Principles of Financial Statement Presentation

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Field of Study	**Accounting**
Level of Knowledge	**Overview**
Prerequisite:	**General understanding of FASB ASC**
Advanced Preparation	**None**
Recommended CPE hours	**4**
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Course Overview

This course provides an overview of the key presentation requirements with respect to an entity's financial statements. This includes a discussion of key principles related to an entity's overall presentation as well as specific topics with respect to its balance sheet, income statement, comprehensive income, statement of cash flows, as well as notes to the financial statements. The course also addresses the considerations around changes in accounting principles. The information related to this course is primarily sourced from the Financial Standards Accounting Board's (FASB) Accounting Standards Codification (ASC).

Learning Objectives

Upon completion of this course, you will be able to:

- Recognize overall financial statement presentation requirements
- Identify requirements for discontinued operations and liquidation basis of accounting reporting
- Determine when certain balance sheet accounts can be offset
- Identify presentation requirements for the income statement and comprehensive income
- List the different methods used for statement of cash flow presentation
- Differentiate between operating, financing, and investing activities in the statement of cash flows
- Identify disclosure requirements with respect to an entity's accounting policies
- Recognize the requirements regarding changes in accounting principles

Introduction

When first embarking on a journey of the FASB ASC, subsequent to the discussion of Generally Accepted Accounting Principles (GAAP) in ASC Topic 105, one of the first overall topics relates to presentation. The primary ASC topics with respect to presentation include, but are not limited to, requirements around the balance sheet, income statement, comprehensive income, statement of cash flows, notes to financial statements, etc. While the presentation requirements are extensive and include many major topics, the focus of this course is on the following ASC topics:

- ASC Topic 205, *Presentation of Financial Statements*
- ASC Topic 210, *Balance Sheet*
- ASC Topic 220, *Comprehensive Income*
- ASC Topic 225, *Income Statement*
- ASC Topic 230, *Statement of Cash Flows*
- ASC Topic 235, *Notes to Financial Statements*
- ASC Topic 250, *Accounting Changes and Error Corrections*

As a result, this course is organized around these primary ASC topics with expansive discussion of the related subtopics included within each. For example, as will be noted in the first section of this course, the discussion around presentation of financial statements will include an overview of other subtopics within ASC 205 to include discontinued operations, liquidation basis of accounting, and going concern reporting considerations.

Presentation of Financial Statements

As noted above, the primary requirements with respect to presentation of financial statements is prescribed within ASC Topic 205. Additionally, this ASC topic is further broken down into various subtopics to include subtopic 20 (Discontinued Operations), subtopic 30 (Liquidation Basis of Accounting), and subtopic 40 (Going Concern). While there are additional industry specific subtopics included within ASC Topic 205 (for example, subtopic 915 for development stage entities and subtopic 954 for health care entities), these are outside the scope of this course.

One of the key principles with respect to financial statement presentation is that the presentation of comparative financial statements in annual and other reports enhances the usefulness of such reports and brings out more clearly the nature and trends of current changes affecting the entity (ASC 205-10-45-1). Further to this point, this type of comparative presentation emphasizes the fact that statements for a series of periods are far more significant than those for a single period (ASC 205-10-45-1). In situations where comparability is affected based on certain reclassifications or other significant reasons, entities should explain the reasons for these effects on comparability. In short, it is a well-recognized principle that any change in practice that affects comparability of financial statements should be appropriately disclosed (ASC 205-10-50-1).

Discontinued Operations

As noted above, ASC Topic 205 includes several subtopics, one of which is subtopic 20 related to discontinued operations. ASC Topic 205-20 primarily provides guidance on the presentation and disclosure requirements with respect to discontinued operations, including the criteria for determining when the presentation of discontinued operations is appropriate. Separate reporting of discontinued operations is appropriate in order to provide users of financial statements the information required to determine and assess the effects of a disposal transaction on the continuing operations of an entity.

What do we mean though by the term discontinued operations? Prior to the adoption of the FASB's Accounting Standards Update (ASU) 2014-08, *Reporting Discontinued Operations and Disclosure of Disposals of Components of an Entity*, it was noted that many asset disposals were being reported as discontinued operations by entities. In the FASB's Basis for Conclusions (BC), the following was noted in BC2:

> "Some stakeholders told the Board that under current guidance too many disposals of assets qualify for discontinued operations presentation, resulting in financial statements that are less decision useful for users and higher costs for preparers. Additionally, some users of financial statements stated that too many disposals of small groups of assets that are recurring in nature are classified as discontinued operations. Those users agree that a disposal activity should be presented in discontinued operations only when an entity has made a strategic shift in its operations."

As a result of the feedback received and FASB's amended guidance, a disposal transaction qualifies for reporting as a discontinued operation if all of the following criteria are met (ASC 205-20-45-1B):

- The disposal group is a component of an entity (or a group of components);
- The component of an entity or group of components of an entity is disposed of by sale and meets the held for sale criteria, or it is to be disposed of other than by sale (such as an abandonment or in a distribution to owners in a spinoff);
- The component of an entity or group of components being disposed of represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results

The key point to emphasize with reporting discontinued operations is that the disposal must represent a strategic shift that has (or will have) a major effect on an entity's operations and financial results. With the FASB including this amended guidance as a result of ASU 2014-08, less asset disposals should qualify as discontinued operations. Each of the above criteria for discontinued operations is discussed in more detail in the following sections.

Disposal Group is a Component (or Group)

As noted above, one of the first criteria for a transaction qualifying for discontinued operations reporting is that the disposal group is a component of an entity. Specifically though, what is meant by a "component of an entity"? The FASB ASC Master Glossary defines this term as the following:

> "A component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. A component of an

entity may be a reportable segment or an operating segment, a reporting unit, a subsidiary, or an asset group."

Based on the above definition, it is clear that the determination of a component does not specifically rely on the legal form of the discontinued component. In other words, whether disposal group is a subsidiary, a division, or an investee, is not important in the assessment. What is important is whether the component has distinguishable operations and cash flows from the rest of the entity. This is not to say that a subsidiary or a division does not meet this definition. What is important is to note that solely because a disposal group is considered a subsidiary or a division, that classification in and of itself does not support the determination of whether the disposal group is a component. Because there are no bright lines with respect to the definition of a component, professional judgment is definitely needed when determining whether a disposal group constitutes a component of an entity.

Meets Held for Sale Criteria

Once an entity has concluded that the disposal group represents that of a component of the entity, the next criteria that must be met for discontinued operations reporting relates to whether that component meets the held for sale criteria. In order to be classified as held for sale, a long-lived asset to be sold must meet all of the following criteria (ASC 360-10-45-9):

- Management, having the authority to approve the action, commits to a plan to sell the asset (disposal group)
- The asset (disposal group) is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (disposal groups).
- An active program to locate a buyer and other actions required to complete the plan to sell the asset (disposal group) have been initiated
- The sale of the asset (disposal group) is probable, and transfer of the asset (disposal group) is expected to qualify for recognition as a completed sale, within one year, except as permitted by paragraph 360-10-45-11. The term probable refers to a future sale that is likely to occur
- The asset (disposal group) is being actively marketed for sale at a price that is reasonable in relation to its current fair value
- Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn

It is important to note that even if only one of the above criteria is not met, a long-lived asset cannot be classified as held for sale. Further to this point, if at any time the criteria note above is not met (subject to limited exceptions), the long-lived asset should be reclassified as held and used (ASC 360-10-45-10). An expansive discussion of each of the criteria above is included in the following sections.

<u>Management Commits to a Plan to Sell the Asset</u>

Ordinarily, the commitment to sale should be evidenced by appropriate documentation and approved by the appropriate level of authority within the entity. In other words, if given the magnitude of the sale it would require CEO approval, the criteria would not be met until the CEO approves the sale. If the sale is approved by someone below the CEO that would not have the sufficient authority (but would nonetheless be included in the approval chain) then the criteria cannot be met.

The FASB does not provide any additional information with respect to this criteria within GAAP. However, what can be interpreted from this criteria is that management should actually commit to the sale and not simply commit to a plan of selling to an interested party. Said another way, simply exploring the opportunity to sell an asset or assessing the possibility of selling is not a management commitment to a plan to sell the asset.

<u>Asset Available for Immediate Sale in its Present Condition</u>

In order for an asset to be available for immediate sale, an entity must have both the intent and ability to sell the component in its present condition. Said another way, if an entity imposes a delay in the actual transfer of the component, this would call into question whether the component is actually available for immediate sale in its present condition.

The FASB also included language that the sale only be subject to usual and customary terms, which suggests that an entity that is attempting to sell the component should determine whether the terms are consistent/comparable with similar entities who also sell similar assets.

Active Program to Locate a Buyer and Other Actions have been Initiated

The FASB does not provide additional guidance with respect to this criteria, so entities are afforded some additional flexibility in justifying that this criteria has been met. However, the key point to note here is that the entity should be making progress in identifying a buyer related to the disposal transaction. In some situations, commissioning a sales agent to help facilitate locating a buyer for the entity's long-lived asset would help to justify an entity has met this criteria. Additionally, other forms of marketing activities would help to serve as evidence that this criteria is met. The important point to note with respect to this criteria is that an entity cannot simply assert it intends to sell an asset, it has to prove, and document, that it is taking steps to accomplish that goal. The method with which that intent is proved will depend on the facts and circumstances of the entity and the component being marketed for sale.

Sale is Probable and Expected to be Completed as a Sale in One Year

This criteria should be viewed as two separate requirements. The first requirement is that the sale must be probable. Next, it must be completed within a year (subject to limited exceptions). Within ASC 360-10-45-9(e) the FASB defines the term probable as "likely to occur." If an entity concludes that this is the case, it must next assess whether the sale can be completed in one year.

While the conclusion with respect to this criteria can be subjective, the FASB does include implementation guidance that assists entities in understanding how the assessment of this criteria can be applied. For example, ASC 360-10-55-43 provides two examples of situations where this criteria cannot be met. This includes the following:

- An entity commits to a plan to sell a property that is in use, and the transfer of the property will be accounted for as a sale-leaseback through which the seller-lessee will retain more than a minor portion of the use of the property.
- An entity that is a commercial leasing and finance company is holding for sale or lease equipment that has recently come off lease and the ultimate form of a future transaction (sale or lease) has not yet been determined.

In both of the situations above, the criteria for a sale being probable and completed within a year is not met. As a result, the component subject to the sale cannot be classified as held for sale.

