
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<tr>
<td>Noncontrolling interest</td>
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<td>x,xxx</td>
</tr>
<tr>
<td><strong>Total equity</strong></td>
<td></td>
<td>x,xxx</td>
<td>x,xxx</td>
</tr>
<tr>
<td><strong>Noncurrent Liabilities</strong></td>
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<tr>
<td>Pension and other benefit obligations</td>
<td>v</td>
<td>x,xxx</td>
<td>x,xxx</td>
</tr>
<tr>
<td>Loans and borrowings</td>
<td>n</td>
<td>x,xxx</td>
<td>x,xxx</td>
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<tr>
<td>Deferred tax liabilities</td>
<td>o</td>
<td>x,xxx</td>
<td>x,xxx</td>
</tr>
<tr>
<td>Other liabilities &amp; provisions</td>
<td>w</td>
<td>x,xxx</td>
<td>x,xxx</td>
</tr>
<tr>
<td><strong>Noncurrent liabilities</strong></td>
<td></td>
<td>x,xxx</td>
<td>x,xxx</td>
</tr>
</tbody>
</table>
Lecture 2.05

REVENUE RECOGNITION (FASB ASC TOPIC 606)

In many ways, the amount reported as sales or revenue on an entity's income statement is considered the most important piece of information on the financial statements. One reason is that an overstatement of revenue, when not accompanied by offsetting errors or fraudulent misstatements, has an immediate effect on the amount of net income reported.

In addition, in many circumstances and in many industries, revenue is considered a key indicator of the future success of an entity and a great deal of importance is placed upon it. When one entity is contemplating acquiring another for the purpose of eliminating competition, the acquirer often intends to integrate the acquiree's customers and sales into the acquirer's business and will not be operating in the same manner that management of the acquiree was. As a result, the costs incurred by the acquiree are not necessarily relevant to the acquirer, but the amount reported as revenue is.

Overstatements of revenue are among the most common and the largest incidents of fraudulent financial reporting. In many cases, revenues are overstated due to fictitious transactions while, in others, the overstatement is due to the acceleration of when revenue is recognized. Revenue is also often overstated when entities include cash receipts that are not actually revenues.

Until recently, US GAAP recognized numerous revenue recognition principle, some differing due to the industry to which they related, some due to the nature of the transactions that the entity participates in, and others for a variety of other reasons. To reduce the ability of an entity to fraudulently report revenues; to eliminate the numerous different approaches to revenue recognition being applied by different entities or for different transactions, causing a lack of comparability among companies and, sometimes a lack of consistency within an entity; and to adopt revenue recognition standards that are similar to those applied in financial statements prepared in accordance with International Financial Reporting Standards, the FASB and the IASB developed a joint standard that replaces almost all of the individual revenue recognition standards that currently exist.

The FASB issued ASU 2014-09, Revenues from Contracts with Customers (Topic 606) in May of 2014. It has been amended numerous times and is now effective for public entities for periods beginning after December 15, 2017 and one year later for nonpublic entities. It was effective on the CPA Exam January 1, 2018.
It applies to all entities that enter into contracts with their customers unless the contracts are accounted for in accordance with another set of standards, such as lease contracts and insurance contracts. It replaces existing standards for:

- Revenues and gains
- Installment sales and the cost recovery method of recognizing revenues
- Sales of products, including those with the right of return
- Sales of services including:
  - Extended warranties and product maintenance arrangements
  - Commissions from insurance arrangements
  - Loan guarantee fees
  - In-transit freight services
  - Advertising barter transactions
  - Multiple element arrangements
  - Rights to use
  - Construction-type and production-type contracts
  - Gains and losses
  - Principal and agent considerations
  - Customer payments and incentives
  - The milestone method
- Revenues from the sales of franchises
- Revenues from lending and financing activities
- Consideration given by a service vendor to a customer
- Exchanges of nonmonetary assets for barter credits
- Revenues recognized by government contractors
- Internal-use software subsequently marketed
- Sales of leased property to a customer
- Transfers or sales of property, plant, and equipment in transactions with customers
- Industry guidance, including:
  - Agriculture other than cooperatives
  - Contractors – including both construction contractors and federal government contractors
  - Development stage entities
  - Entertainment – including Broadcasters, Cable Television, Casinos, Films, and Music
  - Extractive industries – including oil and gas
  - Financial services – including brokers and dealers, depositary and lending institutions, investment companies, and mortgage banking
  - Franchisors
  - Health care entities other than charity care and related fundraising entities
  - Not-for-profit entities other than contributions
  - Real estate – including general real estate, common interest realty associations, real estate investment trusts, retail land, and time-sharing activities
  - Regulated operations other than alternative revenue programs
  - Software other than a provision for losses

Revenue recognition standards that were not superseded include:

- Transactions that do not involve contracts with customers
  - Agriculture – Revenue recognition guidance on cooperatives
  - Financial services – Insurance – Revenue recognition guidance on insurance contracts
  - Health care entities – Revenue recognition guidance on contributions from related fundraising entities and charity care
Regulated operations – Revenue recognition guidance on alternative revenue programs

Guidance on dealing with losses – considered onerous contracts

- Provision for losses on separately priced extended warranty and product maintenance contracts
- Provision for losses on construction-type and production-type contracts
- Software – revenue recognition
- Insurance – revenue recognition
- Financial services – Insurance – revenue recognition
- Contractors – Federal government – costs
- Health care entities – commitments related to continuing care retirement communities
- Health care entities – Contingencies related to prepaid health care services
- Regulated operations – Intangibles – goodwill and other intangibles related to long-term power sales contracts

Overview of Revenue Recognition Principles

The core revenue recognition principle consists of two components:

- Revenue is to be recognized upon the transfer of promised goods and services to customers; and
- The amount of revenue recognized represents the consideration the entity expects to receive in exchange for those goods and services.

Revenues are recognized by applying a five-step process:

1. Identify contracts with customers – determine when an arrangement is considered a contract with customers and determine when multiple contacts with the same customer should be combined and accounted for as a single contract
2. Identify all separate performance obligations within each contract
3. Determine the total consideration for the contract
4. Allocate the total consideration among the separate performance obligations
5. Recognize revenue, either:
   - When the entity has satisfied its performance obligations, which is generally associated with revenues resulting from delivering products; or
   - While the entity is satisfying its performance obligations, which is generally associated with revenues resulting from providing services.

1. Identify Contracts with Customers

As clearly indicated by the title, this set of standards relates to revenue-related contracts entered into with customers. As a result, there are two issues that must be addressed to determine if the standard applies. For one, it must be determined that the counterparty to the transaction, which is for the provision of goods or services in the seller’s ordinary course of business, is a customer. Second, the arrangement must be a legally binding contract. There is no requirement that the contract be in writing. It may be formal or informal, written or oral, and may even be implicit based on the normal manner in which entities or individuals act, applicable to certain industries or specific circumstances.

A contract is an arrangement between two or more parties that creates legally enforceable rights and obligations. If either party can terminate the arrangement without penalty, it is not considered a contract. A contract will conform to four criteria:
• The parties must have approved the provisions and must have committed to perform.
• The rights in the contract, and the payment terms can be identified. They do not necessarily need to be explicit in the contract as long as the parties can discern a clear understanding from what the understanding does include.
• The contract has commercial substance.
• Collection is probable.

If all of the criteria are met, the arrangement is a contract with customers and will be accounted for using the 5-step process. Once that determination is made, the arrangement does not have to be reevaluated again to make certain that the criteria continue to be met unless the arrangement is modified. When one or more of the criteria are not met, the arrangement is not a contract and it will be accounted for differently. When that is the case, however, the arrangement is to be reevaluated every reporting period to determine whether it has met the criteria, at which time the method of accounting will be changed to the 5-step process.

Revenue Arrangements that are Not Contracts with Customers
An entity may enter into an arrangement that has some of the characteristics of a revenue-related contract in that it involves providing goods or services in exchange for some form of compensation. It may not, however, meet all of the criteria. When this is the case, and for as long as the arrangement does not meet the criteria, all amounts received will be recognized as a liability such as deferred or unearned revenue.
• The liability represents the entity's obligation to provide the goods or services that are the subject of the arrangement or to refund the consideration received.
• The liability will be measured as the amount received.

If the criteria to be considered a contract are essentially never met, the liability is derecognized and treated as revenue when one of the following occurs:
• The entity has no remaining obligations to the customer; all, or substantially all, of the consideration has been received by the entity; and the amounts received are nonrefundable; or
• The arrangement has been terminated and consideration received is nonrefundable.

Combining Contracts
In general, each contract is considered a separate accounting unit and, as a result, each contract is evaluated and accounted for separately. There are certain circumstances in which the relationship with a customer appears to take the form of numerous contracts but the substance of the arrangement is the equivalent of a single contract. This may be done for a variety of reasons, but most provide the seller with the opportunity to accelerate or delay the recognition of revenue.

Contracts should be combined if one or more of the following criteria are met:
• Contracts negotiated as a single package with a single commercial objective;
• Amount of consideration to be paid in one contract depends on the price or performance of the other contracts (multiple deliverables); or
• Goods or services promised in the contracts are a single performance obligation.

In some cases, two or more contracts are negotiated as a package with a single objective. A manufacturer, for example, may purchase several pieces of equipment from a single supplier, each on a separate contract, with all of the equipment intended to become part of an assembly line operation. Assume none of the equipment will be used for anything that is not an operation of the assembly line and that all of the tasks that the equipment is intended for will require that all of the
equipment on the assembly line is used. These contracts will be combined and accounted for as if they were a single contract.

- If they were treated as separate contracts, the seller would recognize revenue with the transfer of each piece of equipment.
- Until all of the equipment has been delivered, the buyer does not have resources that can be readily put to use.

Another situation that will result in the combining of contracts occurs when the consideration agreed upon for one contact is affected by the consideration agreed upon for another contract. In a circumstance involving multiple deliverables, a seller could place all items to be delivered in the current period into one contract at inflated prices, and all items to be delivered in a subsequent period into a separate contract at discounted prices, accelerating the recognition of revenue. These contracts will also be combined and accounted for as a single contract.

- This prevents the seller from recognizing the inflated revenue amounts in the earlier period.
- The latter items could only be purchased at a discount if the buyer paid the inflated prices for the items delivered earlier.

An entity, for example, may be selling two identical machines using separate contracts, each of which has a normal sales price of $100,000. One may be scheduled for delivery in the current fiscal period and the other scheduled for delivery in the next fiscal period. The seller may attempt to accelerate the recognition of revenue by establishing a contract price of $150,000 for the equipment to be delivered in the current period and only $50,000 for the one to be delivered in the subsequent period.

The seller would not likely sell the second piece of equipment for $50,000 if the first one was not sold to the same customer for $150,000. As a result, the prices are interdependent, the contracts would be combined, and the two pieces of equipment will be accounted for as two identical performance obligations that are part of a single contract. In applying the principles in the standard for revenue-related contracts with customers, the total consideration of $200,000 will be allocated to the two identical performance obligations, resulting in an allocation of $100,000 to each piece of equipment.

Contracts will also be combined when the goods or services called for in two or more contracts constitute a single performance obligation. This would be the case if the customer is unable to benefit from the goods or services received in one contract without the goods or services in the other. If, for example, an entity was to sell the shell of a piece of equipment to a customer in one contract and the working parts of that equipment in another, the arrangement will be evaluated to determine if the customer can benefit from one without the other.

If the equipment that is the subject of the contract is not unique, the customer may be able to acquire all of the working parts for the equipment from another supplier and would be able to benefit from the shell without receiving the remainder from the same supplier. Since the customer could benefit from one without the other, they represent distinct performance obligations with revenue recognized as each performance obligation is satisfied.

If, however, the working parts were not readily available to the customer other than from the same supplier, they would be considered a single performance obligation and the contracts would be combined.
In some cases, contracts having similar characteristics may be combined into a **portfolio** and treated as a single contract. This would be done to reduce the cost and burden associated with doing a lot of contracts, especially if they are not individually material.

**Contract Modifications**

When a contract is modified, the nature of the modification will dictate the accounting treatment to be applied. Some contract modifications are treated as new, separate contracts. Others are considered effective terminations of the existing contract, replacing it with a new contract. The remaining modifications are treated as an adjustment to an existing contract. Some modifications represent some combination of those alternatives.

A modification may be in the form of an amendment, a change order, or a variation. It may be written, oral, or implicit from the behavior of the parties. When a modification involves a change in the consideration associated with the contract in an unknown amount, the change will be estimated using the same approaches that are used to estimate variable consideration.

In addition, the estimate of the change in price is subject to the constraint on estimates of variable consideration. It requires that it be probable that, when the uncertainty is resolved, there will be no significant reversal of the cumulative amount of revenue that has already been recognized. In applying the constraint, the likelihood and magnitude of a potential reversal are considered.

A contract modification is considered a **new, separate contract** when the modification calls for an increase in the scope of the contract involving additional distinct goods and services and there is an increase in the contract price that is reflective of the additional goods and services. A modification of this sort is accounted for by applying the 5-step process.

A contract modification is treated as a **cancellation of the existing contract** accompanied by a **new contract** when the performance obligations that remain unsatisfied are distinct from those that have been satisfied up through the date of the modification. When this is the case, total consideration for the new contract will be equal to:

- The remainder of the consideration from the original contract that has not yet been recognized, plus
- Any additional consideration resulting from the modification.

The total consideration for the new contract will be allocated among all remaining performance obligations, including those remaining from the original contract and any new ones added by the modification. The entity will use the same 5-step process for recognizing revenue on the new contract.

**Upon modification of a contract**, when the remaining goods, services, or both that are yet to be delivered do not represent distinct performance obligations, they are combined into a single performance obligation that is considered partially satisfied.

- Total consideration will consist of the original amount combined with any adjustments resulting from the modification.
- This will be applied to the single performance obligation, including the changes that result from the modification.
  - If the contract qualifies for revenue recognition while the performance obligation is being met, revenue is recognized in the current year on a catch-up basis. The amount revenue that would have been earned if the contract had originally been analyzed with the modification included is reduced by revenues recognized to date with the difference recognized in the current period.
If the contract does not qualify for revenue recognition while the performance obligation is being satisfied, balance sheet accounts will be adjusted for additional amounts received and costs incurred, but no revenue will be recognized until the single performance obligation has been satisfied.

Lecture 2.06

2. Identify Separate Performance Obligations

A contract will have at least one, and often more than one, performance obligation, which is an enforceable promise to transfer goods or services to a customer. They are identified at the inception of the contract, and may involve:

- Selling goods produced or purchased by the entity
- Reselling rights to goods or services that were purchased by the entity
- Performing a task that is agreed upon
- Being prepared to provide a good or service or making goods or services available to the customer with transfer at the customer's discretion
- Arranging for another party to provide goods or services to a customer
- Providing the rights to future goods or services to a customer who may, in turn, resell or otherwise provide them to their customers
- Creating an asset on behalf of a customer
- Granting licenses
- Granting options to purchase additional goods or services.

An activity that does not result in the transfer of goods or services to a customer is not a performance obligation.

Individual performance obligations are either identified as distinct performance obligations or are combined with other performance obligations until such combination constitutes a distinct performance obligation. Distinct performance obligations are those that meet two criteria:

- The customer must be able to benefit from the good or service on its own or together using other resources that are readily available to the customer; and
- The promise to transfer the good or service is separately identified from other promises in the contract.

If “distinct” criteria are not met, then combine with other promised goods/services until bundle is distinct.

A good or service can be used on its own if it can be consumed, sold for more than scrap, or used for economic benefit. Resources are readily available if they are sold separately, by the same seller or others, or if the customer has previously acquired them.

If, for example, a furniture dealer was selling a kitchen table and a living room sofa to a customer, the kitchen table could be used without the sofa and vice versa. As a result, they would each represent a distinct performance obligation.

If, on the other hand, the two items were a unique table top and a base that was designed exclusively for that table top, neither the table top nor the base could be used without the other. As a result, neither would be a distinct performance obligation but, on a combined basis, they make up a single distinct performance obligation.
In the same situation, if the table top was a standard size and if the customer could acquire a base from a variety of vendors, the table top and the base would each be a distinct performance obligation.

Promises are separately identifiable in a contract if goods or services are promised separately as opposed to promising to deliver goods or services on a combined basis with promised goods or services being used as inputs.

- Promises may be made, for example, to deliver a computer and an operating system.
  - The intent may be to use the operating system in the computer.
  - Since an operating system could be acquired from a different vendor and installed into the computer, and the operating system could be installed in a computer purchased from a different vendor, the computer and the operating system are separately identifiable and would be distinct performance obligations.

- A promise may be made to deliver a computer with an operating system installed.
  - Since the contract combines the computer and the operating system into a single promise, the promises are not separately identifiable.
  - Even though the operating system could be used with another computer and the computer with another operating system, since they are not separately identifiable and they are not distinct performance obligations.

Other factors may indicate that promises are separately identifiable.

- The entity does not need to integrate the goods or services with others that are part of the contract.
- Other goods or services are not significantly modified by the good or service in the contract.
- Goods or services are neither highly dependent on nor highly interrelated to other goods or services in the contract.

When goods or services are not material, it is not necessary to determine if they constitute performance obligations. In addition, an entity may elect to consider shipping and handling costs that are incurred after the control of goods has been transferred as a cost of fulfilling a promise, rather than as a separate promise.

As previously indicated, if a separately identifiable promise is not considered a distinct performance obligation, it is combined with other promises until the combination (bundle) does constitute a distinct performance obligation.

**Warranties**

Warranties can be accounted for in a variety of ways and the circumstances surrounding the warranty will determine which accounting approach is most appropriate.

Warranties may be purchased separately. This will often be the case when the customer is purchasing an item that has no warranty, has a limited warranty with significant gaps in coverage, has a warranty that ends too quickly, or some combination.

- The price of the warranty is generally either established or negotiated separately.
- The warranty is a distinct performance obligation.

Some products provide warranties without requiring an additional or separate payment. The cost of the warranty is included in the purchase price of the goods to which the warranty relates. Some of these warranties are assurance-type warranties, while others are service-type warranties.
An **assurance-type** warranty protects the customer from obtaining a product that is not capable of performing at the level that the seller indicated that it would. These warranties are generally only available from the seller. To the seller, such a warranty is a contingent liability.

- A liability will be incurred if the product does not perform.
- Unless this is a unique product to the seller, the seller should be able to estimate:
  - The frequency with which these products will not perform at an acceptable level;
  - and
  - The average cost incurred to repair or replace the product when it does not perform acceptably.
- It is very likely that there will be some units that will not perform acceptably.
  - Even entities with outstanding internal control experience some human error.
  - In addition, some units are bound to have parts fail or other problems.
- As a result, an assurance-type warranty represents a contingent liability that is probable and estimable and should be accrued in the period incurred, generally the period of sale.

A **service type** warranty generally provides a customer with repairs in the form of parts and labor in addition to making certain that the product performs as was promised. Service-type warranties may be required by law, may extend beyond the reasonable amount of time it should take to evaluate the product's performance, or may provide services that extend beyond making certain that the asset performs as expected.

- A service-type warranty is a separately identifiable promise in a contract; and
- It is a distinct performance obligation.

To illustrate an **assurance-type warranty**, assume a company sells drilling equipment at an average sales price of $40,000, which it acquires at a cost of $25,000. The seller provides a warranty to assure the buyer that the drill will perform to a certain standard and be suitable for drilling through certain types of materials.

- The company has been manufacturing these drills for several years and they are confident in their manufacturing process, the quality of the materials used, and the quality of its labor force.
- Despite that, human error, the occasional faulty material, or some other factor causes 1 out of every 100 units to fail and require replacement.
- At a cost of $25,000 per drill, a loss of 1 out of every 100 will cost the company $250 per drill on average.

The sale of a single drill will be recorded as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (or A/R)</td>
<td>40,000</td>
</tr>
<tr>
<td>Sales Revenue</td>
<td>40,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>25,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>25,000</td>
</tr>
<tr>
<td>Warranty expense</td>
<td>250</td>
</tr>
<tr>
<td>Estimated warranty liability</td>
<td>250</td>
</tr>
</tbody>
</table>

To illustrate a **service-type warranty**, assume a company sells washing machines to the public. To stimulate sales, the company provides a 3-year warranty that basically will repair the machine, regardless of the cause of the malfunction, for a period of 3 years.
- The washing machine has a sales price, including the warranty, of $1,200. Although the company does not sell their machines without the warranty, an appliance store within a mile of the company's store does sell the same washing machine for $950 on an “as-is” basis.
- The washing machine costs the company $600.
- The company does sell 3-year service contracts, comparable to the warranties, to owners of washing machines purchased from other dealers at a sales price of $250.
  - The company estimates that it costs approximately $175 to service the warranty.
  - Both the washing machine without the warranty and the warranty are distinct performance obligations.

Since both the washing machine and the service-type warranty are distinct performance obligations, the revenue of $1,200 will be allocated based on their relative standalone prices. The revenue allocated to the washing machine will be recognized upon satisfaction of the performance obligation, which would be the point of sale. The revenue allocated to the warranty will be recognized while the performance obligation is being satisfied and, as a result, will be recognized over the 3-year term.

| Cash (or A/R) | 1,200 |
| Sales | 950 |
| Deferred revenue – warranty | 250 |

| Cost of sales | 600 |
| Inventory | 600 |

**Option to Purchase Additional Goods or Services**

In some cases, a contract with a customer may include an option to purchase additional goods or services at a discount. That discount may be comparable to a discount that is available to a wide range of individuals, including customers and noncustomers alike. This would not be considered a distinct performance obligation since customers who receive the discount when making the purchase are not getting anything of value that is not available to others who make no purchase.

When a discount of this sort exceeds what is available to noncustomers, the customer is receiving something of value and both the goods sold and the discount represent distinct performance obligations. As a result, the gross sales price will be allocated between the sale of the merchandise in the current period and the discount on future purchases.

- *The value of the merchandise* will be equal to what it would be sold for if there was no discount on future purchases or any other benefits.
- *The value of the future discounts* will be based on an estimate of how much in the way of discounts is expected to be applied, and will be adjusted to its present value since at least a portion of them will be applied in future periods.

Revenue allocated to the sale of goods will recognized upon satisfaction of the performance obligation, at the point of sale. Revenue allocated to the future will be recognized while the performance obligation is being satisfied in the pattern in which the discounts are estimated to be taken, or when it expires if a discount voucher, for example.
Lecture 2.07

3. Determine the Transaction Price

The transaction price is the amount of consideration that the entity expects to be entitled to in exchange for transferring goods or services in a satisfactory manner, excluding amounts to be collected on behalf of others, such as sales taxes. There are many factors that will affect the amount of revenue that is recognized.

- Whether the reporting entity is a principal or an agent in the transaction will affect whether the gross or net amount of revenues is recognized.
- Variable consideration may be estimated and included or may be excluded and recognized in the period earned.
- Amounts may be reported at their present values when there are potentially lengthy periods between satisfaction of the performance obligations and the transfer of funds.
- There may be nonmonetary consideration requiring measurement.
- The seller may be providing consideration to the customer.

Principal versus Agent Considerations

When more parties are involved in revenue related transactions involving contracts with customers than a seller and a buyer, the roles of the parties must be understood to determine the amount of revenue to be recognized by each party.

When the seller is a principal in the transaction, the entire amount of revenue will be recognized and amounts paid to third parties will be recognized as expenses or as a component of cost of sales.

When the seller is an agent, only the net amount, which is the amount of revenue to be retained after paying the principal, is recognized.

- A principal has the obligation to provide goods or services
- An agent has the obligation to arrange for another party, the principal, to provide goods and services.

To distinguish between a principal and an agent, a significant factor is who has control of the goods or services that are the subject of the contract before they are transferred to the customer.

A principal controls goods or services before the transfer and may either satisfy the performance obligation or may engage another to do so.

The fact that a party obtains control of the goods and immediately transfers them to a customer does not constitute control. A principal has control of:

- Goods or assets obtained from another party and transferred to the customer; or
- Rights to a service to be provided by another party at the direction of the principal; or
- Goods or services obtained from other parties to combine with other goods or services to satisfy a performance obligation, such as by integrating goods or services provided by another into specified goods or services to be provided to a customer.

Indications of who has control of goods or services prior to transfer to the customer include:

- Primary responsibility for providing goods or services to the customer.
- Risk of loss associated with inventory both before delivery to the customer and after delivery to a customer, such as when a customer returns goods.
- Authority to set prices for the goods or services that are the subject of the contract.
Similar to the relationship between a principal and an agent, a seller may collect funds on behalf of a third party, such as when a sale is subject to state sales tax, which is collected by the seller and remitted to the taxing authority. These funds are not considered part of the consideration in a contract.

**Variable Consideration**

Variable consideration may result from discounts or rebates provided to buyers; credits, price concessions, or incentives; performance bonuses; or penalties. Variable consideration may also result from contingencies such as an exchange of resources that will be made based on the occurrence or nonoccurrence of a future event, or a performance bonus based on achieving a milestone.

Variable consideration is a factor when either the customer has a valid expectation that the seller will accept less than the contract amount in the form of a discount, rebate, refund, credit, or other price concession; or facts indicate that the seller intended, as of the inception of the contract, to make a price concession.

Variable consideration is estimated at the inception of a contract and is included in the total consideration to be earned through the satisfaction of all performance obligations. The amount will be estimated applying one of two approaches:

- Under the **expected value approach**, different amounts that will be obtained based on various levels of performance will each be assigned a probability with the total of the probabilities equaling 100%. Each amount is multiplied by the probability of achieving it and the total is the expected amount of variable consideration.

- Under the **most likely amount approach**, different outcomes are each assigned a probability such that the total of the probabilities equals 100% and the outcome with the greatest probability of occurrence is assumed to be the amount that is to be recognized.

In a period in which cash receipts exceed the expected amount, the excess is reported as a refund liability.

The standard establishes a **constraint** on the amount of variable consideration that can be recognized. The constraint is designed to prevent an entity from recognizing revenues in one period only to be required to reverse it in a subsequent period. In applying the constraint, the entity should consider the likelihood and the magnitude of a potential reversal.

Factors that increase the likelihood or the magnitude of a **potential reversal** include:

- Amounts that are susceptible to factors, such as market volatility, that are beyond the control of the entity;
- Uncertainties that are not likely resolved for long periods;
- Amounts due cannot be reliably anticipated due to a lack of experience or having experience that is not predictive;
- There has been the practice of making price concessions or changing terms and conditions; or
- There is a wide range of possible consideration amounts.

Variable consideration is required to be reassessed each period such that the transaction price at the end of any given period reflects the circumstances at that time.
The Time Value of Money
Present value and the time value of money is taken into consideration when measuring consideration if either the buyer or seller obtains a significant financing benefit, which may be due to a provision of the contract or because of a time lag between performance and the transfer of consideration.

Financing is significant requiring consideration of the time value of money when there is a difference between the amount of consideration and the cash price for the goods or services. The effect will depend on the time lag between performance and payment and prevailing interest rates.

There is no financing component included in measuring consideration if:
- The customer paid in advance and the timing of performance is at the discretion of the buyer;
- Variable consideration is significant and is contingent on factors outside the control of the entity; or
- The difference between the amount of consideration and the cash price for the goods or services is due to factors other than financing and the amount is commensurate with some factor such as protection from nonperformance.

When the time between performance and payment is expected to be one year or less, no financing component is required.

When a financing component is included, it may be calculated using the discount rate that is applicable for separate financing transactions between the parties, or the rate at which the present value of the consideration is equal to its equivalent cash price.
- The financing component is recognized as interest income or expense, separate from revenues from customers; and
- Interest income or expense is only recognized to the extent that a contract asset or liability has been recognized.
  - A contract liability results from a customer’s unexercised rights
  - It is recognized in the amount of prepayments received for unsatisfied performance obligations.

Nonrefundable prepayments received may be taken into income to the extent of breakage, which is the portion that is not expected to be redeemed by the customer.
- If breakage is expected, it is recognized in proportion to the pattern of rights exercised by the customer.
- If breakage is not expected, it is recognized when the likelihood that the customer will exercise rights becomes remote.
- Not taken into income and recognized as a liability instead when the amounts are required to be remitted to a third party.

Noncash Consideration
Noncash consideration is measured at fair value.
- When the fair value is not determinable, it will be measured by reference to the standalone selling price of goods or services exchanged.
- Resources contributed by the customer to assist the entity in satisfying a performance obligation is accounted for as noncash consideration if the entity obtains control.
Consideration Paid to a Customer
A seller may make a payment to a customer in cash or in the form of a credit, or coupon or voucher. It may also be paid to another party purchasing the entity's goods or services the from the customer, such as in the form of a rebate.

When consideration paid to a customer is in exchange for distinct goods or services, it is accounted for as an asset or expense, as appropriate.

- If the amount paid exceeds the value of the distinct goods or services, the excess reduces the transaction price.
- If the value of the goods or services cannot be determined, the entire payment reduces the transaction price.

A reduction to the transaction price is recognized at the later of

- The recognition of revenue resulting from the transfer of goods or services to the customer; or
- The payment of the consideration to the customer or the promise to do so.

Nonrefundable Upfront Fees
Nonrefundable upfront fees received by the entity are only recognized in income if they are in exchange for the satisfaction of a performance obligation, indicating that the customer received something of value in exchange.

- Often intended as compensation to seller for an activity performed near the inception of the contract.
- May be for the purposes of covering administrative costs of setting up the contract such as a membership fee paid to a health club
  - Customer does not obtain anything of value as a result of setting up membership and no performance obligation has been satisfied
  - Value to customer is use of the facility, not the obtaining of a membership card or the likes
  - Considered part of total consideration for the contract and is allocated among distinct performance obligations along with other consideration

Sale with Right of Return
Goods may be sold under terms that allow the customer to return the goods for a refund. When that is the case, the entity recognizes revenue in amount equal to the portion that is expected to be retained by the entity.

- Estimated amount of returns recognized as refund liability.
- Asset recognized based on right to recover goods from the customer.

Lecture 2.08
4. Allocate the Transaction Price to the Performance Obligations in the Contract
The total consideration from a contract is allocated to all performance obligations in proportion to their standalone selling prices. The **standalone selling price** is the price the entity sells a good or service for separately in comparable transactions. If they sell it separately, we have an **observable price**, so we can use that price as the best evidence of the standalone price. However, if they don't sell them separately, then we must estimate the standalone selling price using one of the following 3 approaches.

- Measured as of date of the **inception** of the contract
- May be estimated if not known, using one of
  - **Adjusted market assessment approach**
Evaluate the market, see what a customer might be willing to pay or also look at competitors.

**Expected cost plus a margin approach**
- Forecast expected costs and add an appropriate profit margin for that good or service.

May only use **residual value method approach** if either:
- Some goods or services are sold for different amounts to different customers; or
- The good or service not previously been sold as a standalone product or service and a price has not yet been set.

**Discounts**, equal to difference between total of standalone sales prices and total consideration, allocated proportionately among performance obligations. May be allocated to some but not all performance obligations when 4 criteria apply:
- Each distinct good or service in the contract is also sold as a standalone good or service on a regular basis;
- Some distinct goods and services are also sold as a bundle at a discount;
- The discount on the contract is comparable to the discount on the distinct goods and services sold in a bundle as a discount; and
- If allocated to some, but not all performance obligations, the residual approach is not applied until after the discounts have been allocated.

In a **multiple element arrangement**, if a bundle of goods is sold at a discount and is also included in a bigger bundle with a discount that exceeds the one on the smaller bundle, the discounts are allocated on a **step basis**.
- First, the discount that applies to the smaller bundle will be allocated among the items in that bundle.
- Next, the remaining discount is allocated among all items using the standalone sales prices for those items that were not included in the small bundle and using the standalone sales prices minus the discount already allocated to the items in the small bundle.

A company sells appliances and one contract with a customer who is buying a refrigerator, a stove, a dishwasher, and a washer and dryer combination. The company sells each of these items as standalone goods. The refrigerator is normally sold for $2,700, the stove for $600 the dishwasher for $700, and the washer and dryer combination for $1,000. The company has never discounted its goods in the past.

The store manager has agreed to sell the appliances as a bundle at a combined price of $4,200. The company will not be able to deliver all of the appliances in the same period and is not certain which ones will be delivered in this fiscal period and which will be delivered in the next. As a result, to facilitate the recording of the sales when they do occur, the company has decided to allocate the $4,200 among the appliances.

The sum of standalone sales prices is $2,700 + $600 + $700 + $1,000 or $5,000, resulting in a discount on the bundle of $5,000 - $4,200 or $800. This represents 16% of the sum of the standalone sales prices. Each appliance can be discounted by 16% to determine how much of the $4,200 bundle price will be allocated to each appliance.

The discount on the refrigerator will be 16% x $2,700 or $432, resulting in an allocation of $2,268 as the sales price in the bundle. The discount on the stove will be 16% x $600 or $96 for a sales price of $504. The discount on the dishwasher will be 16% x $700 or $112 for a sales price of $588,
and the discount on the washer and dryer combination will be 16% x $1,000 or $160 for a bundle sales price of $840.

The revenue allocation can be summarized as $2,268 + $504 + $588 + $840 = $4,200.

A neighboring store sells furniture and a customer wishes to buy a sofa that normally sells for $3,000, a loveseat that normally sells for $1,800, a kitchen table with 4 chairs that normally sell for $2,500, and a dining room set that normally sells for $2,700. The total sales price of the furniture at normal prices would be $3,000 + $1,800 + $2,500 + $2,700 or $10,000.

The store normally promotes living room sets and bundles the sofa and loveseat for a discounted bundle price of $4,200. The store has also quoted a bundle price of $9,400 for all four pieces.

In allocating the sales price, the discount on the sofa and loveseat will be allocated. Since the sofa normally sells for $3,000, and the loveseat normally sells for $1,800, for a total of $4,800. Since the bundle is sold for $4,200, the discount is the difference of $600, which is 12.5% of the normal sales prices.

The $600 discount will be allocated to the sofa and loveseat with 12.5% x $3,000 or $375 allocated to the sofa and $12.5% x $1,800 or $225 allocated to the loveseat, resulting in sales prices of $2,625 for the sofa and $1,575 for the loveseat.

The four items in the larger bundle now have adjusted standalone sales price for the sofa of $2,625 and for the loveseat of $1,575 and unadjusted standalone sales prices for the kitchen table and chairs of $2,500, and for the dining room set of $2,700 for a total of $2,625 + $1,575 + $2,500 + $2,700 for a total of $9,400 for the four items, which is the price of the bundle.

There is another store that sells recreational vehicles. There is a water package that consists of a jet ski with a normal standalone sales price of $2,900 and a motorized raft with a normal standalone sales price of $3,600. They can be purchased in a bundle for $5,525. In addition, they sell a small off-road motorcycle with a normal standalone sales price of $2,800 and a snowmobile that has a normal standalone sales price of $3,000 and these items are being bundled as the off-road package for a total $5,220. The store also sells a larger bundle, consisting of all four items in their sportsman’s package at a total cost of $10,100.

To determine how the $9,995 will be allocated, the discounts will be allocated on a step basis. The water package includes the jet ski with a normal standalone sales price of $2,900, and a motorized raft with a normal standalone sales price of $3,600 for a total of $6,500. With a bundle price of $5,525, there is a discount associated with that bundle of $975, which is 15% of the total of the standalone sales prices. As a result, the discount on the jet ski will be 15% x $2,900 or $435, resulting in an adjusted standalone sales price of $2,465. The motorized craft will have a discount of 15% x $3,600 or $540, resulting in an adjusted sales price of $3,060 and a total for the water package of $2,465 + $3,060 or $5,525.

The off-road consists of the motorcycle at $2,800 and the snowmobile at $3,000 for a total of $5,800. Since the bundle price is $5,220, indicating a discount of the difference of $580, which is 10%. As a result, the discount allocated to the motorcycle will be 10% x $2,800 for a total of $280 resulting in an adjusted price of $2,520. The discount allocated to the snowmobile will be 10% x $3,000 or $280, resulting in an adjusted standalone sales price of $2,700. The total for the off-road package is $2,520 + $2,700 or $5,220.
The two packages combined would then be $5,525 + $5,220 or $10,745. Since the package can be purchased for $10,100, providing a discount of $645. This is 6% of $10,745. As a result, the additional discount to be allocated to the jet ski would be 6% x $2,465 or $148, adjusting the price to $2,317. The discount allocated to the motorized raft would be 6% x $3,060 or $184, resulting in an adjusted price of $2,876. The discount allocated to the motorcycle would be 6% x $2,520 or $151 resulting in an adjusted price of $2,369. The discount allocated to the snowmobile would be 6% x $2,700 or $162 for an adjusted price of $2,538. As a result, the total consideration would be allocated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jet ski</td>
<td>$2,317</td>
</tr>
<tr>
<td>Motorized raft</td>
<td>$2,876</td>
</tr>
<tr>
<td>Motorcycle</td>
<td>$2,369</td>
</tr>
<tr>
<td>Snowmobile</td>
<td>$2,538</td>
</tr>
<tr>
<td>Total</td>
<td>$10,100</td>
</tr>
</tbody>
</table>

Allocation of Variable Consideration

Variable consideration may relate to one or more distinct performance obligations in a contract without relating to them all, or one or more goods or services called for within a distinct performance obligation without relating to them all.

- May relate to a single performance obligation such as a bonus for timely delivery of a good or timely performance of a service.
- May be an increase in the cost to be incurred in satisfying a performance obligation, such as an increase in the monthly fee to an inspector that is expected to increase during the completion period.

Variable costs are generally required to be allocated to all performance obligations on the same basis as the allocation of other consideration. May be allocated to specific performance obligations or specific goods or services if two criteria apply:

1. Variable payment must be associated with efforts/outcomes to satisfy a specific performance obligation or to deliver a distinct good or service.
2. Allocation of entire amount of variable consideration is consistent with objectives of revenue recognition standard

Price changes may apply to a specific distinct performance obligation, but only allocated to one or more, but not all, if same criteria as applied to variable consideration apply. Otherwise allocated to all distinct performance on same basis as total consideration using standalone selling prices.

- Changes to standalone selling prices not considered.
- May result in allocation to performance obligations already satisfied.
- Portions allocated to performance obligations already satisfied are taken into income immediately

Lecture 2.09

5. Recognizing Revenue as Performance Obligations are Satisfied

Revenue is recognized when a performance obligation is satisfied or, in some circumstances, while it is being satisfied. A performance obligation is considered satisfied when the entity has transferred the promised goods or services to the customer, which occurs when the customer has control of those goods or services.

A customer has control over goods and services when the customer has

- The ability to direct the use of the goods or services,
- Can prevent others from benefitting from them, and
- Can obtain benefits from the goods or services in the form of cash flows.

When control is uncertain, other factors to consider include whether customer has:
- Legal title to goods
- Physical possession of the goods
- Significant risks and rights associated with ownership of the goods
- Accepted the goods

Revenue may be recognized while the performance obligation is being satisfied if the goods or services promised are transferred to the customer over time. Whether or not this is the case is determined at the inception of the contract, and it is based on the existence of one of three conditions. If none of the conditions apply, revenue is recognized at that point in time when the customer obtains control over the subject goods or services.

Any one of the following three circumstances will indicate that a performance obligation is being satisfied over time and, as a result, revenue will be recognized while the performance obligation is being satisfied. The three circumstances to evaluate are:
- The customer consumes the goods or services as they are being delivered;
- The customer has control over the asset while it is being created or enhanced; or
- The entity has no alternative use for the goods or services and is entitled to payment for performance completed to date.

Consuming Goods or Services Upon Delivery
Certain performance obligations, by their natures, are being consumed as they are being delivered. This is generally true of recurring services being provided to a customer, including cleaning services or gardening and landscaping services. In some circumstances, the determination as to whether goods or services are being consumed as they are being delivered is not necessarily readily determinable. In such cases, one factor to consider is whether another entity that is engaged to provide the remaining services and complete the performance required to satisfy the performance obligation would be required to substantially reperform work that was completed by the original entity. In making such a determination:
- Contract provisions preventing the original entity from, or limiting its ability to, transfer the remainder of the performance obligation to another entity are ignored.
- Assume that an entity engaged to complete the performance obligation would not have the benefit of resources that are currently within the control of the original entity and would remain in control of that entity upon transfer of the performance obligation.

Customer Control Over Asset
In determining whether the customer controls an asset while it is being created or enhanced, the same criteria that are used to determine whether control has been transferred to the customer should be applied. The customer has control over the asset while it is being enhanced if:
- The customer can direct the use of the goods or services;
- The customer can prevent others from benefitting from the goods or services; and
- The customer can obtain benefits from the goods or services in the form of cash flows.

Lack of Alternative Use and Entitlement to Payment
An entity can also recognize revenue while the performance obligation is being satisfied if the entity has no alternative use for the goods or services that are the subject of the contract and if, upon termination of the contract by either the entity or the customer, the entity would be entitled
to payment for the work completed to date. Not having an alternative use for the goods or services includes the assumption that the entity would not be able to transfer them to another customer. An asset is considered as not having an alternative use to the seller if the seller would be required to dispose of it at a substantial cost. This would include:

- Significant costs would be incurred to rework the asset in order to apply it to another use;
- The entity would be able to sell the asset to another customer, but would incur a significant loss upon doing so.

A significant cost would generally be incurred if the asset was being created or enhanced in accordance with the customer’s unique design specifications. That would also be true if the asset was being created as part of the customer’s infrastructure, making it difficult to remove. In addition to having no alternative use for the asset, the entity must be entitled to payment for work completed to date. This would be the case if the entity was entitled to payment if the contract was terminated by either the entity or the customer for some reason other than the entity’s inability to complete performance. The amount the entity is entitled to should reflect the approximate selling price of the goods or services transferred. This would not be the case, for example, if the entity was only entitled to recover its costs incurred, but would be the case if the entity was entitled to recover its costs plus a reasonable profit, although the profit does not have to be equivalent to the profit that would have been earned if the performance obligation had been satisfied.

Many contracts call for partial payments as milestones are being met. In those circumstances, it would not be likely that the entity would have any right to payment if it was requested between milestones, assuming that at that time the entity still intends to complete its responsibilities under the contract and satisfy the performance obligations. In order to recognize revenue while the performance obligations are being satisfied, however, the entity must be entitled to payment assuming that the entity is able to, and intends to complete the project but either the entity or the customer decides to terminate the contract prior to the satisfaction of performance obligations for some other reason.

In evaluating whether the entity is entitled to payment to date, the terms of the contract itself will, of course, be considered. In addition, any applicable laws and regulations should be considered as well as any precedents that may have been set as a result of previous court activities. The customary business practices of the entities as well as those applicable to the industry in which the entities are operating as they are applicable to the contract.

**Recognizing Revenue While the Performance Obligation is Being Satisfied**

In order to recognize revenues while the performance obligation is being satisfied, there must be some means for measuring progress toward completion of the obligation. The two acceptable methods for measuring progress are:

- The output method; and
- The input method.

The focus of the **output method** of measuring progress toward satisfaction of the performance obligation is the value the customer can or does derive from the goods or services that have been transferred to the customer up to that point. When using the output method, the entity should select a base to use for measuring progress that faithfully reflects the entity’s performance toward completion. Alternatives may include:

- Surveys, such as engineering studies, of the work completed;
- Appraisals of results achieved;
Milestones reached;  
Time elapsed; or  
Units produced or delivered.

In some cases, contracts call for consideration on the basis of some criteria, such as the number of hours a professional works on a project that is being billed on an hourly basis. When there is such a measurement guideline, it may also be used as a basis for measuring outputs.

The output method is not always the most practical or reliable way to measure progress and some situations require the use of the input approach. This may be the case, for example, when progress is not necessarily observable or when the information necessary to apply the output approach is not readily available.

The focus of the input method of measuring progress toward completion of a performance obligation is the effort put forth by the entity, including amounts spent on raw materials that will be used in deriving a meaningful measurement. Measurement may be based on a wide variety of inputs, including:

- Resources consumed
- Labor hours expended
- Costs incurred
- Time elapsed
- Machine hours used

In some circumstances, an entity's inputs are expended or efforts put forth somewhat uniformly over the period during which the performance obligation is being satisfied. When this is the case, it may be appropriate to recognize revenue on a straight-line basis over the period during which the performance obligation is being satisfied.

The input method may not be appropriate in all circumstances. This would be true, for example, in contracts where there is no direct relationship between the inputs used by the entity and the transfer of benefits to the customer. As a result, when applying the input method, those inputs that do not depict the entity's performance should be excluded.

When applying the input method using costs incurred as the basis for measuring progress, for example, adjustments may be required for:

- Cost incurred that do not contribute to progress toward completion, such amounts spent for an unanticipated high amount of waste; or
- Costs that are incurred disproportionately with progress toward completion

It may be appropriate to recognize revenue at some amount equal to the cost of a good used to satisfy a performance obligation. An entity may do so if, at the inception of the contract, the entity expects that all the following conditions will apply:

- The good is not distinct;
- The customer is expected to obtain control of the good well; before receiving services related to the good;
- The cost of the transferred good is significant in relation to the total expected costs to be incurred to satisfy the performance obligation; and
- The entity obtains the good from a third party and is not significantly involved in the design or manufacture of the good.
Licensing
When revenue is generated by granting a license to use intellectual property, the method used to recognize revenue will depend on the nature of licensing arrangement and whether it grants a right to use the intellectual property or it grants a right to access to intellectual property.

When a license grants the customer the right to use intellectual property, it is assumed that the property is functional as is and that the licensor does not have any obligation to maintain the property. If, for example, a company wished to use an image from a photograph taken by a professional photographer on an ad the company intends to place, the photograph will have already been taken and the photographer is making it available to the customer for its ad. In such circumstances, the performance obligation is making the image available and it has been satisfied, and revenue will be recognized, in the period in which it is made available, at which time revenue will be recognized.

When a licensor grants access to intellectual property to a customer, on the other hand, the intellectual property is generally more symbolic than it is functional. As a result, the licensor will usually have an obligation to support or maintain the intellectual property, which the customer will have access to over a period of time. Since the licensor’s performance obligation largely consists of the duty to support and maintain the intellectual property over the term of the license, revenue will be recognized over that period of time.

Onerous Performance Obligations
Under the provisions of the standard for revenues from contracts with customers, each distinct performance obligation makes up a separate unit of accounting. The amount of revenue that will be earned during, or at, the completion of the performance obligation is known since it is based on an allocation of total consideration for the contract. In addition, the entity will generally have a pretty clear understanding of what costs will be incurred in satisfying the performance obligation.

If, at any time, the expected cost of satisfying a performance obligation is greater than the amount of revenue allocated to that performance obligation, that performance obligation will incur a loss and it is referred to as an onerous performance obligation and the loss will be reported on the financial statements and the loss is recognized immediately.

The entity will recognize the loss and a corresponding liability in the earliest period in which it is determined that a loss will be incurred. Payments received from the customer essentially become partial reimbursements of the costs incurred in satisfying the performance obligation and payments for costs incurred are payments to reduce the liability to the extent that the they exceed amounts that will be received from the customer.

Accounting for Costs Incurred
Costs incurred in satisfying a performance obligation will be accumulated and reported on the income statement in the period in which the related revenues are recognized. Costs of obtaining a contract will generally be recognized as expenses in the periods in which they are incurred. Certain costs may, however, be capitalized.

Recoverable incremental costs of obtaining a contract are capitalized and reported on the income statement in the same period in which the related revenue is recognized. A land broker, for example, may have land that is all zoned for agricultural use and learns that customers are seeking land that is zoned for multi-family residential units. Costs incurred to re-zone the property
are incremental costs of obtaining the contract. They would be recoverable because the change to the zoning will increase the value, and the selling price, of the property.

**Costs that are required by standards to be capitalized** also will be. In certain Topics, the FASB Accounting Standards Codification specifies that some costs will be recognized as expense and others will be capitalized and appear on the balance sheet.

Finally, the principles for recognizing revenues from contracts with customers provide three criteria, indicating that any costs that meet all three of these criteria should be capitalized. As a result, **costs that meet the following criteria** will also be capitalized:

- The costs relate directly to a contract that is in existence or a specific contract that is currently being negotiated;
- The costs generate or enhance resources that will be used to satisfy performance obligation in the future; and
- The costs are expected to be recovered.

Recovery of costs may be through collections of revenues on the contract if they were anticipated when the contracts were negotiated, or they might have resulted from changes made to the performance obligation that are reimbursable by the customer.

**Disclosures**

In addition to requiring that revenues be recognized and reported in a prescribed manner, the revenue recognition standards require that certain information be disclosed. The disclosures will generally be in the footnotes to the financial statements and may be in a separate footnote devoted exclusively to revenue recognition or may be included in a more general footnote, such as the summary of significant accounting principles.

Both public and nonpublic entities are required to provide certain information about revenues and revenue recognition in their footnotes, although in some cases, the information can be provided more readily on the face of the financial statements. Public entities have to provide additional information. Information that is required of both public and nonpublic entities includes:

Information about disaggregated revenues, contracts balances, and performance obligations:

- If the entity elects not to provide information about disaggregated revenues that is required for public entities, it should disclose, as a minimum, revenues that are disaggregated according to the timing of the transfers of goods and services and qualitative information about how economic factors affect the nature, amount, timing, and uncertainty of revenue and cash flows
- Opening and closing balances of receivables, contract assets, and contract liabilities, unless otherwise provided on the financial statements
- When the entity typically satisfies its performance obligations, such as upon shipment or upon delivery, including when they are satisfied in a bill and hold situation
- Significant payment terms
- The nature of the goods and services the entity has promised to deliver, emphasizing obligations to arrange for delivery by another entity when the reporting entity is acting as an agent
- Obligations related to returns, refunds, and similar items

Public entities are also required to provide the following disclosures, which a nonpublic entity may elect not to provide.
Information about contracts with customers:
- Information about disaggregated revenues in categories that show how the nature, amount, timing, and uncertainty are affected by economic conditions
- A reconciliation of the disaggregated revenues to the amount reported in various segments if the entity is reporting segment information.
- Revenues recognized from contracts with customers, distinguished from revenues from other sources
- Impairment losses recognized on receivables or contract assets derived from transactions involving revenues from contracts with customers
- Information about the timing of the satisfaction of performance obligations and the its relationship to the timing of payments, along with their effects on contract assets and contract liabilities
- Qualitative and quantitative information explaining significant changes in contract assets and contract liabilities during the period including, as appropriate:
  - Changes due to business combinations
  - Cumulative catch-up adjustments due to changes to the measurement of progress toward completion; estimates of the contract price, including those related to variable revenues or the constraint on variable revenues; and contract modifications
  - Contract asset impairments
  - Changes affecting the time for a right to compensation becoming unconditional and being reclassified from a contract asset to a receivable
  - Changes to the time expected to be required for satisfaction of a performance obligation
- Types of warranties and related obligations

While a nonpublic entity may elect not to disclose it, if a public entity has a performance obligation that is part of a contract that has an original expected duration of more than one year, and it does not have the right to consideration in an amount that exactly equals the value to the customer of the entity’s performance to date, as would be the case, for example, if the entity bills on the basis of the number of hours worked on behalf of the client, the entity will disclose:
- The aggregate amount of the transaction price allocated to performance obligations not satisfied as of the end of the period; and
- An indication as to when the entity expects to recognize that amount as revenue, either:
  - Qualitatively; or
  - On a quantitatively using time bands most appropriate for the duration of the remaining performance obligations

**Lecture 2.10**

**CLASS QUESTIONS**

Please see the Class Questions and Class Solutions for this Lecture at the end of this Section.

**Insert at end of Section 2 – New Class Questions**

**Lecture 2.10**

4. PJ’s Paint & Body sells car parts and provides services. PJ’s contracted to provide ten replacement bumpers to Smyth New & Used Auto Mall. When should PJ’s recognize revenue?
   a. When the contract is signed.
   b. When PJ’s places orders for the ten bumpers with PJ’s suppliers.
c. As the bumpers are delivered to Smyth.
d. When the bumpers are delivered to Smyth and the purchase price is collected.

5. Which of the following is a part of the core principle of the revenue recognition standard?
   a. The amount of revenue recognized represents the consideration the entity expects to receive in exchange for goods or services.
   b. If the expected cost of satisfying a performance obligation is greater than the amount of revenue allocated to it, the loss will be recognized when the cost is incurred.
   c. Recoverable incremental costs of obtaining a contract are capitalized and reported on the income statement in the same period in which the related revenue is recognized.
   d. To recognize revenues while the performance obligation is being satisfied, there must be some means for measuring progress toward completion of the obligation.

6. Shipley Clothiers, LLC, specializes in custom-made clothing. Which of the following Shipley contracts most likely has separately identifiable promises resulting in distinct performance obligations for the recognition of revenue?
   a. A contract to make three matching bridesmaid dresses for a wedding, identical except for size.
   b. A contract to make a gold lame evening gown and a cream velvet evening wrap for the customer to wear to the opening night of an art gallery's exhibition.
   c. A contract to make a wool suit with a silk lining and two silk blouses in the same silk as the suit lining.
   d. A contract to make a floral cotton dress and trim a hat with the same fabric for a garden party.

7. Acorn Software provides subscribers with access to web-based software for 365 days for a single payment, regardless of how often the customer uses the software. Acorn developed the software and updates it (to accommodate changes to off-the-shelf operating systems or to provide new functionality) for the entire subscription period, so customers continually have the most recent version. In considering revenue recognition of the subscriptions, what base is Acorn most likely to use for measuring progress that faithfully reflects the entity's performance toward completion?
   a. Appraisals of results achieved.
   b. Milestones reached.
   c. Time elapsed.
   d. Units produced or delivered.
8. Paw Gallery has an extensive collection of animal photographs that may be downloaded and reproduced by its subscribers. Subscribers pay an annual fee for an access code allowing the user to download images from the site. Shell Portraits takes photographs in its studio or at the customer's location. Shell gives each customer an access code good for up to four weeks so each customer may download only his or her own photographs from Shell's website. Shell will print and deliver photos for a separate printing fee or the customer may arrange for an independent printer. Both Paw and Shell allow unlimited reproduction of their images. When should Paw and Shell recognize revenue for these image sales?

<table>
<thead>
<tr>
<th>Paw Gallery</th>
<th>Shell Portraits</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. At access code delivery</td>
<td>At access code delivery</td>
</tr>
<tr>
<td>b. At access code delivery</td>
<td>Over access duration</td>
</tr>
<tr>
<td>c. Over access duration</td>
<td>At access code delivery</td>
</tr>
<tr>
<td>d. Over access duration</td>
<td>Over access duration</td>
</tr>
</tbody>
</table>

9. On March 1, Bunyan Lumber entered into a contract to provide 20,000 board feet of type A Brazilian cherry to Happy Homes, LLC, for $15 per board foot for delivery as called for from July to October. At the time, Bunyan could purchase type A Brazilian cherry at $10 per board foot and deliver it to Happy Homes for less than $1 per board foot. In April, foresters identified a new disease affecting Brazilian cherry. Strict regulations were implemented in May, including requiring pre-transport inspections of Brazilian cherry. Due to the cost of inspections and the decreased supply, prices increased. In May, the price fluctuated wildly between $13 and $21 per board foot. With prices continuing to fluctuate wildly in June, Bunyan purchased 20,000 board feet of type A Brazilian cherry at $16 per board foot. Bunyan delivered 10% of the lumber in August and 90% in September. When should Bunyan recognize a loss relating to this contract?

a. May  
b. June  
c. August  
d. August and September

10. Mod Cons Appliances entered into a contract to provide Reilly Clean Laundromat with 10 premium washer-dryer packages at $2,150 for each package. The premium washer-dryer package includes a washing machine, a dryer, and a 5-year repair plan for each appliance. Mod Cons offers a washer package with a washer and a washer repair plan for $1,350 and a dryer package with a dryer and a dryer repair plan for $950. Mod Cons regularly sells individual washing machines at $1,200 each and individual dryers at $900 each. It sells 5-year repair plans at $300 for washing machines and $100 for dryers. Rounding to the nearest whole dollar, how much of the Reilly contract revenue should be allocated to the washing machines?

a. $10,100  
b. $10,800  
c. $10,320  
d. $12,000
Seagull's Seashells business manager is seeking information on revenue recognition. Identify the location in the professional standards that provides the assumptions to be made regarding modification of a contract for purposes of determining the transaction price in a contract with a customer.
Class Solutions to Lecture 2.10 New Section 2 Class Questions

4. (c) In general, revenue from a contract with a customer is recognized when a distinct performance obligation is satisfied. This occurs when the customer obtains control over the goods or services, usually when they are transferred. Since a customer can use a bumper without requiring additional resources, in the form of goods or services, from the seller, each bumper is a separate performance obligation and revenue would be recognized as each bumper is delivered. The signing of the contract (a) is evidence that a contract does exist, but does not result in the recognition of revenue until performance obligations are being satisfied. Ordering the bumpers from a supplier (b) is simply the seller's means of fulfilling the performance obligation but does not satisfy it. Collection of the contract price (d) is not a requirement for the recognition of revenue as long as collectability is probable.

5. (a) The core revenue recognition principle consists of two components: (1) revenue is to be recognized upon the transfer of promised goods and service to customers and (2) the amount of revenue recognized represents the consideration the entity expects to receive in exchange for those goods and services. The remaining responses are correct statements, but are not part of the core revenue recognition principle. When the cost of satisfying a performance obligation exceeds the revenue allocated to it (b), it is an onerous performance obligation and the loss will be recognized in the earliest period in which it is determined that a loss will be incurred. Recoverable incremental costs of obtaining a contract (c) are capitalized and recognized on the income statement in the same period as revenue is recognized. When certain conditions are present, revenue will be recognized while the performance obligation is being satisfied (d), rather than when it has been satisfied but, in order to apply such an approach, progress toward satisfaction of the performance obligation must be measurable.

6. (b) The evening gown and wrap are made from different fabrics in different colors. Since another evening wrap could be acquired from a different vendor and worn with the lame gown and another evening gown from a different vendor could be worn with the velvet wrap, the evening gown and the evening wrap are separately identifiable and would be distinct performance obligations. Failing to deliver all of the promised items in the other contracts defeats the customers' aims that the items match. It is unlikely that a bridesmaid's dress to match the others (a), a silk blouse in the same silk as the suit lining (c), or a hat trimmed with the same fabric as the dress (d) would be available from a different vendor.

7. (c) For a contract in which revenue is recognized while the performance obligation is being satisfied, measurement of progress toward satisfaction of the performance obligation is a key element. Applying an inputs approach may involve measuring costs incurred to date in satisfying the performance obligation and dividing it by the total estimated cost of complete satisfaction to yield a percent complete or by measuring the time lapsed in the contract term and dividing it by the entire term to yield a percent complete, either of which is acceptable. To use an outputs approach, it is necessary to have expectations as to the results of the contract to determine what portion of those results have been achieved. These expectations are generally very difficult to quantify. To use appraisals of results achieved (a), for example, it would be necessary to know the total appraised value of the cumulative results that are expected to be achieved. To use milestones reached (b) or units produced (d), it would be necessary to know all of the milestones expected to be reached, or the total number of units expected to be produced.

8. (c) Paw Gallery has an obligation to maintain the collection, which the customer will have access to over a period of time. Since Paw's performance obligation largely consists of the duty to support and maintain intellectual property over the term of the subscription, revenue will be recognized
over that time period. For Shell Portraits, the performance obligation of taking the photographs and making the images available is satisfied at access code delivery.

9. (b) At any time, if the expected cost of satisfying a performance obligation is greater than the amount of revenue allocated to that performance obligation, it is referred to as an onerous performance obligation (OPO). The entity will recognize the loss and a corresponding liability in the earliest period in which it is determined that a loss will be incurred, making recognition of the loss in August and September too late. As Bunyan purchased lumber to fulfill the contract at a greater cost than the contract price in June, it is June in which Bunyan knows that a loss will be incurred. The loss recorded at that point would be the entire loss, including expected selling expenses. As prices fluctuated in May between a price that would not create an OPO and a price that would create an OPO, Bunyan would not know in May that the performance obligation would be onerous. Even if Bunyan did conclude that the contract had an OPO in May, it would be difficult to measure the amount of loss objectively with wildly fluctuating prices.

10. (a) When multiple deliverables are subject to a discount, that discount is generally allocated among all performance obligations in proportion to their standalone selling prices. When, however, some of the items may be packaged to provide a discount on those items, that discount will be allocated first, adjusting the standalone selling prices of those items. Any remaining discount is allocated among all performance obligations in proportion to their adjusted standalone prices. Since a washer and a 5-year maintenance plan normally sell for $1,200 and $300, respectively, for a total of $1,500, and may be purchased as a package for $1,350, the $150, or 10% discount will be allocated with $120 reducing the price of the washer to $1,080, and $30 reducing the price of the maintenance agreement to $270. Likewise, since a dryer and a 5-year maintenance plan normally sell for $900 and $100, respectively, for a total of $1,000, and may be purchased as a package for $950, the $50, or 5% discount will be allocated with $45—reducing the price of the dryer to $855, and $5 reducing the price of the maintenance agreement to $95. Adjusted standalone sales prices would then be $1,080 for the washer, $855 for the dryer, and $270 and $95 for the maintenance plans for the washer and dryer, respectively, for a total of $2,300. With a package price of $2,150 for all 4 items, the final $150 discount will be allocated proportionately as follows:

<table>
<thead>
<tr>
<th></th>
<th>Standalone</th>
<th>Discount</th>
<th>Adjusted Standalone</th>
<th>%</th>
<th>Revenue Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Washer</td>
<td>$1,200</td>
<td>0.10</td>
<td>$1,080</td>
<td>47</td>
<td>$1,010</td>
</tr>
<tr>
<td>Washer repair plan</td>
<td>300</td>
<td>0.10</td>
<td>270</td>
<td>12</td>
<td>252</td>
</tr>
<tr>
<td>Dryer</td>
<td>900</td>
<td>0.05</td>
<td>855</td>
<td>37</td>
<td>799</td>
</tr>
<tr>
<td>Dryer repair plan</td>
<td>100</td>
<td>0.05</td>
<td>95</td>
<td>4</td>
<td>89</td>
</tr>
<tr>
<td>Total</td>
<td>$2,500</td>
<td></td>
<td>$2,300</td>
<td>100</td>
<td>$2,150</td>
</tr>
</tbody>
</table>

The revenue allocated to washers for 10 packages is 10 x $1,010 = $10,100.

Task-Based Simulation Solution 3

| FASB ASC | 606 | 10 | 32 | 4 |
Section 3 – Investments in Debt and Equity Securities

Corresponding Lectures

Watch the following course lectures with this section:

Lecture 3.01 – Investments in Debt Securities - Trading
Lecture 3.02 – Investments in Debt Securities – Available For Sale
Lecture 3.03 – Debt Securities - Trading vs. Available For Sale – Class Questions
Lecture 3.04 – Debt Securities - Sale of AFS and Impairment Loss
Lecture 3.05 – Debt Securities - HTM / Fair Value Option and Equity Securities - Fair Value Accounting
Lecture 3.06 – Debt and Equity Securities – Class Questions
Lecture 3.07 – Investments under IFRS – Investment Securities

EXAM NOTE: Please refer to the AICPA FAR Blueprint in the Introduction to find a listing of the representative tasks (and their associated skill levels—i.e., Remembering and Understanding, Application, and Analysis) that the candidate should be able to perform based on the knowledge obtained in this section.
Investments in Debt and Equity Securities

**Lecture 3.01**

INVESTMENTS IN DEBT SECURITIES

**Note:** The following content reflects the changes brought about by the FASB's ASU 2016-01, *Financial Instruments - Overall (Subtopic 825-10)*. These changes became effective on the CPA Exam January 1, 2018.

There is a wide variety of investments an entity may decide to make, including the securities of other entities. Securities fall into two basic categories. There are debt securities, the most common of which is bonds, and there are equity securities, which are shares of stock and derivative instruments that are associated with the stock. The FASB Accounting Standards Codification (ASC) provides principles and guidance for accounting for securities.

ASC Topic 320 relates to investments in debt securities, although it does not apply to brokers and dealers (ASC Topic 940); Defined benefit pension and other postretirement or postemployment plans (ASC Topics 960, 962, and 965) or investment companies (ASC 946). Topic 321 relates to investments in equity securities, Topic 323 relates to the equity method of accounting for certain equity securities and joint ventures; and Topic 325 relates to other investments, such as investments in insurance contracts and beneficial interests in securitized financial assets.

In general, if an entity acquires the debt securities of other entities, depending on the nature of the securities, it is essentially becoming a creditor with a receivable from the other entity. While it holds the receivable, it will generally be receiving periodic interest payments and, depending on the terms of the instrument, may be receiving periodic payments to reduce the principal balance as well. In other cases, the principal balance may be paid as a single lump sum at the end of the receivable's term.

The value of a receivable is equal to the present value of the payments to be received, applying an appropriate interest rate. The rate used may be the investor's cost of capital, the return on other investments, or some target based on whatever criteria the investing entity determines is applicable. The rate, and ultimate valuation, is adjusted to consider both market risk and performance risk. **Market risk** is the risk that market interest rates will rise, making the lower rate on the receivable less desirable and reducing its value, or that other investments will become available that offer a greater return, also diminishing its value. **Performance risk** is the risk that the debtor will not perform, which could mean that some or all payments will be missed or late.

Some investments in debt securities are made for reasons other than the cash flows they generate, including those that do not provide regular interest and principal payments. Since the value of these securities is affected by a wide variety of factors, many investors acquire them on speculation. An investor may anticipate changes in one or more of those factors, such as market interest rates, an issuing entity's credit rating, the availability of investment alternatives, economic conditions. Such an investor can benefit from the changes in the form of gains on trades and other transactions. Investments in debt securities may also be made to balance out an investment portfolio, establish or enhance a fund for obtaining assets, retire debt, enhance a relationship with the issuer of the security, or for some other reason.
The FASB ASC defines a debt security as “any security representing a creditor relationship with an entity”. The term debt security also includes all of the following:

a. Preferred stock that by its terms either must be redeemed or is redeemable at the option of the investor
b. A collateralized mortgage obligation (or other instrument) that is issued in equity form but is required to be accounted for as a nonequity instrument regardless of how that instrument is classified (that is, whether equity or debt) in the issuer's statement of financial position
c. U.S. Treasury securities
d. U.S. government agency securities
e. Municipal securities
f. Corporate bonds
g. Convertible debt
h. Commercial paper
i. All securitized debt instruments, such as collateralized mortgage obligations and real estate mortgage investment conduits
j. Interest-only and principal-only strips

The term debt security excludes all of the following:

a. Option contracts
b. Financial futures contracts
c. Forward contracts
d. Lease contracts
e. Receivables that do not meet the definition of a security and, so are not debt securities, for example
   Trade accounts receivable arising from sales on credit by industrial or commercial entities
   Loans receivable arising from consumer, commercial, and real estate lending activities of lending institutions.

**Investments in Debt Securities (ASC 320)**

Investments in debt securities are reported on an investor's balance sheet in one of three categories. They may be trading securities, available-for-sale securities, or held-to-maturity securities.

**Trading Securities (HFT – Held For Trading)** are investments in debt instruments, such as bonds, which the investor has acquired in an attempt to make profits by buying and selling within a short period of time. These are normally classified as current assets.

**Available-For-Sale (AFS/AVS)** securities are all investments in marketable debt instruments that do not fit the definitions of HTM or trading securities. These may be classified as current or noncurrent assets, depending on the expected date of sale. If the holding period of the securities is indefinite, they should be classified as noncurrent assets.

**Held-To-Maturity (HTM)** securities are investments in bonds and other debt instruments that the investor has the ability and intent to hold until the due date for repayment. These are classified as noncurrent assets until the maturity date is less than one year from the balance sheet date. When principal is paid in installments, whether annually, at the end of the term, or in some other pattern, the principal that will be paid within the next year is classified as a current asset. If an entity has an operating cycle that exceeds a year, the current amount will be the principal amount to be paid within the next operating cycle.
Debt Securities Overview

<table>
<thead>
<tr>
<th>B/S</th>
<th>Trading securities (HFT)</th>
<th>Available for sale (AFS)</th>
<th>Held to maturity (HTM)</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV</td>
<td>Usually Current</td>
<td>Current/non-current</td>
<td>Non-current (current)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>FMV</td>
<td>Amortized cost</td>
</tr>
<tr>
<td></td>
<td></td>
<td>*Unrealized gains/losses</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>OCI on Stmt of comprehensive</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Income &amp; accum on B/S in</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Stkhldrs’ Eq as Accum OCI</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>I/S</th>
<th>*Unrealized gains/losses</th>
<th>Realized gain/loss</th>
<th>Realized gain/loss</th>
<th>Realized gain/loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Realized</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-Fixed</td>
<td></td>
<td>ATM</td>
<td>ATM</td>
<td>ATM</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Interest income</td>
<td>Interest income</td>
<td>Interest income</td>
</tr>
</tbody>
</table>

Cash Flows

<table>
<thead>
<tr>
<th>(purchase or sale)</th>
<th>Usually Operating activity</th>
<th>Investing activity</th>
<th>Investing Activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV</td>
<td>Usually Current</td>
<td>Current/non-current</td>
<td>Non-current (current)</td>
</tr>
<tr>
<td></td>
<td>FMV</td>
<td></td>
<td>Amortized cost</td>
</tr>
<tr>
<td></td>
<td>*Unrealized gains/losses</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>OCI on Stmt of comprehensive</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Income &amp; accum on B/S in</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Stkhldrs’ Eq as Accum OCI</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


Accounting for Trading Securities (HFT)

When trading securities are acquired, they are recorded at cost. Since they are being purchased for the purpose of generating profits from resale, they are a part of the entity's working capital, and transactions are normally reported in the operating activities section of the statement of cash flows.

Due to the marketable nature of these securities, and the intention to sell them in the near future, unrealized gains and losses resulting from fluctuations in market price are reported in net income each period. Any realized gain or loss from the sale or other disposal of these securities is, of course, also reported in net income each period. The carrying values of the securities are adjusted to market price every period, including interim periods if interim financial statements are prepared in addition to the annual financial statements.

To summarize:

- Initially recorded at cost, but carried at FMV (ASC 320)
- Any unrealized gains and losses (temporary) appear on the income statement
- Realized gains and losses are always on the Income statement along with interest and dividend income.
- Cash Flows, as per ASC 320-10-45-11, related to the acquisition (outflows) or disposal (inflows) of trading securities may be classified as operating or investing activities on the statement of cash flows.
  - When trading securities are acquired for short term appreciation, they are reported as current assets and the cash flows are classified as operating activities on the statement of cash flows. This is the more common classification.
  - When trading securities are acquired for long-term appreciation, they are reported as noncurrent assets and the cash flows are classified as investing activities.
**CLASS EXAMPLE:**
An entity acquires bonds of another entity with a cost and face value of $100. They are being held in anticipation of an increase in value due to an expected decrease in market interest rates. The following information relates to cost and market values.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price, 1/1/X1</td>
<td>$100</td>
</tr>
<tr>
<td>FMV, 12/31/X1</td>
<td>$140</td>
</tr>
<tr>
<td>FMV, 12/31/X2</td>
<td>$90</td>
</tr>
</tbody>
</table>

**To purchase:**

Investment in trading securities 100
Cash 100

**At 12/X1 the FMV is now $140.** Since the security must be reported at FMV, the increase is recorded in the investment account, or set up as valuation allowance.