The second component of this criteria relates to the fact that the sale must occur within a year. As noted above, there are limited exceptions to this requirement. In general, these exceptions occur when a situation takes place that is outside the control of the entity. Said another way, the entity is not impeding the sale based on certain conditions, instead, certain outside circumstances that the entity cannot control is preventing the sale from occurring within the year time frame. The general guidance here to note is that a delay in the period required to transact a sale does not automatically prevent a component from being classified as held for sale if the delay is caused by events beyond the entity's control and the entity remains committed to consummating the sale. Accordingly, ASC 360-10-45-11 includes three specific exceptions to this one year requirement. These include the following:

- If at the date an entity commits to a plan to sell a long-lived asset (disposal group) the entity reasonably expects that others (not a buyer) will impose conditions on the transfer of the asset (group) that will extend the period required to complete the sale and both of the following conditions are met:
  - Actions necessary to respond to those conditions cannot be initiated until after a firm purchase commitment is obtained, and
  - A firm purchase commitment is probable within one year.

- If an entity obtains a firm purchase commitment and, as a result, a buyer or others unexpectedly impose conditions on the transfer of a component previously classified as held for sale that will extend the period required to complete the sale and both of the following conditions are met:
    - Actions necessary to respond to the conditions have been or will be timely initiated, and
    - A favorable resolution of the delaying factors is expected.
- If during the initial one-year period, circumstances arise that previously were considered unlikely and, as a result, a component previously classified as held for sale is not sold by the end of that period and all of the following conditions are met:
    - During the initial one-year period the entity initiated actions necessary to respond to the change in circumstances
    - The component is being actively marketed at a price that is reasonable given the change in circumstances
    - The criteria in paragraph 360-10-45-9 are met.

<u>Actively Marketed at a Price Reasonable to its Fair Value</u>

This criteria serves to evidence that an entity actually has the intent to sell a component. The key point to note here is that if an entity truly has the intent to sell an asset, it will attempt to sell that asset within a reasonable range of its fair market value. For example, if an entity is attempting to sell the component for a price significantly in excess of its fair market value, then this calls into question whether the sale is in fact probable. An entity simply testing the market would not provide evidence that this criteria is met.

<u>Unlikely Significant Changes to Plan will be made or the Plan will be Withdrawn</u>

If an entity meets all of the previous requirements, and does not anticipate any significant changes to the plan (or that the sale will be cancelled), then the entity has meet the requirements for held for sale classification for the component. Like some of the other criteria previously discussed, the FASB does not provide expanded guidance with respect to this criteria. If an entity has a well-developed plan and course of action, coupled with the fact that the entity does not have a history of "pulling the plug" on similar sale transactions, it's reasonable to assume that the entity has met this criteria.

Disposal Represents a Strategic Shift

The final criteria with respect to discontinued operations reporting is that the disposal must represent a strategic shift. Like many other standards within GAAP, the definition of what represents a strategic shift does not include any bright lines, and as a result, professional judgment is needed to determine whether a disposal constitutes a strategic shift. The FASB does, however, include certain examples of what would constitute a strategic shift. ASC 205-20-45-1C identifies examples such as a disposal of a major geographical area, a major line of business, a major equity method investment, or other major parts of an entity. Additionally, the implementation guidance found within subtopic 55 also provides several examples of instances when a certain disposal transaction results in a strategic shift. Refer to two of these examples included below.

Example 1 – Consumer Products Manufacturer

ASC 205-20-55-84 thru 86

An entity manufactures and sells consumer products that are grouped into five major product lines. Each product line includes several brands that comprise operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, for that entity, each major product line includes a group of components of the entity. The entity has experienced high growth in its discount cleaning product line that has lower price points than its premium cleaning product line. Total revenues from the discount cleaning product line are 15 percent of the entity's total revenues; however, the discount cleaning product line will require significant future investments to increase its profits. Therefore, the entity decides to shift its strategy of selling cleaning products at multiple price points and focus solely on selling cleaning products at a premium price point. As a result, the entity decides to sell the discount cleaning product line. Because the entity shifts its strategy of offering discount cleaning products to consumers and because the discount cleaning product line is one of five major product lines that is a major part of the entity's operations and financial results, the disposal represents a strategic shift that is reported in discontinued operations.

Example 2 – General Merchandise Retailer

ASC 205-20-55-90 thru 92

An entity that is a general merchandise retailer operates 1,000 retail stores in 2 different store formats—malls and supercenter stores—throughout the United States. The entity divides its stores into five major geographical regions: the Northwest, Southwest, Midwest, Northeast, and Southeast. For that entity, each retail store comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, for that entity, each retail store is a component of the entity. The entity has experienced declining net income at its 200 stores located in malls across all 5 major geographical regions. Historically, net income from the 200 stores in malls has been in a range of 30 to 40 percent of the entity's total net income. Total net income from the 200 stores in malls is down to 15 percent of the entity's total net income because of declining customer traffic in malls. Therefore, the entity decides to shift its strategy of selling products in malls and sell the 200 stores located in malls. Because the entity decides to shift its strategy of selling products in malls and focus solely on its supercenter stores and because the 200 stores located in malls are a major part of the entity's operations and financial results, the disposal represents a strategic shift that is reported in discontinued operations.

Reporting Discontinued Operations

Once it is concluded that a disposal transaction meets the criteria for being reported as a discontinued operation, the next consideration to address is how specifically a discontinued operation is presented on an entity's financial statements. The following sections address these presentation considerations both from an income statement and balance sheet perspective.

Income Statement Presentation

Simply put, the results of the discontinued operations are required to be reported as a separate component of income (ASC 205-20-45-3A). Further to this point, the FASB includes the following illustration as an example of this type of separation presentation.

Income from continuing operations before income taxes	$XXXX	
Income taxes	XXX	
Income from continuing operations		$XXXX
Discontinued operations (Note X)		
Loss from operations of discontinued Component X (including loss on disposal of $XXX)		XXXX
Income tax benefit		XXXX
Loss on discontinued operations		XXXX
Net income		$XXXX

As you can note from the illustration above, this type of presentation clearly identifies and calls out the discontinued operations, which allows for more decision-useful information for investors. In addition to the activity illustrated above, an entity should also consider the related gain or loss recognized on the disposal. In this instance, ASC 205-20-45-3B prescribes that a gain or loss on disposal should be presented separately on the face of the income statement or, alternatively, it can be disclosed in the notes to the financial statements.

In addition to the presentation considerations above, an entity should also consider the appropriate accounting for adjustments made to amounts previously reported in discontinued operations. What is an example of an adjustment? The FASB notes in ASC 205-20-45-5 that adjustments can be any of the following:

- The resolution of contingencies that arise pursuant to the terms of the disposal transaction, such as the resolution of purchase price adjustments and indemnification issues with the purchaser
- The resolution of contingencies that arise from and that are directly related to the operations of the discontinued operation before its disposal, such as environmental and product warranty obligations retained by the seller
- The settlement of employee benefit plan obligations (such as pension, postemployment benefits other than pensions, etc.), provided that the settlement is directly related to the disposal transaction

When these adjustments occur, an entity is required to present these separately in the current period in the discontinued operations section of its income statement (ASC 205-20-45-4).

<u>Balance Sheet Presentation</u>

Similar to the presentation of a discontinued operation in an entity's income statement, the same principles hold true for balance sheet presentation. That said, in the period that a discontinued operation meets the criteria to be classified as held for sale, and all prior periods presented, the assets and liabilities of the discontinued operation should be presented separately in the balance sheet (ASC 205-20-45-10). Additionally, it is also important to note that the respective assets and liabilities of the discontinued operation should not be offset and presented as a single amount (ASC 205-20-45-10).

Entities are also afforded some flexibility in the presentation of the major classes of assets and liabilities of a discontinued operation. For example, an entity can either present on the face of the balance sheet these major classes, or alternatively, an entity can elect to disclose these major classes in the notes to the financial statements (ASC 205-20-45-11). One final point to note though is that if a loss is recognized on a discontinued operation, that loss should not be allocated to the major classes of assets and liabilities (ASC 205-20-45-11).

Discontinued Operations Disclosures

One of the more involved reporting processes with respect to discontinued operations is fulfilling the financial statement disclosures prescribed by GAAP. Further to this point, the required disclosures regarding discontinued operations varies depending on the nature of the discontinued operation (ASC 205-20-05-2). For example, if a discontinued operation includes a component or group of components of an entity that is not an equity method investment, a more comprehensive set of disclosures about the discontinued operation is required (ASC 205-20-05-2). Alternatively, if the discontinued operation includes an equity method investment, or a business or nonprofit activity that is classified as held for sale on acquisition, a more limited set of disclosures is required (ASC 205-20-05-2).

First, we turn our attention to the required disclosures for all types of discontinued operations. The required disclosures include the following (ASC 205-20-50-1 thru 4B):

- A description of both of the following:
    - The facts and circumstances leading to the disposal or expected disposal
    - The expected manner and timing of that disposal
- The gain or loss recognized, if not separately presented on the face of the income statement as part of the discontinued operations section
- The segment in which the discontinued operations is included
- A description of the facts and circumstances leading to a decision to change the plan of sale, if applicable
- The nature and amount of adjustments to amounts previously reported in discontinued operations that are directly related to the disposal of a discontinued operation in a prior period
- Information with respect to the entity's continuing involvement with a discontinued operation after the disposal date
    - Examples of continuing involvement can include, but is not limited to, the following:
        - Supply and distribution agreements
        - Financial guarantees
        - Option to repurchase a discontinued operation

    - Equity method investment in the discontinued operation
  - If an entity determines it does have a continuing involvement, it is required to disclose the following:
    - A description of the nature of the activities that give rise to the continuing involvement
    - The period of time during which the involvement is expected to continue
    - The amount of any cash inflow or outflows from or to the discontinued operation after the disposal transaction
    - Revenues or expenses presented in continuing operations after the disposal transaction that before the disposal transaction were eliminated in consolidated financial statements as intra-entity transaction

It's also important to note that there are additional required disclosures for a discontinued operation if an entity retains an equity method investment in the discontinued operation. These disclosures include each of the following (ASC 205-20-50-4B):

- Pretax income of the investee in which the entity retains an equity method investment
- The entity's equity ownership interest in the discontinued operations both before and after the disposal transaction
- The entity's share of the income or loss of the investee in the period(s) after the disposal transaction
  - This also includes identifying the line item in the income statement where this amount is included

Review Questions

1. Which of the following FASB ASC topics prescribe the overall financial statement presentation requirements for reporting entities?
    a. ASC Topic 205.
    b. ASC Topic 210.
    c. ASC Topic 230.
    d. ASC Topic 250.

2. Which of the following ASUs resulted in less asset disposals qualifying for discontinued operations recognition?
    a. ASU 2014-05.
    b. ASU 2014-08.
    c. ASU 2015-01.
    d. ASU 2016-02.