Market Adjustment - Trading Security (B/S) 40
Unrealized gain (I/S) 40

The market adjustment account is on the B/S and increases the carrying value of the trading security in the current asset section; the unrealized gain is on the income statement as part of income from continuing operations.

At 12/X2 the FMV is now $90, resulting in a **loss of $50 ($140 – $90)**

Unrealized Loss (I/S) 50
Market Adjustment – Trading Security (B/S) 50

**Note:** The income statement effect in X1 is $40, and in X2 is ($50). These amounts represent the current year effects only since they are both Income statement items. The valuation allowance will have a credit balance of $10, resulting from a debit of $40 in X1 and a credit of $50 in X2.

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**Lecture 3.02**

**Accounting for Available For Sale Securities (AFS/AVS)**

AFS securities are similar to trading securities in that they are likely to be sold prior to maturity. They are also reported at FMV at the balance sheet date, with changes in market price reflected whenever the entity prepares financial statements. Available-for-sale securities are not purchased primarily to gain short-term profits from resale and are not reported as current assets until such time as management has decided to dispose of them, or otherwise believes they will be disposed of, within one year.

Purchases and sales are reported in investing activities. Unrealized gains and losses resulting from fluctuations in FMV prior to disposal are **not** reported in net income until the securities are sold or otherwise disposed of. Instead, they are a component of other comprehensive income, reported on the statement of comprehensive income and accumulated in a stockholders' equity account.
accumulated other comprehensive income, reported in equity immediately below retained earnings.”

**Available for sale securities** are debt securities that don't fall into either of the other two categories.

- They may be **current or noncurrent**, depending on the expected holding period and generally considered noncurrent if the holding period is indefinite.
- Initially recorded at cost, but carried at **FMV (ASC 320)**
- Any **unrealized gains and losses** appear on the **statement of comprehensive income** as a component of Other comprehensive income and accumulated on the **balance sheet** as part of **Accumulated other comprehensive income** in the stockholders’ equity section.
- Realized gains and losses appear on the **income statement** as does interest income.
- Cash flows related to the acquisition (outflows) and disposal (inflows) of AFS investments are reported as **investing activities** on the statement of cash flows.

Same example as above, except for the treatment of the unrealized gain and loss.

**To purchase:**

| Investment in AFS security | 100 |
| Cash                       | 100 |

**At 12/X1 the FMV is now $140.** Since the security is required to be reported at FMV, the increase is recorded in the investment account, or set up as a valuation allowance.

| Market Adjustment - AFS Security (B/S) | 40 |
| Unrealized gain (Stmt of comp inc)    | 40 |

The market adjustment account is on the B/S and increases the carrying value of the available-for-sale security in the asset section; the unrealized gain is reported on the statement of comprehensive income as a component of other comprehensive income and accumulated in the Accumulated other comprehensive income in the equity section of the balance sheet.

**At 12/X2 the FMV is now $90,** resulting in a loss of $50 ($140 – $90).

| Unrealized Loss (Stmt of comp inc) | 50 |
| Market Adjustment – AFS Security (B/S) | 50 |

**Note:** The unrealized gain in X1 of $40, and the unrealized loss in X2 of $50, are reported in Other comprehensive income in each period's statement of comprehensive income. The amount is accumulated in a stockholders’ equity account on the balance sheet, referred to as Accumulated other comprehensive income or AOCI. The amount, which is the same as the balance in the valuation account, is a negative equity amount (debit balance) of $10.
### GAAP Statement of Comprehensive Income (ON-TIDe-N-OC)

<table>
<thead>
<tr>
<th></th>
<th>20X1</th>
<th>20X2</th>
<th>If Trading, goes here</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-operating</td>
<td>40</td>
<td>(50)</td>
<td></td>
</tr>
<tr>
<td>Taxes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income continuing operations</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discontinued Operations</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Income</td>
<td>100</td>
<td>200</td>
<td>300 to RE</td>
</tr>
<tr>
<td>Other Comprehensive Income (OCI)</td>
<td>40</td>
<td>(50)</td>
<td>(10) Accumulated OCI</td>
</tr>
<tr>
<td>Comprehensive Income</td>
<td>140</td>
<td>150</td>
<td>290 net effect on B/S</td>
</tr>
</tbody>
</table>

The above items may be presented in a single statement of comprehensive income, as above, or in two separate statements.

- The first statement is the **income statement**, ‘statement of earnings’, or ‘statement of operations. It includes all elements leading to net income or ‘earnings.’

- The second statement is the **statement of comprehensive income**. It is required to immediately follow the income statement when both statements are presented. It includes net income, components of other comprehensive income, a total for other comprehensive income, and the grand total of both net income and other comprehensive income. This grand total is comprehensive income.

### Lecture 3.03

**CLASS QUESTIONS**

Please see the Class Questions and Class Solutions for this Lecture at the end of this Section.

### Lecture 3.04

**Sale of Available For Sale (AFS) Securities**

When the investment in **AFS is sold**, the difference between the cost and the proceeds is treated as a **realized gain/loss**. Ignore the allowance account and adjust to the new target balance without the security that was just sold, unless it is the last investment, then the allowance and the unrealized gain/loss must both be eliminated.

**Impairment Loss – “Other Than Temporary”**

Investments in trading securities would not be subject to impairment loss. Since they are reported at market value and unrealized gains and losses are already recognized in income, any impairment would be recognized in the ordinary course of accounting for them.

Investments in debt securities that are accounted for as held-to-maturity would be subject to an impairment loss if the investor had reason to believe that the issuer of the debt security would not make all principal and interest payments as scheduled. Since the investor intends to hold the securities until they mature, fluctuations in the market value of the securities would not affect the cash flows that the investor will receive and, as a result, would not be reported as an adjustment to the carrying value of the investment.
Investments in debt securities that are accounted for as available for sale securities are subject to impairment loss. They are impaired when there is a decline in value that is considered “other than temporary”. Although the investment will already be written down to its market value at the balance sheet date, the portion of the unrealized loss that represents the nontemporary decline will be recognized in income.

- The amount will be the difference between the investment's original cost and the declined value from which it is not expected to recover.
- That amount will be reclassified out of other comprehensive income and recognized as a loss in calculating net income.
- Once written down, recoveries will not be recognized.
  - The security is written down to FMV
  - The loss is treated as a realized loss on the income statement, and the remaining balance is considered to be the new cost.

\[
\text{Loss} \times (1/S) = \text{Investment in AFS} \times X
\]

**A 2-step process** is applied to determine if a decline in value is other than temporary, requiring an adjustment:

- **Step 1 - Determine whether an investment is impaired**
  - If the Fair value is less than its Cost, the investment is considered to be impaired.

- **Step 2 - Evaluate whether an impairment is Other-Than-Temporary**

When determining if an impairment is other than temporary for investments in available-for-sale debt securities.

- If the entity intends to sell the security, a nontemporary loss is considered to have occurred.
- If the entity does not intend to sell the security, a nontemporary loss will be recognized if it is more likely than not that the entity will be required to sell the security before the value is recovered or if the present value of the amount expected to be recovered is less than the carrying value.

If a decline is determined to be other than temporary, the amount of loss will be:

- If the investor expects to sell, or to be required to sell the security before recovery, the difference between the fair value at the balance sheet date and the amortized cost.
- If the investor does not expect to sell, or be required to sell the security before recovery, a portion of the loss attributable to credit factors will be recognized in earnings and the remainder, attributable to other factors, will be recognized in other comprehensive income.

**Reclassifications**

Reclassifications between Trading and AFS may sometimes occur as a result of changes in management's intentions (ASC 320).

Securities may be reclassified from one of the categories to another, and the accounting approaches vary depending on the old and new classifications. Exam testing has been on reclassifications between trading securities and AFS securities. The approach is to treat the securities as if they are being sold from the portfolio they are leaving, then repurchased at the...
current market price into the portfolio they are entering. In other words, current market price is used to determine the transfer.

- Reclassify at FMV
- The difference is treated as a **realized** gain/loss on the income statement.
- Eliminate any related valuation allowance accounts.

Reclassifications between *Held to Maturity and AFS*

- Reclassify at **FMV**
- If HTM to AFS then record in Other Comprehensive Income (OCI)
- If AFS to HTM then the unrealized holding gain/loss is reported on the Statement of comprehensive income, transferred to the **B/S** in Accumulated other comprehensive income and amortized over the remaining life of the security.

**Lecture 3.05**

**Accounting for Held to Maturity Securities (HTM)**

Investments in the debt securities of other entities that the entity has both the intent and the ability to hold until maturity.

An HTM security is initially recorded at cost, and the difference between the cost and the face or maturity value is amortized over the life of the security, using the effective rate method discussed in the bond section. The straight-line method may be used if it doesn't materially differ. Interest income is recognized in each period.

Since HTM securities are not going to be sold, fluctuations in market price are disclosed but not recorded, and they are always carried at the amortized cost, unless there is a nonpermanent decline in value that will be recognized as an impairment, as indicated above. In the rare cases where these securities are not held to maturity an ordinary gain or loss on disposal results. This would be the case, for example, when the issuer of the debt security exercises a call provision compelling the investor to redeem them early. The cash effects of purchases (outflows) and sales or redemptions (inflows) of these securities are classified as investing activities on the statement of cash flows.

- Non-current, unless maturity date is less than one year from the balance sheet date.
- Record at cost
- Carry at **Amortized cost** (face net of unamortized discount or premium)
- Unrealized gains/losses – not applicable
- Realized gains/losses shouldn't happen, but could
- Report interest income net of amortization on the Income Statement
- Investing activity on the statement of cash flows
- Considered held to maturity if sale occurs after at least 85% of principal has been collected.

In addition to the three methods of accounting for and reporting investments in debt securities, the investor may also elect to apply the **fair value option** under which they will be reported at FMV on the balance sheet and both realized and unrealized gains and losses will be reported on the income statement, as a component of income from continuing operations in the same period as the change in FMV or disposal, as appropriate.
INVESTMENTS IN THE EQUITY SECURITIES OF OTHER ENTITIES  
(ASC 821)

FASB ASC Topic 821, Investments – Equity Securities, applies to most investments in the equity securities of another entity and to other ownership interests, such as investments in partnerships, unincorporated joint ventures, and limited liability entities as if those interests were equity securities.

It does not apply to investments accounted for under the adjusted cost method or the equity method, investments in consolidated subsidiaries, a membership in an exchange representing an ownership interest in the exchange, or Federal Home Loan Bank and Federal Reserve Bank Stock.

Investments in equity securities are originally recorded at cost. They are adjusted to FMV each balance sheet date (Fair Value Approach). When adjusted to fair value, the unrealized gains and losses are reported in income as a component of income from continuing operations. This is the same as the accounting for investments in debt securities classified as trading securities.

Dividends received in relation to these investments is recognized as dividend income.

On the statement of cash flows, the classifications of cash flows related to the acquisition (outflows) or disposal (inflows) related to these investments will be based on the nature and purpose for which they are acquired, either operating or investing.

On the balance sheet, the classification of these investments will be determined by the measurement category they fall into, either current or noncurrent assets, as specified in ASC 825, Financial Instruments.

To summarize:

- Initially recorded at cost, but carried at FMV
- Any unrealized gains and losses (temporary) appear on the income statement
- Realized gains and losses are always on the income statement along with interest and dividend income.
- Cash Flows related to the acquisition (outflows) or disposal (inflows) of trading securities may be classified as operating or investing activities on the statement of cash flows.
- Balance Sheet could be either current or noncurrent asset.

As will be seen in the next section, if the Fair Value is not readily determinable for the equity securities, then we use the adjusted cost method (cost minus any impairment losses). Again, these will be covered in the next section.

FAIR VALUE ACCOUNTING OPTION (ASC 825)

FASB ASC Topic 825, Financial Instruments, allows an entity to value various eligible items at fair value at certain dates, referred to as election dates.

Eligible items include:

- Most recognized financial instruments
  - Applies to both financial assets and financial liabilities
  - Does not apply to certain instruments
    - Subsidiaries or VIEs required to be consolidated
    - Deferred compensation arrangements including pension or other postretirement or post-employment obligations and stock option or stock purchase plans
Assets or liabilities recognized under leases
Deposit liabilities of depository institutions
Financial instruments classified as a component of stockholders’ equity
Firm commitments involving only financial instruments that would not be recognized at inception
If a reporting entity has an equity interest in an entity that reports net asset value per share, ASC 820 allows the reporting entity, as a practical expedient, to report the investment at its published net asset value per share.
Deposit liabilities of depository institutions
Financial instruments classified as a component of stockholders’ equity
Firm commitments involving only financial instruments that would not be recognized at inception
If a reporting entity has an equity interest in an entity that reports net asset value per share, ASC 820 allows the reporting entity, as a practical expedient, to report the investment at its published net asset value per share.
Written loan commitments
Rights and obligations under insurance contracts or warranties when certain requirements are met:
- The insurance contract or warranty is not a financial instrument
- The insurer or warrantor is allowed by the terms to pay a third party to provide goods or services to settle the obligation

A financial instrument can be cash, a security representing an ownership interest in another entity, or a contract that has two components:
- It represents a potential financial liability for one party by imposing an obligation to do one of the following:
  - Deliver cash or another financial instrument to another entity
  - Exchange other financial instruments with the other entity on potentially unfavorable terms
- It represents a potential financial asset for the other party by conveying a right to one of the following:
  - Receive cash or another financial instrument from the other entity
  - Exchange other financial instruments with the other entity on potentially favorable terms

The fair value option may be elected for eligible items only on election dates. In addition to when the entity first recognizes an item on its financial statements, election dates include:
- The date on which the entity enters into an eligible firm commitment
- When an item that was reported at fair value due to specialized accounting principles, with unrealized gains or losses reported in earnings, no longer qualify for the specialized accounting treatment
- An investment that becomes subject to the equity method or a retained interest in a subsidiary or VIE that no longer qualifies for consolidation
- A circumstance requiring the item to be reported at fair value at a point in time but not at each reporting date, other than an impairment

An election date also occurs when an event requires an eligible item to be reported at fair value or to be recognized initially, such as:
- Business combinations
- Consolidation or deconsolidation of a VIE
- Significant debt modifications

The fair value option can be elected on an instrument-by-instrument basis. Electing the fair value option for a particular instrument does not require election for a similar instrument held by the same entity. This includes a circumstance where the investor holds bonds, for example, with a
total face value of $100,000, allowing the investor to elect the fair value option for one portion and account for the remainder as Held to maturity securities.

Some of the specific applications of the fair value option include the following:

▪ An investment which otherwise qualifies for the **equity method** would be reported at fair value on each balance sheet date, increases or decreases will be recognized as unrealized gains or losses on the income statement, and dividends received will be recognized as income. In other words, the fair value option overrides the equity method.

▪ **Available for sale securities** will be reported at fair value on each balance sheet date, as already required. Unrealized gains or losses are reported as a component of net income, however, instead of other comprehensive income.

▪ **Trading securities** are not affected.

▪ **Held to maturity** securities continue to be accounted for at amortized cost, recognizing interest income under the effective interest method. In addition, the carrying value is adjusted to fair value on each balance sheet date with the increase or decrease recognized as a component of net income.

Once the fair value option is elected, it is **irrevocable** until a subsequent election date.

**Disclosures under Fair Value Accounting Option**

When an entity elects the **fair value option**, certain disclosures are required as of each balance sheet date.

▪ Management's reasons for electing the fair value option for each item for which the election was made

▪ If elected for some, but not all, items within a group of similar items, a description of the similar items, the reasons for a partial election, and how the similar items affect line items on the statement of financial position

▪ The differences between fair value amounts and principal balances of receivables or payables with contractual principal amounts

▪ Disclosures required when applying the fair value option for investments that would have been accounted for under the equity method if the fair value election had not been made

Disclosures are also required for each period for which an income statement is presented:

▪ Amounts of each gain or loss recognized in earnings as a result of changes in fair values

▪ An indication as to where interest and dividends are reported on the income statement and how they are measured

▪ For receivables held as assets, the gains or losses resulting from changes in the instrument's credit risk, including how it is measured

▪ For liabilities affected by changes in the instrument's credit risk during the period, the gains or losses resulting from changes in the instruments credit risk, reasons for the change, and how the gains or losses are measured

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**Lecture 3.06**

**CLASS QUESTIONS**

Please see the Class Questions and Class Solutions for this Lecture at the end of this Section.
INVESTMENTS IN FINANCIAL INSTRUMENTS OF OTHER ENTITIES UNDER IFRS

IFRS defines a financial instrument as any contract that results in a financial asset of one entity and a financial liability or equity instrument of another entity.

A financial asset is:
- Cash
- An equity instrument of another entity
- A contractual right:
  - To receive cash or another financial asset from another entity; or
  - To exchange financial assets or financial liabilities with another entity on potentially favorable terms
- A contract that will be settled in the entity's own equity instruments

A financial liability is:
- A contractual obligation:
  - To deliver cash or another financial asset to another entity; or
  - To exchange financial assets or financial liabilities with another entity on potentially unfavorable terms
- A contract that will be settled in the entity's own equity instruments

Financial assets and liabilities are not recognized until an entity becomes a party to the contract that results in them.

Financial assets are generally measured at fair value through profit or loss (FVTPL). When measured at FVTPL, increases or decreases in fair value are reported as gains or losses on the statement of operations (Income Statement).

Under certain circumstances, financial assets are measured at amortized cost. This is only the case if two conditions are met:
- The entity's business model is to hold the asset to collect scheduled cash flows
- The terms of the instrument call for cash flows that are exclusively payments of principal and interest on specified dates

When a financial asset is recognized under the amortized cost method, the entity is required to evaluate the asset for impairment at the end of each reporting period. The initial assessment is done by determining if there is objective evidence indicating that the financial asset has been impaired, which will be in the form of a loss event or events occurring since acquisition of the financial asset. Examples of loss events include those that normally surround significant financial difficulty on the part of the other party, including:
- Breach of contract, such as a default or delinquency
- Granting a concession to the borrower for economic or legal reasons related to the debtor's financial circumstances
- Likelihood of the debtor going into bankruptcy
- Inactivity of the market for the instrument due to the financial difficulty
- Observable data indicating an expected decrease in future cash flows
- Economic conditions contributing to defaults
When a financial asset recognized at amortized cost is impaired, the present value of the expected future cash flows will be measured.

- The asset is written down to that amount
- The difference is recognized as an impairment loss

An **impairment loss may be reversed** if the asset recovers in value. The recovery must be the result of an event occurring after the impairment and may not increase the asset above the amount that would have been recorded at its amortized cost if the impairment had not been recognized.

An entity may also **elect** to report financial assets at FVTPL that would otherwise be measured at amortized cost.

- The election must be made when the financial asset is first recognized.
- The election is irrevocable
- Fair value measurement must eliminate or reduce an inconsistency that would result from recognizing gains or losses on a different basis

In general, financial liabilities are measured at amortized cost. Certain liabilities may be measured under an alternate approach when it will result in more relevant information.

- Derivatives that are liabilities, and similar liabilities, are measured at FVTPL
- Financial guarantee contracts are measured at the higher of their original amount less accumulated amortization or amounts that would be recognized under the requirements for contingent liabilities

Similar to financial assets, an entity may elect to report financial liabilities at FVTPL.

- The election must be made when the financial liability is first recognized.
- The election is irrevocable.
- Doing so provides more relevant information.

Financial assets and liabilities that are not reported at FVTPL are initially recognized at their fair values adjusted for transaction costs directly attributable to the acquisition of a financial asset or issuance of a financial liability.

**Gains and losses** on financial assets or liabilities measured at fair value are generally recognized in profit or loss. That is not the case, however, when:

- The instrument is part of a hedging relationship, in which case hedge accounting would apply
- It is an investment in an equity instrument and the entity has elected to report gains and losses in other comprehensive income (OCI)
- It is a financial liability designated as FVTPL
  - Increases or decreases in value resulting from changes in credit risk are recognized in other comprehensive income
  - Remaining increases or decreases in value are recognized in profit or loss

Gains and losses on financial assets measured at amortized cost, other than that amount recognized as a result of amortization, are recognized when the financial asset is impaired, reclassified, or derecognized.

When an **investment in an equity instrument** is not held for trading, the entity may elect to recognize changes in **fair value** in other comprehensive income (FVTOCI) rather than in profit or loss.

- The election must be made at initial recognition
- The election is irrevocable
- Dividends are recognized in profit or loss

When an equity investment is measured at FVTOCI, impairment losses are recognized in profit or loss. Subsequent to an impairment loss, recoveries in fair value, to the extent of previously recognized impairment losses, are recognized in income. Increases in fair value in excess of previously recognized impairment losses are recognized in OCI.

<table>
<thead>
<tr>
<th>Financial Investments</th>
<th>US GAAP</th>
<th>IFRS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Most equity securities are reported at fair value, same as IFRS.</strong> Debt securities may be classified as Trading, Available for sale, or Held to maturity.</td>
<td>• Marketable securities are reported at Fair value through profit or loss (FVTPL) or at amortized cost if the security consists of principal and interest and is expected to be held for the purpose of collecting the cash flows.</td>
<td></td>
</tr>
<tr>
<td><strong>For debt securities that are not held to maturity, a change in interest rate may cause a decline in fair value that will result in an impairment loss.</strong></td>
<td>• Generally, only as a result of a loss event resulting from significant financial difficulty of other party to instrument is reported at amortized cost</td>
<td></td>
</tr>
<tr>
<td><strong>The cost basis of the investment is reduced as a result of an impairment loss and recoveries are not recognized</strong></td>
<td>• Impairment losses in securities reported at amortized cost may be reversed upon occurrence of a recovery event.</td>
<td></td>
</tr>
<tr>
<td><strong>Loans, notes, and other receivables are measured at amortized cost if held for investment and lower of cost or fair value if held for sale. Either will be recognized at fair value if the fair value option is elected.</strong></td>
<td>• Financial assets normally measured at <strong>Fair Value Through Profit or Loss (FVTPL)</strong> by electing the fair value option</td>
<td></td>
</tr>
<tr>
<td><strong>Compound (hybrid) financial instruments may be bifurcated, dividing them into debt and derivative components, but are not divided into debt and equity components.</strong></td>
<td>• Compound (hybrid) financial interests (e.g., convertible bonds) are treated as a single contract and accounted for at amortized cost, as appropriate.</td>
<td></td>
</tr>
</tbody>
</table>
CLASS QUESTIONS

Work through the below Class Questions while following along with the respective lectures. Once this is complete, you can begin independently practicing what you've learned by quizzing yourself on this course section in your Interactive Practice Questions (IPQ), which can be found in your online Student Dashboard. Your IPQ simulates the computer-based testing experience, and will also help you understand how concepts are applied to the exam. Each question includes answer explanations from expert CPAs that will help you determine why you answered a question correctly or incorrectly. This is key to your success on the CPA Exam.

Lecture 3.03

1. Nola has a portfolio of marketable debt securities that it does not intend to sell in the near term. Assume Nola does not elect the fair value option to report these securities. How should Nola classify these securities, and how should it report unrealized gains and losses from these securities?

<table>
<thead>
<tr>
<th>Classify as</th>
<th>Report as a</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Trading securities</td>
<td>Component of income from continuing operations</td>
</tr>
<tr>
<td>b. Available-for-sale securities</td>
<td>Separate component of other comprehensive income</td>
</tr>
<tr>
<td>c. Trading securities</td>
<td>Separate component of other comprehensive income</td>
</tr>
<tr>
<td>d. Available-for-sale securities</td>
<td>Component of income from continuing operations</td>
</tr>
</tbody>
</table>

2. Data regarding Ball Corp.'s available-for-sale debt securities follow:

<table>
<thead>
<tr>
<th></th>
<th>Cost</th>
<th>Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 20X2</td>
<td>$150,000</td>
<td>$130,000</td>
</tr>
<tr>
<td>December 31, 20X3</td>
<td>150,000</td>
<td>160,000</td>
</tr>
</tbody>
</table>

   Differences between cost and market values are considered temporary. Ball does not elect the fair value option to account for available-for-sale securities. Ball's 20X3 other comprehensive income would be

   |   |   |
   | a. | $30,000  |
   | b. | $20,000  |
   | c. | $10,000  |
   | d. | $ 0      |
Lecture 3.06

Items 3 and 4 are based on the following:

Sun Corp. had investments in marketable debt securities costing $650,000 that were classified as available-for-sale. On June 30, 20X3, Sun decided to hold the investments to maturity and accordingly reclassified them to the held-to-maturity category on that date. The investments’ market value was $575,000 at December 31, 20X2, $530,000 at June 30, 20X3, and $490,000 at December 31, 20X3. Sun does not elect the fair value option to account for these investments.

3. What amount of loss from investments should Sun report in its 20X3 income statement?
   a. $ 45,000
   b. $ 85,000
   c. $120,000
   d. $0

4. What amount should Sun report as net unrealized loss on marketable debt securities in its 20X3 statement of stockholders’ equity?
   a. $ 40,000
   b. $ 45,000
   c. $160,000
   d. $120,000

5. Alton Co. began operations on January 1, 20X8. The following information pertains to Alton’s December 31, 20X8 portfolio of marketable debt securities:

<table>
<thead>
<tr>
<th></th>
<th>Trading Securities</th>
<th>Available-for-Sale Securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggregate cost</td>
<td>$360,000</td>
<td>$550,000</td>
</tr>
<tr>
<td>Aggregate market value</td>
<td>320,000</td>
<td>450,000</td>
</tr>
<tr>
<td>Aggregate lower of cost or market value applied to each security in the portfolio</td>
<td>304,000</td>
<td>420,000</td>
</tr>
</tbody>
</table>

Alton uses the provisions of ASC 825 and elects the fair value option for all financial instruments. If the market declines are judged to be temporary, what amounts should Alton report as a loss on these securities in its December 31, 20X8 income statement?

<table>
<thead>
<tr>
<th></th>
<th>Trading Securities</th>
<th>Available-for-Sale Securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$40,000</td>
<td>$0</td>
</tr>
<tr>
<td>b.</td>
<td>$0</td>
<td>$100,000</td>
</tr>
<tr>
<td>c.</td>
<td>$40,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>d.</td>
<td>$56,000</td>
<td>$130,000</td>
</tr>
</tbody>
</table>
6. Antonio Corp. has a portfolio of marketable debt securities that it does not intend to sell in the near term. Antonio elects the fair value option for reporting its financial assets in accordance with ASC 825. How should Antonio classify these securities, and how should it report unrealized gains and losses?

<table>
<thead>
<tr>
<th>Classify as</th>
<th>Report as a</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Trading securities</td>
<td>Component of income from continuing operations</td>
</tr>
<tr>
<td>b. Available-for-sale securities</td>
<td>Separate component of other comprehensive income</td>
</tr>
<tr>
<td>c. Trading securities</td>
<td>Separate component of other comprehensive income</td>
</tr>
<tr>
<td>d. Available-for-sale securities</td>
<td>Component of income from continuing operations</td>
</tr>
</tbody>
</table>

7. In 20X2, Gem Corp, which prepares its financial statements in accordance with IFRS, made a $125,000 investment in marketable equity securities. The securities are not held for trading and Gem has elected to recognize changes in fair value in other comprehensive income rather than profit or loss. At December 31, 20X2, the investment had a fair value of only $95,000 and it was determined that it was required to recognize an impairment loss in income. At December 31, 20X3, the investment had a market value of $140,000. At what amount will the investment be reported on the balance sheet and how will the change be recognized by Gem?

a. The investment will be reported at $125,000 and $30,000 will be reported in other comprehensive income.

b. The investment will be reported at $140,000 and $45,000 will be reported in other comprehensive income.

c. The investment will be reported at $140,000 and $30,000 will be recognized in profit or loss; $15,000 will be reported in other comprehensive income.

d. The investment will be reported at $125,000 and $30,000 will be recognized in profit or loss.
CLASS SOLUTIONS

1. (b) Investments in debt securities that an entity does not intend to sell in the near future are accounted for as available for sale. They are reported at their balance sheet market values and any decreases that are nontemporary and any increases are recognized in other comprehensive income until the investments are disposed of or reclassified. Trading securities, which are investments in debt securities the entity does intend to sell in the near future, are also reported at their balance sheet market values, but differences are recognized in income.

2. (a) The amount reported in other comprehensive for available for sale (AFS) investments is the increase or decrease in market value during the period. Since the AFS were reported at their market value of $130,000 at 12/31/X2, they would be increased to their 12/31/X3 market value of $160,000 with an increase to the investment and a credit (increase) to other comprehensive income for the difference of $30,000. However, the accumulated OCI would be $10,000, but that wasn’t asked in this problem.

3. (d) When an investment in a debt security is reclassified from available for sale (AFS) to held to maturity (HTM), the transfer occurs at its market value on the date of transfer. Any unrealized holding gain or loss is recognized in other comprehensive income (OCI) and amortized as an adjustment to the effective interest rate on the HTM security. On the date of transfer, the market value of $530,000 is $120,000 lower than its $650,000 cost, which is recognized in OCI, but no portion is recognized in income.

4. (d) When an investment in a debt security is reclassified from available for sale (AFS) to held to maturity (HTM), the transfer occurs at its market value on the date of transfer. Any unrealized holding gain or loss is recognized in other comprehensive income (OCI) and amortized as an adjustment to the effective interest rate on the HTM security. On the date of transfer, the market value of $530,000 is $120,000 lower than its $650,000 cost, which is recognized in OCI, but no portion is recognized in income.

5. (c) When an entity elects the fair value option for all financial instruments, all changes in fair value are recognized in income regardless of whether the securities are classified as trading, available for sale (AFS), held to maturity, or otherwise. The trading securities had a cost of $360,000 and a fair value of $320,000, resulting in a loss of $40,000, which would be recognized in income regardless of whether or not the fair value option had been elected. The AFS securities had a cost of $550,000 and a fair value of $450,000 resulting in an unrealized loss of $100,000, which would also be reported in income.

6. (d) Electing the fair value option does not have any effect on how debt securities are classified. Since Antonio does not intend to sell the investments in the near term, they are considered available for sale (AFS) securities. Unrealized gains and losses on AFS debt securities are normally recognized as a component of other comprehensive income, but are recognized in income from continuing operations if the fair value option is elected.
7. (c) When an entity elects to recognize changes in fair value of an equity instrument in other comprehensive income (OCI) rather than profit or loss, the investment is reported at its fair value on the balance sheet and any increases or decreases are recognized in OCI. This is not the case with impairments, which are recognized in profit or loss. When an investment for which changes are recognized in OCI increases in fair value, any previously recorded impairment losses are reversed. Any remaining increase is reported in OCI. Gem would have recognized an impairment loss of $30,000 in 20X2. In 20X3, the investment would be increased to its fair value of $140,000, representing a $45,000 increase. The loss of $30,000 would be reversed, resulting in a $30,000 gain in profit or loss. The remaining $15,000 is recognized in OCI.
Lecture 3.03

TASK-BASED SIMULATIONS

Task-Based Simulation 1

The Uniform CPA Examination

Required:

Items 1 through 4 are based on the following:
Camp Co. purchased various debt securities during 20X4 to be classified as held-to-maturity securities, trading securities, or available-for-sale securities.

Items to be answered:

Items 1 through 4 describe various securities purchased by Camp. For each item, select from the following list the appropriate category for each security.

H. Held-to-maturity.
T. Trading.
A. Available-for-sale.

1. Debt securities bought and held for the purpose of selling in the near term.

2. U.S. Treasury bonds that Camp has both the positive intent and the ability to hold to maturity.

3. $3 million debt security bought and held for the purpose of selling in three years to finance payment of Camp's $2 million long-term note payable when it matures.

4. Convertible debentures that Camp believes will increase in value but does not intend to sell in the near term.
Lecture 3.06

Task-Based Simulation 2

Required:

Dayle Inc. purchased various debt securities during the year to be classified as held-to-maturity, trading securities and available-for-sale securities. The following information pertains to the investment portfolio of marketable investments for the year ended December 31, 20X2:

<table>
<thead>
<tr>
<th>Security</th>
<th>Cost 12/31/X1</th>
<th>Purchases</th>
<th>Sales</th>
<th>Cost 12/31/X2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Held-to-maturity securities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Security ABC</td>
<td></td>
<td>$100,000</td>
<td></td>
<td>$95,000</td>
</tr>
<tr>
<td><strong>Trading securities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Security DEF</td>
<td>$150,000</td>
<td>$160,000</td>
<td></td>
<td>155,000</td>
</tr>
<tr>
<td><strong>Available-for-sale securities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Security GHI</td>
<td>190,000</td>
<td>165,000</td>
<td></td>
<td>$175,000</td>
</tr>
<tr>
<td>Security JKL</td>
<td>170,000</td>
<td>175,000</td>
<td></td>
<td>160,000</td>
</tr>
</tbody>
</table>

Security ABC was purchased at par. All declines in fair value are considered to be temporary. Dayle, Inc. does not elect the fair value option for any of its debt securities.

For the following questions, choose from the answer list below.

**Answer List**

A. $0  D. $15,000  G. $100,000  J. $160,000
B. $5,000  E. $25,000  H. $150,000  K. $170,000
C. $10,000  F. $95,000  I. $155,000
**Items to be answered:**

**Items 1 through 6** describe amounts to be reported in Dayle, Inc. 20X2 financial statements. For each item, select from the following list the correct numerical response. An amount may be selected once, more than once, or not at all. Ignore income tax considerations.

<table>
<thead>
<tr>
<th>1. Carrying amount of security ABC at December 31, 20X2.</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(A)</td>
</tr>
<tr>
<td></td>
<td>(B)</td>
</tr>
<tr>
<td></td>
<td>(C)</td>
</tr>
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<td></td>
<td>(D)</td>
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<td></td>
<td>(H)</td>
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<tr>
<td></td>
<td>(I)</td>
</tr>
<tr>
<td></td>
<td>(J)</td>
</tr>
<tr>
<td></td>
<td>(K)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2. Carrying amount of security DEF at December 31, 20X2.</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(A)</td>
</tr>
<tr>
<td></td>
<td>(B)</td>
</tr>
<tr>
<td></td>
<td>(C)</td>
</tr>
<tr>
<td></td>
<td>(D)</td>
</tr>
<tr>
<td></td>
<td>(E)</td>
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<td></td>
<td>(F)</td>
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<td></td>
<td>(G)</td>
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<td></td>
<td>(H)</td>
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<tr>
<td></td>
<td>(I)</td>
</tr>
<tr>
<td></td>
<td>(J)</td>
</tr>
<tr>
<td></td>
<td>(K)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>3. Carrying amount of security JKL at December 31, 20X2.</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(A)</td>
</tr>
<tr>
<td></td>
<td>(B)</td>
</tr>
<tr>
<td></td>
<td>(C)</td>
</tr>
<tr>
<td></td>
<td>(D)</td>
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<tr>
<td></td>
<td>(E)</td>
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<td></td>
<td>(H)</td>
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<tr>
<td></td>
<td>(I)</td>
</tr>
<tr>
<td></td>
<td>(J)</td>
</tr>
<tr>
<td></td>
<td>(K)</td>
</tr>
</tbody>
</table>

**Items 4 through 6** require a second response. For each item, indicate whether a gain or a loss is to be reported.

<table>
<thead>
<tr>
<th>4. Recognized gain or loss on sale of security GHI.</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(A)</td>
</tr>
<tr>
<td></td>
<td>(B)</td>
</tr>
<tr>
<td></td>
<td>(C)</td>
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<tr>
<td></td>
<td>(D)</td>
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<td></td>
<td>(E)</td>
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<td></td>
<td>(F)</td>
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<td></td>
<td>(G)</td>
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<tr>
<td></td>
<td>(H)</td>
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<tr>
<td></td>
<td>(I)</td>
</tr>
<tr>
<td></td>
<td>(J)</td>
</tr>
<tr>
<td></td>
<td>(K)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>5. Unrealized gain or loss to be reported in 20X2 net income.</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(A)</td>
</tr>
<tr>
<td></td>
<td>(B)</td>
</tr>
<tr>
<td></td>
<td>(C)</td>
</tr>
<tr>
<td></td>
<td>(D)</td>
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<td></td>
<td>(E)</td>
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<tr>
<td></td>
<td>(F)</td>
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<tr>
<td></td>
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<td>(H)</td>
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<tr>
<td></td>
<td>(I)</td>
</tr>
<tr>
<td></td>
<td>(J)</td>
</tr>
<tr>
<td></td>
<td>(K)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>6. Unrealized gain or loss to be reported at December 31, 20X2, as a separate component of stockholders' equity entitled “accumulated other comprehensive income.”</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(A)</td>
</tr>
<tr>
<td></td>
<td>(B)</td>
</tr>
<tr>
<td></td>
<td>(C)</td>
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<td>(D)</td>
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<td></td>
<td>(E)</td>
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<td></td>
<td>(F)</td>
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<td>(G)</td>
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<td></td>
<td>(H)</td>
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<tr>
<td></td>
<td>(I)</td>
</tr>
<tr>
<td></td>
<td>(J)</td>
</tr>
<tr>
<td></td>
<td>(K)</td>
</tr>
</tbody>
</table>
Task-Based Simulation 3

A company is accumulating funds for future expansion and has begun investing in debt securities of other entities. Identify the location in professional standards that indicates how investments in debt securities should be measured for balance sheets prepared subsequent to their acquisition.

Task-Based Simulation 4

An entity has a note receivable from an unrelated entity that bears interest at a relatively high rate. They think it has increased in value due to a decline in market rates. Identify the location in professional standards that indicates when an entity may choose to elect the fair value option for an eligible item.
TASK-BASED SIMULATION SOLUTIONS

Task-Based Simulation Solution 1

1. T  Debt securities that are acquired with the intention of selling them in the near term, are classified as trading securities.
2. H  When a company acquires debt securities, including U.S. Treasury bonds, that it has the intent and the ability to hold until maturity, they are classified as held-to-maturity.
3. A  Debt securities that are acquired with the intent of holding them for a while, but ultimately selling them prior to maturity, are classified as securities available for sale.
4. A  Debt securities that are acquired with the intent of holding them for a while, but ultimately selling them prior to maturity, are classified as securities available for sale.

Task-Based Simulation Solution 2

Amount

<table>
<thead>
<tr>
<th>(A)</th>
<th>(B)</th>
<th>(C)</th>
<th>(D)</th>
<th>(E)</th>
<th>(F)</th>
<th>(G)</th>
<th>(H)</th>
<th>(I)</th>
<th>(J)</th>
<th>(K)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. Carrying amount of security ABC at December 31, 20X2.

2. Carrying amount of security DEF at December 31, 20X2.

3. Carrying amount of security JKL at December 31, 20X2.

4. Recognized gain or loss on sale of security GHI.

5. Unrealized gain or loss to be reported in 20X2 net income.

6. Unrealized gain or loss to be reported at December 31, 20X2, as a separate component of stockholders’ equity entitled “accumulated other comprehensive income.”

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Explanation of solutions

1. (G; $100,000) Debt securities classified as held-to-maturity are originally recorded at cost. Any discount or premium is then amortized using the effective interest method resulting in a carrying value at amortized cost. Since Security ABC was acquired at par, there is no discount or premium to amortize and the carrying amount will be the cost of $100,000.

2. (I; $155,000) Trading securities are reported at their fair market values as of the balance sheet date. Security DEF will be reported at its 12/31/X2 market value of $155,000.

3. (J; $160,000) Debt securities classified as available for sale are reported at their fair market values as of the balance sheet date. Security JKL will be reported at its 12/31/X2 market value of $160,000.

4. (D, L) The amount of gain or loss recognized on the sale of a debt security classified as available for sale will be the realized gain or loss, equal to the difference between the sales price and the original cost. Security GHI had a sales price of $175,000 compared to an original cost of $190,000 resulting in a realized loss to be reported in the amount of $15,000.

   The journal entry to record the sale would be

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>175,000</td>
</tr>
<tr>
<td>Realized loss on sale of AFS</td>
<td>15,000</td>
</tr>
<tr>
<td>A-F-S securities</td>
<td>165,000</td>
</tr>
<tr>
<td>Unrealized loss on AFS (OCI)</td>
<td>25,000</td>
</tr>
</tbody>
</table>

5. (B, L) Unrealized gains or losses on trading securities are reported on the income statement. Security DEF, the only trading security, was adjusted to its market value of $160,000 at 12/31/X1. As of 12/31/X2, it will be reduced to its market value of $155,000 resulting in an unrealized loss of $5,000 to be reported in the income statement.

6. (C, L) The amount reported as a separate component of stockholders’ equity is the cumulative amount of unrealized gain or loss on debt securities available for sale. As of 12/31/X2, the only security available for sale is security JKL with a cost of $170,000 and a carrying value equal to its market value of $160,000. The difference is an unrealized loss of $10,000 would be reported as both a valuation allowance reducing the investment account and as a separate component of stockholders’ equity (accumulated other comprehensive income).
### Task-Based Simulation Solution 3

| FASB ASC | 320 | 10 | 35 | 1 |

### Task-Based Simulation Solution 4

| FASB ASC | 825 | 10 | 25 | 4 |
Section 4 – The Adjusted Cost Method and the Equity Method

Corresponding Lectures

Watch the following course lectures with this section:

Lecture 4.01 – Investments in the Stock of Other Entities
Lecture 4.02 – Adjusted Cost Method
Lecture 4.03 – Cost and Equity Method – Class Questions
Lecture 4.04 – Investments in Financial Instruments Under IFRS
Lecture 4.05 – The Adjusted Cost Method and the Equity Method TBS – Class Questions

EXAM NOTE: Please refer to the AICPA FAR Blueprint in the Introduction to find a listing of the representative tasks (and their associated skill levels—i.e., Remembering and Understanding, Application, and Analysis) that the candidate should be able to perform based on the knowledge obtained in this section.
The Adjusted Cost Method and the Equity Method

Lecture 4.01

INVESTMENTS IN THE STOCK OF OTHER ENTITIES

An investor may acquire equity securities (common or preferred stock), debt securities (bonds), and derivatives (stock rights) of other companies. When a company acquires equity securities of another entity, they are generally reported on the balance sheet at their fair market values as of the balance sheet date, with both realized and unrealized gains and losses being reported in income. As indicated previously, however, there are three circumstances that either require or allow a different accounting treatment.

- **0 – 20% Adjusted cost method***
  - Investment does not provide investor with ability to exercise significant influence over investee
  - Used when fair value is not readily determinable.
  - Requires election.

- **20 – 50% Equity method**. (one-line consolidation)
  - The investor has the ability to exercise significant influence over the entity.
  - Investor does not have a controlling financial interest in the entity.

- **50% + Consolidation** (Another Section)
  - The investor has a controlling financial interest in the investee (Acquiree).
  - May result from equity ownership or other factors, such as representation on the board of directors making the investor the primary beneficiary of a Variable Interest Entity (VIE).

* There is no longer an official term for the accounting for these types of investments. ‘Adjusted cost method’ is used for the sake of convenience.

**Equity Method (ASC 323)**

The equity method is used when the investor has the ability to exercise **significant influence** over the operating and financial policies of the investee. This method is more consistent with accrual accounting in that the investor recognizes its share of the investee’s income in the period earned, regardless of if or when the income is distributed to equity holders.

It is generally assumed that the investor has such ability when it holds 20% or more of the voting equity stock, but that is not required. When ownership is less than 20%, the degree of influence held by the investor is a matter of professional judgment and considers various factors:

- Significant intercompany transactions, or technological dependency.
- Officers of the investor serving as officers or board members of the investee.
- The investor is a major customer or supplier of the investee.
- The investor owns at least 20% of the voting stock of the investee provided:
  - No other investor holds a larger voting block, or
A small group of investors own a majority of the equity and exercises total control.

• The investor has definite plans to acquire additional stock in the future to bring their interest up to at least 20%.

When applying the **equity method**:

• The investment is originally recorded at Cost

• As the investee reports earnings, it is reported on the investor's income statement as "**equity in earnings**", equal to the investor's percentage owned multiplied by the investee's earnings, as a component of continuing operations.

  o Similar to consolidated financial statements, the effects of intercompany transactions are eliminated.

  o The investor increases the investment by the same amount.

• If the investee reports losses, the entity will recognize its share of the losses in earnings as "**equity in losses**", reducing the investment by the same amount.

  o In general, losses cannot be recognized that reduce the carrying value of the investment below zero unless the investor has guaranteed investee obligations or is committed to provide additional financial support;

  o If the investee subsequently becomes profitable again, unrecognized equity method losses will be offset against the investor's share of profits until they have been absorbed;

• Dividends received are considered a reduction of the investment account and do NOT appear on the income statement. The assumption is that the investor already recorded its share of the investee's income prior to its being distributed in the form of dividends.

• When the purchase price is not equal to the investor's percentage owned multiplied by the investee's book value, adjustments to equity in earnings will result in order to reflect the investor's true share of the investee's income.

  o Those **differences are considered**:

    ▪ FMV write up of assets (FMV increment)

    o PP&E - depreciated

    o Inventory - written off when sold

    o Land - not depreciated but written off when sold

    o Goodwill - not amortized but impairment losses recognized

Ownership of **preferred stock** cannot, by itself, give an investor significant influence, but the investor may have such influence due to other causes, and use the equity method of accounting for the preferred stock investment. Preferred stock income under the equity method is equal to the dividends allocated to it. For non-cumulative preferred stock, this will equal declared dividends only. For cumulative preferred stock, this will equal the annual dividend preference regardless of payments in that year.

To illustrate the accounting under the equity method, assume an investor paid $300 on 1/1/X1 to acquire 30% of the stock of an investee, at a time when the investee's net assets (equity) equaled $1,000. As a result, the original investment equaled the investor's 30% share of equity.

In 20X1, the investee reported net income of $400 and paid dividends totaling $100 to stockholders of record on 12/31/X1 with a payment date of 1/7/X2. The investment entry is:

\[
\begin{array}{ccc}
1/1/X1 & \text{Investment} & 300 \\
 & \text{Cash} & 300 \\
\end{array}
\]

The entry to report the investor's share of income is:
The entry to record the dividend:

\[
\begin{align*}
12/31/X1 & \quad \text{Dividends receivable} \quad 30 \\
& \quad \text{Investment} \quad 30
\end{align*}
\]

There is also an entry on 1/7/X2 for the collection of the receivable. Notice that the investor's investment account changes as the equity of the investee changes.

\[
\begin{array}{c|c|c}
\text{S/E of Investee} & \text{Investment (30%)} \\
\hline
\text{Purchase Date, 1/1/X1} & $1,000 & $300 \\
\text{Net Income} & 400 & 120 \\
\text{Dividends} & (100) & (30) \\
\text{Balance, 12/31/X1} & 1,300 & 390
\end{array}
\]

In the earlier example, the $300 purchase price equaled 30% of the equity of the investee. When the purchase price exceeds the investor's share of equity, the excess needs to be identified, and accounted for in an appropriate manner. First, any assets with fair values differing from carrying values are identified, and the investor determines their percentage share of that excess (or deficiency). Any remaining excess is assumed to represent goodwill on the purchase.

The excess of the cost of the investment over book value is not reported separately on the financial statement; it is included in the investment. Nevertheless, it will have an impact on the subsequent reporting of income by the investor that depends on the nature of the asset causing the difference:

- Depreciable and amortizable assets – differences will be amortized against the reported equity in investee income based on the appropriate life of the asset.
- Goodwill – amount initially recorded will later reduce reported income in periods in which impairment losses are recognized. If the alternative accounting approach for nonpublic entities is elected, it is amortized.
- All assets – outstanding differences will be written off against reported income at the time the asset is sold or otherwise disposed of.

These adjustments are necessary for reporting the investor's true share of the investee's earnings. For example, an equity method investee may have a building that had a book value of $50,000 when the investor acquired its shares, but if the fair value of the building was greater, say $1,000,000 on that date, the value, and therefore the purchase price of the shares would include the $1,000,000 amount, not the $50,000. When the investee is depreciating the building, its depreciation expense will be based on the book value of $50,000. The investor, on the other hand, paid the equivalent of its share of $1,000,000 and has to depreciate the difference.

Assume the investor's 30% investment in the previous example cost $380 instead of $300, that $10 of the excess was attributable to inventory, which was sold during 20X1, $30 was attributable to land, which was still owned by the investee at the end of 20X1, and the remaining $40 represented a building, with an estimated useful life of 40 years. The inventory excess should be written off in 20X1, the land excess should remain, and building depreciation of $40 / 40 = $1 should be recorded in 20X1. As a result, the equity in investee income reported by the investor is $109, computed as follows:
Net income of investee  400
Percentage  30%
Investor share  120
Inventory  (10)
Land  (0)
Building  (1)
Equity in investee income  109

Examine the changes in the investment account in 20X1, in comparison to the changes in the investor's share of the investee's equity:

<table>
<thead>
<tr>
<th></th>
<th>S/E of Investee</th>
<th>Investment (30%)</th>
<th>Equity (30%)</th>
<th>Excess</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase Date, 1/1/X1</td>
<td>$1,000</td>
<td>$380</td>
<td>$300</td>
<td>$80</td>
</tr>
<tr>
<td>Net Income</td>
<td>400</td>
<td>109</td>
<td>120</td>
<td>(11)</td>
</tr>
<tr>
<td>Dividends</td>
<td>(100)</td>
<td>(30)</td>
<td>(30)</td>
<td>------</td>
</tr>
<tr>
<td>Balance, 12/31/X1</td>
<td>1,300</td>
<td>459</td>
<td>390</td>
<td>69</td>
</tr>
</tbody>
</table>

By including the adjustments for the sale of inventory and depreciation on the building in income, the excess of cost over book value in the initial investment is gradually being written off. After the land is sold by the investee and building is completely depreciated, the investment will equal equity, and further reported income will simply be the investor's ownership percentage multiplied by the investee's reported income.

**Lecture 4.02**

**Adjusted Cost Method**

When an investment gives the investor neither a controlling financial interest, making consolidation inappropriate, nor the ability to exercise significant influence over the activities of the investee, making the equity method inappropriate, the investor will initially record the investment at cost. In most cases, it will then be adjusted to its fair market value (Fair Value Method) on each balance sheet date with both realized and unrealized gains and losses recognized in income. Realized gains and losses will, of course, be adjusted for any portion that may have been reported in a prior period as an unrealized gain or loss. This is similar to the Trading Securities approach discussed in an earlier section.

When the market value of an investment is not readily determinable, the entity will determine if it is eligible to measure fair value using what is called a practical expedient. It involves using the published fair value of net assets per share, or equivalent amount, multiplied by the number of shares or units held by the investor. This approach can only be used when the fair value per share is calculated in a manner that is consistent with the approaches used by an investment company, as discussed in Topic 946, Financial Services – Investment Companies.
If the investment also does not qualify to be measured by applying the practical expedient, the entity may elect to report it at an amount equal to its cost minus any impairment losses (Adjusted Cost Method) that have been recognized and adjusted for any changes resulting from observable price changes.

- The entity is required to make a qualitative assessment every reporting period, evaluating impairment indicators to determine if the investment is impaired. Examples of impairment indicators are provided in the Impairments discussion below.
- An observable price change occurs when there is an orderly transaction involving an identical security or a similar security of the same issuer.
- Once elected, the investment continues to be accounted for in that manner until it no longer qualifies to use it.
  - This will occur when either the market value becomes readily determinable or when it becomes eligible for the practical expedient. Additionally, the investor may gain the ability to exercise significant influence over the investee, at which point the equity method would be appropriate, applied on a prospective basis.
  - As long as this approach is in use, the entity is required to reassess whether the investment continues to qualify to use this measurement every reporting period.

**Impairments**

Each reporting period, the entity is required to perform a qualitative analysis to determine if there is an indication that the investment has been impaired. The qualitative evaluation will look for circumstances that might adversely affect the investee, such as:

- A deterioration in earnings, financial position, credit rating, asset quality, or business prospects;
- Changes in the regulatory, economic, or technological environment;
- Changes in the market conditions relevant to the entity’s geographical area or industry;
- A bona fide offer to purchase the entity, or a completed auction process, for less than the carrying amount of the net investment; or
- Factors affecting the investee’s ability to continue as a going concern.

When there is such an indication, the entity will determine if an estimate of the fair value is lower than the carrying value, in which case an impairment loss is recognized. The impairment loss reduces the carrying value of the investment and is reported in the current period’s income. The impairment loss may be recovered as more information is obtained and the securities are adjusted back upward to FMV.

As is true for all investments in equity securities that are not required to be accounted for via consolidation or the equity method, dividend income from investments in equity securities is reported in income.

- The original investment is recorded at cost
- When the investee earns money, NO journal entry is recorded
- When a dividend is received it is recorded as Dividend Income on the income statement (not a reduction of the Investment)
  - In rare cases, if the dividend received is greater than the investor’s proportionate share of the investee’s income since acquisition, then it is recorded as a reduction of the investment (these usually are distributions of an investee’s earnings that occurred BEFORE the investor made their purchase of the investee).

\[
\text{Cash} \quad \times \quad \text{Investment} \quad \times
\]
No difference between BV and purchase price is taken into consideration (no excess amortization or depreciation as in the equity method).

Disclosures
Disclosures for equity investments accounted for under this approach when the fair value is not readily determinable will include:
- The carrying amount of the investments
- Impairment losses, if any, both for the current period and on a cumulative basis
- Upward adjustments to the investment, both for the current period and on a cumulative basis
- Considerations applied in determining the carrying amounts of the investments, upward or downward adjustments, and additional information the entity considers necessary to enable users to understand the qualitative disclosures

Example for Both Equity and Adjusted Cost
On 1/1/X1, we acquire 30% of a company for $1,000. FV of investee is $3,000 and BV is $2,500. The difference is from PP&E with a FMV $500 higher than its BV. During the year, the investee reports income of $120 and pays dividends of $40. PP&E is depreciated over 10 years and 10% of initial goodwill is impaired that year.

A significant amount of research was performed, and experts were consulted, to assist in the measurement of the fair value of the entity to enable a reasonable purchase price. As a general rule, however, the fair value of this investment is not readily determinable and there were no observable market transactions involving the security during the period X1. In addition, reviewing all relevant information, there were no indications that the investment was impaired or that the investee would have a substantial doubt as to its ability to continue as a going concern.

<table>
<thead>
<tr>
<th>Investee's balances at 1/1/X1</th>
<th>FMV</th>
<th>$3,000</th>
<th>/Investee's income = $120 / G/w impaired at 1/1/X1</th>
<th>B.V.</th>
<th>$2,500</th>
<th>/Dividend paid = $40 by $10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price</td>
<td></td>
<td>$1,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FMV of investor's share</td>
<td></td>
<td>&gt; $100</td>
<td>Goodwill – impaired by $10 = $10</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>share of investee</td>
<td></td>
<td>$900</td>
<td>(3000 x 30%)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B.V of investor's share</td>
<td></td>
<td>&gt;$150</td>
<td>FMV increment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>share of investee</td>
<td></td>
<td></td>
<td>(PP&amp;E) /10yrs</td>
<td></td>
<td>$15 yr</td>
<td>$25</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The journal entries under the **Equity method** would be:

**Acquisition of investment at cost**

<table>
<thead>
<tr>
<th>Investment</th>
<th>$1000</th>
<th>(B.V. $750 + PP&amp;E $150 + G/W $100)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td></td>
<td>$1000</td>
</tr>
</tbody>
</table>
Investor records % of earnings ($120 annual income x 30% = 36)

Investment $36
Equity in earnings $36 (I/S account)

% of Cash dividend ($40 is dividend received x 30% = 12)

Cash $12
Investment $12

To record Amortization/Depreciation/Impairment of excess between BV and purchase price (1000-750)

Equity in earnings $25 ($10 G.W + $15 PP&E)
Investment $25

The T-account for the investment under the equity method would look as follows:

<table>
<thead>
<tr>
<th>Investment T-account</th>
</tr>
</thead>
<tbody>
<tr>
<td>1000</td>
</tr>
<tr>
<td>+36</td>
</tr>
<tr>
<td>-12</td>
</tr>
<tr>
<td>-25</td>
</tr>
<tr>
<td>999</td>
</tr>
</tbody>
</table>

Note: The investment account changes as the investee’s equity account changes, better accrual.

The same example for the Adjusted Cost method: (owns 30% but other investor owns 70%).

Record at cost

Investment 1000
Cash 1000

Record % of earnings
No entry

Record % of cash dividend (40 x 30%)
Cash 12
Dividend income 12 (Income statement account)

Amortization/Depreciation of excess
No entry

Note: the investment at the end of the year is still at COST

<table>
<thead>
<tr>
<th>Investment T-account</th>
</tr>
</thead>
<tbody>
<tr>
<td>1000</td>
</tr>
<tr>
<td>1000</td>
</tr>
</tbody>
</table>
Notice that, while the investor's share of the investee net income is $120 \times 30\% = $36, only the dividend received of $40 \times 30\% = $12 is recorded in income. The reason for the difference in the handling of income and dividends is the difference in the relationship between investor and investee under each circumstance. Since the equity method is used when the investor has the ability to exercise significant influence over the activities of the investee, it is assumed that the investor could convince the investee to distribute more, or even all, of its income in the form of dividends. This is considered an application of the accrual method.

When the investor does not have the ability to exercise such influence, it has no assurance that it will receive any dividends beyond those which have been declared. Although this is not consistent with the accrual method, it is not considered a departure since accrual of a receivable that is not necessarily probable would be considered inappropriate.

In general, dividends from investments in equity securities are reported as income. This would not be the case, of course, if the investee is a consolidated subsidiary, in which case dividends from the subsidiary to the parent are eliminated. Nor would it be the case under the equity method, in which case the investor reports its entire share of investee income as an increase in the investment, and distributions of dividends reduce the investment. When dividends are received from investments that are either reported at fair value or via the adjusted cost method, however, they are generally reported as income.

Dividends received, however, are not always distributions of income to the investor. If the investee declares dividends that exceed the cumulative income it has earned since the date of the investment, the excess distribution is a return of capital to the investor, and is accounted for as a reduction in the carrying value of the investment.

For example, if the investee declares a dividend of $450, and the income earned since the investment date is only $400, the entry on the dividend record date by a 10% investor would have been:

\[
\begin{align*}
\text{Dividends receivable} & \quad 45 \\
\text{Dividend income} & \quad 40 \\
\text{Investment} & \quad 5
\end{align*}
\]

If an investee declares a stock dividend or issues stock rights or other classes of stock to existing shareholders, no income is reported. Instead, the carrying value of the investment is simply allocated over the increased quantity of securities. If the securities are all of the same class, no entry is needed, and the number of shares is disclosed in the notes to the financial statements, if material. If the new securities are in a different class, an entry is made to transfer part of the carrying value, using the relative FMV approach.

For example, assume a client purchased 100 shares of stock at a price of $22 per share, or a total cost of $2,200:

\[
\begin{align*}
\text{Investment in stock} & \quad 2,200 \\
\text{Cash} & \quad 2,200
\end{align*}
\]

If the investee declares a 10% stock dividend, then the number of shares held by the investor will increase to 110, but no entry is made. Instead, the $2,200 is allocated over 110 shares, so that the cost basis of each share becomes $20.

If, instead, the investee issues a stock right for each existing share, and the FMV of the stock and the stock rights on the record date are $24 per share and $6 per right, respectively, then the rights will be allocated $6 / (24+6) = 20\%$ of the carrying value of the securities:
Investment in rights
Investment in stock

No income is reported on dividends in arrears on cumulative preferred stock under the cost method, since this represents dividends that have not been declared. Only once they are declared and the date of record is reached can they be reported in the investor’s records as dividend income.

The purchase of life insurance on an officer can be a form of investment, when it builds up a cash value (cash surrender value). The portion of the premium that increases the cash value is accumulated as an asset (non-current asset) on the balance sheet, and the rest of the premium is recognized as life insurance expense. If the officer dies, the proceeds from the policy are recognized as income only to the extent they exceed the cash value. Dividends on life insurance are treated as reductions of the net premium cost, and are not reported as dividend income.

<table>
<thead>
<tr>
<th>EQUITY</th>
<th>ADJUSTED COST</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) <strong>Buy</strong></td>
<td>1) <strong>Buy</strong></td>
</tr>
<tr>
<td>Investment 1000 (Includes 750 BV; 150 FMV&gt;BV; 100 Goodwill)</td>
<td>Investment 1000</td>
</tr>
<tr>
<td>Cash 1000</td>
<td>Cash 1000</td>
</tr>
</tbody>
</table>

2) **Investee Earns Money**

<table>
<thead>
<tr>
<th>EQUITY</th>
<th>ADJUSTED COST</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment 36 (120 x 30%)</td>
<td>No Journal Entry</td>
</tr>
<tr>
<td>Equity in Earnings 36</td>
<td></td>
</tr>
<tr>
<td>EIE = I/S (N) section (\Rightarrow) Not cash (\Rightarrow) back out in Cash Flow</td>
<td></td>
</tr>
</tbody>
</table>

3) **Pay a Dividend**

<table>
<thead>
<tr>
<th>EQUITY</th>
<th>ADJUSTED COST</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash 12 (40 x 30%)</td>
<td>Cash 12</td>
</tr>
<tr>
<td>Investment 12</td>
<td>Dividend Income 12</td>
</tr>
<tr>
<td>DI = I/S (N) section</td>
<td></td>
</tr>
</tbody>
</table>
4) Amortize/Depreciation/Impairment of Excess

<table>
<thead>
<tr>
<th>Purchase</th>
<th>$1000</th>
<th>Goodwill</th>
<th>$1000 - 900</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV</td>
<td>900</td>
<td></td>
<td>100</td>
</tr>
<tr>
<td>BV</td>
<td>750</td>
<td>Impairment</td>
<td>$10</td>
</tr>
<tr>
<td>Depreciation</td>
<td>900 - 750</td>
<td>150/10</td>
<td>$15</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$25</td>
</tr>
</tbody>
</table>

Equity in Earnings 25
Investment 25

Taking out Amortization/Depreciation/Impairment

No Journal Entry

*Investment follows Equity Balance of Investee, better Accrual*

4) Amortize/Depreciation of Excess

Changes in Ownership Percentages

There are a variety of ways in which an investor may gain the ability to exercise significant influence over the investee. The investor may do so by acquiring additional shares of the investee's stock; as a result of the retirement of shares by the investee; by establishing a significant business dependency, such as becoming a significant customer or supplier; or by obtaining greater representation in the investee's governance.

When an investor gains the ability to exercise significant influence over the activities of an investee, the investment qualifies for the equity method and it is required to be applied prospectively.

- The carrying value of the investment is not adjusted.
- The cost of additional shares of the investee acquired by the investor, if any, is added to the carrying value of the investment.
- The equity method of accounting is applied to the investment from that point forward, using the percentage of the investee that is owned by the investor.

An investor entity may also lose the ability to exercise significant influence over the activities of the investee. This may result from the disposal of a portion of the investment; the issuance of additional shares by the investee, reducing the investor's ownership percentage; the termination of a business dependency, such as discontinuing being a significant supplier or customer; or by reducing the investor's representation in governance.

When an investor loses the ability to exercise significant influence over the activities of the investee, it no longer qualifies for use of the equity method of accounting for the investment. The investor will:

- Apply the equity method up until the date on which the investment no longer qualifies for its use.
- The carrying value of the investment is considered its new cost.
- The investor applies the appropriate method other than the equity method:
  - If the market value of the investee is readily determinable, the investment will be adjusted to its fair value on each balance sheet date with unrealized gains and losses reported in earnings for the period.
If the market value of the investee is not readily determinable, the investor may elect the adjusted cost method and so indicate in the summary of significant accounting policies.

In all cases, the change in methods is applied **prospectively.**

**FAIR VALUE ACCOUNTING OPTION (ASC 825)**

FASB ASC 825, Financial Instruments, includes a provision that allows an entity to choose to report almost any of its financial instruments, including both its financial assets and financial liabilities, at fair value. This is referred to as the fair value option and may be applied to **eligible financial instruments** on specified **election dates** on a **security by security basis** and may be applied to some or all of a group of securities.

Under GAAP, a financial instrument is defined as “cash, evidence of an ownership interest in an entity, or a contract that both:

a. Imposes on one entity a contractual obligation (**financial liability**) either:
  1. To deliver cash or another financial instrument to a second entity.
  2. To exchange other financial instruments on potentially unfavorable terms with the second entity.

b. Conveys to that second entity a contractual right (**financial asset**) either:
  1. To receive cash or another financial instrument from the first entity.
  2. To exchange other financial instruments on potentially favorable terms with the first entity."

As a result, all receivables and payables are financial instruments as are derivatives and investments in debt and equity securities. **Eligible financial instruments** include:

- Recognized financial assets and liabilities.
- Firm commitments that involve only financial instruments or written loan commitment.

The **election dates** on which an entity may elect the fair value option include:

- When the eligible item is first recognized.
- When an eligible firm commitment is entered into.
- When items previously presented at fair value due to specialized accounting principles, with unrealized gains or losses recognized in earnings, no longer qualify for the specialized accounting principles.
- When an investment becomes subject to the equity method.
- When an item is required to be measured at fair value on a one-time basis but is not required to be adjusted to fair value on subsequent financial statement dates.

On a given election date, the entity may elect to report the item or items at fair value or may apply the election to only some of the items, with the decision being made on a **security by security basis**.

- An entity with numerous firm commitments may elect to report some, all, or none of them at fair value.
- An entity with several investments accounted for under the equity method may elect to report some, all, or none of them at fair value.

Once made, a fair value election is irrevocable. It may, however, be changed on a subsequent election date. When the fair value election is made, the eligible item will be measured at its **fair value on each balance sheet date**. Any unrealized gains or losses will be recognized as a component of **income**. If the fair value election were applied to:
An equity method investment, it would be measured at fair value on each balance sheet date and any changes, net of dividends received, will be recognized as a gain or loss.

An available for sale (AFS) investment in debt securities, will be reported at the same value as before the election but the unrealized gains and losses will be reported as a component of income rather than other comprehensive income.

A held to maturity (HTM) investment in debt securities, it would continue to be accounted for under the amortized cost method, applying the effective interest method, but after amortization of discount or premium, the carrying value will be increased or reduced to fair value at the balance sheet date and the unrealized gain or loss will be recognized in income.

A firm commitment, such as a foreign currency forward exchange contract, an asset or liability would be recognized at fair value as the subject of the commitment, such as the foreign currency exchange rate, changes.

**Lecture 4.03**

**CLASS QUESTIONS**

Please see the Class Questions and Class Solutions for this Lecture at the end of this Section.

**Lecture 4.04**

**INVESTMENTS IN FINANCIAL INSTRUMENTS UNDER IFRS**

When an entity acquires the debt or equity securities of another entity, it is considered an investment in financial assets. In addition, financial assets may be originated by the entity, such as when it makes a loan to another entity. IFRS provides for different methods of accounting for various investments, based on their natures. There are three general approaches applied to investments in financial instruments.

When certain conditions are met, an investment in a financial instrument is reported at amortized cost. Under the amortized cost approach, any difference between the original cost and the face amount is treated as a discount or premium and the effective interest method of amortization is applied. The conditions are:

- The instrument calls for scheduled payments that consist exclusively of principal and interest.
- The entity's business model has, as an objective, to **hold until maturity** such instruments in order to collect the contractual cash flows.

A second type of investment in financial instrument is accounted for at **fair value** with unrealized gains and losses recognized in **other comprehensive income (OCI)**. This approach is referred to as **fair value through other comprehensive income** or **FVTOCI**. It is applied to financial assets when two conditions are met.

These conditions are similar to those for using the amortized cost approach except the FVTOCI approach is required if the entity, as a business model, may either hold the financial asset to maturity or dispose of it, whereas the amortized cost approach is only applied when the entity, as a business model, holds the financial asset to maturity.

The applicable requirements for FVTOCI are:

- The instrument calls for scheduled payments that consist exclusively of principal and interest.
The entity's business model has, as an objective, to either hold such instruments in order to collect the contractual cash flows or to sell them.

Under this approach, such items as interest income, foreign exchange gains and losses, and impairment losses are recognized in income. After recognizing those items and adjusting the investment to its fair value, the net difference is recognized as an adjustment to other comprehensive income.

The amortized cost and the FVTOCI approaches would generally not be appropriate for investments in the equity securities of another entity since they do not generally call for scheduled payments of principal and interest. Therefore, they only deal with debt securities.

- FVTOCI may only be applied only to those equity securities that are neither held for trading nor as contingent consideration recognized by an acquirer in a business combination.
- The entity must make an irrevocable election when the investment is initially recognized.
- While changes in fair value are recognized in OCI, dividends are recognized in profit or loss.

When an equity investment is measured at FVTOCI, impairment losses are recognized in profit or loss. Subsequent to an impairment loss, recoveries in fair value, to the extent of previously recognized impairment losses, are recognized in income. Increases in fair value in excess of previously recognized impairment losses are recognized in OCI. All other investments in financial instruments (all equity and some debt) are reported at fair value. They are remeasured to fair value at the end of each accounting period, with unrealized gains and losses recognized in income. This is often referred to as the fair value through profit or loss method or FVTPL.

Under IFRS, accounting for impairment depends on the nature of the financial asset.

For financial assets accounted for using the FVTPL approach, any impairment is included in the adjustment of the instrument to its fair value and is recognized in income.

For purchased financial assets and those that are credit impaired at inception, expected credit losses are taken into account when the financial asset is originally recognized, increasing or decreasing the effective interest rate. Changes in expected losses identified after initial recognition of these financial assets are recognized in income and accumulated in an allowance account.

For financial assets accounted for at amortized cost and for those measured at FVTOCI, expected credit losses are recognized using a loss allowance.

In certain circumstances, the amount will be the expected credit losses for all credit related circumstances over the life of the instrument. This measurement is required to be used when either:

- The credit risk of the financial asset has increased significantly, or
- The financial asset is either a contract asset or trade receivable.

For all other financial assets, the amount will be based on the credit losses expected to result from defaults within a 12-month period.

When an investment is made in an entity over which it has significant influence, it is considered an investment in an associate (affiliate). An investment in an associate is accounted for under the equity method of accounting. Significant influence indicates that the investor has the authority and power to participate in policy decisions of the investee without having or sharing control of the entity.
- If the investor has control, consolidated financial statements are appropriate.
- If the investor shares control in a joint arrangement, the investment will be considered either a joint operation or a joint venture, which will determine the accounting.

A joint arrangement is considered a **joint venture** if those who share control also have rights to the net assets of the arrangement. Such an arrangement is referred to as a joint venture and is accounted for under the **equity method** of accounting.

When those with joint control do not also have rights to the net assets, the joint arrangement is referred to as a **joint operation** and is accounted for using a **proportionate consolidation** approach.
- The investor measures and recognizes a proportionate amount of the operation's assets, liabilities, revenues, and expenses for inclusion on its financial statements.
- Measurement and recognition is in accordance with the IFRS relevant to the particular assets, liabilities, revenues, or expenses.