3. Each of the following is a criteria for a disposal meeting the held for sale criteria, except?
    a. Management commits to a plan to sell the asset.
    b. The asset is available for immediate sale in its present condition.
    c. An active program to locate a buyer will commence within 6 months.
    d. The sale of the asset is probable and expected to be completed within one year.

Liquidation Basis of Accounting

We now turn our attention to the liquidation basis of accounting. In short, liquidation is the process whereby an entity converts its assets to cash or other assets and settles its obligations with creditors in anticipation of ceasing all of its activities. As noted within the FASB ASC Master Glossary, liquidation may be either compulsory or voluntary. An entity in liquidation is required to prepare its financial statements using a basis of accounting that communicates information to users of those financial statements to enable them to appropriately develop expectations about how much the organization will have available for distribution to investors after disposing of its assets and settling its obligations.

In 2013, the FASB issued ASU 2013-07, *Presentation of Financial Statements (Topic 205): Liquidation Basis of Accounting*, which clarified when and how public and not-for-profit organizations should prepare statements using the liquidation basis of accounting. Prior to the release of this ASU, GAAP provided minimal guidance on the application of the liquidation basis of accounting. As noted within the previous discussions, the accounting guidance with respect to the liquidation basis of accounting is prescribed within subtopic 30 under ASC Topic 205. This guidance, as noted within ASC 205-30-15-1, is applicable to all entities except investment companies regulated under the Investment Company Act of 1940.

The primary issue an entity should consider before preparing its financial statements using the liquidation basis or accounting is to determine whether liquidation is imminent. If an entity concludes that liquidation is not imminent, the entity should continue to prepare its financial statements under the assumption that it is a going concern. Alternatively, if liquidation is imminent, the entity should prepare its financial statements using the liquidation basis of accounting. Herein lies the fundamental question - how is the term "imminent" defined within the accounting standards?

ASC 205-30-25-2 prescribes that liquidation is imminent when either of the following occurs:

- A plan for liquidation has been approved by the person or persons with the authority to make such a plan effective, and the likelihood is remote that any of the following will occur:
    - Execution of the plan will be blocked by other parties
    - The entity will return from liquidation
- A plan for liquidation is imposed by other forces (such as involuntary bankruptcy, and the likelihood that the entity will return from liquidation is remote

In the FASB's BCs for ASU 2013-07, the FASB noted the following with respect to the use of the imminent (BC9):

> "The Board chose to use the term imminent because it is consistent with the guidance on the liquidation basis of accounting that currently exists in the AICPA's Codification of Statements on Auditing Standards Section AU 9508, Reports on Audited Financial Statements: Auditing Interpretations of Section 508, and Statement of Position 93-3, Rescission of Accounting Principles Board Statements."

Prior to the final amendments being adopted as a result of ASU 2013-07, the FASB heard from respondents to its 2012 Exposure Draft that the definition of the term "imminent" was subjective and, therefore, the guidance would be difficult to apply. While the Board made targeted amendments on account of this feedback, in its final assessment the Board noted that an entity's primary evaluation should be whether the entity is compelled to sell its assets in exchange for proceeds that are not commensurate with the fair value of those assets (BC11).

The FASB included two examples within the implementation guidance (subtopic 55) to assist entities in determining whether it should apply the liquidation basis of accounting. These two examples are included below.

Example 1 – Unplanned Liquidation

ASC 205-30-55-2

Entity A is a manufacturer of goods. In 20X3, Entity A began experiencing financial difficulty because of declining market demand for its goods. On September 19, 20X3, Entity A's board of directors approved a plan for liquidation. The board of directors had the authority to make the plan effective. There were no other parties that could block the execution of the plan, and the likelihood that the entity would return from liquidation was remote. Entity A should begin applying the liquidation basis of accounting as of September 19, 20X3, which is the date that Entity A's board of directors approved the plan for liquidation.

Example 2 – Liquidation That Does Not Follow a Plan Specified at an Entity's Inception

ASC 205-30-55-2

The governing documents from Entity B's inception specified that its contractual life would end in Year 10. On March 11 of Year 6, Entity B's board of directors determined that the entity would not be able to meet its debt obligations and voted to begin liquidating the entity earlier than planned. Entity B required approval from Entity C, a third party, to make its plan of liquidation effective. Entity B obtained approval from Entity C on April 10 of Year 6. No other parties could block the execution of the plan of liquidation, and the likelihood that Entity B would return from liquidation was remote. Under the plan of liquidation, Entity B anticipated that it would not have sufficient time to sell its assets in exchange for consideration that would approximate the fair value of those assets. Entity B should begin preparing its financial statements using the liquidation basis of accounting as of April 10 of Year 6, which is the date that the entity had obtained all of the approvals required to make its plan of liquidation effective.

Measurement

Once an entity has concluded that liquidation is imminent and that it should apply the liquidation basis of accounting, the next obvious question is how should that basis of accounting be applied? More specific to this point, how should an entity's assets and liabilities be valued and presented? The FASB provided additional insight in its BC13 within ASU 2013-07 as follows:

> "The Board believes that financial statements that are prepared using the liquidation basis of accounting provide users of those financial statements with specialized information because the emphasis shifts from reporting about the entity's economic performance and position to reporting about the amount of cash or other consideration that an investor might reasonably expect to receive after liquidation. Financial statements that are prepared using the liquidation basis of accounting should convey information about the amount of cash or other consideration that an entity expects to collect and the amount that the entity is obligated or expects to be obligated."

With respect to an entity's assets, an entity is required to measure assets to reflect the estimated amount of cash or other consideration that the entity expects to collect in settling or disposing of those assets in carrying out its plan for liquidation (ASC 205-30-30-1). While in some cases fair value may approximate the amount that an entity expects to collect, an entity should not automatically presume this to be true for all assets (ASC 205-30-30-1). The important takeaway here is that the value ascribed to the assets should be representative of the cash proceeds (or other consideration) the entity expects to receive.

Switching gears, an entity also should consider how it measures and presents its liabilities when applying the liquidation basis of accounting. Generally speaking, an entity should measure its liabilities in accordance with measurement provisions of other ASC topics. In other words, an entity should follow other applicable GAAP for its liabilities and other obligations. The Board included expansive discussion on this topic within its BC15 as follows:

> "The Board observed that unless it was legally released from having to pay a liability, an entity generally would not be able to estimate the amount that it would be required to pay in any meaningful way. Consequently, the Board decided that liabilities should not be written down under the liquidation basis until legally forgiven. Although the measurement basis for an entity's liabilities will not change when the entity determines that liquidation is imminent, the Board expects that this determination could change an entity's measurement assumptions and, therefore, might affect the amounts recognized in the statement of net assets in liquidation. For example, as a result of its determination that liquidation is imminent, the entity might conclude that it would be required to pay a particular liability earlier than it had previously contemplated."

There are two exceptions to the overall principles noted above that are prescribed in ASC 205-30-25-6 thru 7. This includes the following:

- An entity should accrue estimate costs to dispose of assets or other items that it expects to sell in liquidation and present those costs in the aggregate separately from those assets or items; and
- An entity should accrue costs and income that it expects to incur or earn through the end of liquidation if and when it has a reasonable basis for estimation

It's also important to note that the FASB acknowledges that the measurement principles outlined above might require certain estimations be made. The important point to note here is that when certain estimations are made, and certainly those that result in material adjustments/changes, an entity should disclose those significant assumptions used to measure the assets and liabilities.

Finally, at each reporting date, an entity should remeasure its assets, liabilities, accruals, and other costs or income to reflect the actual or estimate change in carrying value from the previous reporting date (ASC 205-30-35-1).

Presentation

At minimum, an entity using the liquidation basis of accounting is required to prepare the following with a description of each from the ASC Master Glossary:

- A statement of net assets in liquidation
  - This is a statement that presents a liquidating entity's net assets available for distribution to investors and other claimants as of the end of the reporting period.
- A statement of changes in net assets in liquidation
  - This is a statement that presents the changes during the period in net assets available for distribution to investors and other claimants during liquidation.

The FASB also provided expanded discussion for why it prescribed these presentation as requirements in its BC17 as follows:

> "The Board decided to require a statement of changes in net assets in liquidation instead of a statement of comprehensive income because it considers the former to be more relevant to users of the financial statements of an entity that is in liquidation. While an entity is not explicitly required to prepare a statement of net assets as of the date liquidation becomes imminent, the Board acknowledges that such information would be necessary so that the entity could prepare the statement of changes in net assets in liquidation for the first period in which liquidation becomes imminent."

One critical point to be aware of with respect to presentation of these statements is that the liquidation basis of accounting should be applied prospectively from the day that liquidation becomes imminent (ASC 205-30-45-2).

Required Disclosures

As to be expected when an entity prepares its financial statements using the liquidation basis of accounting, there are certain and specific disclosures an entity is required to make. At a minimum, an entity is required to disclose all of the following when it applies the liquidation basis of accounting (ASC 205-30-50-2):

- That the financial statements are prepared using the liquidation basis of accounting, including the facts and circumstances surrounding the adoption of the liquidation basis of accounting and the entity's determination that liquidation is imminent.
- A description of the entity's plan for liquidation, including a description of each of the following:
  - The manner by which it expects to dispose of its assets and other items it expects to sell that it had not previously recognized as assets (for example, trademarks)
  - The manner by which it expects to settle its liabilities
  - The expected date by which the entity expects to complete its liquidation.
- The methods and significant assumptions used to measure assets and liabilities, including any subsequent changes to those methods and assumptions.

- The type and amount of costs and income accrued in the statement of net assets in liquidation and the period over which those costs are expected to be paid or income earned.

Going Concern

The final subtopic we'll discuss with respect to presentation of financial statements relates to going concern. In general, a going concern identifies those businesses that function without the threat of liquidation for the foreseeable future (usually regarded as roughly 12 months). Said another way, it's the business's indication that its intent is to keep running its activities for the next year. Under GAAP, the continuation of an entity as a going concern is presumed to be the basis for preparing financial statements, unless liquidation becomes imminent. This is commonly referred to as the going concern basis of accounting.

However, even if liquidation is not imminent (as discussed extensively in the previous section), there may be certain events or conditions that may raise substantial doubt about an entity's ability to continue as a going concern. While seemingly counterintuitive, in these situations financial statements should continue to be prepared under the going concern basis of accounting.

Introducing GAAP through ASU 2014-15

Currently, there is no guidance in GAAP with respect to management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern or to provide related footnote disclosures. However, as a result of the FASB's release of ASU 2014-15, *Presentation of Financial Statements – Going Concern (Subtopic 205-40)*, certain disclosures may be required by an entity in these situations when substantial doubt exists about an entity's ability to continue as a going concern. While the amendments in ASU 2014-15 are not effective for calendar year entities until 2017 (i.e. effective for annual periods after December 15, 2016 with early application is permitted), this section of this course addresses these impending amendments.

The amendments included with ASU 2014-15 require that management assess the entity's ability to continue as a going concern by incorporating and expanding upon certain principles that are currently in U.S. Auditing Standards. Yes, you read that correctly - the new accounting requirements prescribed by the release of ASU 2014-15 are primarily founded on Auditing standards. As a result, when an entity is preparing its financial statements for each annual and interim reporting period, the entity's management is required to evaluate whether there are conditions and/or events, considered in the aggregate, that raise substantial doubt about an entity's ability to continue as a going concern within one year after the date that the financial statements are issued (ASC 205-40-50-1). This leads to obvious next question – what are some examples of these conditions and/or events that could cause this doubt?

ASC 205-40-55-2 provides the following (not all-inclusive) as examples of adverse conditions and events that may give rise to substantial doubt about an entity's ability to continue as a going concern:

- Negative financial trends such as the following:
  - Recurring operating losses
  - Working capital deficiencies
  - Negative cash flows from operating activities
  - Other adverse key financial ratios
- Other indications of possible financial difficulties such as the following:
  - Default on loans or similar agreements
  - Arrearages in dividends
  - Denial of usual trade credit from suppliers
  - A need to restructure debt to avoid default
  - Noncompliance with statutory capital requirements
  - A need to seek new sources or methods of financing or to dispose of substantial assets.
- Internal matters such as the following:
  - Work stoppages or other labor difficulties
  - Substantial dependence on the success of a particular project

    - Uneconomic long-term commitments
    - A need to significantly revise operations
- External matters such as the following:
    - Legal proceedings
    - Legislation, or similar matters that might jeopardize the entity's ability to operate
    - Loss of a key franchise, license, or patent
    - Loss of a principal customer or supplier
    - Uninsured or underinsured catastrophe such as a hurricane, tornado, earthquake, or flood.

It's important to note that management's evaluation should be based on relevant conditions that are known and are reasonably knowable at the date that the financial statements issued (ASC 205-40-50-4). Further to this point, management should consider both quantitative and qualitative information about the following conditions and events (ASC 205-40-50-5):

- The entity's current financial condition, including its liquidity sources at the date that the financial statements are issued
- The entity's conditional and unconditional obligations due or anticipated within one year after the date that the financial statements are issued
- The funds necessary to maintain the entity's operations considering its current financial condition, obligations, and other expected cash flows within one year after the date that the financial statements are issued
- Other conditions or events, when considered with those above, that may adversely affect the entity's ability to meet its obligations within one year after the date that the financial statements are issued

So what happens when management determines that substantial doubt exists? When management of an entity identifies conditions or events that raise substantial doubt about the entity's ability to continue as a going concern, management should consider whether its plans that are intended to mitigate those relevant conditions or events will alleviate the substantial doubt. However, it's important to note that the mitigating effect of management's plans should be considered only to the extent that it is probable that the plans will be effectively implemented and it is probable that the plans will mitigate the conditions or events (ASC 205-40-50-7). Included within the implementation guidance are examples of management plans that may be implemented in order to mitigate the conditions or events that are giving rise to the substantial doubt. These plans, which are not all-inclusive, include the following (ASC 205-40-55-3):

- Plans to dispose of an asset or business:
    - Restrictions on disposal of an asset or business, such as covenants that limit those transactions in loan or similar agreements, or encumbrances against the asset or business
    - Marketability of the asset or business that management plans to sell
    - Possible direct or indirect effects of disposal of the asset or business
- Plans to borrow money or restructure debt:
    - Availability and terms of new debt financing, or availability and terms of existing debt refinancing, such as term debt, lines of credit, or arrangements for factoring receivables or sale-leaseback of assets
    - Existing or committed arrangements to restructure or subordinate debt or to guarantee loans to the entity
    - Possible effects on management's borrowing plans of existing restrictions on additional borrowing or the sufficiency of available collateral
- Plans to reduce or delay expenditures:
    - Feasibility of plans to reduce overhead or administrative expenditures, to postpone maintenance or research and development projects, or to lease rather than purchase assets
    - Possible direct or indirect effects on the entity and its cash flows of reduced or delayed expenditures
- Plans to increase ownership equity:

- Feasibility of plans to increase ownership equity, including existing or committed arrangements to raise additional capital.
- Existing or committed arrangements to reduce current dividend requirements or to accelerate cash infusions from affiliates or other investors.

Required Disclosures

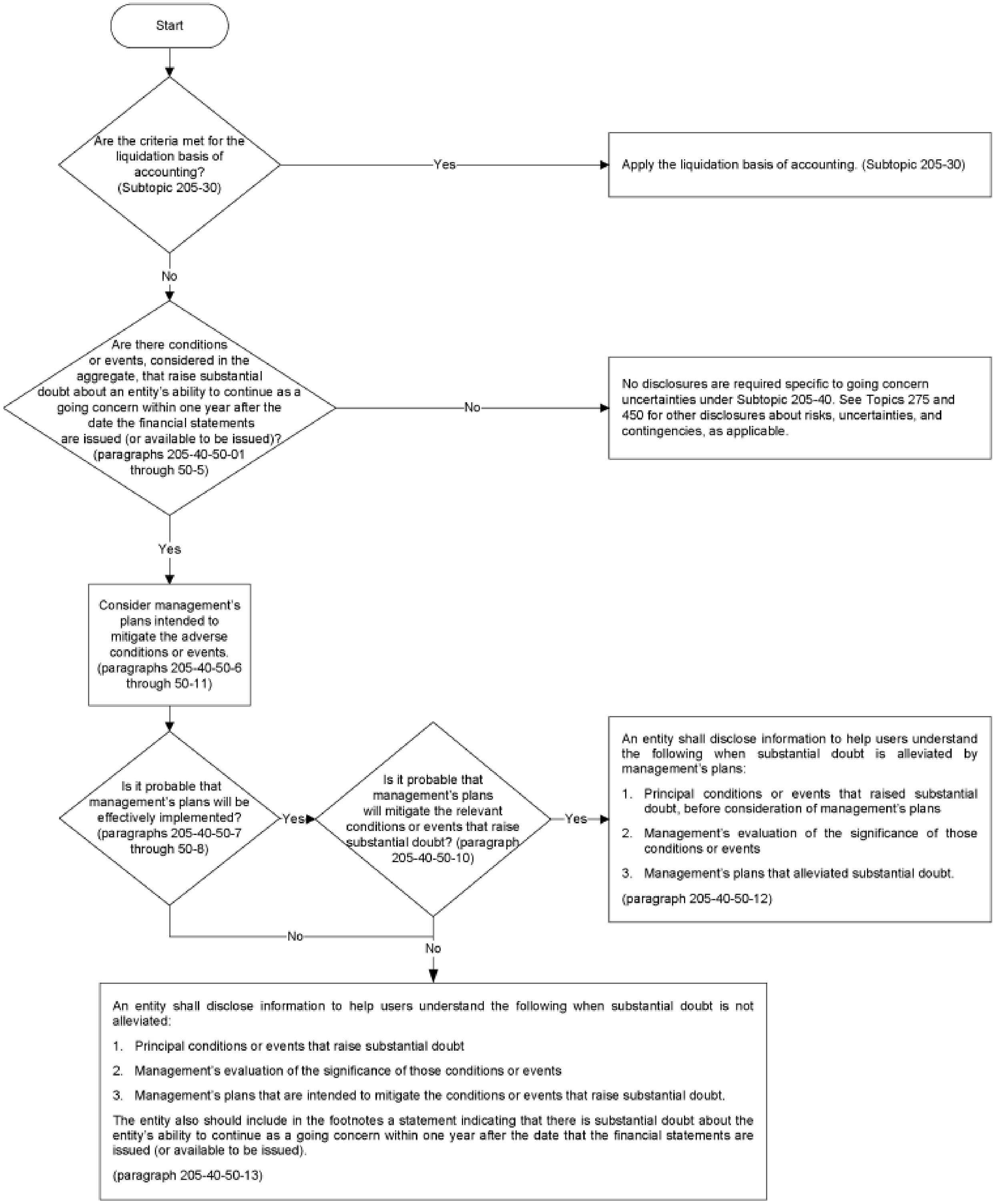
The disclosures required by ASC Topic 205 vary on account of whether the substantial doubt is alleviated or not based on management's plan. If substantial doubt about an entity's ability to continue as a going concern is alleviated as a result of the consideration of management's plan, an entity is required to disclose the following (ASC 205-40-50-12):

- Principal conditions or events that raised substantial doubt about the entity's ability to continue as a going concern (before consideration of management's plans)
- Management's evaluation of the significance of those conditions or events in relation to the entity's ability to meet its obligations
- Management's plans that alleviated substantial doubt about the entity's ability to continue as a going concern.

Alternatively, if management of an entity determines that their plans do not alleviate the substantial doubt about the entity's ability to continue as a going concern, the entity is required to disclose the above information as well. However, in this situation, the entity is required to make a direct statement within its footnotes that there is a substantial doubt about the entity's ability to continue as a going concern within one year after the date the financial statements are issued (ASC 205-40-50-13).

It's also important to note that if the conditions or events that are giving rise to the substantial doubt continue to exist in subsequent annual or interim reporting periods, an entity is required to continue to provide the necessary disclosures. Furthermore, disclosures should become more extensive as additional information becomes available about the relevant conditions or events and about management's plans (ASC 205-40-50-14). An entity is also required to provide appropriate context and continuity in explaining how conditions or events have changed between reporting periods. And finally, in the period in which substantial doubt no longer exists (whether it be before or after consideration of management's plans), an entity is required to disclose how the relevant conditions or events that raised substantial doubt were resolved (ASC 205-40-50-14).

In order to simplify and illustrate the disclosure requirements, the FASB also included a helpful flowchart within the implementation guidance (ASC 205-40-55-1). Refer to a copy of this flowchart included below.