**Lecture 4.05**

**CLASS QUESTIONS**

Please see the Class Questions and Class Solutions for this Lecture at the end of this Section.
CLASS QUESTIONS
Work through the below Class Questions while following along with the respective lectures. Once this is complete, you can begin independently practicing what you've learned by quizzing yourself on this course section in your Interactive Practice Questions (IPQ), which can be found in your online Student Dashboard. Your IPQ simulates the computer-based testing experience, and will also help you understand how concepts are applied to the exam. Each question includes answer explanations from expert CPAs that will help you determine why you answered a question correctly or incorrectly. This is key to your success on the CPA Exam.

Lecture 4.03

1. Sage, Inc. bought 40% of Adams Corp.’s outstanding common stock on January 2, 20X3, for $400,000. The carrying amount of Adams’ net assets at the purchase date totaled $900,000. Fair values and carrying amounts were the same for all items except for plant and inventory, for which fair values exceeded their carrying amounts by $90,000 and $10,000, respectively. The plant has an eighteen-year life. All inventory was sold during 20X3. During 20X3, Adams reported net income of $120,000 and paid a $20,000 cash dividend. Assume that Sage uses the equity method to account for this investment. What amount should Sage report in its income statement from its investment in Adams for the year ended December 31, 20X3?
   a. $48,000
   b. $42,000
   c. $36,000
   d. $32,000

2. Park Co. uses the equity method to account for its January 1, 20X3 purchase of Tun Inc.’s common stock. On January 1, 20X3, the fair values of Tun’s FIFO inventory and land exceeded their carrying amounts. How do these excesses of fair values over carrying amounts affect Park’s reported equity in Tun’s 20X3 earnings?
<table>
<thead>
<tr>
<th>Inventory Excess</th>
<th>Land Excess</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Decrease</td>
<td>Decrease</td>
</tr>
<tr>
<td>b. Decrease</td>
<td>No effect</td>
</tr>
<tr>
<td>c. Increase</td>
<td>Increase</td>
</tr>
<tr>
<td>d. Increase</td>
<td>No effect</td>
</tr>
</tbody>
</table>

3. On January 1, 20X3, Point, Inc. purchased 10% of Iona Co.’s common stock. Point purchased additional shares bringing its ownership up to 40% of Iona’s common stock outstanding on August 1, 20X3. During October 20X3, Iona declared and paid a cash dividend on all of its outstanding common stock. Point uses the equity method to account for its investment in Iona. How much income from the Iona investment should Point’s 20X3 income statement report?
   a. 10% of Iona’s income for January 1 to July 31, 20X3, plus 40% of Iona’s income for August 1 to December 31, 20X3.
   b. 40% of Iona’s income for August 1 to December 31, 20X3 only.
   c. 40% of Iona’s 20X3 income.
   d. Amount equal to dividends received from Iona.
4. On January 2, 20X3, Well Co. purchased 10% of Rea, Inc.’s outstanding common shares for $400,000. Well is the largest single shareholder in Rea, and Well's officers are a majority on Rea's board of directors. Rea reported net income of $500,000 for 20X3, and paid dividends of $150,000. Well does not elect the fair value option to report its investment in Rea. In its December 31, 20X3 balance sheet, what amount should Well report as investment in Rea?
   a. $450,000
   b. $435,000
   c. $400,000
   d. $385,000

5. Under IFRS an equity investment is considered an investment in an associate if the investor has significant influence over the investee. Significant influence is indicated by

   a. Ownership of at least 10%.
   b. Ownership of at least 20% but no more than 50%.
   c. Having the power to participate in the decisions of the investee.
   d. Having the power to direct the activities of the investee.
CLASS SOLUTIONS

1. (b) Sage's unadjusted equity in Adams' earnings is 40% x $120,000, or $48,000. This amount must be adjusted for any differences between the book and fair values of Adams' total assets at the time of Sage's investment, prorated by Sage's ownership percentage. Since the fair values of Adams' plant and inventory exceeded their book values by $90,000 and $10,000, respectively, these differences will be prorated by Sage's ownership percentage and either expensed in the year(s) sold, which is the case with inventory, or amortized over the depreciable life of the asset, which is the case with plant. Therefore, Sage will reduce equity in earnings by $2,000 as an adjustment for plant (($90,000 / 18) x 40% = $2,000) and will reduce equity in earnings by $4,000 as an adjustment for inventory, which was all sold during the year ($10,000 x 40% = $4,000). Sage will report equity in earnings from its investment in Adams of $48,000 - $2,000 - $4,000, or $42,000.

2. (b) Similar to consolidation, under the equity method, when assets or liabilities of the investee are under- or over-valued at the acquisition date, the investor's share of the investee's net income is adjusted to reflect income as if the items had been reported at their fair values on the acquisition date. If the inventory had been adjusted, since the investee uses FIFO, those goods would have been sold in the following year, increasing cost of sales and decreasing earnings. Land is not depreciated and has no income statement effect unless it is impaired or disposed of.

3. (b) 40% of Iona's income for August 1 to December 31, 20X3 only. When an investor obtains the ability to exercise significant influence over an investee during the period, often as a result of an increase in ownership, the investor applies the equity method to the investment on a prospective basis only. Therefore, the equity method only becomes effective August 1, when Point became a 40% owner of Iona. With 40% ownership, Point records equity in earnings of 40% of Iona's income from August 1 onward.

4. (b) Although an owner of less than 20% of the equity of another entity does not generally have the ability to exercise significant influence over the investee, other factors, such as being the largest single shareholder and occupying the majority of the seats on the board of directors, when combined with a smaller ownership percentage, will generally result in that ability. As a result, in this case, Well will apply the equity method and will recognize 10% of Rea's income as an increase in the investment and 10% of the dividends paid by Rea as a reduction.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial investment</td>
<td>$400,000</td>
</tr>
<tr>
<td>Income (10% of $500,000)</td>
<td>50,000</td>
</tr>
<tr>
<td>Dividends (10% of $150,000)</td>
<td>(15,000)</td>
</tr>
<tr>
<td>Ending balance</td>
<td>$435,000</td>
</tr>
</tbody>
</table>

5. (c) Under both GAAP and IFRS, the equity method is applied when an entity has the ability to exercise significant influence over the investee. Under IFRS, that is considered to be the case when the investor has the power to participate in the decisions of the investee. Answer (a) is incorrect because ownership of 10% would not give an investor significant influence over an investee under either GAAP or IFRS unless other factors contributed to that influence. Answer (b) is incorrect because under US GAAP, not IFRS, ownership of at least 20% but no more than 50% would be an indication of significant influence unless other factors indicated otherwise. Answer (d) is incorrect because the power to direct activities of an investee is an indication of control, which would require consolidation, not significant influence.
Task-Based Simulation 1

Scenario

Johnson, an investor in Acme Co., asked Smith, CPA for advice on the propriety of Acme's financial reporting for two of its investments. Smith obtained the following information related to the investments from Acme's December 31, 20X7, financial statements:

- 20% ownership interest in Kern Co., represented by 200,000 shares of outstanding common stock purchased on January 2, 20X7, for $600,000.
- 20% ownership interest in Wand Co., represented by 20,000 shares of outstanding common stock purchased on January 2, 20X7, for $300,000.
- On January 2, 20X7, the carrying values of the acquired shares of both investments equaled their purchase price.
- Kern reported earnings of $400,000 for the year ended December 31, 20X7, and declared and paid dividends of $100,000 during 20X7.
- Wand reported earnings of $350,000 for the year ended December 31, 20X7, and declared and paid dividends of $60,000 during 20X7.
- On December 31, 20X7, Kern’s and Wand’s common stock were trading over-the-counter at $18 and $20 per share, respectively.
- The investment in Kern is accounted for using the equity method.
- Acme does not have the ability to exercise significant influence over Wand.

Smith recalculated the amounts reported in Acme's December 31, 20X7, financial statements, and determined that they were correct. Stressing that the information available in the financial statements was limited, Smith advised Johnson that, assuming Acme properly applied generally accepted accounting principles, Acme may have appropriately used two different methods to account for its investments in Kern and Wand, even though the investments represent equal ownership interests.

Required:

Complete the schedule indicating the amounts Acme should report for the two investments in its December 31, 20X7, balance sheet (1a & 2a) and statement of income (1b & 2b) and comprehensive income (1c & 2c). Show all calculations. Ignore income taxes.
## Items to be answered:

<table>
<thead>
<tr>
<th>Carrying Value on Balance Sheet</th>
<th>Answers:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kern investment on B/S</td>
<td>1a.</td>
</tr>
<tr>
<td>Wand investment on B/S</td>
<td>2a.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Income on Income Statement (I/S)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Kern investment</td>
<td>1b.</td>
</tr>
<tr>
<td>Wand investment</td>
<td>2b.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Other comprehensive income (OCI)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Kern investment</td>
<td>1c.</td>
</tr>
<tr>
<td>Wand investment</td>
<td>2c.</td>
</tr>
</tbody>
</table>
Task-Based Simulation 2

On January 2, 20X4, Bing Co. purchased 39,000 shares of Latt Co.’s 200,000 shares of outstanding common stock for $585,000. On that date, the carrying amount of the acquired shares on Latt’s books was $405,000. Bing attributed the excess of cost over carrying amount to goodwill. Bing’s policy is to evaluate goodwill each period for impairment. As of December 31, 20X4, goodwill has not been impaired.

During 20X4, Bing’s president gained a seat on Latt’s board of directors. Latt reported earnings of $400,000 for the year ended December 31, 20X4, and declared and paid dividends of $100,000 during 20X4. On December 31, 20X4, Latt’s common stock was trading over-the-counter at $15 per share.

Items to be answered:

1. What criteria should Bing consider in determining whether to account for its investment in Latt under the equity method? Is the equity method consistent with accrual accounting? Explain.

2. Assuming Bing accounts for the investment using the equity method, prepare a schedule of the amounts related to this investment to be reported on Bing’s income statement for the year ended 20X4 and the amount in the investment in Latt account in the balance sheet at December 31, 20X4. Show all computations. Disregard income taxes.
Task-Based Simulation 3

A company accounting for an equity investment under the equity method is preparing its income statement and is trying to determine what amount should be included as income from the investee. Identify the location in professional standards that indicates that, under the equity method, the investor recognizes its share of the earnings or loss of the investee.

Task-Based Simulation 4

A company’s investment in an unaffiliated non-public entity does not qualify for the equity method of accounting and the investee’s market value is not readily determinable. The company is aware of the entity’s earnings, a portion of which was received as a dividend. Identify the location in professional standards that indicates that, under the appropriate method, dividends are recognized in earnings.
1. Under the equity method of accounting, Acme would account for the investment in Kern as follows:

The initial investment would be recorded at cost of $600,000.
Acme would recognize 20% of Kern's $400,000 in income, or $80,000 as an increase in the investment and on the income statement as "equity in earnings of Kern".
Acme would recognize 20% of Kern's $100,000 in dividends, or $20,000, as a decrease in the investment.

Carrying amount = $600,000 + $80,000 - $20,000 = $660,000

As a result, your solution should indicate:
Acme's Balance Sheet would report an investment in Kern of $660,000.

Acquisition of investment in Kern at cost:

| Investment | $600 |
| Cash       | $600 |

Investor records % of earnings ($400,000 annual income x 20% = $80,000)

| Investment | $80 |
| Equity in earnings | $80 (I/S account) (1b.) |

% of Cash dividend ($100,000 is dividend received x 20% = 20)

| Cash | $20 |
| Investment | $20 |
The T-account for the investment under the equity method would look as follows:

<table>
<thead>
<tr>
<th>Investment T-account</th>
</tr>
</thead>
<tbody>
<tr>
<td>600</td>
</tr>
<tr>
<td>+80</td>
</tr>
<tr>
<td>-20</td>
</tr>
<tr>
<td>(1a.) 660</td>
</tr>
</tbody>
</table>

So for KERN,
1a. $660,000
1b. $80,000
1c. $0 (no effect on comprehensive income)

2. Since the investment in Wand does not qualify for the equity method of accounting and the market value of the Wand shares is readily determinable, the investment will be reported at market value with increases and decreases recognized in income as unrealized gains and losses. Acme would account for the investment in WAND as follows:

**To purchase:**

<table>
<thead>
<tr>
<th>Investment in Wand</th>
<th>300</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>300</td>
</tr>
</tbody>
</table>

**At 12/x7 the FMV is now 400 (20,000 x $20).** The investment will be adjusted to its fair value with an increase to the investment account and the recognition of an unrealized gain.

| Market adjustment equity security (B/S) | 100 |
| Unrealized gain (I/S)                  | 100 (I/S) (2b) |

The market adjustment account is on the B/S and increases the carrying value of the investment in the asset section from $300 to $400 (2a); the unrealized gain of $100,000 will be recognized on the income statement (2b). No part of these transactions has an effect on other comprehensive income (2c).

The dividends received would be recorded as cash and dividend income on the income statement of $60,000 x 20% = $12,000 (also 2b).

| Cash (B/S) | 12 |
| Dividend Income (I/S) | 12 (2b) |

As an investment in equity securities that does not qualify for the equity method and which has a readily determinable market value, the investment in Wand will be accounted for as follows:
- The initial investment would be recorded at cost of $300,000.
- Acme would not recognize any portion of Wand's $350,000 in income.
- Acme would recognize 20% of Wand's $60,000 in dividends, or $12,000, as dividend income on the income statement.
Since Wand's shares were trading for $20 per share at 12/31/x7, the investment would be adjusted to its market value of 20,000 x $20 or $400,000. The adjustment of $100,000 would be an unrealized gain, reported in net income.

As a result, your solution should indicate:

2a. - Acme's **Balance Sheet** would report an investment in Kern of $400,000.

2b, 2c. - Acme's **Statement of Income and Comprehensive Income** would report dividend income of $12,000 and an unrealized gain on Wand of $100,000, both in net income (I/S).
Task-Based Simulation Solution 2

1. The primary criterion that Bing should consider in determining whether or not to use the equity method of accounting for its investment in Latt is whether or not Bing has the ability to exercise significant influence over the operating and financing policies of Latt. It is normally assumed that an investor has the ability to exercise significant influence when ownership is 20% or more. Despite the fact that Bing owns only 19 ½% of Latt's stock, the fact that Bing's president gained a seat on Latt's board of directors makes it likely that Bing will have the ability to exercise significant influence indicating the equity method of accounting.

The equity method of accounting is consistent with the accrual method of accounting since the investor recognizes its proportionate share of the investee's earnings in the period in which they are earned by the investee regardless of the period in which they are distributed.

2. Bing will report its proportionate share of Latt's earnings as Equity in income of Latt Co. on its income statement. It will be reported as a component of income from continuing operations.

Since Bing invested $585,000 for shares that had an underlying book value of $405,000, the difference of $180,000 will be attributed to goodwill, which has not been impaired. As a result, Bing's share of Latt's income will be:

| Latt's reported income | $400,000 |
| Bing's ownership percentage | 19 ½ % |
| Bing's share of Latt's reported income | $ 78,000 |

Bing will report the investment as a long-term investment in the noncurrent asset section of its balance sheet. Under the equity method, the investment is initially recorded at its cost. It is increased by the investor's share of the investee's income and decreased by its share of dividends.

| Initial investment | $585,000 |
| Equity in earnings of Latt Co. (above) | 78,000 |
| Dividends - $100,000 x 19 ½% | 19,500 |
| Investment at 12/31/X4 | $643,500 |
Task-Based Simulation Solution 3

| FASB ASC | 323 | 10 | 35 | 4 |

Task-Based Simulation Solution 4

| FASB ASC | 321 | 10 | 35 | 6 |
Section 17 – Reporting the Results of Operations and IFRS Financial Statements

Corresponding Lectures

Watch the following course lectures with this section:

Lecture 17.01 – Statement of Earnings
Lecture 17.02 – Discontinued Operations
Lecture 17.03 – Comprehensive Income
Lecture 17.04 – Reporting the Results of Ops – Class Questions
Lecture 17.05 – SEC Reporting Requirements
Lecture 17.06 – SEC Reporting Requirements – Class Question
Lecture 17.07 – IFRS Financial Statements
Lecture 17.08 – IFRS Financial Statements – Class Questions

EXAM NOTE: Please refer to the AICPA FAR Blueprint in the Introduction to find a listing of the representative tasks (and their associated skill levels—i.e., Remembering and Understanding, Application, and Analysis) that the candidate should be able to perform based on the knowledge obtained in this section.
Reporting the Results of Operations and IFRS Financial Statements

Lecture 17.01

STATEMENT OF EARNINGS

The current FASB presentation of Results of Operations is a Statement of Earnings and Comprehensive Income. It includes up to 3 different sections:

- Income from Continuing Operations
- Discontinued operations
- Other Comprehensive income

Income from Continuing Operations may be prepared using two different formats:

- Multiple step income statement
- Single step income statement

The multiple step approach includes subtotals for gross profit, operating income, and income before taxes, while the single step approach does not. Nevertheless, income from continuing operations is identical under the two approaches.

Income Statement
(Stmt of Profit or Loss)

\[
\begin{align*}
\text{Operating Income} &= \text{Sales} - \text{Cost of Goods Sold} \\
&= \text{Gross Margin} \\
&\quad \text{- Selling, General & Administrative exp.} \\
&= \text{Operating Income}
\end{align*}
\]

\[
\begin{align*}
\text{Nonoperating Income} &= \text{Current} + \text{Deferred} \\
\text{Taxes} &= \text{Net Income (Goes to Retained Earnings)} \\
&\pm \text{Other Comprehensive Income (DENT)}
\end{align*}
\]

Comprehensive Income (Goes to B/S – an Equity Account)

Beg Inventory
\(+\) Net Purchases
\(=\) Goods Available for Sale
\(-\) Ending Inventory
\(=\) Cost of Goods Sold
## Multiple Step (ON-TIDe-N-OC)

Roger Company  
**Statement of Earnings and Comprehensive Income**  
(Statement of Profit or Loss)  
For the Year Ended December 31, 20X3

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>$600,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>$1,400,000</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Selling expenses</td>
<td>$340,000</td>
</tr>
<tr>
<td>General &amp; administrative expenses</td>
<td>$260,000</td>
</tr>
<tr>
<td><strong>Depreciation Expense (impairment loss – public co)</strong></td>
<td>$100,000</td>
</tr>
<tr>
<td><strong>Operating income (O)</strong></td>
<td>$700,000</td>
</tr>
<tr>
<td><strong>Other income and (expense): (Non-operating)</strong></td>
<td></td>
</tr>
<tr>
<td>Interest/Dividend income</td>
<td>$10,000</td>
</tr>
<tr>
<td>Interest expense/unusual and/or infrequent items</td>
<td>($20,000)</td>
</tr>
<tr>
<td>Loss due to earthquake</td>
<td>($72,000)</td>
</tr>
<tr>
<td><strong>Gain on sale of equipment/Investments (imp loss –nonpublic)</strong></td>
<td>$30,000</td>
</tr>
<tr>
<td><strong>Income before income tax</strong></td>
<td>$648,000</td>
</tr>
<tr>
<td><strong>Provision for income Tax (T):</strong></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>$150,000</td>
</tr>
<tr>
<td>Deferred</td>
<td>$40,000</td>
</tr>
<tr>
<td><strong>Deferred</strong></td>
<td>$190,000</td>
</tr>
<tr>
<td><strong>Income from continuing operations (I)</strong></td>
<td>$458,000</td>
</tr>
<tr>
<td><strong>Gain (loss) from operations of Discontinued component unit, (FASB ASC 205)</strong></td>
<td></td>
</tr>
<tr>
<td>net of tax of $30,000 (De)</td>
<td>$45,000</td>
</tr>
<tr>
<td><strong>Net income (N)</strong></td>
<td>$503,000</td>
</tr>
<tr>
<td><strong>Other Comprehensive income (OCI) (DENT)</strong></td>
<td></td>
</tr>
<tr>
<td>Derivative Cash Flow Hedge Gain/Loss (net of tax)</td>
<td>xxx</td>
</tr>
<tr>
<td>Excess adjustment of Pension PBO and FV of Plan assets at year end</td>
<td>(xxx)</td>
</tr>
<tr>
<td>Net Unrealized holding gains (AFS) arising during period (net of tax)</td>
<td>xxx</td>
</tr>
<tr>
<td>Translation adjustment of Foreign currency (net of tax)</td>
<td>xxx</td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>xxx</td>
</tr>
<tr>
<td><strong>Comprehensive Income (C)</strong></td>
<td>$xxx,xxx</td>
</tr>
</tbody>
</table>

**Earnings per share:**

- Income from Continuing operations: $2.29
- Income from Discontinued operations: $0.23

**Net income per share:** $2.52
As part of a simplification initiative, the concept of extraordinary gains and losses was eliminated. This change was made in order to align GAAP more closely to IAS 1, Presentation of Financial Statements.

### Operating Income (“O”)

**Sales or revenues** from contracts with customers are recognized when the promised goods or services have been delivered to the customer or, when certain criteria are met, while the goods or services are being delivered. Revenues that do not arise from contracts are recognized when the entity no longer has any obligations to provide goods or services to the customer and it is not likely that revenues received will be required to be returned to the customer.

Recognize expenses or losses when:
- Economic benefit is used up (as incurred)

#### Cost of goods sold (COGS)

- Beginning inventory
- Net purchases (COG manufactured)
- Cost of goods available for sale
- Ending inventory

\[
\text{COGS} = \text{Beginning inventory} + \text{Net purchases} - \text{Ending inventory}
\]

*Note:* Freight-in is included in Net Purchases

#### Selling Expenses

- Salaries and commissions, advertising, freight out
  *Note:* Freight out may be included in either cost of goods sold or selling expenses

#### General and Administrative Expenses

- Officers’ salaries, accounting and legal, insurance
  *Note:* Bad debt expense could be either a Selling or G & A expense

#### Non - Operating Items (“N”) (Other Income or Expense, Gains and Losses)

- Interest income or expense, dividend income, gain/loss on sale of PP&E or Investments, foreign currency transactional gains/losses, unrealized gain/loss from Trading securities, and gains, losses, revenues, and expenses that are unusual or infrequent or both.
- The tax effects related to these items are included in the tax provision.
**Taxes (“T”)** (provision for taxes)

- Current income tax expense (current taxable income x current tax rate)
- Deferred income tax expense (Temporary differences x enacted tax rate)

\[
\text{Income from continuing operations (“I”)} = \text{Income from continuing operations (“I”)}
\]

---

**Lecture 17.02**

**DISCONTINUED OPERATIONS (“De”) (ASC 205)**

When an entity decides to dispose of a portion of its business, it will determine if it should be accounted for as a disposal of assets or discontinued operations. A disposal of a component of an entity or a group of components is reported as discontinued operations if the disposal represents a strategic shift that will have a significant effect on the entity's operations and financial results.

Disposal of a component or group of components would be a strategic shift when:

- The entity is discontinuing operations in a major geographical region
- The entity is discontinuing a major product line
- The entity is disposing of a significant investment accounted for under the equity method
- Other major “parts” of an entity

When reported as discontinued operations, the assets of the component or group of components are reported separately in the asset section of the balance sheet and identified as assets related to discontinued operations. Liabilities of the discontinued operations are likewise separately reported in the liability section of the balance sheet. In addition, the operations of the component or components, and any gains or losses on disposals of assets and settlements of liabilities, are reported separately on the income statement, net of tax, after income from continuing operations and before net income.

A component or group of components that qualifies as a strategic shift, will be reported in discontinued operations if it is disposed of by sale or by some other means during the period; or if it qualifies to be classified as “held for sale”. A component qualifies as held for sale if all of the following criteria are met:

- A plan to sell the component has been committed to by those with the authority to do so.
- The component is in salable condition and available for immediate sale
- Actions to complete the plan for disposal have been initiated and a buyer is being actively sought
- The sale is probable and expected to be completed and to qualify for recognition within one year
- The price at which the component is being marketed is reasonable
- It is unlikely that significant changes will be made to the plan or that it will be withdrawn.
Special Items to Note:

- Expected gains or losses from operations in future periods are **not** included until the period they occur.
- The expected loss on a disposal may, however, indirectly be recognized through **impairment testing** that causes the write-down of a component to its fair market value. Long-lived assets to be disposed of by sale should be measured at the lower of carrying amount or fair value less the cost of disposal (NRV). An asset held for disposal **CAN be written up or Down** in future periods as long as the write-up is never greater than the carrying amount of the asset before the impairment.
- Gain or loss is reported net of taxes with disclosure of the tax effect on the face of the income statement. EPS disclosure is also required (DE).
- Disposals of assets or asset groups that are **not** components are reported in continuing operations and included in the determination of operating profit.
- For **comparative purposes**, the income statement must be adjusted retrospectively to enhance comparability with the current year's income statement for all prior years presented. The amounts are netted into one figure for each year presented, “Income (loss) from Discontinued Operations”. The Balance sheet of previous periods must also reclassify assets and liabilities of a discontinued operation.
- Regardless of when during the period the decision is made to discontinue a segment, all results of operations for that segment, as well as any gains or losses on the disposal of assets during the period, are recognized as discontinued operations.
- The costs of termination benefits, lease termination, and consolidating facilities or relocating employees related to a disposal activity that involves discontinued operations should be included in the results of discontinued operations.

**Disclosures**

- Description of the reasons for the disposal; the means of disposal; and the expected date
- Carrying amounts of assets and liabilities included in the disposal group
- Gains and losses on assets held for sale along with an indication as to where on the income statement they appear
- Any revenues, expenses, and pretax profit or loss from discontinued operations and where it is presented on the income statement if not presented separately
- The business segment in which the assets that are part of the disposal group are reported

\[= \text{Net Income ("N")}\]
Lecture 17.03

Comprehensive Income ("O,C") (ASC 220) (O = Other comprehensive income and C = Comprehensive Income)

The purpose of reporting comprehensive income is to report a measure of overall enterprise performance. Comprehensive income includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. It should be prominently displayed (net of tax effect) within the financial statements. It may be displayed in any one of two ways:

1. As a separate statement of comprehensive income that immediately follows the income statement.
2. In a combined statement of income and comprehensive income.

Roger Company
Statement of Comprehensive Income
FYE 12/31/20X3

<table>
<thead>
<tr>
<th>Net Income</th>
<th>$xxx,xxx</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other comprehensive income (OCI) (net of tax)</td>
<td></td>
</tr>
<tr>
<td>Derivative, cash flow hedges</td>
<td>$xxx</td>
</tr>
<tr>
<td>Excess adjustment of Pension PBO and FV of Plan assets at year end</td>
<td>$xxx</td>
</tr>
<tr>
<td>Net unrealized gain/loss Avail-for-sale Securities</td>
<td>$xxx</td>
</tr>
<tr>
<td>Translation gains and losses</td>
<td>$xxx</td>
</tr>
<tr>
<td>Comprehensive income</td>
<td>$xxx,xxx</td>
</tr>
</tbody>
</table>

Although they also result in changes in net assets, the following items are not currently included in the reporting of other comprehensive income:

- Contributions from owners
- Distributions to owners (dividends)
- Prior period adjustments

A prior period adjustment actually is a form of comprehensive income, but since it doesn't relate to the current year, it isn't reported in the other comprehensive income section of the statement. Prior period adjustments, along with distributions of earnings, are reported on the Statement of Retained Earnings, while contributions by owners and distributions that represent a return of capital are not currently required to be reported on any of the financial statements.

Accumulated Other Comprehensive Income

This is reported on the balance sheet as a component of stockholders' equity that includes the total of other comprehensive income (OCI) for the current and previous periods.
Earnings Per Share (EPS – ASC 260)
Companies with publicly-traded stock are required to include earnings per share information at the bottom of the statement for:
- Income from continuing operations (ONT)
- Net income

Additional EPS numbers must be reported either at the bottom of the statement or in the notes for:
- Discontinued operations

No EPS information is reported for comprehensive income or for the other comprehensive income section.

The presentation of EPS information for companies with complex capital structures must include:
- Basic EPS
- Diluted EPS
A sample Statement of Earnings and Comprehensive Income for a publicly-held company follows (we'll use the single step format for the continuing operations section):

### ABC Company

**Statement of Earnings and Comprehensive Income**  
**For the Year Ended December 31, 20X3**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Dividend income</td>
<td>4,000</td>
</tr>
<tr>
<td>Total revenue</td>
<td>1,004,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>600,000</td>
</tr>
<tr>
<td>Selling, general, and administrative expenses</td>
<td>300,000</td>
</tr>
<tr>
<td>Loss on sale of equipment</td>
<td>17,000</td>
</tr>
<tr>
<td>Current income tax expense</td>
<td>23,000</td>
</tr>
<tr>
<td>Deferred income tax expense</td>
<td>3,000</td>
</tr>
<tr>
<td><strong>Income from continuing operations</strong></td>
<td>61,000</td>
</tr>
<tr>
<td>Discontinued operations:</td>
<td></td>
</tr>
<tr>
<td>Gain (loss) from operations of discontinued component, net of $12,600 taxes</td>
<td>29,400</td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td>90,400</td>
</tr>
<tr>
<td>Other comprehensive income:</td>
<td></td>
</tr>
<tr>
<td>Translation adjustment, net of $2,400 taxes</td>
<td>5,600</td>
</tr>
<tr>
<td>Unrealized gain on available-for-sale securities, net of $9,600 taxes</td>
<td>22,400</td>
</tr>
<tr>
<td><strong>Comprehensive income</strong></td>
<td>118,400</td>
</tr>
</tbody>
</table>

**Earnings per share:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Basic</th>
<th>Diluted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from continuing operations</td>
<td>6.10</td>
<td>4.88</td>
</tr>
<tr>
<td>Net income</td>
<td>9.04</td>
<td>7.01</td>
</tr>
</tbody>
</table>

---

**Lecture 17.04**  
**CLASS QUESTIONS**

Please see the Class Questions and Class Solutions for this Lecture at the end of this Section.

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**Lecture 17.05**  
**SEC Reporting Requirements under Regulations S-K and S-X**

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Section 22 – Recognizing Revenue When Collectibility of Receivables is Uncertain

Corresponding Lectures

Watch the following course lectures with this section:

Lecture 22.01 – Collectibility of Receivables is Uncertain and IFRS
Lecture 22.02 – Collectibility of Receivables is Uncertain – Class Questions

EXAM NOTE: Please refer to the AICPA FAR Blueprint in the Introduction to find a listing of the representative tasks (and their associated skill levels—i.e., Remembering and Understanding, Application, and Analysis) that the candidate should be able to perform based on the knowledge obtained in this section.
Recognizing Revenue When Collectibility of Receivables is Uncertain

Lecture 22.01

RECOGNIZING REVENUE

When an entity enters into a transaction involving the sale of goods or services in the ordinary course of business, the proceeds will be reported as revenues or sales on the income statement. These sales or revenues are recognized in accordance with FASB ASC Topic 606, Revenues from Contracts with Customers. This standard establishes a 5-step process for recognizing revenue, provided it is a transaction between the entity and a customer and that the relationship is contractual.

The five-step process for recognizing revenues are:

1. Identify contracts with customers – determine when an arrangement is considered a contract with customers and determine when multiple contacts with the same customer should be combined and accounted for as a single contract
2. Identify all separate performance obligations within each contract
3. Determine the total consideration for the contract
4. Allocate the total consideration among the separate performance obligations
5. Recognize revenue, either:
   o When the entity has satisfied its performance obligations, which is generally associated with revenues resulting from delivering products; or
   o While the entity is satisfying its performance obligations, which is generally associated with revenues resulting from providing services.

For Step number 1, having a contractual relationship does not require that there be a signed written contract. The FASB has described certain characteristics, indicating that a relationship that does not conform to those characteristics will not be treated as a contract. Revenue, instead, will be recognized in accordance with a separate set of guidelines.

A customer is defined as “a party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities in exchange for consideration.

A contract is an arrangement between two or more parties that creates enforceable rights and obligations. If either party can terminate the arrangement without penalty, it is not considered a contract. A contract will conform to four criteria:

- The parties must have approved the provisions and must have committed to perform.
- The rights in the contract, and the payment terms can be identified. They do not necessarily need to be explicit in the contract as long as the parties can discern a clear understanding of what the arrangement does include.
- The contract has commercial substance.
- Collection is probable.

If all of the criteria are met, the arrangement is a contract with customers and will be accounted for using the 5-step process. Once that determination is made, the arrangement does not have to be reevaluated again to make certain that the criteria continue to be met unless the arrangement is modified.
When one or more of the criteria are not met, the arrangement is not a contract and it will be accounted for differently. When that is the case, however, the arrangement is to be reevaluated every reporting period to determine whether it has met the criteria, at which time the method of accounting will be changed to the 5-step process.

**Collection Uncertainty**

When the sale is made in exchange for a receivable, the entity should be able to determine whether or not the receivable is likely to be collected. There is no requirement that the receivable is fully collectible and if the entity determines that it is probable that substantially all of the receivable will be collected, the sale will be recorded and an allowance for uncollectibility will probably be recorded against that receivable and others under the assumption that at least some are likely to become uncollectible.

- Most entities will not sell goods on credit to a customer if collection is not probable and most entities will either have a credit department that will evaluate each customer's credit before a sale is made or apply some comparable process.
- Regardless of how cautious the seller may be, customers' circumstances often change over time and some who had the ability to pay at the time of sale may not have that ability when the receivable is due.
- As a result, sales are recorded and an estimate of either an amount or a proportion of sales that are likely to become uncollectible will be made using the entity's experience and current knowledge, which is recognized as an allowance for uncollectibility, reducing the carrying amount of the receivables, and an expense.
- As specific customers default on their balances, those that prove uncollectible are written off against the allowance.

In some cases, however, an entity may sell to a customer on credit even though collection is highly uncertain. It may be because the sale is at such a great margin that the initial payments plus the value of the merchandise that will be repossessed upon the customer's default still provides a profit to the seller, although not as great as if the customer performs. It may be a sale to a start-up business in a competitive environment in which the seller believes that market share will be gained if the customer performs, making the risk worthwhile. In fact, there are numerous reasons an entity may sell to a customer when collection is not probable.

The probability of collection, however, is one of the criteria that is required in order for the transaction to be considered a contract. As a result, the transaction would not be considered a contract and revenue will not be recognized in accordance with the 5-step process.

**Revenue Arrangements that are Not Contracts with Customers**

When an entity enters into an arrangement that has some of the characteristics of a revenue-related contract but not all, it is not considered a contract for revenue recognition purposes. It may be an arrangement, for example, that involves providing goods or services in exchange for some form of compensation. It may not, however, meet all of the criteria. As a result, revenue will be recognized in accordance with another approach, usually resulting in revenues being recognized later.

- Until all revenues on the arrangement have been recognized, the entity will reassess the arrangement every reporting period to determine if it qualifies as a contract and if it does, the 5-step process will be applied.
- Until all criteria have been complied with and the arrangement qualifies as a contract, all receipts from the customer for the goods or services that are the subject of the arrangement will be reported as a liability account.
• The liability represents the entity's obligation to provide the goods or services that are the subject of the arrangement or to refund the consideration received.
• The liability will be measured at the amount received.

As long as the criteria are not met, and they may never be met, the liability will be derecognized, and amounts will be reported in income when one of the following occurs:
• The entity has no remaining obligations to the customer; all, or substantially all, of the consideration has been received; and the amounts received are nonrefundable;
• The arrangement has been terminated and consideration received is nonrefundable; or
• Consideration received relates to goods or services, the control of which, has been transferred to the customer; the entity has stopped transferring goods and services to the customer, and neither has an obligation to, nor intends to, provide any additional goods or services to the customer; and all amounts that have been received from the customer are nonrefundable.

The last of the three circumstances that allow an entity to recognize amounts received as revenue is very similar to a situation that would have required the application of the installment sales method. Under that approach, which is no longer allowed under GAAP, but is still applicable for tax purposes, the sale and related cost of sale was reported in the period of sale but the profit was recorded in a liability account. As collections were made, a portion of the profit would be recognized that is proportionate to the portion of the receivable that has been collected.