Start
Are the criteria met for the liquidation basis of accounting? (Subtopic 205-30)
Yes
Apply the liquidation basis of accounting. (Subtopic 205-30)
No
Are there conditions or events, considered in the aggregate, that raise substantial doubt about an entity's ability to continue as a going concern within one year after the date the financial statements are issued (or available to be issued)? (paragraphs 205-40-50-01 through 50-5)
No
No disclosures are required specific to going concern uncertainties under Subtopic 205-40. See Topics 275 and 450 for other disclosures about risks, uncertainties, and contingencies, as applicable.
Yes
Consider management's plans intended to mitigate the adverse conditions or events. (paragraphs 205-40-50-6 through 50-11)
Is it probable that management's plans will be effectively implemented? (paragraphs 205-40-50-7 through 50-8)
Yes
Is it probable that management's plans will mitigate the relevant conditions or events that raise substantial doubt? (paragraph 205-40-50-10)
Yes
An entity shall disclose information to help users understand the following when substantial doubt is alleviated by management's plans:
1. Principal conditions or events that raised substantial doubt, before consideration of management's plans
2. Management's evaluation of the significance of those conditions or events
3. Management's plans that alleviated substantial doubt.
(paragraph 205-40-50-12)
No
No
An entity shall disclose information to help users understand the following when substantial doubt is not alleviated:
1. Principal conditions or events that raise substantial doubt
2. Management's evaluation of the significance of those conditions or events
3. Management's plans that are intended to mitigate the conditions or events that raise substantial doubt.
The entity also should include in the footnotes a statement indicating that there is substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial statements are issued (or available to be issued).
(paragraph 205-40-50-13)

Balance Sheet Presentation

The previous section of this course dealt primarily with overall financial statement presentation and topics such as discontinued operations, liquidation basis of accounting, and going concern. In this section of the course, we turn our attention more directly to balance sheet presentation. The primary accounting guidance with respect to this area can be found within ASC Topic 210. Like many other ASC topics, there is an overall subtopic (10) which lays out the general principle with respect to balance sheet presentation. Included also within ASC Topic 210 is subtopic (20) related to offsetting. The overall subtopic provides general guidance on the classification of current assets and current liabilities, along with the determination of working capital (ASC 210-10-05-4). Given the fundamental nature of the information provided within the overall subtopic, information within the overall subtopic is not included within this course. Subtopic 20, related to offsetting, provides the criteria for offsetting amounts related to certain contracts and provides guidance on presentation (ASC 210-20-05-1). An expansive discussion of offsetting is included in the following section.

Balance Sheet Offsetting

In general, offsetting assets and liabilities in an entity's balance sheet is improper unless a right of setoff exists (ASC 210-20-05-1). The FASB ASC Master Glossary defines a right of setoff as "…a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor." The offsetting of assets and liabilities is most commonly thought of within the context of unconditional receivables from and payables to another party (ASC 210-20-05-2).

As noted above, it is generally inappropriate to offset balance sheet accounts (i.e. assets and liabilities) unless a right of setoff exists. The obvious next question then is when does a right of setoff exist? Simply put, a right of setoff exists when all of the following conditions are met (ASC 210-20-45-1):

- Each of two parties owes the other determinable amounts
- The reporting party has the right to setoff the amount owed with the amount owed by the other party
- The reporting party intends to setoff
- The right of setoff is enforceable by law

As you can clearly note from the requirements above, there must be a legal right of setoff existing between two parties and the reporting party intends to exercise this right. If any of the above conditions are not met, balance sheet offsetting should not occur.

<u>Repurchase and Reverse Repurchase Agreements</u>

Two specific types of transactions discussed within subtopic 20 relate to repurchase agreements accounted for as collateralized borrowing and reverse repurchase agreements accounted for as collateralized borrowings. The former, as defined by the FASB ASC Master Glossary is "…a transaction in which a seller-borrower of securities sells those securities to a buyer-lender with an agreement to repurchase them at a stated price plus interest at a specified date or in specified circumstances. The later, the reverse purchase agreement is "…a transaction that is accounted for as a collateralized lending in which a buyer-lender buys securities with an agreement to resell them to the seller-borrower at a stated price plus interest at a specified date or in specified circumstances."

The important point with respect to the above transaction is that an entity may, but is not required to, offset amounts recognized as payables under repurchase agreements accounted for as collateralized borrowings and amounts recognized as receivables under reverse repurchase agreements accounted for as collateralized borrowings if all of the following conditions are met (ASC 210-20-45-11):

- The repurchase and reverse repurchase agreements are executed with the same counterparty.
- The repurchase and reverse repurchase agreements have the same explicit settlement date specified at the inception of the agreement.

- The repurchase and reverse repurchase agreements are executed in accordance with a master netting arrangement.
- The securities underlying the repurchase and reverse repurchase agreements exist in book entry form and can be transferred only by means of entries in the records of the transfer system operator or securities custodian.
- The repurchase and reverse repurchase agreements will be settled on a securities transfer system that operates in the manner described in paragraphs 210-20-45-14 through 45-17 and the entity must have associated banking arrangements in place as described in those paragraphs.
- The entity intends to use the same account at the clearing bank or other financial institution at the settlement date in transacting both the cash inflows resulting from the settlement of the reverse repurchase agreement and the cash outflows in settlement of the offsetting repurchase agreement.

<u>Disclosure Requirements</u>

Given the complexity of the offsetting requirements as noted above, the disclosure requirements assist users of an entity's financial statements to better understand the effects of the netting arrangements. The disclosure requirements with respect to balance sheet offsetting apply to the following types of transactions (ASC 210-20-50-1):

- Recognized derivative instruments to include the following:
    - Bifurcated embedded derivatives
    - Repurchase agreements accounted for as collateralized borrowings
    - Reverse repurchase agreements accounted for as collateralized borrowings
- Securities borrowing and securities lending transactions

In order to enable users of an entity's financial statements to evaluate the effect of netting arrangements, entities are required to disclose the following quantitative information separately for assets and liabilities (ASC 210-20-50-3):

- The gross amounts of those recognized assets and those recognized liabilities
- The amounts offset to determine the net amounts presented in the balance sheet
- The net amounts presented in the balance sheet
- The amounts subject to an enforceable master netting arrangement or similar agreement

The disclosures are required to be presented in a tabular format separately for assets and liabilities (ASC 210-20-50-4). An example disclosure included within the implementation guidance is included below as an illustration (ASC 210-20-55-22).

Application of Paragraph 210-20-50-3(a)–(c) by Instrument and Paragraph 210-20-50-3(c)–(e) by Counterparty

Offsetting of Financial Assets and Derivative Assets

$ million

As of December 31, 20XX	(i)	(ii)	(iii) = (i) – (ii)
	Gross Amounts of Recognized Assets	**Gross Amounts Offset in the Statement of Financial Position**	**Net Amounts of Assets Presented in the Statement of Financial Position**
Description			
Derivatives			
Interest rate contracts			
Over the counter	$XX,XXX	$XX,XXX	$XX,XXX
Exchange traded	XX,XXX	XX,XXX	XX,XXX
Exchange cleared	XX,XXX	XX,XXX	XX,XXX
Foreign exchange contracts			
Over the counter	XX,XXX	XX,XXX	XX,XXX
Exchange traded	XX,XXX	XX,XXX	XX,XXX
Exchange cleared	XX,XXX	XX,XXX	XX,XXX
Equity contracts			
Over the counter	XX,XXX	XX,XXX	XX,XXX
Exchange traded	XX,XXX	XX,XXX	XX,XXX
Exchange cleared	XX,XXX	XX,XXX	XX,XXX
Commodity contracts			
Over the counter	XX,XXX	XX,XXX	XX,XXX
Exchange traded	XX,XXX	XX,XXX	XX,XXX
Exchange cleared	XX,XXX	XX,XXX	XX,XXX
Credit contracts			
Over the counter	XX,XXX	XX,XXX	XX,XXX
Exchange traded	XX,XXX	XX,XXX	XX,XXX
Exchange cleared	XX,XXX	XX,XXX	XX,XXX
Other contracts			
Over the counter	XX,XXX	XX,XXX	XX,XXX
Exchange traded	XX,XXX	XX,XXX	XX,XXX
Exchange cleared	XX,XXX	XX,XXX	XX,XXX
Total derivatives, subject to a master netting arrangement or similar arrangement	XX,XXX	XX,XXX	XX,XXX
Total derivatives, not subject to a master netting arrangement or similar arrangement	XX,XXX	XX,XXX	XX,XXX
Total derivatives	XX,XXX	XX,XXX	XX,XXX
Reverse repurchase, securities borrowing, and similar arrangements	XX,XXX	XX,XXX	XX,XXX
Total	$XX,XXX	$XX,XXX	$XX,XXX

Review Questions

4. Which of the following schedules/statements is a reporting entity required to prepare if it is using the liquidation basis of accounting?
    a. Statement of cash flows.
    b. Statement of financial position.
    c. Statement of net assets held for sale.
    d. Statement of changes in net assets in liquidation.

5. If management determines that its plans do not alleviate the substantial doubt about the entity's ability to continue as a going concern, the entity is required to do which of the following?
   a. Present its financial statements using the liquidation basis of accounting.
   b. Disclose the principle conditions/events that raised the substantial doubt.
   c. Remeasure assets and liabilities at fair market value.
   d. Restate its financial statements on a cash basis.

6. Which of the following terms identify a debtor's legal right to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor?
   a. Right of setoff.
   b. Securities custodian.
   c. Leveraged lease.
   d. Repurchase agreement accounted for as collateralized borrowing.

Income Statement

We now turn our attention to the income statement. Principles and requirements with respect to income statement presentation are prescribed within ASC Topic 225. Like the previous section with respect to the balance sheet, general information related to income statement presentation (subtopic 10) is not included within this course, however, certain specific topics such as extraordinary and unusual items (subtopic 20) as well as business interruption insurance (subtopic 30) are discussed. Refer to the following sections for a discussion of these topics.

Extraordinary and Unusual Items

As noted above, specific requirements with respect to extraordinary and unusual items is prescribed within subtopic 20 of ASC Topic 225. One of the fairly recent updates with respect to this area relates to the FASB's release of ASU 2015-01, *Income Statement – Extraordinary and Unusual Items (Subtopic 225-20)*, wherein the long standing concept of extraordinary was removed from GAAP. Historically, if an event or transaction met the criteria for extraordinary classification (i.e. unusual in nature and infrequent in occurrence), an entity was required to segregate the extraordinary item from the results of ordinary operations and present the item separately in the income statement, net of tax, after income from continuing operations. In addition, an entity was also required to disclose the applicable income taxes and either present or disclose earnings per share data that was applicable to the extraordinary item.

In the FASB's release of the ASU that eliminated this concept, the FASB noted the following:

> "The Board heard from stakeholders that the concept of extraordinary items causes uncertainty because it is unclear when an item should be considered both unusual and infrequent. Additionally, some stakeholders said that although users find information about unusual or infrequent events and transactions useful, they do not find the extraordinary item classification and presentation necessary to identify those events and transactions. Other stakeholders noted that it is extremely rare in current practice for a transaction or event to meet the requirements to be presented as an extraordinary item."

The FASB also further noted the following with respect to the elimination of this concept:

> "Eliminating the concept of extraordinary items will save time and reduce costs for preparers because they will not have to assess whether a particular event or transaction event is extraordinary (even if they ultimately would conclude it is not). This also alleviates uncertainty for preparers, auditors, and regulators because auditors and regulators no longer will need to evaluate whether a preparer treated an unusual and/or infrequent item appropriately."