Under the new revenue recognition standards, assuming the goods have been transferred to the customer and all of the factors associated with that third situation have been met, cash receipts would be recognized as revenue when they are received as long as they are nonrefundable. The remainder of the transaction might be reported by derecognizing the inventory that has been transferred to the customer and recognize a receivable for the portion of the sales price that has not yet been collected.

Due to the uncertainty of collection, the receivable will be considered to be impaired, which means it will be written down to its fair value. For impairment purposes, the fair value of a receivable is its market value, which is not likely to be known, the present value of the payments that are expected to be collected, which is also not known; or, if the loan is collateralized and the creditor is likely to take the collateral in settlement, it is the net realizable value of the collateral, which is most likely what would be used. If, of course, services were delivered instead of goods, such as the development of a computer program, there will be no collateral.

**Installment Sales Method (For TAX)**

Prior to the introduction of the recent revenue recognition standard in ASC 606, Revenues from Contracts with Customers, when collectibility of a receivable was uncertain, and the amount that will be collected is not readily determinable, the installment method was applied.

• Only used when there is no way to reasonably estimate the degree of collectability.
• Allows revenue to be deferred and recognized each year in proportion to the cash collected during that year – Conservatism.

This method is still allowable for tax purposes and its use does not require the uncertainty of collection that was required under GAAP.
Two calculations:

- **Gross Profit recognized**
  
  \[
  \text{Cash collected} \times \text{Gross Profit} \% = \text{Profit recognized (I/S)}
  \]

- **Deferred Gross Profit**
  
  \[
  \text{Receivable balance} \times \text{Gross Profit} \% = \text{Deferred Profit (B/S)}
  \]

(Gross Profit = Sales – COGS)  
(Gross Profit % = Gross Profit / Sales Price)

**Normal Accrual Method** – profit is recognized at point of sale.

<table>
<thead>
<tr>
<th>Cash</th>
<th>150</th>
</tr>
</thead>
<tbody>
<tr>
<td>AR</td>
<td>750</td>
</tr>
<tr>
<td>Sales</td>
<td>900</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>COGS</th>
<th>540</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>540</td>
</tr>
</tbody>
</table>

Gross Profit = 360 (900 – 540)  
Gross Profit % = 40% (360/900)

**Installment Sales method** – profit is recognized as cash is collected

<table>
<thead>
<tr>
<th>Cash</th>
<th>150</th>
</tr>
</thead>
<tbody>
<tr>
<td>AR</td>
<td>750</td>
</tr>
<tr>
<td>Sales</td>
<td>900</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>COGS</th>
<th>540</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>540</td>
</tr>
</tbody>
</table>

**Unrealized Gross Profit**  
Deferred Gross Profit = 300

1) **Gross Profit Recognized**

\[
\text{Cash (GP%)} = 150 \times 40\% = 60
\]

2) **Deferred Gross Profit**

\[
\text{Receivable Balance} = 750 \times 40\% = 300
\]

I/S – Reduction of Sales & COGS  
B/S – As an adjustment to Receivables

\[
\text{Unrealized Gross Profit} = 300
\]

\[
\text{Deferred Gross Profit} = 300
\]

\[
\text{I/S} \rightarrow \text{B/S}
\]

\[
\text{Unrealized Gross Profit} \rightarrow \text{Deferred Gross Profit}
\]
For example, assume a client has made a sale on 12/31/X1 of $100 of an item that cost $70, and is collecting $20 of the sales price on the date of sale, with the remaining $80 (plus interest) to be collected in future years. The calculation of realized gross profit in 20X1 and deferred gross profit at 12/31/X1 follows:

<table>
<thead>
<tr>
<th>Sales</th>
<th>100</th>
<th>Collected</th>
<th>20</th>
<th>Receivable</th>
<th>80</th>
</tr>
</thead>
<tbody>
<tr>
<td>COGS</td>
<td>70</td>
<td>GP%</td>
<td>30%</td>
<td>GP%</td>
<td>30%</td>
</tr>
<tr>
<td>GP</td>
<td>30</td>
<td>Realized GP</td>
<td>6</td>
<td>Deferred GP</td>
<td>24</td>
</tr>
</tbody>
</table>

Note that the realized and deferred gross profit figures can be used to determine the cash collected and receivable balances, respectively, by using the gross profit percentage as a divisor instead of a multiplier. For example, the cash collected of $20 equals the $6 realized profit divided by the 30% profit percentage.

In the year the sale takes place, the client reports the entire sales price and cost of sales on the income statement, then defers the profit not recognized by the end of the year. In subsequent years, the additional profit is recognized as cash is collected, and interest income is reported as well.

For example, assume that in the previous example with the sale of $100, cost of sale of $70, and down payment on 12/31/X1 of $20, the remaining $80 is to be collected in four installments of $20 each on December 31, 20X2, 20X3, 20X4, and 20X5, plus interest at the market rate of 10% on the unpaid balance. Looking only at the effects on income related to this sale and collections, the following would appear:

<table>
<thead>
<tr>
<th>Year</th>
<th>20X1</th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
<th>20X5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>100</td>
<td>---</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: COGS</td>
<td>70</td>
<td>---</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross profit</td>
<td>30</td>
<td>---</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: Unrealized-current sales</td>
<td>24</td>
<td>---</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Realized-current sales</td>
<td>6</td>
<td>---</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Realized-prior sales</td>
<td>---</td>
<td>6</td>
<td>6</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Realized-total</td>
<td>6</td>
<td>6</td>
<td>6</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Interest income</td>
<td>---</td>
<td>8</td>
<td>6</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>Net income</td>
<td>6</td>
<td>14</td>
<td>12</td>
<td>10</td>
<td>8</td>
</tr>
</tbody>
</table>

Study the numbers until you’re comfortable with how they were determined. The realized profit each year represents the cash collected multiplied by the profit percentage, and the interest income is 10% of the receivable outstanding throughout the year.

When it has been determined that none of the remaining receivable will be collected, it will be written off. In such cases, both the receivables and deferred gross profit accounts will be eliminated.

For example, assume that $100,000 of sales with 40% gross profit rates took place in 20X1, that $30,000 was collected, and that $10,000 of accounts were written off during the year. At 12/31/X1,
the remaining installment receivables are $100,000 - $30,000 - $10,000 = $60,000, and deferred gross profit is $60,000 x 40% = $24,000.

Also keep in mind that profit must be computed separately on each sale, to determine the gross profit percentage to be applied to all collections in both the current and subsequent years.

Other Revenue Recognition Topics

Sometimes an entity may arrange to sell multiple goods and/or services as part of one sale. Special consideration must be given to the amount and timing of revenue recognition under such a multiple-element arrangement. The accounting for these arrangements is specified in the new revenue recognition standard, ASC 606, Revenue from Contracts with Customers.

For instance, Roger Co. may sell a customer a Rogetron 3000, plus a 3-year service contract for the device, for a total of $5,000. Roger Co. also sells Rogetron 3-year service contracts separately. Because Roger Co. sells the service contract separately, its standalone sales price is the amount that Roger Co. would sell it for as a separate item. The $5,000 sale of the device plus service contract is considered a multiple-element arrangement because the contract has two or more distinct performance obligations.

As indicated in the fourth step of the 5-step process for recognizing revenues in the total consideration for the contract will be allocated among distinct performance obligations in proportion to their relative standalone prices. The standalone sales price may be any of the following and the standard does not require any one to be given priority over either of the others:

- The amount the entity sells the product or service for without bundling it with other items, assuming they do sell it as a separate item. This, referred to as vendor specific objective evidence (VSOE) of the standalone sales price is the most reliable measure.
- The amount other entities sell the product or service for as a separate item. If VSOE is not available, this would be the next most reliable measure.
- The entity's best estimate of the standalone sales price, the third approach, is probably the least reliable of the three.

In this case, the amount allocated to the Rogetron 3000 would be recognized upon satisfaction of the performance obligation, which is to provide the machine to the customer. The service contract would likely provide revenue that qualifies for recognition while the performance obligation was being met and revenue on the 3-year service contract will be allocated over the 3-year term of the contract.

The relative fair value method is commonly used to allocate the transaction price among the separate elements of a multiple-element arrangement. If the Rogetron 3000 normally sells separately for $4,750, and the 3-year service contract normally sells separately for $528, the $5,000 transaction price for both will be allocated 4,750 / 5,278, or 90%, to the Rogetron, and 528 / 5,278, or 10%, to the service contract:

<table>
<thead>
<tr>
<th>Cash</th>
<th>5,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue – Rogetron 3000</td>
<td>4,500</td>
</tr>
<tr>
<td>Deferred Revenue – Service Contract</td>
<td>500</td>
</tr>
</tbody>
</table>

Another difficulty arises with revenue recognition for arrangements involving continuous delivery. The most common such arrangements are long-term construction contracts, which will be covered in the next section.
With the joint adoption of IFRS 15 by both the IASB and the FASB, most significant differences between IFRS and GAAP have been eliminated. One difference, regarding the acceptability of the completed contract method, is covered in the next section.

**REVENUE RECOGNITION UNDER IFRS**

The International Accounting Standards Board issued IFRS #15, Revenue from Contracts with Customers, which follows the same methodology for recognizing revenue as under US GAAP, discussed in an earlier section. It became effective for periods beginning on or after January 1, 2018, with early adoption permitted.

Revenues from *interest, royalties, and dividends* are recognized when it is *probable* that an economic benefit will flow to the entity and the amount can be *reasonably measured*.

- Interest revenues are recognized using the effective interest method.
- Royalties are recognized on the accrual basis.
- Dividends are recognized when the shareholder obtains the right to receive payment.

An entity will *disclose its revenue recognition policies* and amounts from each significant category of revenues, including those from:

- The sale of goods;
- Rendering services;
- Interest;
- Royalties; and
- Dividends

**Lecture 22.02**

**CLASS QUESTIONS**

Please see the Class Questions and Class Solutions for this Lecture at the end of this Section.
CLASS QUESTIONS
Work through the below Class Questions while following along with the respective lectures. Once this is complete, you can begin independently practicing what you've learned by quizzing yourself on this course section in your Interactive Practice Questions (IPQ), which can be found in your online Student Dashboard. Your IPQ simulates the computer-based testing experience, and will also help you understand how concepts are applied to the exam. Each question includes answer explanations from expert CPAs that will help you determine why you answered a question correctly or incorrectly. This is key to your success on the CPA Exam.

Lecture 22.02
1. Luge Co., which began operations on January 2, 20X3, appropriately uses the installment sales method of accounting for tax purposes. The following information is available for 20X3:

   Installment accounts receivable, December 31, 20X3 $800,000
   Deferred gross profit, December 31, 20X3 (before recognition of realized gross profit for 20X3) $560,000
   Gross profit on sales 40%

   For the year ended December 31, 20X3, cash collections and realized gross profit on sales should be

   a. $400,000 $320,000
   b. $400,000 $240,000
   c. $600,000 $320,000
   d. $600,000 $240,000

2. According to the installment method of accounting, which is no longer used for GAAP financial reporting but is still allowable for tax purposes, gross profit on an installment sale is recognized in income
   a. On the date of sale.
   b. On the date the final cash collection is received.
   c. In proportion to the cash collection.
   d. After cash collections equal to the cost of sales have been received.

3. Income recognized using the installment method of accounting, which is no longer used for GAAP financial reporting but is still allowable for tax purposes, generally equals cash collected multiplied by the
   a. Net operating profit percentage.
   b. Net operating profit percentage adjusted for expected uncollectible accounts.
   c. Gross profit percentage.
   d. Gross profit percentage adjusted for expected uncollectible accounts.
CLASS SOLUTIONS

1. (d) With a 40% gross profit on sales and an installment receivable of $800,000 at 12/31/X3, deferred gross profit at 12/31/X3 would be ($800,000 x 40%) $320,000. Since the unadjusted balance is $560,000, deferred gross profit will be reduced and realized gross profit would be recognized for the difference of $240,000. The realized gross profit represents 40% of collections. As a result, collections can be determined by dividing the realized gross profit of $240,000 by 40% to give collections of $600,000.

2. (c) Under the installment method of accounting, which is no longer allowable under GAAP but may still be used for tax purposes, the gross profit percentage on a sale is calculated and revenue is recognized by multiplying that percentage by amounts collected. Revenue, as a result, is recognized in proportion to collections. Answer (a) is incorrect because revenue is recognized on the date of sale under the accrual basis, not the installment method. Answer (b) is incorrect because there is no method of recognizing revenue that postpones recognition until the final payment is received unless collections prior to that point did not at least equal cost of sales or, under the completed contract method, the last payment is received upon completion of the contract. Answer (d) is incorrect because profit is recognized after collections equal cost of sales under the cost recovery method, not the installment method.

3. (c) Under the installment method of accounting, which is no longer allowable under GAAP but may still be used for tax purposes, the gross profit percentage on a sale is calculated and revenue is recognized by multiplying that percentage by amounts collected. Answer (a) is incorrect because the net operating profit percentage, which would be income from operations divided by total revenues, is not used. Answer (b) is incorrect because the net operating profit percentage adjusted for expected uncollectible accounts is not used. Answer (d) is incorrect because the gross profit percentage is not adjusted for expected uncollectible accounts.
TASK-BASED SIMULATIONS

Task-Based Simulation 1

A client has entered into certain revenue related transactions in which the collection of the sales price is not reasonably assured. The client wishes to determine at what point the consideration collected can be recognized as revenue. Identify the location in professional standards that indicates when it is appropriate to recognize collections as revenue in an arrangement in which collection is not reasonably assured.

Task-Based Simulation 2

A client has entered into certain revenue related transactions in which the collection of the sales price is not reasonably assured. The client wishes to determine how it should account for cash collected until such time that collection is reasonably assured. Identify the location in professional standards that indicates how collections are recorded on a sales arrangement in which collection of consideration is not reasonably assured.
TASK-BASED SIMULATION SOLUTIONS

Task-Based Simulation Solution 1

| FASB ASC | 606 | 10  | 25  | 7   |

Task-Based Simulation Solution 2

| FASB ASC | 606 | 10  | 25  | 8   |
Section 23 – Long-Term Construction-Type and Production-Type Contracts

Corresponding Lectures

Watch the following course lectures with this section:

Lecture 23.01 – Long-Term Contracts
Lecture 23.02 – Long-Term Contracts – Class Questions

EXAM NOTE: Please refer to the AICPA FAR Blueprint in the Introduction to find a listing of the representative tasks (and their associated skill levels—i.e., Remembering and Understanding, Application, and Analysis) that the candidate should be able to perform based on the knowledge obtained in this section.
Long-Term Construction-Type and Production-Type Contracts

Lecture 23.01

LONG-TERM CONTRACTS

Many industries provide services that may require several accounting periods to complete. The construction industry is one example. Contractors may enter contracts with governmental units to construct infrastructure including roads and highways, which may require several accounting periods or major projects like dams that may require decades. They use long-term construction-type contracts that, in some cases will have a single distinct performance obligation.

In other industries, companies will enter long-term supply contracts because their customers want to be able to rely on a supply of a resource that is considered critical without the need to renegotiate every purchase. Suppliers will use long-term production-type contracts. Some commit the customer to purchase all output produced by the supplier, usually with limitations; some commit the supplier to produce all of the resources needed by the customer; and some commit the supplier to produce and the customer to purchase a certain amount or quantity of the resource over an extended period of time.

Recognizing revenue over the course of these contracts, rather than when they are complete, makes sense since the work that generates the revenue is performed over the term of the contact, rather than in the period in which the contract is complete.

The current revenue recognition standards, ASC 606, Revenue from Contracts with Customers, indicate that certain conditions must be met for the entity to recognize revenue while the performance obligation is being satisfied. Otherwise, revenues are recognized upon satisfaction of the performance obligation.

Long-term construction contracts often allow the contractor to bill the customer at intervals, as it reaches various milestones in the project. These billings do not represent the amounts that should be recognized as revenue and are generally for amounts that are lower than a proportionate payment to the amount of work completed on the contract. They are generally designed:

- To make certain that the customer has enough of an investment in the project to assure the contactor that the customer will meet its obligation to accept and pay the contractor;
- To provide the contractor with working capital to enable the contractor to pay sub-contractors and for materials, providing assurance to the customer that the project can be completed; and
- To make certain that the contractor has something to gain, the remaining unpaid balance on the contract, by completing the contract on a timely basis

Under either method, costs incurred on the contract are inventoried as they occur in a construction in progress account, while billings are accumulated in a current liability account called billings on uncompleted contracts. Notice that both accounts are current, not long-term. This is because the income from such contracts is realized in only one operating cycle of the company, and when that cycle is longer than a year, items that normally would seem to be long-term are classified as current.
ASC 606, Revenues from Contracts with Customers provides principles indicating what costs may be capitalized. Costs incurred in satisfying a performance obligation will be accumulated and reported on the income statement in the period in which the related revenues are recognized.

- In long-term construction contracts, for those recognizing revenues while the performance obligation is being satisfied, as in the percentage-of-completion method, costs would be charged against income in proportion to the revenues being recognized.
- Under the completed-contract method, used when revenues are recognized upon satisfaction of the performance obligation, costs will be recognized upon the completion of the contract in the same period in which revenues are recognized.

Costs of obtaining a contract will generally be recognized as expenses in the periods in which they are incurred. Certain costs may, however, be capitalized.

**Recoverable incremental costs of obtaining a contract** are capitalized and reported on the income statement in the same period in which the related revenue is recognized. A land broker, for example, may have land that is all zoned for agricultural use and learns that customers are seeking land that is zoned for multi-family residential units. Costs incurred to re-zone the property are incremental costs of obtaining the contract. They would be recoverable because the change to the zoning will increase the value, and the selling price, of the property.

**Costs that are required by standards to be capitalized** also will be. In certain Topics, the FASB Accounting Standards Codification specifies that some costs will be recognized as expense and others will be capitalized and appear on the balance sheet.

Finally, the principles for recognizing revenues from contracts with customers provide three criteria, indicating that any costs that meet all three of these criteria should be capitalized. As a result, **costs that meet the following criteria** will also be capitalized:

- The costs relate directly to a contract that is in existence or a specific contract that is currently being negotiated;
- The costs generate or enhance resources that will be used to satisfy performance obligation in the future; and
- The costs are expected to be recovered.

The last category of costs include those that are normally incurred and accumulated in construction-in-progress. Recovery of costs may be through collections of revenues on the contract if they were anticipated when the contracts were negotiated, or they might have resulted from changes made to the performance obligation that are reimbursable by the customer.

When using the completed contract method, spending, billing, and collections each year are recorded in entries affecting various balance sheet accounts, but no income statement entries are made until the year the contract is completed, unless there is an anticipated loss on the contract, referred to as an onerous performance obligation and the loss is recognized immediately.

When using the percentage-of-completion method, an entry is made at the end of each period to report an appropriate portion of the total revenue expected from the contract and a proportionate amount of costs.

Although the percentage-of-completion method seems preferable because, as previously indicated, revenue is recognized as it is earned by the performance of work and as it is realized through billings and collections. The completed contract method may be preferred when these conditions and performance obligations may not be satisfied or when there is significant uncertainty as to whether the contract will actually be performed by both sides, based on the
modifying convention of **conservatism**. Which method will be applied is determined on the basis of whether the contract meets the requirements for recognizing revenue while the performance obligation is being met.

A performance obligation is considered satisfied when the entity has transferred the promised goods or services to the customer, which occurs when the customer has **control** of those goods or services.

A customer has control over goods and services when the customer has:
- The ability to direct the use of the goods or services,
- Can prevent others from benefitting from them, and
- Can obtain benefits from the goods or services in the form of cash flows.

When control is uncertain, other factors to consider include whether customer has:
- Legal title to goods
- Physical possession of the goods
- Significant risks and rights associated with ownership of the goods
- Accepted the goods

Revenue may be recognized while the performance obligation is being satisfied if the goods or services promised are transferred to the customer over time. Whether or not this is the case is determined at the inception of the contract, and it is based on the existence of one of three conditions. If none of the conditions apply, revenue is recognized at that point in time when the customer obtains control over the subject goods or services.

Any one of the following three circumstances will indicate that a performance obligation is being satisfied over time and, as a result, revenue will be recognized while the performance obligation is being satisfied. The three circumstances to evaluate are:
- The customer consumes the goods or services as they are being delivered;
- The customer has control over the asset while it is being created or enhanced; or
- The entity has no alternative use for the goods or services and is entitled to payment for performance completed to date.

**Consuming Goods or Services Upon Delivery**

Certain performance obligations, by their natures, are being consumed as they are being delivered. This is generally true of recurring services being provided to a customer, including cleaning services or gardening and landscaping services

In some circumstances, the determination as to whether goods or services are being consumed as they are being delivered is not necessarily readily determinable. In such cases, one factor to consider is whether another entity that is engaged to provide the remaining services and complete the performance required to satisfy the performance obligation would be required to substantially reperform work that was completed by the original entity. In making such a determination:

- Contract provisions preventing the original entity from, or limiting its ability to, transfer the remainder of the performance obligation to another entity are ignored.
- Assume that an entity engaged to complete the performance obligation would not have the benefit of resources that are currently within the control of the original entity and would remain in control of that entity upon transfer of the performance obligation.
Customer Control Over Asset

In determining whether the customer controls an asset while it is being created or enhanced, the same criteria that are used to determine whether control has been transferred to the customer should be applied. The customer has control over the asset while it is being enhanced if:

- The customer can direct the use of the goods or services;
- The customer can prevent others from benefitting from the goods or services; and
- The customer can obtain benefits from the goods or services in the form of cash flows.

Lack of Alternative Use and Entitlement to Payment

An entity can also recognize revenue while the performance obligation is being satisfied if the entity has no alternative use for the goods or services that are the subject of the contract and if, upon termination of the contract by either the entity or the customer, the entity would be entitled to payment for the work completed to date. Not having an alternative use for the goods or services includes the assumption that the entity would not be able to transfer them to another customer. An asset is considered as not having an alternative use to the seller if the seller would be required to dispose of it at a substantial cost. This would include:

- Significant costs would be incurred to rework the asset in order to apply it to another use; or
- The entity would be able to sell the asset to another customer, but would incur a significant loss upon doing so.

A significant cost would generally be incurred if the asset was being created or enhanced in accordance with the customer’s unique design specifications. That would also be true if the asset was being created as part of the customer’s infrastructure, making it difficult to remove.

In addition to having no alternative use for the asset, the entity must be entitled to payment for work completed to date. This would be the case if the entity was entitled to payment if the contract was terminated by either the entity or the customer for some reason other than the entity’s inability to complete performance. The amount the entity is entitled to should reflect the approximate selling price of the goods or services transferred. This would not be the case, for example, if the entity was only entitled to recover its costs incurred, but would be the case if the entity was entitled to recover its costs plus a reasonable profit, although the profit does not have to be equivalent to the profit that would have been earned if the performance obligation had been satisfied.

Many contracts call for partial payments as milestones are being met. In those circumstances, it would not be likely that the entity would have any right to payment if it was requested between milestones, assuming that at that time the entity still intends to complete its responsibilities under the contract and satisfy the performance obligations. In order to recognize revenue while the performance obligations are being satisfied, however, the entity must be entitled to payment assuming that the entity is able to, and intends to complete the project but either the entity or the customer decides to terminate the contract prior to the satisfaction of performance obligations for some other reason.

In evaluating whether the entity is entitled to payment to date, the terms of the contract itself will, of course, be considered. In addition, any applicable laws and regulations should be considered as well as any precedents that may have been set as a result of previous court activities. The customary business practices of the entities as well as those applicable to the industry in which the entities are operating as they are applicable to the contract.
Recognizing Revenue While the Performance Obligation is Being Satisfied

In order to recognize revenues while the performance obligation is being satisfied, there must be some means for measuring progress toward completion of the obligation. The two acceptable methods for measuring progress are:

- The output method; and
- The input method.

The focus of the **output method** of measuring progress toward satisfaction of the performance obligation is the value the customer can or does derive from the goods or services that have been transferred to the customer up to that point. When using the output method, the entity should select a base to use for measuring progress that faithfully reflects the entity’s performance toward completion. Alternatives may include:
  - Surveys, such as engineering studies, of the work completed;
  - Appraisals of results achieved;
  - Milestones reached;
  - Time elapsed; or
  - Units produced or delivered.

In some cases, contracts call for consideration on the basis of some criteria, such as the number of hours a professional works on a project that is being billed on an hourly basis. When there is such a measurement guideline, it may also be used as a basis for measuring outputs.

The output method is not always the most practical or reliable way to measure progress and some situations require the use of the input approach. This may be the case, for example, when progress is not necessarily observable or when the information necessary to apply the output approach is not readily available.

The focus of the **input method** of measuring progress toward completion of a performance obligation is the effort put forth by the entity, including amounts spent on raw materials that will be used in deriving a meaningful measurement. Measurement may be based on a wide variety of inputs, including:
  - Resources consumed
  - Labor hours expended
  - Costs incurred
  - Time elapsed
  - Machine hours used

In some circumstances, an entity's inputs are expended or efforts put forth somewhat uniformly over the period during which the performance obligation is being satisfied. When this is the case, it may be appropriate to recognize revenue on a straight-line basis over the period during which the performance obligation is being satisfied.

The input method may not be appropriate in all circumstances. This would be true, for example, in contracts where there is no direct relationship between the inputs used by the entity and the transfer of benefits to the customer. As a result, when applying the input method, those inputs that do not depict the entity's performance should be excluded.

When applying the input method using costs incurred as the basis for measuring progress, for example, adjustments may be required for:
  - Cost incurred that do not contribute to progress toward completion, such amounts spent for an unanticipated high amount of waste; or
  - Costs that are incurred disproportionately with progress toward completion.
It may be appropriate to recognize revenue at an amount equal to the cost of a good used to satisfy a performance obligation. An entity may do so if, at the inception of the contract, the entity expects that all the following conditions will apply:

- The good is not distinct;
- The customer is expected to obtain control of the good well; before receiving services related to the good;
- The cost of the transferred good is significant in relation to the total expected costs to be incurred to satisfy the performance obligation; and
- The entity obtains the good from a third party and is not significantly involved in the design or manufacture of the good.

### Percentage-of-Completion Method

The percentage-of-completion method is used when the contract qualifies for recognizing revenue while the performance obligation is being satisfied. Progress toward completion may be measured using an inputs approach or an outputs approach.

- Profit is recognized in each period of the contract. The amount of profit recognized is determined on the accrual basis taking into account the estimated profit on the contract, the portion of the contract that is completed (% complete), and any profit that has been previously recognized.

- Better **Matching**.

Accounting during year

- **Billings** are added to billings on uncompleted contracts.

  \[
  \begin{array}{c|c}
  \text{A/R} & 850 \\
  \text{Billings} & 850 \\
  \end{array}
  \]

  As **cash is collected**, the Receivable is reduced.

  \[
  \begin{array}{c|c}
  \text{Cash} & 800 \\
  \text{A/R} & 800 \\
  \end{array}
  \]

- **As Costs that qualify for capitalization are incurred**, they are added to Construction in Progress (CIP).

  \[
  \begin{array}{c|c}
  \text{Construction in Progress (CIP)} & 700 \\
  \text{Cash} & 700 \\
  \end{array}
  \]

- **Profits** are added to Construction in Progress (CIP) based on the formula below.

  \[
  \begin{array}{c|c}
  \text{CIP} & 100 \\
  \text{Cash Income} & 700 \\
  \end{array}
  \]

This example is using the cost-to-cost approach, which is an **inputs approach**. Under this method, the costs incurred to date are compared to the total estimated costs of completing the performance obligations with the resulting ratio considered the percentage complete.
Profit is calculated in steps:
1. Total contract – estimated total cost = estimated total profit.
2. Costs to date / estimated total cost = % of completion.
3. Estimated total profit x % of completion = GP to date.
4. GP to date – GP to date at end of last period = GP in current period.
   - GP added to construction in Progress (CIP) account.

   - At year end, Billings and CIP are netted on the balance sheet to report either:
     - **Current Asset** (Costs + profit in excess of billings)
     - **Current liability** (Billings in excess of costs + profits)

   - The income statement will report:
     - **Revenues** earned to date, which will be the total consideration multiplied by the percentage less revenues already recognized in prior periods.
     - **Cost of sales** equal to the costs, but not the profit, added to construction in progress during the current period.

**Anticipated Losses** are always recognized **Immediately**. When a contract is expected to result in a loss, it is an **onerous performance obligation** because the cost of completing the performance obligation exceeds the revenues allocated to it.

### Percentage of Completion
(Cost-to-Cost Method)

\[
\text{Costs INCURRED to date (700)} \div \text{TOTAL construction Costs} = \text{Percentage of Completion (%)}
\]

\[
\text{700} \div \text{3,500} = 20% \\
\text{X Total Profit} = 4,000 - 3,500 = 500 \\
\text{Profit Recognized to Date} = 100
\]

\[
\text{- (Profit Previously Recognized/in previous years)} = 0
\]

\[
\text{= Profit to recognize This Year} = 100
\]

- **Total Profit will always change, so use new profit amount.**
- **Anticipated Losses are Recognized immediately under both methods.**

### Class Example: Roger Builders has agreed to construct a building for CPA Inc at a total contract price of $4,000,000. The estimated construction costs at inception are $3,000,000 and the actual costs for both years 1 and 2 are below. The construction was completed after year 2.

Total contract price = $4,000,000
Estimated costs = $3,000,000
Estimated Profit = $1,000,000
Completed-Contracted Method (Conservatism)

- Report no profit until the job is finished.
- Accumulate costs in the CIP account
- Billings accumulated in the Billings account.
  - At year end net CIP and Billings, similar to the Percentage-of-completion method, except no profit is added to the CIP account.
- Recognize all anticipated losses immediately.
To show how revenues and profits under the percentage-of-completion method are computed each year, let's use the following example. A contractor has signed a fixed price contract for $1,000 on 1/1/X1 to build a house. The following events occur in the first 2 years of the job:

<table>
<thead>
<tr>
<th>Year</th>
<th>20X1</th>
<th>20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spending</td>
<td>150</td>
<td>200</td>
</tr>
<tr>
<td>Cumulative</td>
<td>150</td>
<td>350</td>
</tr>
<tr>
<td>Estimated costs to complete</td>
<td>600</td>
<td>350</td>
</tr>
<tr>
<td>Estimated total costs</td>
<td>750</td>
<td>700</td>
</tr>
<tr>
<td>Cost-to-cost percentage</td>
<td>20%</td>
<td>50%</td>
</tr>
<tr>
<td>Billings</td>
<td>210</td>
<td>430</td>
</tr>
<tr>
<td>Cumulative</td>
<td>210</td>
<td>430</td>
</tr>
<tr>
<td>Collections</td>
<td>180</td>
<td>210</td>
</tr>
<tr>
<td>Cumulative</td>
<td>180</td>
<td>390</td>
</tr>
</tbody>
</table>

The cost-to-cost percentage represents the cumulative costs incurred divided by the estimated total costs of the job as of the end of each year. This is the normal method used on the exam to determine the percentage of completion, and is used in this example.

**To calculate income each year**, use the following steps:
1. Compare the total contract price with the estimated total costs of the job at the end of that year to determine estimated total profits.
2. Multiply the total profit by the percentage of completion to determine the profit to date.
3. Subtract profits recognized in earlier years to determine the profit to be reported in the current year.
4. If the exam question asks for revenue rather than profit, add the current period expenses to the profit that needs to be reported, and the result is revenue.

The calculations for the first 2 years of this contract are:

<table>
<thead>
<tr>
<th>Year</th>
<th>20X1</th>
<th>20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract price</td>
<td>1000</td>
<td>1000</td>
</tr>
<tr>
<td>Estimated total costs</td>
<td>750</td>
<td>700</td>
</tr>
<tr>
<td>Estimated total profit</td>
<td>250</td>
<td>300</td>
</tr>
<tr>
<td>Percentage complete</td>
<td>20%</td>
<td>50%</td>
</tr>
<tr>
<td>Profit to date</td>
<td>50</td>
<td>150</td>
</tr>
<tr>
<td>Earlier years’ profits</td>
<td>---</td>
<td>50</td>
</tr>
<tr>
<td>Current period profit</td>
<td>50</td>
<td>100</td>
</tr>
<tr>
<td>Current costs</td>
<td>150</td>
<td>♦ 200</td>
</tr>
<tr>
<td>Current revenue</td>
<td>200</td>
<td>300</td>
</tr>
</tbody>
</table>

Notice that an alternative method of deriving revenue is to multiply the contract price by the percentage of completion. Revenue in 20X1, $1,000 x 20% = $200. Revenue in 20X2, $1,000 x 50% = $500 cumulative revenue, reduced by the $200 reported in the prior year to $300 for the current year.
The entries in 20X1 for spending, billings, and collections are as follows:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction in progress</td>
<td>150</td>
</tr>
<tr>
<td>Cash</td>
<td>150</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>210</td>
</tr>
<tr>
<td>Billings on uncompleted contracts</td>
<td>210</td>
</tr>
<tr>
<td>Cash</td>
<td>180</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>180</td>
</tr>
</tbody>
</table>

Actually, the credit to cash in the first entry may be made to other balance sheet accounts reflecting construction costs, such as various accrued expenses and payables, and accumulated depreciation on assets used for construction.

Assuming the completed contract method has been used, these are the only entries made each year. On the balance sheet at 12/31/X1, the construction in progress and billings on uncompleted contracts accounts are not reported separately, but are netted together for each contract. For those contracts where construction in progress exceeds billings, the net amount is reported as a current asset. For those contracts where billings exceed construction in progress, the net amount is reported as a current liability. In the above case, the amounts reported are:

**Current assets**
Accounts receivable 30

**Current liabilities**
Billings in excess of related costs 60

In order to see the additional entry required under the percentage-of-completion method, let's repeat the earlier calculation of 20X1 income for convenience:

<table>
<thead>
<tr>
<th>Year</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract price</td>
<td>1000</td>
</tr>
<tr>
<td>Estimated total costs</td>
<td>750</td>
</tr>
<tr>
<td>Estimated total profit</td>
<td>250</td>
</tr>
<tr>
<td>Percentage complete</td>
<td>20%</td>
</tr>
<tr>
<td>Profit to date</td>
<td>50</td>
</tr>
<tr>
<td>Earlier years' profits</td>
<td>---</td>
</tr>
<tr>
<td>Current period profit</td>
<td>50</td>
</tr>
<tr>
<td>Current costs</td>
<td>150</td>
</tr>
<tr>
<td>Current revenue</td>
<td>200</td>
</tr>
</tbody>
</table>

In 20X1, an entry is made to report revenues and profits as follows:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction in progress</td>
<td>50</td>
</tr>
<tr>
<td>Construction expense</td>
<td>150</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Construction revenue</td>
<td>200</td>
</tr>
</tbody>
</table>
Notice that the profit is added to the inventory account. This will also affect the reporting of excess billings on the balance sheet. At 12/31/X1, the accounts presented will be:

**Current assets**
Accounts receivable 30

**Current liabilities**
Billings in excess of related costs and profits 10

The accounts receivable represent the billings of $210 minus collections of $180. The billings of $210 also exceed the $150 costs plus $50 profits by $10.

All of the calculations under the percentage-of-completion method have been based on the assumption that the contract would eventually result in a profit. Occasionally, though, a contract will incur sufficient cost overruns so as to result in a loss to the contractor. When estimated total costs exceed the contract price, the excess should be immediately reported on the income statement in its entirety as an estimated loss, regardless of which method was chosen for the recognition of contract profits. If profits were reported in earlier years under the percentage-of-completion method, these will have to be reversed as well.