As a result of the ASU and the elimination of the concept of extraordinary, a significant majority of the guidance included within subtopic 20 was superseded. Note, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2015. So starting in 2016, for a calendar year filer, this concept will no longer be used. Entities are also given the optionality of adopting the amendments prospectively or retrospectively to all prior periods presented.

One concept that does remain within the guidance in this subtopic is the presentation of unusual or infrequently occurring items. While this was the former criteria for that of an extraordinary item, the presentation requirements are different. With the former extraordinary item concept, an entity would present information with respect to that item separately from ordinary operations. With the presentation of unusual or infrequently occurring items, an entity is required to either present these items as a separate component of continuing operations (i.e. not broken out as a separate component after continuing operations), or alternatively, disclose the item in the notes to the financial statements (ASC 225-20-45-16).

So what are some examples of a transaction that is both unusual in nature and infrequent in occurrence? ASC 225-20-55-3 provides three examples of these types of events as noted below:

- A large portion of a tobacco manufacturer's crops are destroyed by a hail storm. Severe damage from hail storms in the locality where the manufacturer grows tobacco is rare.
- A steel fabricating entity sells the only land it owns. The land was acquired 10 years ago for future expansion, but shortly thereafter the entity abandoned all plans for expansion and held the land for appreciation.
- An earthquake destroys one of the oil refineries owned by a large multination oil entity.

Business Interruption Insurance

As defined by the FASB ASC Master Glossary, business interruption insurance is "… insurance that provides coverage if business operations are suspended due to the loss of use of property and equipment resulting from a covered cause of loss. Business interruption insurance coverage generally provides for reimbursement of certain costs and losses incurred during the reasonable period required to rebuild, repair, or replace the damaged property." ASC 225-30-05-2 notes that the types of costs and losses covered by business interruption insurance typically include the following:

- Gross margin that was lost or not earned due to the suspension of normal operations
- A portion of fixed charge and expenses in relation to that lost gross margin
- Other expenses incurred to reduce the loss from business interruption such as rent of temporary facilities and equipment and use of subcontractors

With respect to presentation of business interruption insurance recoveries received, entities are afforded some flexibility on this front so long as the classification is not contrary to existing GAAP (ASC 225-30-45-1). Furthermore, the disclosure requirements with respect to business interruption insurance are also fairly straightforward. When these types of recoveries are recognized, the following information is required to be disclosed (ASC 225-30-50-1):

- The nature of the event resulting in business interruption losses
- The aggregate amount of business interruption insurance recoveries recognized during the period and the line item(s) in the income statement in which those recoveries are classified

Comprehensive Income

What is comprehensive income? In short, it's the change in equity of an entity from non-owner sources in addition plus net income. These changes attributed to non-owner sources is commonly referred to as other comprehensive income. The focus of this section of the course is on the presentation of comprehensive income.

Presentation

In 2011, the FASB release ASU 2011-05, *Comprehensive Income (Topic 220).* The FASB noted in its release that the objective of this ASU was to improve the comparability, consistency, and transparency of financial reporting and to increase the prominence of items reporting in other comprehensive income. The primary amendments within the ASU prescribe that all non-owner changes in stockholder's equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The important point to note is whether an entity elects the single or two separate statement approach, entities are required to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income. With respect to these reclassification adjustments, the FASB, in BC13, noted the following:

> "Without that presentation, users may not realize that certain items of net income may have already been included in a prior period's comprehensive income. Therefore, the Board concluded that the presentation of reclassification adjustments provides users with important information about the composition of a current period's net income (profit and loss) and other comprehensive income."

Included within the implementation guidance are examples of the single continuous statement (ASC 220-10-55-7) and separate two-statement approach (ASC 220-10-55-9). Refer to each of these examples included below.

Entity XYZ
Consolidated Statement of Comprehensive Income
Year Ended December 31, 201X

Revenues			$ 140,000
Expenses			(65,700)
Other gains and losses			8,000
Gain on sale of securities			2,500
Income from operations before tax			84,800
Income tax expense			(21,200)
[Net income			63,600]
Less: net income attributable to the noncontrolling interest		$ (12,720)	
Net income attributable to Entity XYZ shareholders		50,880	
Earnings per share			
Basic and diluted	0.46		
Other comprehensive income, before tax:			
Foreign currency translation adjustments [(a)]			8,000
Unrealized gains on debt securities: [(b)]			
Unrealized holding gains arising during period		13,000	
Less: reclassification adjustment for gains included in net income		(1,500)	11,500
Defined benefit pension plans: [(c)]			
Prior service cost arising during period		(1,600)	
Net loss arising during period		(1,600)	
Less: amortization of prior service cost included in net periodic pension cost		100	(2,500)
[Other comprehensive income			17,000]
[Comprehensive income			80,600]
Less: comprehensive income attributable to the noncontrolling interest			(16,120)
Comprehensive income attributable to Entity XYZ shareholders			$ 64,480

(a) It is assumed that there was no sale or liquidation of an investment in a foreign entity. Therefore, there is no reclassification adjustment for this period.

(b) This illustrates the gross display of amounts reclassified out of accumulated other comprehensive income. Alternatively, a net display can be used, with disclosure of the gross amounts (current-period gain and reclassification adjustment) in the notes to the financial statements.

(c) This illustrates the gross display of amounts reclassified out of accumulated other comprehensive income. Alternatively, a net display can be used, with disclosure of the gross amounts (prior service cost and net loss for the defined benefit pension plans less amortization of prior service cost) in the notes to the financial statements.

Entity XYZ
Statement of Consolidated Comprehensive Income
Year Ended December 31, 201X

Net income		$ 63,600
Other comprehensive income, net of tax:		
Foreign currency translation adjustments [(a)]		8,000
Unrealized gains on debt securities: [(b)]		
Unrealized holding gains arising during period	$ 13,000	
Less: reclassification adjustment for gains included in net income	(1,500)	11,500
Defined benefit pension plans: [(c)]		
Prior service cost arising during period	(1,600)	
Net loss arising during period	(1,000)	
Less: amortization of prior service cost included in net periodic pension cost	100	(2,500)
[Other comprehensive income		17,000]
[Comprehensive income		80,600]
Less: comprehensive income attributable to the noncontrolling interest		(16,120)
Comprehensive income attributable to Entity XYZ shareholders		$ 64,480

(a) It is assumed that there was no sale or liquidation of an investment in a foreign entity. Therefore, there is no reclassification adjustment for this period.

(b) This illustrates the gross display of amounts reclassified out of accumulated other comprehensive income. Alternatively, a net display can be used, with disclosure of the gross amounts (current-period gain and reclassification adjustment) in the notes to the financial statements.

(c) This illustrates the gross display of amounts reclassified out of accumulated other comprehensive income. Alternatively, a net display can be used, with disclosure of the gross amounts (prior service cost and net loss for the defined benefit pension plans less amortization of prior service cost) in the notes to the financial statements.

Statement of Cash Flows

One of the more important metrics that stakeholders should know is the entity's cash flow from operations, which is often overlooked in lieu of the income statement and balance sheet figures. Being able to internally generate sufficient cash is key to maintaining a healthy entity. Said another way, a statement of cash flows serves as a roadmap that indicates where cash came from and where it went, and is a crucial planning tool for any entity's long term success.

The accounting requirements with respect to the statement of cash flows is prescribed within ASC Topic No. 230. Like other ASC topics previously discussed, this topic includes a discussion of the objectives of the guidance, certain scope exceptions, a glossary, as well as presentation and disclosure matters.

For starters, it is important that the user have a good understanding of what is actually meant by the term cash. The FASB defines cash within its ASC Master Glossary as the following:

> "Cash includes not only currency on hand but demand deposits with banks or other financial institutions. Cash also includes other kinds of accounts that have the general characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively may withdraw funds at any time without prior notice or penalty"

It's also important to note that throughout ASC 230, the term "cash equivalents" is also frequently used. The ASC Master Glossary defines this term as the following short-term, highly-liquid investments that have the following characteristics:

- Readily convertible to known amounts of cash;
- So near their maturity dates that they pose an insignificant risk of changes in value;

The primary objective of a statement of cash flows is to provide relevant information about the cash receipts and cash payments of an entity during a period (ASC 230-10-10-1). Unfortunately, many investors inappropriately look directly at an entity's income statement as a measure of its profitability and investment quality. However, the importance of the statement of cash flows should not be overlooked. As previously noted, being able to internally generate sufficient cash is key to maintaining a healthy business.

In addition to reporting how cash was earned and used in operations, the statement of cash flows can highlight other key factors to consider in a business's strategy. For example, a statement of cash flow can identify the following:

- Whether it is running out of money, even if it is profitable at the same time;
- Are the owners taking too much money out of the business;
- How much money was used to purchase property and equipment;
- How loan payments affect cash in the bank;

The statement of cash flows is regarded by many users of the financial statements in a number of different industries as the most important financial statement that an entity presents to its stakeholders. When the statement of cash flows is combined with other financial information, the statement of cash flows can be a useful tool to determine key relationships in the financial statements, evaluate and assess past performance, and forecast future performance.

The statement of cash flows can also identify circumstances whereby earnings growth does not closely align with operating cash flow growth. This apparent disconnect, though perhaps not very apparent without a careful financial analysis, may alert users to the need to look closely at the drivers of earnings. It may also be an indicator of other lifecycle considerations for emerging or declining businesses. Credit rating agencies, investors, and analysts also utilize cash flow information when developing certain valuation models. The transparency of historical cash flow information, including cash inflows and outflows from operating activities, can help promote a better understanding of a company's relative performance and enhance the predictive value of its cash flow results.

As can be inferred from the discussion so far, the statement of cash flows is very important to investors because it shows how much actual cash an entity has generated. The income statement, however, often includes noncash revenues or expenses, which the statement of cash flows obviously excludes. In addition, the FASB also notes within the codification that information provided within an entity's statement of cash flows, when used in conjunction with related disclosures and information in other financial statements should help creditors and other stakeholders (as well as potential investors) to assess all of the following (ASC 230-10-10-2):

- The entity's ability to generate positive future net cash flows;
- The reasons for differences between net income and associated cash receipts and payments;
- The entity's ability to meet its obligations, its ability to pay dividends, and its needs for external financing;
- The effects on an entity's financial position of both its cash and noncash investing and financing transactions during the period.

With regard to the entities that are required to prepare a statement of cash flows, in general, unless an entity meets a specific scope exception, it is required to prepare a statement of cash flows. In other words, both business entities and not-for-profit entities are required to prepare a statement of cash flows unless a specific scope exception exists. While the preparation of a statement of cash flows is required by nearly all entities, there are certain entities that are in fact excluded from the scope of these requirements. This includes the following entities (ASC 230-10-15-4):

- Defined benefit pension plans that present financial information in accordance with the requirements of ASC Topic 960, Plan Accounting – Defined Benefit Pension Plans
- Certain investment companies (such as common trust funds and variable annuity accounts) where substantially all of their investments were carried at fair value;
    - This is only case if the investment company had little to no debt and it provided a statement of changes in net assets;

Before proceeding further, let's take a look at an example of the statement of cash flows sourced from ASC 230-10-55-13.