**LONG-TERM CONSTRUCTION CONTRACTS UNDER IFRS**

Under IFRS, long-term construction contracts are accounted for applying the same principles that apply to other contracts:

- If the contract qualifies for recognition of revenue as the performance obligation is being satisfied, a method similar to the percentage-of-completion approach will be applied.
- If the contract does not meet the requirements for recognition as the performance obligation is being satisfied, it is not recognized until the performance obligation has been satisfied, comparable to the completed contract approach.

<table>
<thead>
<tr>
<th>Revenue Recognition of Construction Contracts</th>
<th>US GAAP</th>
<th>IFRS</th>
</tr>
</thead>
<tbody>
<tr>
<td>• If certain criteria are met, revenues are recognized <em>while</em> the performance obligation is being satisfied and construction contracts are accounted for using the percentage-of-completion (stage of completion). If the contract does not qualify for recognizing revenues while the performance obligation is being satisfied, revenues are recognized <em>upon satisfaction</em> of the performance obligation and the completed contract method is used.</td>
<td></td>
<td>• The completed contract method is never allowed for construction contracts. If certain criteria are met, the percentage-of-completion method is used. Otherwise, revenue recognition is limited to the costs incurred, using the cost recovery (zero profit) method.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• As a result of IFRS 15, long-term construction contracts will be accounted for applying the same principles as applied in other revenue-related transactions. In most cases, the revenues will be recognized as performance obligations are being met as opposed to when they have been met.</td>
</tr>
</tbody>
</table>

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Lecture 23.02

CLASS QUESTIONS

Please see the Class Questions and Class Solutions for this Lecture at the end of this Section.
TASK-BASED SIMULATION SOLUTION

Task-Based Simulation Solution 1

| FASB ASC | 205 | 40 | 50 | 13 |
There are 3 categories of activities in the statement of cash flows:

**Operating Activities** – Inflows and outflows of cash related to the production of income from continuing operations. All transactions that are NOT investing and financing activities are considered operating.
- Collections on sales from customers
- Cash payments for COGS and SGA
- Interest received and paid
  - The portion of a settlement of zero-coupon debt instruments attributable to principal
- Dividends received
- Acquisition and disposal of trading securities
- Payments for income taxes
- All other receipts/disbursements that do not stem from transactions defined as Investing or Financing activities.

**Investing Activities** – Investing in yourself or others.
- Principal collections or Loans made by the entity (interest and dividends received are Operating)
- Acquisition or disposal of available-for-sale or held-to-maturity Investments (Not Trading)
- Acquisition or disposal of Property, plant & equipment and intangibles
- Cash received in settlement of corporate-owned life insurance policies
- Cash received from payments on receivables transferred in exchange for a beneficial interest in a securitized transaction
Financing Activities – Issuing Debt or Equity
- Proceeds from issuing or payments for retiring Bonds (interest is Operating)
- Issuance or Reacquisition of stock or Treasury stock
- Borrowing or repaying a loan
- Debt prepayment or debt extinguishment costs
- The portion of a settlement of zero-coupon debt instruments attributable to principal
- Dividends paid to shareholders (dividends received is Operating)

Examples of Financing activities

<table>
<thead>
<tr>
<th>Cash</th>
<th>Common stock</th>
<th>Preferred stock</th>
<th>APIC</th>
<th>N/P</th>
<th>Bonds Payable</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

The classification of some items is determined based on the nature of the payment and the circumstances under which it is received or paid. For example:

- Contingent consideration related to a business combination that is paid in a period after that of the business combination;
  - If made soon after the acquisition, it is an outflow for investing activities
  - If paid to settle a contingent consideration liability that was recorded at the acquisition date, it is an outflow for financing activities to the extent that it reduces the contingent liability with any excess classified as an outflow for operating activities.

- Cash proceeds from the settlement of insurance claims are classified on the basis of the nature of the loss.

- Cash payments for insurance premiums on corporate-owned policies may be reported as outflows for investing activities, for operating activities, or some combination of the two.

- Distributions from equity method investments may be treated using either of two approaches:
  - Under the cumulative earnings approach – distributions received are cash inflows from operating until the cumulative amount recognized equals the cumulative equity in earnings recognized by the investor. Any excess is an inflow from investing activities.
  - Under the nature of distribution approach – distributions are classified based on the nature of the activity that generated the distribution, with returns on investment classified as cash inflows from operating activities and as cash inflows from investing activities when a return of investment.

Cash receipts and payments that have characteristics associated with more than one classification may be subject to specific requirements identified in the FASB Accounting Standards Codification, indicating how they should be classified on the statement of cash flows. If not, cash flows related to each separately identifiable source should be classified based on the nature of the underlying cash flows. When cash flows with characteristics of more than one classification cannot be separated by source, they should be classified based on the most predominate characteristic.
Supplementary Disclosures

- **If direct method** is used:
  - Schedule to **reconcile net income** to cash flow from operations
    - Identical to indirect method of preparing operating activities section.
  - Schedule of non-cash investing and financing activities
    - Transactions having no effect on cash
      - Conversion of bonds to stock.
      - Purchase financed entirely by loan.

- **If indirect method** is used:
  - Cash payments for Interest and Income Taxes must be **Disclosed**.
  - Schedule of non-cash investing and financing activities.

- **If cash or cash equivalents are restricted**, the restricted amount is included in the total of cash and cash equivalents when reconciling the beginning and ending balances
  - If reported separately on the balance sheet, statement of cash flows required to identify amounts of cash, cash equivalents, and restricted cash or restricted cash equivalents, on the balance sheet as well as the line items on the balance sheet where they are located
  - The sums of the line items identified in the beginning and ending balance sheets should agree with the beginning and ending balances reported on the statement of cash flows
  - Disclosures may be in the footnotes or on the face of the statement of cash flows and may be in a narrative or a tabular form.

**Cash flows per share** are **NOT Disclosed**
GASB 80 Blending Requirements for Certain Component Units
GASB 80 requires the blending of a component unit that was incorporated as a not-for-profit corporation with the governmental unit is the sole corporate member.

GASB 81 Irrevocable Split-Interest Agreements
GASB 81 provides accounting guidelines for accounting for irrevocable split-interest agreements in which a donor provides resources to two or more beneficiaries, including governments, which may be through trusts or other forms of agreements. In such agreements, the donor transfers resources to an intermediary who holds and administers them on behalf of the government and one or more other recipients.

GASB 82 Pension Issues – An Amendment of GASB Statements No. 67, No. 68, and No. 73
GASB 82 modifies some of the requirements related to the reporting of pension plans, including a requirement to present covered-employee payroll in RSI, defined as employees provided with pensions through the pension plan, and ratios using that measure, to requiring the presentation of covered payroll, which is payroll on which contributions to the pension plan are based, and ratios using that measure. It also specifies that a deviation from the guidance in the Actuarial Standard of Practice is not considered to be in conformity with the requirements of GASB Statements No. 67, No. 68, or No. 73 for the selection of assumptions used to determine the pension liability and other measures. Finally, it indicates that employer contributions made to satisfy contribution requirements identified by plan terms should be classified as plan member contributions for purposes of applying GASB Statement No. 67, and as employee contributions for Statement No. 68.

GASB 83 Certain Asset Retirement Obligations (AROs)
GASB 83 provides criteria for recognition of a liability and deferred outflow of resources for AROs. Timing should be based on local laws, regulations, contracts, or judgments along with events requiring the government to perform ARO activities. It also requires an ARO to be measured based on the best estimate of the current value of outlays expected to be incurred. The ARO is to be remeasured only when there is a significant change in estimated outlays and the recognized deferred outflows of resources should be reduced and recognized as outflows in a systematic and rational manner over the estimated useful life of the tangible capital asset to which the ARO relates. It also requires disclosure of how funding and assurance requirements are being met. Disclosure is required regarding the nature of government AROs, methods and assumptions used to measure liabilities, and the estimated useful life of the associated tangible capital assets.

GASB 84 Fiduciary Activities
GASB 84 establishes criteria for identifying governmental fiduciary activities, with a focus on whether the government is controlling the assets of the fiduciary activity; and the beneficiaries with whom the fiduciary relationship exists. Activities meeting the criteria are to be reported in a fiduciary fund in the basic financial statements, and to present a statement of fiduciary net position and a statement of changes in fiduciary net position. It describes four fiduciary funds that should be reported if applicable including pension fund and other employee benefit trust funds; investment trust funds; private-purpose trust funds; and custodial funds. The statement also requires the recognition of a liability to the beneficiaries when the occurrence of an event compels the government to distribute fiduciary resources, such as when a demand has been made or when no further action, approval, or condition is required to be taken or met by the beneficiary to release the assets.
GASB 85 Omnibus 2017
GASB 85 addresses practice issues identified upon implementation and application of certain GASB Statements, including:

- Blending a component unit when the primary government is a business-type activity with financial statements having a single column.
- Reporting amounts that were previously reported as goodwill and negative goodwill.
- Classifying real estate held by insurance entities.
- Measuring certain money market investments and participating interest-earning investment contracts at amortized cost.
- Timing of the measurement of pension plan or other postemployment benefit (OPEB) liabilities and expenditures recognized in financial statements prepared using the current financial resources measurement focus.
- Recognizing on behalf payments for pensions or OPEBH in employer financial statements.
- Presenting payroll-related measures in RSI for purposes of reporting by OPEB plans and employers that provide OPEB.
- Classifying employer-paid member contributions for OPEB.
- Simplifying certain aspects of the alternative measurement method for OPEB.
- 'Accounting and financial reporting for OPEB provided through multiple-employer defined benefit OPEB plans.

GASB 86 Certain Debt Extinguishment Issues
GASB 86 addresses accounting and reporting for an in-substance defeasance of debt, which occurs when a debtor places resources, excluding the proceeds from the issuance of debt, into an irrevocable trust for the sole purpose of extinguishing debt. Provided the trust meets certain conditions, debt is considered defeased when the debtor irrevocably places resources in the trust, which may only be used for satisfying scheduled principal and interest payments on the defeased debt. When preparing financial statements applying the economic resources measurement approach, any difference between the reacquisition price, which is the amount that is needed to be put into the trust, and the net carrying value of the liability is to be recognized as a separately reported recognized as a separately reported gain or loss in the period of the defeasance. For purposes of calculating the difference between the reacquisition price and the carrying value of the debt, any remaining prepaid insurance related to the defeased debt remaining in effect at the time of the defeasance be added to the carrying value of the debt. For all in-substance defeasance transactions, if the substitution of monetary assets that are not risk free is not prohibited, that fact should be disclosed in the period in which the debt is defeased, along with the amount of defeased debt that is still at risk of substitution.
Service Concession Arrangements

There are times when a governmental unit will contract with a private company in order to provide government services to the public on a more efficient basis than if the government undertook the endeavor itself. In some circumstances, private companies are better equipped to perform tasks that are more closely associated with business entities than governmental ones.

One example is toll roads. The government may hire a private company to collect tolls, maintain an accounting, and distribute funds to various agencies within the government, earning a fee for performing the service.

Typical arrangements will involve a private company conducting a business activity using infrastructure that belongs to the public, or to the governmental agency with which they are conducting business. In such an arrangement, the hiring entity is the governmental unit, referred to, in such arrangements as the grantor. They hire an operating entity providing it with the infrastructure necessary to conduct the activity or provide the service.

The grantor is responsible for determining who the service will be provided for, and at what price, as well as any other decisions regarding the performance of the service. The grantor controls the infrastructure, which reverts back to the grantor at the termination of the arrangement.

Although there are currently no guidelines as to how such an arrangement should be accounted for, there are a few guidelines as to how certain may or may not be dealt with. For example:

- The operating entity will not recognize the infrastructure used to provide the service as property, plant, and equipment on its balance sheet.
- Despite the fact that the operating entity will generally use the infrastructure of the governmental agency for the duration of the contract, at which time it will revert back to the grantor, the arrangement cannot be accounted for as a lease.

The operating entity is encouraged to identify the types of business entities that its products or service is most similar to and to adopt, and adapt, the way in which that business entity operates and how it accounts for its operations.

Like almost all entities, the operating entity will recognize its revenues in accordance with ASC 606, Revenue from Contracts with Customers. In evaluating how the operating entity will recognize revenue, it's customer is the grantor, not the driver paying a toll for its use of the toll road.

- If the driver was the customer, the performance obligation would be access to the toll road and revenue would be recognized with each use.
- Since the grantor is the customer, their revenues to be earned over the term of the contract are variable and require estimation. In addition, the arrangement would most likely qualify for recognition of revenue while the performance obligation is being satisfied rather than upon satisfaction of it.
Section 30 – Nonprofit Accounting

Corresponding Lectures

Watch the following course lectures with this section:

Lecture 30.01 – Nonprofit Accounting – Financial Statements
Lecture 30.02 – Nonprofit Accounting – Statement of Activities
Lecture 30.03 – Contribution Revenue
Lecture 30.04 – Functional Expense Analysis and Disclosures
Lecture 30.05 – Contributions – Services
Lecture 30.06 – Hospitals – Private Sector
Lecture 30.07 – Nonprofit Accounting – Class Questions
Lecture 30.08 – Nonprofit Accounting – Class Question - TBS

EXAM NOTE: Please refer to the AICPA FAR Blueprint in the Introduction to find a listing of the representative tasks (and their associated skill levels—i.e., Remembering and Understanding, Application, and Analysis) that the candidate should be able to perform based on the knowledge obtained in this section.
Nonprofit Accounting

Lecture 30.01

NPO FINANCIAL STATEMENTS (FASB ASC 958)

Note: The following content reflects the changes brought about by the FASB's ASU 2016-14, Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities. These changes were effective on the CPA Exam January 1, 2018.

The focus of reporting for a not-for-profit organization (NPO) is on presenting basic information for the entity as a whole. NPO's focus on providing delivery of services funded with public or private resources that generally come from contributions or fees that are not taxable. NPO accounting covers 4 different groups:

- Health care
- Colleges and universities
- Voluntary health and welfare (VHWO) (United Way, Red Cross, Greenpeace, Salvation Army)
- All others not above (fraternities, labor unions, museums, libraries, nonprofit organizations)

Accrual accounting is used and the financial statements that must be prepared for all such organizations parallel the 3 basic financial statements (balance sheet, income statement, statement of cash flows) used by private businesses. Their reporting emphasis is on disclosing the sources of resources and how they were expended. The 3 basic statements include:

- Statement of Financial Position
- Statement of Activities
- Statement of Cash Flows

The Statement of Financial Position (B/S)

The Statement of Financial Position (B/S) reports assets, liabilities, and net assets (equity) of the NPO. Assets and liabilities may be classified or reported in order of liquidity and payment date. Assets restricted with donor restrictions must be reported separately from those that are not. The net asset section of the statement includes two accounts:

- **Net assets WITHOUT Donor Restrictions** are those resources of the NPO that are available for the general use of the entity and can include assets set aside by the board of trustees, including a board-designated endowment fund, since a true restriction must come from an outside donor. Net assets without donor restrictions are the remainder of the net assets of an NPO after considering those that are subject to donor-imposed restrictions.

- **Net assets WITH Donor Restrictions** are those resources of the NPO that are subject to donor-imposed restrictions. A donor-imposed restriction is any stipulation that specifies a use for a contributed asset that is more specific than just broad limits resulting from the nature or purpose of the NPO, or from the environment in which the NPO operates (restriction will eventually **LAPSE due to time, use or purpose**). This category also includes endowments. The earnings from the endowment may either be WITHOUT Restriction, or WITH Restriction.
• For example – a donor may stipulate that a sum be earmarked for cancer research or for the improvement of a building, or may only be used after a prescribed period of time or upon the occurrence of an event.

A donor may also intend to create an endowment fund, which is an established fund of cash, securities, or other assets to provide income for the maintenance of the NPO. A common donor restriction in such cases is to protect the original donated amount, also known as the principal or corpus, from being depleted, with only the fund's income or gains being available for operational expenditures by the NPO. Sometimes a portion of the fund's income or gains may be required to be reinvested and added to the principal as well. This is a donor-restricted endowment fund.

Statement of Financial Position for a Not-for-Profit Organization

Not-for-Profit Organization
STATEMENTS OF FINANCIAL POSITION
June 30, 20X1 and 20X0
(in thousands)

<table>
<thead>
<tr>
<th></th>
<th>20X1</th>
<th>20X0</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>$ 75</td>
<td>$ 460</td>
</tr>
<tr>
<td>Accounts and interest receivable</td>
<td>2,130</td>
<td>1,670</td>
</tr>
<tr>
<td>Inventories and prepaid expenses</td>
<td>610</td>
<td>1,000</td>
</tr>
<tr>
<td>Contributions receivable</td>
<td>3,025</td>
<td>2,700</td>
</tr>
<tr>
<td>Short-term investments</td>
<td>1,400</td>
<td>1,000</td>
</tr>
<tr>
<td>Assets restricted to investment in land, buildings, and equipment</td>
<td>5,210</td>
<td>4,560</td>
</tr>
<tr>
<td>Land, buildings, and equipment</td>
<td>61,700</td>
<td>63,590</td>
</tr>
<tr>
<td>Long-term investments</td>
<td>218,070</td>
<td>203,500</td>
</tr>
<tr>
<td>Total assets</td>
<td>$292,220</td>
<td>$278,480</td>
</tr>
<tr>
<td><strong>Liabilities and net assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$ 2,570</td>
<td>$ 1,900</td>
</tr>
<tr>
<td>Refundable advance</td>
<td></td>
<td>650</td>
</tr>
<tr>
<td>Grants payable</td>
<td>875</td>
<td>1,300</td>
</tr>
<tr>
<td>Notes payable</td>
<td></td>
<td>1,140</td>
</tr>
<tr>
<td>Annuity obligations</td>
<td>1,685</td>
<td>1,700</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>5,500</td>
<td>6,500</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>10,630</td>
<td>13,190</td>
</tr>
<tr>
<td>Total assets</td>
<td>$292,220</td>
<td>$278,480</td>
</tr>
<tr>
<td><strong>Net assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net assets without donor restrictions</td>
<td>115,228</td>
<td>103,648</td>
</tr>
<tr>
<td>Net assets with donor restrictions</td>
<td>166,362</td>
<td>161,642</td>
</tr>
<tr>
<td>Total net assets</td>
<td>281,590</td>
<td>265,290</td>
</tr>
<tr>
<td>Total liabilities and net assets</td>
<td>$292,220</td>
<td>$278,480</td>
</tr>
</tbody>
</table>
Lecture 30.02

The Statement of Activities (I/S & R/E)

The Statement of Activities (I/S & R/E) reports revenues, net assets released from restriction, and expenses. The statement separately reports the two categories of net assets.

- **Revenues, gains, and other support** typically include contributions from donors and investment income. Property is included at FMV at date of gift and services are only included if professional and the NPO would have otherwise paid for them. They are reported in the appropriate column depending on whether the revenues are with or without donor restrictions. Investment income reported in the With Donor Restrictions net asset column should only represent net capital gains or other income that will remain part of the permanent donor-restricted endowment.

- **Net assets released from restriction** only reports formerly donor-restricted net assets that became free of donor restrictions during the year, generally due to the expiration of time restrictions or the performance of purpose restrictions. Identical dollar amounts are reported as positive numbers in the Without Donor Restrictions column and negative numbers in the With Donor Restrictions net assets column.

- **Expenses** are reported only in the Without Donor Restrictions column. The expenditure of net assets with donor restrictions has the effect of releasing the assets from restriction, and is reported as both a release, as discussed in the preceding paragraph, and an expense from the Without Donor Restrictions category. Donor-restricted net assets designated for endowment funds generally cannot be spent. The expenses are categorized as either program services, support services or combined costs.

**Expenses (all from net assets Without Donor Restrictions)**

- Program – activities representing NPO purpose.
- All are reported in the “Without Donor Restrictions” net assets column.
- May be classified different ways
  - **Object** – what - type of cost e.g. salaries, Dep.
  - **Function** – why – purpose e.g. health care, police, fire
  - **Character** – when – time period
    - Debt service – past
    - Current service – present
    - Capital outlay – future
      - Functional must be presented in either:
        - Statements
        - Foot Notes
## Statement of Activities for a Not-for-Profit Organization

### Not-for-Profit Organization
**STATEMENT OF ACTIVITIES**

**Year Ended June 30, 20X1**

*(in thousands)*

<table>
<thead>
<tr>
<th>Without Donor Restrictions</th>
<th>With Donor Restrictions</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues, gains, and other support:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contributions</td>
<td>$8,640</td>
<td>$8,390</td>
</tr>
<tr>
<td>Fees</td>
<td>5,400</td>
<td>5,400</td>
</tr>
<tr>
<td>Investment return, net</td>
<td>6,650</td>
<td>18,300</td>
</tr>
<tr>
<td>Gain on sale of equipment</td>
<td>850</td>
<td>850</td>
</tr>
<tr>
<td>Other</td>
<td>150</td>
<td>150</td>
</tr>
<tr>
<td><strong>Net assets released from restrictions:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Satisfaction of program restrictions</td>
<td>11,990</td>
<td>(11,990)</td>
</tr>
<tr>
<td>Satisfaction of equipment acquisition restrictions</td>
<td>1,500</td>
<td>(1,500)</td>
</tr>
<tr>
<td>Expiration of time restrictions</td>
<td>1,250</td>
<td>(1,250)</td>
</tr>
<tr>
<td>Appropriation from donor endowment and subsequent satisfaction of any related donor restrictions</td>
<td>7,200</td>
<td>(7,200)</td>
</tr>
<tr>
<td>Total net assets released from restrictions</td>
<td>21,940</td>
<td>(21,940)</td>
</tr>
<tr>
<td><strong>Total revenues, gains, and other support</strong></td>
<td>43,630</td>
<td>4,750</td>
</tr>
<tr>
<td><strong>Expenses and losses:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Program A</td>
<td>13,100</td>
<td>13,100</td>
</tr>
<tr>
<td>Program B</td>
<td>8,540</td>
<td>8,540</td>
</tr>
<tr>
<td>Program C</td>
<td>5,760</td>
<td>5,760</td>
</tr>
<tr>
<td>Management and general</td>
<td>2,420</td>
<td>2,420</td>
</tr>
<tr>
<td><strong>Fundraising</strong></td>
<td>2,150</td>
<td>2,150</td>
</tr>
<tr>
<td><strong>Total expenses</strong></td>
<td>31,970</td>
<td>31,970</td>
</tr>
<tr>
<td>Fire loss</td>
<td>80</td>
<td>80</td>
</tr>
<tr>
<td>Actuarial loss on annuity obligations</td>
<td></td>
<td>30</td>
</tr>
<tr>
<td><strong>Total expenses and losses</strong></td>
<td>32,050</td>
<td>30</td>
</tr>
<tr>
<td><strong>Change in net assets</strong></td>
<td>11,580</td>
<td>4,720</td>
</tr>
<tr>
<td><strong>Net assets at beginning of year</strong></td>
<td>103,648</td>
<td>161,642</td>
</tr>
<tr>
<td><strong>Net assets at end of year</strong></td>
<td><strong>$115,228</strong></td>
<td><strong>$166,362</strong></td>
</tr>
</tbody>
</table>

The following chart summarizes increases and decreases in net assets reported on the statement of activities:

<table>
<thead>
<tr>
<th>Without Donor Restrictions</th>
<th>With Donor Restrictions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td>Increase</td>
</tr>
<tr>
<td><strong>Released</strong></td>
<td>Increase</td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td>Decrease</td>
</tr>
<tr>
<td></td>
<td>N/A</td>
</tr>
</tbody>
</table>
Lecture 30.03

Contribution Revenue (FASB ASC 958)

Many contributions received by a not-for-profit organization (NPO) are unrestricted gifts of cash, and are reported as revenues in the Without Donor Restrictions (no DR) section of the statement of activities:

\[
\begin{align*}
\text{Cash (operating activity)} & : 100 \\
\text{Revenues (no DR)} & : 100
\end{align*}
\]

It is common, however, for NPOs to receive gifts that are restricted. For example, a hospital might receive a donation of $500 with the stipulation that it be spent on the hospital's cancer research program. This causes the donation to be included in With Donor Restrictions (DR), and is recorded as follows:

\[
\begin{align*}
\text{Cash (operating activity)} & : 500 \\
\text{Revenues (DR)} & : 500
\end{align*}
\]

Later, when the hospital actually spends the money on research that satisfies the restriction.

Two entries are needed. The first is to report the release of the restriction:

\[
\begin{align*}
\text{Net assets released (DR)} & : 500 \\
\text{Net assets released (no DR)} & : 500
\end{align*}
\]

The second is to report the research costs:

\[
\begin{align*}
\text{Expenses (no DR)} & : 500 \\
\text{Cash} & : 500
\end{align*}
\]

**Note:** The net of the increase in “net assets without donor restrictions” (no DR) and the increase in the “Expense” (decreases -no DR) has no net effect on net assets without donor restrictions.

Finally, a donation of cash may stipulate that only the income generated from investing the cash may be spent. The donation is reported as net assets with donor restrictions. For example, assume $1,000,000 was donated to endow an ongoing cancer research program. The donation itself is reported as follows:

\[
\begin{align*}
\text{Cash (financing activity)} & : 1,000,000 \\
\text{Revenues (DR)} & : 1,000,000
\end{align*}
\]

If the money earns interest income of $40,000, that money is spendable:

\[
\begin{align*}
\text{Cash} & : 40,000 \\
\text{Revenues (no DR)} & : 40,000
\end{align*}
\]
The Statement of Cash Flows

The Statement of Cash Flows is comparable to the same statement for private businesses, reporting cash flows from operating, investing, and financing activities. Either the direct or indirect method may be used.

- **Operating** activities represent most of the cash flow effects of the items reported in the statement of activities. Inflows include revenues collected and outflows include expenses paid. Contributions that can be spent on operations are included as well.

- **Investing** activities represent the cash flow effects of asset transactions. Inflows include proceeds from the sale of assets and sales of works of art, and outflows include payments for asset purchases.

- **Financing** activities represent the cash flow effects of liability transactions. Inflows include proceeds from loans and outflows include principal payments on loans. Contributions that are subject to donor restrictions are included as well. Financing activities includes 2 categories, proceeds from donor-restricted contributions and other financing activities.

---

### Statement of Cash flows

- **Operating activities** – flow from statement of activities
  - Direct or indirect; if direct, indirect reconciliation **not** required, though may be presented, as shown below
  - Revenues with and without donor restrictions
  - Rev, exp, interest income/expense, dividend income

- **Investing activities** – flow from buying and selling assets
  - Investments acq/sold
  - PP&E acq/disposal

- **Financing activities** – flow from borrowings and repayments
  - 2 categories
    - Proceeds from donor-restricted contribution
    - Other financing activities
  - Donor-restricted revenue
  - For example - money restricted for L/T purpose
    - Pmt on bonds, N/P, $ restricted for Endowment,
    - Money restricted for acq of PP&E.

- Contribution revenue is usually operating
  - Contribution for long-term purpose is financing
## Statement of Cash Flows for a Not-for-Profit Organization

**Not-for-Profit Organization**

**STATEMENT OF CASH FLOWS**

**Year Ended June 30, 20X1**

(in thousands)

<table>
<thead>
<tr>
<th>Cash flows from operating activities:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received from service recipients</td>
<td>$5,220</td>
</tr>
<tr>
<td>Cash received from contributors</td>
<td>8,030</td>
</tr>
<tr>
<td>Cash collected on contributions receivable (promises to give)</td>
<td>2,615</td>
</tr>
<tr>
<td>Interest and dividends received</td>
<td>8,570</td>
</tr>
<tr>
<td>Miscellaneous receipts</td>
<td>150</td>
</tr>
<tr>
<td>Interest paid</td>
<td>(382)</td>
</tr>
<tr>
<td>Cash paid to employees and suppliers</td>
<td>(23,808)</td>
</tr>
<tr>
<td>Grants paid</td>
<td>(425)</td>
</tr>
<tr>
<td>Net cash used by operating activities</td>
<td>(30)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash flows from investing activities:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance proceeds from fire loss on building</td>
<td>250</td>
</tr>
<tr>
<td>Purchase of equipment</td>
<td>(1,500)</td>
</tr>
<tr>
<td>Proceeds from sale of investments</td>
<td>76,100</td>
</tr>
<tr>
<td>Purchase of investments</td>
<td>(74,900)</td>
</tr>
<tr>
<td>Net cash used by investing activities</td>
<td>(50)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash flows from financing activities:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds from contributions restricted for:</td>
<td></td>
</tr>
<tr>
<td>Investment in perpetual endowment</td>
<td>200</td>
</tr>
<tr>
<td>Investment in term endowment</td>
<td>70</td>
</tr>
<tr>
<td>Investment in land, buildings, and equipment</td>
<td>1,210</td>
</tr>
<tr>
<td>Investment subject to annuity trust agreements</td>
<td>200</td>
</tr>
<tr>
<td>Other financing activities:</td>
<td></td>
</tr>
<tr>
<td>Interest and dividends restricted for reinvestment</td>
<td>300</td>
</tr>
<tr>
<td>Payments of annuity obligations</td>
<td>(145)</td>
</tr>
<tr>
<td>Payments on notes payable</td>
<td>(1,140)</td>
</tr>
<tr>
<td>Payments on long-term debt</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Net cash used by financing activities</td>
<td>(1,985)</td>
</tr>
</tbody>
</table>

| Net decrease in cash and cash equivalents | (385) |
| Cash and cash equivalents at beginning of year | 460  |
| Cash and cash equivalents at end of year | $75   |

### Reconciliation of change in net assets to net cash used by operating activities:

Change in net assets $16,300

### Adjustments to reconcile change in net assets to net cash used by operating activities:

- Depreciation $3,200
- Fire loss 80
- Actuarial loss on annuity obligations 30
- Increase in accounts and interest receivable (460)
- Decrease in inventories and prepaid expenses 390
- Increase in contributions receivable (325)
- Increase in accounts payable 670
- Decrease in refundable advance (650)
- Decrease in grants payable (425)
- Contributions restricted for long-term investment (2,740)
- Interest and dividends restricted for long-term investment (300)
- Net unrealized and realized gains on long-term investments (15,800)
- Net cash used by operating activities $ (30)

### Supplemental data for noncash investing and financing activities:

- Gifts of equipment $140
- Gift of paid-up life insurance, cash surrender value $80
Lecture 30.04

Functional Expense Analysis

In addition to the 3 financial statements required of all NPOs, an analysis of functional expenses is required. The analysis is not an additional financial statement. Instead, it is a detailed schedule of expenses broken down by function such as program expenses and support services. It may be presented on the face of the statement of activities, as a separate statement, or as a note to the NPO's financial statements. In such an analysis, the following detail is provided:

<table>
<thead>
<tr>
<th></th>
<th>Program Activities</th>
<th>Supporting Activities</th>
<th>Total Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A</td>
<td>B</td>
<td>C</td>
</tr>
<tr>
<td>Salaries and benefits</td>
<td>$6,660</td>
<td>$3,510</td>
<td>$1,553</td>
</tr>
<tr>
<td>Grants to other organizations</td>
<td>1,868</td>
<td>675</td>
<td>1,733</td>
</tr>
<tr>
<td>Travel and supplies</td>
<td>801</td>
<td>912</td>
<td>449</td>
</tr>
<tr>
<td>Services and professional fees</td>
<td>144</td>
<td>1,341</td>
<td>540</td>
</tr>
<tr>
<td>Office and rent</td>
<td>1,044</td>
<td>540</td>
<td>405</td>
</tr>
<tr>
<td>Depreciation</td>
<td>1,296</td>
<td>720</td>
<td>513</td>
</tr>
<tr>
<td>Interest</td>
<td>154</td>
<td>86</td>
<td>61</td>
</tr>
<tr>
<td>Total Expenses</td>
<td>$11,966</td>
<td>$7,784</td>
<td>$5,253</td>
</tr>
</tbody>
</table>

- **Program Activities** – (Further the mission of the organization) These are expenses that are directly related to the program. For example, a relief organization might report categories for emergency relief, community education, training, research, hospice services, etc. In the example above, Programs A, B, and C represent program services of the NPO.

- **Supporting Activities** – (Secondary to the mission) Fund-raising expenses and General and Administrative expenses are reported.
  - Fundraising – (Print & mail pledge cards, maintaining donor list, preparing and distributing fund raising materials, merchandise sent to potential contributors, salaries of fundraisers, and conducting other activities designed to solicit contributions)
  - Membership development – Soliciting for potential members and for dues, costs associated with member relations and similar activities
Shown on the face of the Statement of Activities:

<table>
<thead>
<tr>
<th>Statement of Activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public support (donated) (contributions, grants, bequests, pledges, Special event revenues)</td>
</tr>
<tr>
<td>+ Revenues (earned) (membership dues, investment income, client service Revenue, fees)</td>
</tr>
<tr>
<td>- Program expenses (further the mission of the organization – boat dep, research, community services, public health and education)</td>
</tr>
</tbody>
</table>
| - Support services (Secondary to the mission)  
  - G & A & M – (marketing/ tax prep/print annual report)  
  - Fundraising – (Print & mail pledge cards, maintaining donor list, merchandise sent to potential contributors, salaries of fundraisers) |
| Excess of revenue over expenses |

Again, the analysis of functional expenses may be presented on the face of the statement of activities, as a separate statement, or as a note to the NPO’s financial statements. One specific type of NPO is a voluntary health and welfare organization (VHWO), which provides community services financed by voluntary contributions from the general public, such as the Red Cross or Greenpeace.

Management & general expenses include the cost of soliciting funds other than contributions and membership dues. This includes advertising and other costs of promoting goods or services for sale to customers; costs of responding to requests for proposals for customer-sponsored contracts, or of administering such contracts. They are not considered fundraising expenses.

Disclosures

Required disclosures for NPOs include:

- Information on endowment funds – net asset classification, composition, and changes; spending policies; related investment policies.
- The board’s interpretation of the laws underlying the NPO’s classification of donor-restricted endowment funds, including its interpretation of the ability to spend from underwater endowment funds. These are endowment funds whose fair value at the reporting date is less than either:
  - the original gift value, or
  - the amount required to be maintained in the fund, either by law or donor stipulation.
- The NPO’s spending policies regarding endowment funds, including underwater endowment funds.
- How the NPO computes its fundraising expenses to amounts raised ratio, if such a ratio is disclosed.
Lecture 30.05

Contributions

*Donations of services* are normally not recorded. However, when an organization receives donations of *professional services* that it normally would have compensated (*essential services*), the service provider is helping to defray expenses of the NPO and should be reported as a donor.

**Essential if:**
- Services create or enhance a non-financial asset (inventory, land, building) - OR
- The services require specialized skills (doctor, lawyer, accountant)

For example, if a hospital receives *donated time* from retired nurses that enables them to avoid hiring and paying additional workers, and the estimated amount that time would have cost the hospital is $30,000, the following entry is made:

\[
\begin{align*}
\text{Expenses (no DR)} & \quad 30,000 \\
\text{Contribution Revenue (no DR)} & \quad 30,000
\end{align*}
\]

Notice that the donation increases the nursing expense as well as contribution revenue, and is reported in net assets without donor restrictions, since services that have been provided cannot be withdrawn later.

NPOs also frequently receive donations of services from volunteers providing *unskilled services* that it would not have contracted to obtain had they not been donated. These are excluded from the financial reporting, since they do not assist the organization in defraying its expenses.

In some cases, services may be provided by the employees of an affiliated NPO. The same basic rule applies as to whether or not to recognize those services in that essential services are recognized and nonessential ones are not. The amount at which they will be recorded will generally be the affiliated NPO's cost. If, however, the cost is significantly higher or lower than the fair value of the services, they may be reported at either the affiliated NPO's cost or the fair value.

For example, if volunteers come regularly to a hospital to visit with lonely patients and read to them, they are certainly performing a service that is valuable and appreciated. Nevertheless, if the hospital does not provide such visitations on a paid contract basis with anyone, then these donated services are not considered relevant in evaluating the NPO itself, and no entry is made.

**Contributions of property** are normally reported as revenues in the same manner as contributions of cash. They may be reported as net assets with or without donor restrictions depending on the conditions of the contribution.

A special rule may be applied, however, to certain donations of *art, artifacts, or antiques*. If the NPO intends to use these items *for display* or research purposes only, the organizations cares for it themselves and if sold, the proceeds must be reinvested in other collectibles, then it is permitted to exclude the donation from its financial statements entirely. This avoids having the organization appear to possess great wealth (and, thus, not be in need of public support) when it is holding assets that cannot be used to finance the operations of the NPO. If they don't meet the above requirements, then they would recognize both an asset and a revenue.

If the NPO reserves the right to sell the asset, however, it will have to include its value on the financial statements and report a donation unless the proceeds of any sale are strictly limited to
the purchase of replacement art, artifacts, or antiques. They may however show as net assets with donor restrictions.

If they receive **donated materials**, they would also record both an asset and a support revenue. If however the materials are “pass through” (donated clothing), then they would debit an expense and credit an contribution revenue without donor restrictions.

Gifts in kind are non-cash contributions to a nonprofit organization. They are recorded at FMV.

** Marketable Securities (FASB ASC 958-320-35)**

NPO's are required to use fair value accounting for most equity and debt investments and report realized and unrealized gains and losses directly in the statement of activities.

- Doesn't cover Equity Method securities

**Pledges** (an unconditional promise to give) that have been made to an NPO may be accrued as receivables (net of allowance) by the organization in the period in which they are made. In doing so, however, the NPO should establish an appropriate allowance for uncollectibles, and treat pledges that aren't due to be paid until a future period as time-restricted donations. The pledges are recorded at P.V. for annuities or amounts not expected to be collected for over a year. Cash contributions however are a revenue or gain when received.

*Conditional promise* to give (matching funds) – Conditional promises to give are pledges that will become payable to the entity when the conditions have been met. As a result, conditional promises to give are not recognized as revenues until they become unconditional. This occurs when either:

- The conditions on which the promise depends have been substantially met.
- There is only a remote likelihood that the conditions on which the promise depends will not be met.

Funds received before conditions are substantially met are recognized as liabilities until such time as the promises become unconditional.

**For example,** assume that an Independence Day pledge drive by the NPO in 20X1 has netted promises totaling $20,000, with half of the pledge due by the end of the current year and the remainder due by the end of 20X2. Based on experience, the organization expects 10% of pledges not to be honored. The entry to be recorded when pledges are received is:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pledges receivable (at P.V.)</td>
<td>20,000</td>
</tr>
<tr>
<td>Allowance for uncollectible pledges</td>
<td>2,000</td>
</tr>
<tr>
<td>Revenues (no DR)</td>
<td>9,000</td>
</tr>
<tr>
<td>Revenues (DR)</td>
<td>9,000</td>
</tr>
</tbody>
</table>

Assuming collection is as expected, the pledges collected in 20X2 effectively eliminate the time restriction:

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/X2</td>
<td>Net assets released (DR)</td>
<td>9,000</td>
</tr>
<tr>
<td></td>
<td>Net assets released (no DR)</td>
<td>9,000</td>
</tr>
</tbody>
</table>
FASB ASC 958-605 – Agent or Trustee (like agency fund – ex. United Way)
If collect money for others such as a foundation, it can be considered either contribution revenue or a liability at FMV. It is considered a revenue if either:
- They have variance power over the donation to redirect the money (OR)
- The beneficiary of the donation is financially related (ongoing economic interest in the net assets of the other).

\[
\begin{align*}
\text{Cash} & \times \\
\text{Contribution Revenue} & \times
\end{align*}
\]

If don't meet Either of the two above, record as a liability

\[
\begin{align*}
\text{Cash} & \times \\
\text{Refundable advance (liability)} & \times
\end{align*}
\]

Example: donor provides funds not just for disaster relief, but to purchase household goods for a specific family affected by the disaster. In this case the NPO is acting merely as an intermediary and would recognize a liability, not contribution revenue.

Depreciation
FASB ASC 958 requires all nonprofit organizations to recognize depreciation in general purpose external financial statements using the same criteria in allocating the depreciable cost of fixed assets over their estimated useful lives as commercial enterprises.

Colleges & Universities
Private colleges and universities are subject to the same guidance as other not-for-profit organizations. Some special issues that relate to colleges and universities include:
- Tuition remissions & scholarships are revenue (if go to school, it's a revenue)
- Refunds – not revenues

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>12,000</td>
</tr>
<tr>
<td>Scholarship expense</td>
<td>10,000</td>
</tr>
<tr>
<td>Tuition remission</td>
<td>8,000</td>
</tr>
<tr>
<td>Tuition revenue</td>
<td>30,000</td>
</tr>
</tbody>
</table>

Lecture 30.06
HOSPITALS (HEALTH CARE ORGANIZATIONS – PRIVATE SECTOR)
The two types of health care organizations are investor-owned health care entities, which provide goods and services for profit, and not-for-profit business oriented health care entities, which have no ownership interests. Not-for-profit health care organizations:
- Charge fees in order to remain self-sufficient rather than to maximize profits.
- May receive contributions from resource providers in transactions that are either nonreciprocal or are not proportionate.

Accounting and financial reporting for both types of health care organizations is consistent, although each has transactions that would not be appropriate for the other. For example:
• A not-for-profit health care organization will not have any transactions or reporting related to shareholders’ equity.
• An investor-owned health care organization will not receive contributions.

Four statements are presented for a private sector not-for-profit hospital, including a balance sheet (Statement of Financial Position), a statement of Operations (Activities), a statement of Changes in Net Assets (or equity), and a statement of Cash Flows. Notes to the financial statements will also be provided. The statements may have other titles that are appropriately descriptive, such as a statement of financial position instead of the balance sheet, or a statement of activities in place of a statement of operations. The statement of cash flows, however, should be entitled as such.

• **The Balance Sheet (Statement of Financial Position)** classifies assets and liabilities as current or noncurrent on a similar basis as for profit entities, although continuing care retirement communities may report assets according to how soon they will be converted to cash and liabilities according to maturity dates.

• Assets of a not-for-profit health care organization are identified as with or without donor restrictions, similarly to other not-for-profit entities. Net assets without donor restrictions, however, include those that are contractually limited, such as proceeds of debt that are deposited with a trustee and are limited in use by the requirements of an agreement, or assets limited to use for identified purposes as a result of an agreement with an outside party other than a grantor or donor, such as restrictions imposed by state law on many health maintenance organizations (HMOs).

• In addition, funds that are internally designated are reported separately from those that are externally designated for some specific purpose. This may be either on the face of the financial statements or in the notes.

• In addition:
  o Cash and claims to cash are reported separately and excluded from current assets when restricted to withdrawal or use for something other than current operations, designated for acquisition or construction of noncurrent assets, required to be segregated for the liquidation of long-term debt, or are limited to long-term use by donor restriction.
  o While receivables for health care services are generally reported at the provider’s full established rates, providing charity care does not result in the recognition of a receivable.
  o Investments in assets that are not financial instruments are reported at amortized cost.
  o A liability will be recognized for medical malpractice claims, including an estimate of losses that will result from unreported incidents that are probable of having occurred before the end of the reporting period.
  o Potential insurance recoveries are reported as insurance receivables, not as reductions to the liability, and are evaluated for the need for an allowance for uncollectibility.

• **The statement of Changes in Net Assets** presents the other changes required by FASB ASC 954. As is true for other NPOs, contributions restricted by the donor, such as for long-term purposes (plant acquisition, endowment, term endowment, etc.), would not be reported in the Statement of Operations (as unrestricted revenue). They would instead be reported in the Statement of Changes in Net Assets as a revenue increasing net assets with donor restrictions, as appropriate.
• **The statement of Cash Flows**, like other not-for-profit entities, is prepared similarly to a statement of cash flows for a private business, reporting cash flows from operating activities, from investing activities, and from financing activities.

• **The Statement of Operations (Activities)** is required to include a **performance indicator**, which may be described as *operating income, revenues over expenses, revenues and gains over expenses and losses, earned income, or performance earnings*. The performance indicator is an operating measure of a for-profit health care entity. It helps in comparing the performance across health care organizations with different organizational forms. Regardless of what description is used, the performance indicator is to be clearly labeled.

• Not-for-profit, business-oriented health care entities are required to report the performance indicator on the same statement that presents the total changes in net assets without donor restrictions.

• A description of the nature and composition of the performance indicator is to be included in the notes to the financial statements. The performance indicator includes items related to investments in debt and equity securities:
  - Dividends, interest, and similar investment income
  - Realized gains and losses
  - Unrealized gains and losses on trading securities (unrealized gains and losses on investments other than trading securities are excluded)
  - Other than temporary impairments

• Other changes in net assets may be presented in the same statement or separately.

• Additional classifications may be used for components within the performance indicator, such as operating and nonoperating, expendable and nonexpendable, earned and unearned, or recurring and nonrecurring.

• Certain items are **excluded** from the performance indicator and are reported separately as changes in net assets.
  - Transactions with owners acting in the capacity as an owner
  - Equity transfers
  - Donor-restricted contributions
  - Contributions of long-lived assets or long-lived assets released from donor restrictions
  - Items reported in, or reclassified from, other comprehensive income
  - Separately reported items, such as discontinued operations
  - Unrealized gains and losses on investments other than trading securities

• Note the separation of items above and below that line. Also note the presentation separately for depreciation, interest, and provision for bad debts. In addition, note that the net assets released from restrictions includes separate amounts for those net assets released for operations and those released for other items.
  - **Patient service revenue** – Accounted for on the *accrual basis* and includes gross billings at established rates before reductions for discounts granted to insurance groups and employees (but excludes *charity care* which isn't billed at all, but is disclosed in the financial statements). Patient service
Revenue includes medical services such as doctors, surgery, and most hospital stay costs.

- **Net patient service revenue** – Patient service revenue after reductions for discounts and contractual adjustments for third-party payments (but not bad debt expense, which is claimed separately as an operating expense)
  - In some cases, the amount collectible cannot be determined at the time the services are provided, such as when a health care facility is required by law to provide emergency services, regardless of the patient’s ability to pay.
  - This may result in the recognition of revenue and a relatively high provision for bad debts in the period of service.
    - When this is the case, the entity will report net patient service revenue, which will consist of patient service revenue reduced by contractual allowances and discounts and a provision for bad debts.
    - All other health care entities would still show bad debts as an operating expense, assuming they only recognize patient service revenue to the extent it expects to collect.

- **Donated supplies** are recognized as a revenue at FMV in the period received and as either an asset or an expense.

<table>
<thead>
<tr>
<th>Supplies or Expense</th>
<th>100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrestricted contribution – other operating Revenue (no DR)</td>
<td>100</td>
</tr>
</tbody>
</table>
GOVERNMENTAL HEALTH CARE ORGANIZATIONS

Governmental health care organizations are generally considered governmental entities that are engaged only in business-type activities, similar to utilities. As such, a governmental health care organization will present financial statements prepared in accordance with the same requirements applied to enterprise funds.

<table>
<thead>
<tr>
<th>Statement of Operations (Activities) – Government Hospital</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Patient service revenue</strong> (hotel type, medical, lab)</td>
</tr>
<tr>
<td>-(Provision for contractual adjustments) Medicare, employee</td>
</tr>
<tr>
<td>Discounts, not charity</td>
</tr>
<tr>
<td><strong>Net patient service revenues</strong></td>
</tr>
<tr>
<td>+ Other Operating revenues, gains &amp; losses (earned)</td>
</tr>
<tr>
<td>▪ Non medical –Parking, gift shop, cafeteria, tuition</td>
</tr>
<tr>
<td>(auxiliary activities)</td>
</tr>
<tr>
<td>▪ Donated medicines and blankets (supplies &amp; equipment)</td>
</tr>
<tr>
<td>▪ Restricted grants</td>
</tr>
<tr>
<td>▪ Net assets released from restriction used for operations</td>
</tr>
<tr>
<td><strong>Operating Expenses</strong> Bad debts, drugs, doctors, Gen &amp; Admin, Dep, Int.</td>
</tr>
<tr>
<td>Results from operations</td>
</tr>
<tr>
<td>+ Non-operating Revenues (Other Income) (unearned)</td>
</tr>
<tr>
<td>▪ Unrestricted donations, gifts, bequests</td>
</tr>
<tr>
<td>▪ Unrestricted Interest &amp; Dividend income</td>
</tr>
<tr>
<td>▪ Unrestricted grants</td>
</tr>
<tr>
<td>▪ Donated services</td>
</tr>
</tbody>
</table>

| Excess of Rev/Gains over Exp/Losses (Performance indicator) |
| (operating income, performance earnings, earned income)   |

<table>
<thead>
<tr>
<th>Items reported separately from performance indicator</th>
</tr>
</thead>
<tbody>
<tr>
<td>*Restricted donations/contributions</td>
</tr>
<tr>
<td>*Assets released from donor restrictions for long-lived assets (PP&amp;E)</td>
</tr>
<tr>
<td>*Restricted Investment Income</td>
</tr>
<tr>
<td>*Change in net unrealized gains and losses (other than trading) on unrestricted investments</td>
</tr>
<tr>
<td>*Transfers to Parent</td>
</tr>
<tr>
<td>*Discontinued operations</td>
</tr>
</tbody>
</table>

| Increase in Unrestricted Net Assets                      |
**Sample Business Oriented Not-for-Profit Hospital**

**STATEMENTS OF OPERATIONS (ACTIVITIES)**

*Years Ended December 31, 20X7 and 20X6*

<table>
<thead>
<tr>
<th></th>
<th>20X7</th>
<th>20X6</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Changes in net assets without donor restrictions:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Revenue, gains, and other support:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><em>Net patient service revenue</em></td>
<td>$85,156</td>
<td>$78,942</td>
</tr>
<tr>
<td>Premium revenue</td>
<td>11,150</td>
<td>10,950</td>
</tr>
<tr>
<td>Other revenue</td>
<td>2,601</td>
<td>5,212</td>
</tr>
<tr>
<td>Net assets released from restrictions used for operations</td>
<td>300</td>
<td>--</td>
</tr>
<tr>
<td>Total revenues, gains and other support</td>
<td>99,207</td>
<td>95,104</td>
</tr>
<tr>
<td><strong>Expenses:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating expenses</td>
<td>88,521</td>
<td>80,585</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>4,782</td>
<td>4,280</td>
</tr>
<tr>
<td>Interest</td>
<td>1,752</td>
<td>1,825</td>
</tr>
<tr>
<td>Provision for bad debts</td>
<td>1,000</td>
<td>1,300</td>
</tr>
<tr>
<td>Other</td>
<td>2,000</td>
<td>1,300</td>
</tr>
<tr>
<td>Total expenses</td>
<td>98,055</td>
<td>89,290</td>
</tr>
<tr>
<td>Operating income</td>
<td>1,152</td>
<td>5,814</td>
</tr>
<tr>
<td><strong>Other income:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment income</td>
<td>3,900</td>
<td>3,025</td>
</tr>
<tr>
<td><strong>Excess of revenues over expenses (Performance Indicator)</strong></td>
<td>5,052</td>
<td>8,839</td>
</tr>
<tr>
<td>Change in net unrealized gains and losses on other than trading securities</td>
<td>300</td>
<td>375</td>
</tr>
<tr>
<td>Net assets released from restrictions used for purchase of property and equipment</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>Change in interest in net assets of Sample Hospital Foundation</td>
<td>283</td>
<td>536</td>
</tr>
<tr>
<td>Transfers to parent</td>
<td>(688)</td>
<td>(3,051)</td>
</tr>
</tbody>
</table>

Increase in net assets without donor restrictions | $5,147 | $6,699 |

*See accompanying notes to financial statements.*
### Sample Business Oriented Not-for-Profit Hospital

#### STATEMENT OF CHANGES IN NET ASSETS

**Years Ended December 31, 20X7 and 20X6**

(in thousands)

<table>
<thead>
<tr>
<th></th>
<th>20X7</th>
<th>20X6</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net assets without donor restrictions:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Excess of revenues over expenses</td>
<td>$5,052</td>
<td>$8,839</td>
</tr>
<tr>
<td>Net unrealized gains on investments, other than trading securities</td>
<td>300</td>
<td>375</td>
</tr>
<tr>
<td>Change in interest in net assets of Sample Hospital Foundation</td>
<td>283</td>
<td>536</td>
</tr>
<tr>
<td>Transfers to parent</td>
<td>(688)</td>
<td>(3,051)</td>
</tr>
<tr>
<td>Net assets released from restrictions used for purchase of property and equipment</td>
<td>200</td>
<td>--</td>
</tr>
<tr>
<td>Increase in net assets without donor restrictions</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Net assets with donor restrictions:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contributions for charity care</td>
<td>140</td>
<td>996</td>
</tr>
<tr>
<td>Contributions for endowment funds</td>
<td>50</td>
<td>411</td>
</tr>
<tr>
<td>Net realized and unrealized gains on investments</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Net assets released from restrictions</td>
<td>(500)</td>
<td>--</td>
</tr>
<tr>
<td>Increase (decrease) in net assets with donor restrictions</td>
<td>(300)</td>
<td>1,417</td>
</tr>
<tr>
<td>Increase in net assets</td>
<td>4,847</td>
<td>8,116</td>
</tr>
<tr>
<td>Net assets, beginning of year</td>
<td>72,202</td>
<td>64,086</td>
</tr>
<tr>
<td>Net assets, end of year</td>
<td>$77,049</td>
<td>$72,202</td>
</tr>
</tbody>
</table>

---

**Lecture 30.07**

**CLASS QUESTIONS**

Please see the Class Questions and Class Solutions for this Lecture at the end of this Section.

---

**Lecture 30.08**

**CLASS QUESTIONS**

Please see the Class Questions and Class Solutions for this Lecture at the end of this Section.
CLASS QUESTIONS

Work through the below Class Questions while following along with the respective lectures. Once this is complete, you can begin independently practicing what you've learned by quizzing yourself on this course section in your Interactive Practice Questions (IPQ), which can be found in your online Student Dashboard. Your IPQ simulates the computer-based testing experience, and will also help you understand how concepts are applied to the exam. Each question includes answer explanations from expert CPAs that will help you determine why you answered a question correctly or incorrectly. This is key to your success on the CPA Exam.

Lecture 30.07

1. Candy Land, a nongovernmental not-for-profit organization, is preparing its year-end financial statements. Which of the following statements is required?
   a. Statement of changes in financial position.
   b. Statement of cash flows.
   c. Statement of changes in fund balance.
   d. Statement of revenue, expenses and changes in fund balance.

2. The Jackson Foundation, a private not-for-profit organization, had the following cash contributions and expenditures in 20X3:
   - Unrestricted cash contributions of $500,000.
   - Cash contributions of $200,000 restricted by the donor to the acquisition of property.
   - Cash expenditures of $200,000 to acquire property with the donation in the above item.
   Jackson's statement of cash flows should include which of the following amounts?

<table>
<thead>
<tr>
<th>Operating activities</th>
<th>Investing activities</th>
<th>Financing activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $700,000</td>
<td>$(200,000)</td>
<td>$0</td>
</tr>
<tr>
<td>b. $500,000</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>c. $500,000</td>
<td>$(200,000)</td>
<td>$200,000</td>
</tr>
<tr>
<td>d. $0</td>
<td>$500,000</td>
<td>$200,000</td>
</tr>
</tbody>
</table>

3. On December 30, 20X3, Leigh Museum, a not-for-profit organization, received a $7,000,000 donation of Day Co. shares with donor-stipulated requirements as follows:
   - Shares valued at $5,000,000 are to be sold, with the proceeds used to erect a public viewing building.
   - Shares valued at $2,000,000 are to be retained, with the dividends used to support current operations.

   As a consequence of the receipt of the Day shares, how much should Leigh report as net assets with donor restrictions on its 20X3 statement of financial position (balance sheet)?
   a. $0
   b. $2,000,000
   c. $5,000,000
   d. $7,000,000
4. The Jones family lost its home in a fire. On December 25, 20X3, a philanthropist sent money to the Amer Benevolent Society, a not-for-profit organization, to purchase furniture for the Jones family. During January 20X4, Amer purchased this furniture for the Jones family. How should Amer report the receipt of the money in its 20X3 financial statements?
   a. As a contribution without donor restrictions.
   b. As a contribution with donor restrictions.
   c. As part of net assets released from restrictions.
   d. As a liability.

5. A not-for-profit organization receives $150 from a donor. The donor receives two tickets to a theater show and an acknowledgment in the theater program. The tickets have a fair market value of $100. What amount is recorded as contribution revenue?
   a. $0
   b. $50
   c. $100
   d. $150

6. Bryant Hospital, a nonprofit hospital affiliated with a religious group, reported the following information for the year ended December 31, 20X5:
   - Gross patient service revenue at the hospital's full established rates: $980,000
   - Bad debts expense: 10,000
   - Contractual adjustments with third-party payors: 100,000
   - Allowance for discounts to hospital employees: 15,000

   On the hospital's statement of operations for the year ended December 31, 20X5, what amount should be reported as net patient service revenue?
   a. $865,000
   b. $880,000
   c. $855,000
   d. $955,000

7. Rosenthal Hospital, a nonprofit hospital affiliated with a private university, reported the following information for the year ended December 31, 20X5:
   - Cash contributions received from donors for capital additions to be acquired in 20X6: $150,000
   - Proceeds from sales at hospital gift shop and snack bar: 75,000
   - Dividend revenue not restricted by donors or by law: 25,000

   Using the information provided, what amount should be reported as “other operating and non-operating revenue and gains” on the hospital's statement of operations (activities) for the year ended December 31, 20X5?
   a. $25,000
   b. $75,000
   c. $100,000
   d. $250,000
CLASS SOLUTIONS

1. (b) A not-for-profit organization is required to include a statement of financial position as of the reporting date, and statements of activities and of cash flows for the reporting period ending on that date whenever presenting a complete set of financial statements. Answer (a) is incorrect because a statement of changes in financial position, which would be similar to a statement of cash flows with a definition of funds that is different from cash and cash equivalents, is not required. Answer (c) is incorrect because a statement of changes in fund balance is not required. Answer (d) is incorrect because a statement of revenues, expenses, and changes in fund balance is not required.

2. (c) Unrestricted cash contributions of $500,000 are cash inflows from operating activities as they may be used for whatever purpose the board deems appropriate. Contributions that are designated by the donor for the funding of a long-term project, such as the $200,000 received that is restricted to the acquisition of property is considered an inflow from financing activities. When the funds are actually used for the acquisition of property, that expenditure will be an investing outflow, since property is a capital asset.

3. (d) Since the shares valued at $5,000,000 were stipulated to be used for the erection of a public viewing building, they will only be released from donor restrictions when used for that purpose and are, therefore, restricted. The shares valued at $2,000,000 are to be retained with no provision for their sale or other disposal. As a result, they are restricted, too. The entire $7,000,000 donation will be part of net assets with donor restrictions on Leigh’s 20X3 statement of financial position.

4. (d) When the recipient of funds has little or no discretion as to how funds will be used, the funds are received by the NPO in the capacity of an agent. They are recognized as a liability, not as revenue, until such time as they are disbursed according to the donor’s instructions.

5. (b) When a not-for-profit receives contributions and provides goods or services in exchange, the amount received in excess of the fair value of the goods or services is recognized as revenues. Of the $150 received, $100 was for the fair value of the tickets and $50 was contributions revenue.

6. (a) Net patient service revenue is the amount that the health care organization expects to collect subject to credit risk. Of the $980,000 billed at full rates, the hospital does not expect to collect the reductions due to contractual adjustments of $100,000 or the employee discounts of $15,000, resulting in $865,000 that the hospital expects to collect. This is subject to credit risk in that some patients or insurance companies may not be able to pay. The result is bad debt expense, on operating expense, of $10,000.

7. (c) On a hospital’s statement of activities, other revenues and gains represent amounts received for reasons other than the performance of health care related services that is available to be used at the discretion of the board. It would not include contributions that are to be used for capital additions, as these are reported on the statement of changes in net assets, but not on the statement of operations (activities). However, the statement of operations would include revenues from gift and snack sales of $75,000 and dividend revenue that is not restricted of $25,000 for a total of $100,000.
Situation:

Items 1 through 10 in the left-hand column represent various transactions pertaining to Philipp University, a private university, for the year ended December 31, 20X3. To the right of these transactions is a listing of how transactions could affect the statement of activities (List A effects) and the statement of cash flows (List B effects).
Required:

Indicate how each transaction should be reported by Philipp University on (1) the statement of activities and (2) the statement of cash flows prepared for the year ended December 31, 20X3. Philipp reports separate columns for the changes in net assets with and without donor restrictions on its statement of activities. In addition, Philipp uses the direct method of reporting its cash flows from operating activities. A List A or List B effect may be used once, more than once or not at all.

<table>
<thead>
<tr>
<th>Transactions</th>
<th>Statement of activities</th>
<th>Statement of cash flows</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>List A effects</td>
<td>List B effects</td>
</tr>
<tr>
<td>1. A donor contributed $100,000 and stipulated that it be invested permanently.</td>
<td>A. Increases net assets without donor restrictions</td>
<td>H. Increases cash flows from operating activities</td>
</tr>
<tr>
<td>2. Donors contributed $500,000 for the acquisition of equipment.</td>
<td>B. Increases net assets with donor restrictions</td>
<td>I. Decreases cash flows from operating activities</td>
</tr>
<tr>
<td>3. Depreciation expense of $750,000 was recorded for 20X3.</td>
<td>C. Decreases net assets without donor restrictions</td>
<td>J. Increases cash flows from investing activities</td>
</tr>
<tr>
<td>4. $3,000,000 was received, representing tuition for the spring, summer and fall semesters.</td>
<td>D. Decreases net assets with donor restrictions</td>
<td>K. Decreases cash flows from investing activities</td>
</tr>
<tr>
<td>5. Investments of $100,000 were acquired with the cash received from the donor in transaction 1.</td>
<td>E. Transaction not reported on the statement of activities</td>
<td>L. Increases cash flows from financing activities</td>
</tr>
<tr>
<td>6. Interest and dividends of $8,000 were received from the investments acquired in transaction 5. The donor stipulated that earnings be used for student scholarships in 20X3.</td>
<td></td>
<td>M. Decreases cash flows from financing activities</td>
</tr>
<tr>
<td>7. $75,000 was received from donors in 20X3 who had pledged that amount in 20X2. The cash will be used to pay for a marketing campaign that aimed at increasing enrollment. The marketing cost was incurred in 20X3 and will be paid in 20X4.</td>
<td></td>
<td>N. Transaction not reported on the statement</td>
</tr>
<tr>
<td>8. $900,000 was paid to faculty for salaries incurred during the year.</td>
<td></td>
<td>O. Transaction reported in the schedule reconciling change in net assets to net cash provided from operating activities</td>
</tr>
<tr>
<td>9. $25,000 was given to the faculty for summer research grants. The grants came from donations made by alumni in 20X2.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. $40,000 of donations were received from alumni who did not stipulate how their donations were to be used.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Task-Based Simulation 2

A not-for-profit client wishes to recognize pledges as revenue at the time the pledge is made, but is uncertain as to whether or not that is allowed. Identify the location in professional standards that indicates when contributions may be recognized as revenue.

Task-Based Simulation 3

A not-for-profit entity received an investment as a contribution and wishes to determine how to recognize it. Identify the location in professional standards that indicates how and when to recognize an investment acquired by contribution.
TASK-BASED SIMULATION SOLUTIONS

Task-Based Simulation Solution 1

1. **(B,L)** When a donor stipulates that some or all of a contribution is to be retained permanently, such as a requirement that it be invested permanently, the resources will be classified as net assets with donor restrictions. Since they are restricted to be used for the purpose of acquiring permanent assets, the contribution is considered an inflow from financing activities.

2. **(B,L)** When contributions are restricted for a particular purpose or for a particular period of time, they are considered net assets with donor restrictions. When they are used for the intended purpose or retained for the requisite period, they then are released from restrictions. Since the resources are to be used to acquire equipment, a long-term asset, the contribution is considered an inflow from financing activities.

3. **(C,O)** All expenses, including depreciation, are considered reductions in net assets without donor restrictions. Since it is an expense that does not involve the use of cash, it is a reconciling item on the reconciliation of the change in net assets to cash flows from operating activities, if the NPO provides such a reconciliation or prepares its statement of cash flows using the indirect method.

4. **(A,H)** Amounts received for tuition are considered revenues and, in general, are increases in net assets without donor restrictions. They represent inflows of funds from the core operations of the college and are classified as inflows from operating activities.

5. **(E,K)** The purchase of securities represents the use of one donor-restricted asset, cash, to acquire another donor-restricted asset, investments. As a result, there is no change in net assets with donor restrictions. The use of cash to acquire investments would be classified as an outflow for investing activities.

6. **(B,H)** Since the donor stipulated that interest and dividends be used for scholarships, those funds are considered restricted until such time as they are used for that purpose, when they become unrestricted. As a result, they are donor-restricted funds and the receipt would represent an increase in net assets with donor restrictions. Interest and dividends received are considered cash inflows from operating activities.

7. **(D,H)** The amounts pledged from donors were recognized as revenues when received in 20X2, increasing net assets with donor restrictions at that time. In 20X3, the costs were actually incurred, and the funds were released from restrictions, resulting in a decrease in donor-restricted funds and an increase in net assets without donor restrictions. At the same time, the expense is recognized, which decreases net assets without donor restrictions resulting in no net change. The reclassification of the cash from donor-restricted to unrestricted is considered an inflow of unrestricted cash and, as a result, an inflow from operating activities.

8. **(C,I)** All expenses are recognized as decreases in net assets without donor restrictions. The payment of expenses, including salaries, is an outflow from operating activities.
9. (D,I) When the donations were received in 20X2, they were recognized as an increase in net assets with donor restrictions. When they are used for their intended purpose, they are first reclassified to net assets without donor restrictions, representing a decrease in donor-restricted net assets. The increase in net assets without donor restrictions is offset by the decrease resulting from payment of the research grants, so there is no net change in net assets without donor restrictions. The payments of grants is considered a cash outflow from operating activities.

10. (A,H) Contributions received that are not restricted by external parties are considered unrestricted resources and result in an increase in net assets without donor restrictions. Contributions received are considered cash inflows from operating activities.

**Task-Based Simulation Solution 2**

| FASB ASC | 958 | 605 | 25 | 2 |

**Task-Based Simulation Solution 3**

| FASB ASC | 958 | 325 | 25 | 1 |
Recording the Acquisition

When the acquirer records the transaction as an investment, recording the acquisition is quite straightforward. The Investment in acquiree is debited for the purchase price, meaning the total fair value of the consideration paid by the acquirer. Essentially, this is the balancing entry to offset the accounts being credited in the remainder of this entry. The book values of the acquiree accounts are ignored.

- Cash is credited for any amounts paid.
- Common stock is credited for the par value of any shares being issued by the acquirer.
- Additional paid-in capital is credited for the excess of the fair value of any shares being issued over their par value.

There is no entry to retained earnings, since the acquirer does not retroactively combine the income of the acquirer in a purchase. The Acquiree's income is included from the date of acquisition (prospective, not retroactive).

The Measurement Period and Measurement Period Adjustments

In some circumstances, the acquirer may believe that the measurement of the fair value of an acquiree, which is used to determine an appropriate acquisition price, is reliable, while the fair values of some of the individual identifiable assets acquired and liabilities assumed could not be reliably determined on a timely basis.

If the acquirer is required to prepare consolidated financial statements prior to being able to obtain a more accurate measurement, the following procedures will be applied:

- The asset or liability for which a reliable fair value has not been determined will be recorded at management's best estimate based on information that is available with that amount referred to as a “provisional” value.
- As a result of using the provisional values, the amount reported as goodwill may be over- or understated, depending on the overstatement or understatement of the assets and liabilities recorded at their provisional amounts.
- Depreciation, amortization, interest income or expense, and other revenue and expense items that are affected by those values are recognized as if the provisional amounts are the actual fair values and the consolidated financial statements are prepared accordingly.

The entity then has one year from the date of acquisition, referred to as the measurement period, to obtain a more reliable measurement. If management is unable to do so, the provisional amounts are accepted as the actual amounts and the items are accounted for as comparable items would be. Neither the items nor their income statement effects will be adjusted.

If, on the other hand, management is able to obtain a more reliable measurement, the following procedures will be followed:

- The assets or liabilities will be adjusted to the amounts that would have been their carrying values as of the balance sheet date if they had originally been recorded at their more reliable amounts.
- The income statement effects, including such items as depreciation and amortization expense, interest net of amortization of discount or premium, and other items that would
have been affected by the change in carrying value will be recalculated as if the appropriate amount had been used on the date of acquisition.

- Current period amounts are adjusted to reflect the correct amounts that would have been reported if the assets and liabilities had been originally recorded at the appropriate amount.
- Amounts related to prior periods were originally required to be accounted for as prior period adjustments, correcting items for the previous period, if comparative financial statements are presented, and recording the net change as an adjustment to beginning retained earnings if only single period financial statements are presented.
- As a result of ASU 2015-16, issued September 2015 and effective for public entities for periods beginning after December 15, 2015, and for nonpublic entities for periods beginning after December 15, 2016, with earlier application permitted, the adjustments to prior period income statement items are reported in the current period's income statement on a “catch up” basis:
  - They may be included with the current period's amounts with the amounts for the prior period disclosed in the notes to the financial statements; or
  - They may be reported separately from the current period's amounts on the face of the income statement.
Page 31-24

The reporting entity will evaluate significant relationships with other entities to determine if it is the primary beneficiary of a VIE. The evaluation consists of 4 steps:

1. The natures of the entities and their relationship are evaluated to determine if there is a potential for a VIE, considering certain exempt relationships identified in ASC 810.
2. The potential VIE is evaluated to determine if it is self-sufficient or if there are indications that it is dependent on some form of additional subordinated financial support. Does the other entity have one or more characteristics of a VIE?
   - There may not be sufficient equity to sustain normal operations.
   - The equity holders may not have the normal characteristics of equity holders.
3. The reporting entity determines if it has a variable interest in the potential VIE, meaning that it will be affected if the value of the other entity's assets increase or decrease.
4. The reporting entity determines if it is the primary beneficiary, which is an entity with a variable interest in the potential VIE that both:
   - Has the power and authority to direct the operations and activities of the potential VIE that are most significant to its economic performance.
   - Participates in the VIE's profits and losses to an extent that is potentially significant to the VIE.

In some cases, related entities that are under common control, essentially meaning that they have the same equity holders, have separate interests in the same VIE, such that:

- On individual entity has a controlling financial interest in the VIE.
- If the interests were to be combined, the combined interest represents a controlling financial interest.

If one of the entities under common control has the first characteristic of the primary beneficiary in the ability to direct the entity's primary operations, it will determine if it would have the second characteristic by combining the financial interests of related entities under common control, that entity will be considered the primary beneficiary and would be required to prepare consolidated financial statements.

If none of the related entities under common control has the first characteristic but, as a group, the related entities have both characteristics of the primary beneficiary, the entity with the closest relationship to the VIE will be considered the primary beneficiary and will be required to prepare consolidated financial statements.

Certain relationships are exempt from applying the VIE provisions. For example, a for profit entity will generally not consolidate with a not-for-profit entity, a for profit entity will generally not consolidate with a governmental entity, and an entity will not consolidate with its entities representing pension trusts or other retirement benefits for its employees.