Entity A
Consolidated Statement of Cash Flows
For the Year Ended December 31, 19X1
Increase (Decrease) in Cash and Cash Equivalents

Cash flows from operating activities:		
Net income		$ 760
Depreciation and amortization	$ 445	
Provision for losses on accounts receivable	200	
Gain on sale of facility	(80)	
Undistributed earnings of affiliate	(25)	
Payment received on installment note receivable for sale of inventory	100	
Change in assets and liabilities net of effects from purchase of Entity B:		
Increase in accounts receivable	(215)	
Decrease in inventory	205	
Increase in prepaid expenses	(25)	
Decrease in accounts payable and accrued expenses	(250)	
Increase in interest and income taxes payable	50	
Increase in deferred taxes	150	
Increase in other liabilities	50	
Total adjustments		605
Net cash provided by operating activities		1,365
Cash flows from investing activities:		
Proceeds from sale of facility	600	
Payment received on note for sale of plant	150	
Capital expenditures	(1,000)	
Payment for purchase of Entity B, net of cash acquired	(925)	
Net cash used in investing activities		(1,175)
Cash flows from financing activities:		
Net borrowings under line-of-credit agreement	300	
Principal payments under capital lease obligation	(125)	
Proceeds from issuance of long-term debt	400	
Proceeds from issuance of common stock	500	
Dividends paid	(200)	
Net cash provided by financing activities		875
Net increase in cash and cash equivalents		1,065
Cash and cash equivalents at beginning of year		600
Cash and cash equivalents at end of year		$1,665

With respect to presentation, gross presentation is generally more useful to the users of financial statements versus net presentation (recall the previous discussion on balance sheet offsetting which is consistent with this principle). For example, it is considered to be more informative to report proceeds from sales of assets of $1 million and capital expenditures of $5 million than to report a net increase in property, plant and equipment of $4 million. As a result, gross presentation usually provides users more meaningful insight into the business and operations of an entity. While gross presentation, instead of net presentation, is encouraged, there are certain exceptions for which gross reporting is not required. This includes investments (other than cash equivalents), loan receivables, and debt, where the maturity of the asset or liability is three months or less (ASC 230-10-45-9).

Review Questions

7. Which of the following FASB ASU's eliminated the concept of extraordinary items?
    a. ASU 2014-09.
    b. ASU 2014-10.
    c. ASU 2015-01.
    d. ASU 2015-02.

8. When used in conjunction with other financial statements, an entity's statement of cash flows should assist stakeholders in assessing each of the following, except?
    a. The entity's ability to generate sufficient future cash flows.
    b. The entity's anticipated comprehensive income.
    c. The primary reasons for differences between net income and cash receipts/payments.
    d. The entity's ability to meet its future financial obligations.

Sections of the Statement of Cash Flows

There are three common sections within every statement of cash flows. This includes cash flow from operating activities, investing activities, and financing activities. Each of these sections are discussed in additional detail in the following sections.

Operating Activities

The ASC Master Glossary defines operating activities as the following:

> "Operating activities include all transactions and other events that are not defined as investing or financing activities. Operating activities generally involve producing and delivering goods and providing services. Cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income."

The ASC provides specific examples of both inflows and outflows as it relates to operating activities. Examples of cash inflows as it relates to operating activities include the following (ASC 230-10-45-16):

- Cash receipts from returns on loans, other debt instruments of other entities, and equity securities—interest and dividends;
- Cash receipts from sales of goods or services, including receipts from collection or sale of accounts and both short- and long-term notes receivable from customers arising from those sales;
- All other cash receipts that do not stem from transactions defined as investing or financing activities, such as amounts received to settle lawsuits or certain proceeds of insurance settlements;

On the other hand, the following transaction are examples of cash outflows as it relates to operating activities (ASC 230-10-45-17):

- Cash payments to acquire materials for manufacture or goods for resale, including principal payments on accounts and both short- and long-term notes payable to suppliers for those materials or goods;
- Cash payments to governments for taxes, duties, fines, and other fees or penalties;
    - This would include the cash that would have been paid for income taxes if increases in the value of equity instruments issued under share-based payment arrangements that are not included in the cost of goods or services recognizable for financial reporting purposes also had not been deductible in determining taxable income;
- Cash payments to other suppliers and employees for other goods or services;
- Cash payment made to settle an asset retirement obligation;

- Cash payments to lenders and other creditors for interest;
- All other cash payments that do not stem from transactions defined as investing or financing activities, such as payments to settle lawsuits, cash contributions to charities, and cash refunds to customers;

Financing Activities

The ASC Master Glossary defines financing activities as the following:

> "Financing activities include obtaining resources from owners and providing them with a return on, and a return of, their investment; receiving restricted resources that by donor stipulation must be used for long-term purposes; borrowing money and repaying amounts borrowed, or otherwise settling the obligation; and obtaining and paying for other resources obtained from creditors on long-term credit."

The following transactions are examples of cash inflows as it relates to financing activities (ASC 230-10-45-14):

- Proceeds from issuing equity instruments;
- Proceeds from issuing bonds, mortgages, notes, and from other short- or long-term borrowing;
- Proceeds received from derivative instruments that include financing elements at inception, whether the proceeds were received at inception or over the term of the derivative instrument, other than a financing element inherently included in an at-the-market derivative instrument with no prepayments;
- Receipts from contributions and investment income that by donor stipulation are restricted for the purposes of acquiring, constructing, or improving property, plant, equipment, or other long-lived assets or establishing or increasing a permanent endowment or term endowment;
- Cash retained as a result of the tax deductibility of increases in the value of equity instruments issued under share-based payment arrangements that are not included in the cost of goods or services that is recognizable for financial reporting purposes;

On the other hand, the following transaction are examples of cash outflows as it relates to financing activities (ASC 230-10-45-15):

- Payments of dividends or other distributions to owners, including outlays to reacquire the entity's equity instruments;
- Distributions to counterparties of derivative instruments that include financing elements at inception, other than a financing element inherently included in an at-the-market derivative instrument with no prepayments;
- Repayments of amounts borrowed;
- Other principal payments to creditors who have extended long-term credit;
- Payments for debt issue costs;

Investing Activities

The ASC Master Glossary defines investing activities as the following:

> "Investing activities include making and collecting loans and acquiring and disposing of debt or equity instruments and property, plant, and equipment and other productive assets, that is, assets held for or used in the production of goods or services by the entity (other than materials that are part of the entity's inventory). Investing activities exclude acquiring and disposing of certain loans or other debt or equity instruments that are acquired specifically for resale"

Examples of cash inflows as it relates to investing activities include the following (ASC 230-10-45-12):

- Receipts from collections or sales of loans made by the entity and of other entities' debt instruments;
- Receipts from sales of loans that were not specifically acquired for resale;
- Receipts from sales of property, plant, and equipment and other productive assets;
- Receipts from sales of equity instruments of other entities;
- Receipts from disposing of loans, debt or equity instruments, or property, plant, and equipment;

    - Note: this would include directly related proceeds of insurance settlements, such as the proceeds of insurance on a building that is damaged or destroyed.

Alternatively, examples of cash outflows as it relates to investing activities include the following (ASC 230-10-45-13):

- Payments to acquire equity instruments of other entities;
    - Except other than certain equity instruments carried in a trading account;
- Disbursements for loans made by the entity and payments to acquire debt instruments of other entities;
    - This would not include cash equivalents and certain debt instruments that are acquired specifically for resale;
- Payments at the time of purchase or soon before or after purchase to acquire property, plant, and equipment and other productive assets, including interest capitalized as part of the cost of those assets;

Challenges to Classification

It should be apparent that there will undoubtedly be situations where a cash transaction does not fit nicely within one of the three classifications. As an example, this could be the situation where a certain item could either be considered inventory or a productive asset. In these situations, the FASB notes that the appropriate classification shall depend on the activity that is likely to be the predominant source of cash flows for the item (ASC 230-10-45-22).

Further to this point, the Securities & Exchange Commission (SEC) Staff, based on its remarks at the 2006 AICPA National Conference on Current SEC and PCAOB Developments, cautioned that if the most appropriate classification is not clear, this does not mean that any classification is appropriate. Instead, registrants must analyze the nature of the activity and the predominant source of the related cash flows. The SEC staff also noted that registrants should provide disclosure sufficient to inform investors of the statement of cash flows classification selected and the alternative classifications considered and rejected. The SEC staff continues to comment when classification of cash flow activities is not clear, correct, or consistent.

More specifically, there are several areas/transactions where cash flow classification can prove more difficult. This includes the following areas, each of which are discussed in addition detail below:

- Acquisition and sales of certain securities
- Leasing Activities
- Trade and loans receivables
- Proceeds from insurance claims

<u>Acquisition and Sales of Certain Securities</u>

ASC 230 notes that cash receipts and cash payments resulting from purchases and sales of securities classified as trading securities should be classified based on the nature and purpose for which the securities were acquired (ASC 230-10-45-19). Furthermore, cash receipts and cash payments resulting from purchases and sales of other securities and other assets should be classified as operating cash flows if those assets are acquired specifically for resale and are carried at fair value in a trading account (ASC 230-10-45-20).

ASC 230 further requires that debt and equity securities have separate classification of cash flow activity for the held-to-maturity, available-for-sale, and trading securities in the statement of cash flows. Cash flows associated with purchases, sales, and maturities of available-for-sale securities and held-to-maturity securities are required to be classified as cash flows from investing activities and reported gross for each classification. To that end, if an entity has three categories of investments, with purchases, sales, and maturities in each category, it is possible the entity would be required to present nine different captions in the statement of cash flows related to investment activity.

<u>Leasing Activities</u>

At the start of a capital lease, there are no statement of cash flow impacts. Instead, an entity discloses the lease as noncash investing and financing activity. As lease payments are made, they are classified as financing cash outflows in the statement of cash flows. Alternatively, in a direct finance lease arrangement, the lessor generally presents the cash outflow associated with the leased asset purchase at inception as an investing cash outflow. After inception though, the principal portion of lease payments are classified as investing cash flows and the interest portion of those payments are classified as operating cash inflows. However, in a sales-type lease arrangement, the lessor commonly reports the gain/loss at lease inception as an adjustment to operating cash flows.

Accounting for a leveraged lease by the lessor, on the other hand, requires net presentation on the balance sheet of the investment in the leased asset and the related non-recourse debt obligation that finances part of the cost of the leased asset. However, individual cash flows related to the investment, principal payments received under the lease, the debt incurred, and principal payments made on the debt are presented separately in the investing and financing activities sections of the statement of cash flows.

<u>Trade and Loans Receivables</u>

Classification of cash flows related to trade and loan receivables requires that an entity make a determination of the source of the funds. If the loans or receivables result from the sale of the entity's goods or services to its customers, the cash receipts should be treated as operating cash inflows. However, if an entity originates or purchases loans or trade receivables that do not result directly from the sale of its goods or services to its end customers (in other words, it's not in the entity's ordinary course of business), the classification of the cash is based on management's intent to either hold the loans or trade receivables for sale or for investment.

To that end, cash receipts and cash payments resulting from acquisitions and sales of loans should be classified as operating cash flows if those loans are acquired specifically for resale and are carried at fair value or at the lower of cost or fair value (ASC 230-10-45-21). On the other hand, cash receipts and cash payments from sales of loans acquired as investments should be classified as investing cash inflows regardless of a change in the purpose for holding these loans (ASC 230-10-45-12). As a result, if at the loan origination or purchase, the entity initially classifies loans or trade receivables as held for investment, the related cash receipts and payments should be classified as investing cash flows. This is true even if management subsequently decides to sell the loans or trade receivables or subsequently classifies the receivables as held for sale.

<u>Proceeds from Insurance Claims</u>

ASC 230 requires that proceeds received from insurance settlements be classified as cash inflows from operating activities (ASC 230-10-45-16(c)). However, it is important to understand that there is a distinction between these proceeds and those directly related to investing or financing activities. Evaluating cash flows from insurance claim proceeds requires consideration of the nature of the insurance coverage to the related loss. In other words, it is not dependent on how the entity plans to use the proceeds. As a result, if a claim relates partially to business interruption and partially to property, plant, and equipment owned or under capital lease, the presentation of cash flows from proceeds should be allocated between cash flows from operating activities for the business interruption portion of the claim and cash flows from investing activities for the property, plant and equipment portion of the claim. If the claim relates to property, plant and equipment under an operating lease though, the classification of the proceeds should be an operating activity, as well as proceeds for a claim related to lost or damaged inventory.

Presentation – Direct vs. Indirect Methods

ASC 230 allows for two different methods of presenting the statement of cash flows, the direct method and the indirect method. The overall principle though is that an entity is required to provide a reconciliation of net income and net cash flow from operating activities (ASC 230-10-45-2). This reconciliation generally provides information about the net effects of operating transactions and other events that affect net income and operating cash flows in different periods. Each of the acceptable methods of presentation are described below.

- Direct Method – Presents major classes of cash receipts and payments.
- Indirect Method – Presents a reconciliation of net income to net cash flow from operating activities.

It's important to understand that the end result, the presentation of net cash flow from operating activities, is consistent regardless of the method used. For entities that elect the use of the direct method, these entities must also provide the reconciliation of net income and net cash flow from operating activities in a separate schedule. Alternatively, entities electing the use of the indirect method are required to provide sufficient information, including separate identification of changes in receivables, inventory and payables for operating items (in the reconciliation), and separate disclosure of interest paid and of income taxes paid (outside the statement of cash flows), so stakeholders can estimate amounts that would have been presented had the direct method been used.

While the use of the direct method is encouraged, the indirect method is predominantly used in practice. Conceptually, the direct method is more consistent with the presentation of investing and financing activities as it more clearly presents the actual cash receipts and payments during the period, however, it is extremely difficult to implement. The indirect approach, however, provides the following benefits to preparers:

- A less costly approach to preparation;
- A useful link to income statements and balance sheets;
- A more familiar view to financial statement users;

Direct Method

While the FASB encourages the use of the direct method based on the additional information it provides with respect to movements in cash, the majority of entities elect to use the indirect method of presentation. The exhibit below provides an example of the use of the direct method excerpted from ASC 230-10-55-10.

Cash flows from operating activities:		
Cash received from customers	$13,850	
Cash paid to suppliers and employees	(12,000)	
Dividend received from affiliate	20	
Interest received	55	
Interest paid (net of amount capitalized)	(220)	
Income taxes paid	(325)	
Insurance proceeds received	15	
Cash paid to settle lawsuit for patent infringement	(30)	
Net cash provided by operating activities		$1,365

Based on the requirements of ASC 230, when using the direct method, entities are required to report the following information, at a minimum (ASC 230-10-45-25):

- Cash collected from customers, including lessees, licensees, and the like;
- Interest and dividends received;
- Other operating cash receipts, if any;
- Cash paid to employees and other suppliers of goods or services, including suppliers of insurance, advertising, and the like;
- Interest paid;
- Income taxes paid and separately, the cash that would have been paid for income taxes if increases in the value of equity instruments issued under share-based payment arrangements that are not included as a cost of goods or services recognizable for accounting purposes also had not been deductible in determining taxable income;
- Other operating cash payments, if any;

Entities are also encouraged to provide further detail and breakdowns of certain operating cash receipts and payments that they consider meaningful and feasible (ASC 230-10-45-25). As was previously noted, if an entity uses the direct method of reporting net cash flow from operating activities, the entity is also required to provide a reconciliation of net income to net cash flow from operating activities in a separate schedule (ASC 230-10-45-30).

Indirect Method

Under the indirect method of presenting the statement of cash flows, the presentation begins with net income or loss, with subsequent additions to or deductions from that amount for non-cash revenue and expense items, resulting in net income provided by operating activities. The illustration below provides an example of the use of the indirect method which is excerpted from ASC 230-10-55-13.

Cash flows from operating activities:		
Net income		$ 760
Depreciation and amortization	$ 445	
Provision for losses on accounts receivable	200	
Gain on sale of facility	(80)	
Undistributed earnings of affiliate	(25)	
Payment received on installment note receivable for sale of inventory	100	
Change in assets and liabilities net of effects from purchase of Entity B:		
Increase in accounts receivable	(215)	
Decrease in inventory	205	
Increase in prepaid expenses	(25)	
Decrease in accounts payable and accrued expenses	(250)	
Increase in interest and income taxes payable	50	
Increase in deferred taxes	150	
Increase in other liabilities	50	
Total adjustments		605
Net cash provided by operating activities		1,365

As noted from above, the statement of cash flows starts with net income and then adjusts for each non-cash item included on the entity's income statement (e.g. depreciation, amortization, gains or losses on sales, etc.). As a result, this requires adjusting net income of an entity to remove both of the following:

- The effects of all deferrals of past operating cash receipts and payments such as changes during the period in inventory, deferred income, accruals of expected future operating cash receipts and payments such as changes during the period in receivables and payables.
- All items that are included in net income that do not affect net cash provided from, or used for, operating activities, such as depreciation of property, plant, and equipment and amortization of finite-life intangible assets;

Entities are also allowed to either include this reconciliation within the actual statement of cash flows or have it included in a separate schedule (ASC 230-10-45-31). However, predominant practice is to present the reconciliation from net income to cash flows from operating activities on the face on the statement of cash flows although it is acceptable to present the reconciliation in the notes to the financial statements. If the reconciliation is presented separately in the notes to the financial statements, net cash flow from operating activities should be presented as a single line item in the statement of cash flows.

Statement of Cash Flows – Indirect Method Example

Given the importance of the statement of cash flows, the FASB provides helpful implementation guidance within subtopic 55. In this section, we'll leverage some of this implementation guidance to walkthrough a comprehensive example of presentation of the indirect method previously discussed.

As previously noted, the starting point for the statement of cash flows using the indirect method is net income. For our example, we will use the following consolidated statement of income (ASC 230-10-55-19). Note, the starting figure for our statement of cash flows will be the $760 net income figure.

Entity A
Consolidated Statement of Income
For the Year Ended December 31, 19X1

Sales	$13,965
Cost of sales	(10,290)
Depreciation and amortization	(445)
Selling, general, and administrative expenses	(1,890)
Interest expense	(235)
Equity in earnings of affiliate	45
Gain on sale of facility	80
Interest income	55
Insurance proceeds	15
Loss from patent infringement lawsuit	(30)
Income before income taxes	1,270
Provision for income taxes	(510)
Net income	$ 760

In addition to the consolidated statement of income above, we will also need the balance sheet (also from ASC 230-10-55-19) that also provides the changes from period to period. One important point to be aware of is the end result, which being the change in cash (an increase of $1,065).

	1/1/X1	12/31/X1	Change
Assets:			
Cash and cash equivalents	$ 600	$ 1,665	$ 1,065
Accounts receivable (net of allowance for losses of $600 and $450)	1,770	1,940	170
Notes receivable	400	150	(250)
Inventory	1,230	1,375	145
Prepaid expenses	110	135	25
Investments	250	275	25
Property, plant, and equipment, at cost	6,460	8,460	2,000
Accumulated depreciation	(2,100)	(2,300)	(200)
Property, plant, and equipment, net	4,360	6,160	1,800
Intangible assets	40	175	135
Total assets	$ 8,760	$ 11,875	$ 3,115
Liabilities:			
Accounts payable and accrued expenses	$ 1,085	$ 1,090	$ 5
Interest payable	30	45	15
Income taxes payable	50	85	35
Short-term debt	450	750	300
Lease obligation	-	725	725
Long-term debt	2,150	2,425	275
Deferred taxes	375	525	150
Other liabilities	225	275	50
Total liabilities	4,365	5,920	1,555
Stockholders' equity:			
Capital stock	2,000	3,000	1,000
Retained earnings	2,395	2,955	560
Total stockholders' equity	4,395	5,955	1,560
Total liabilities and stockholders' equity	$ 8,760	$ 11,875	$ 3,115

We begin first with preparing the cash flows from operating activities section of the statement of cash flows presented below. As previously noted, the starting point is net income, and then adjustments for noncash items are made to net income to arrive at the net cash provided by operating activities. A comprehensive calculation of each of these figures is outside the scope of this course, but a few of the items below are further addressed to illustrate the overall principles. The specific transactions and events occurring that support each of the line items below, as well as the line items for the investing and financing activities discussed in a later section, can be found within ASC 230-10-55-20.

Cash flows from operating activities:		
Net income		$ 760
Depreciation and amortization	$ 445	
Provision for losses on accounts receivable	200	
Gain on sale of facility	(80)	
Undistributed earnings of affiliate	(25)	
Payment received on installment note receivable for sale of inventory	100	
Change in assets and liabilities net of effects from purchase of Entity B:		
Increase in accounts receivable	(215)	
Decrease in inventory	205	
Increase in prepaid expenses	(25)	
Decrease in accounts payable and accrued expenses	(250)	
Increase in interest and income taxes payable	50	
Increase in deferred taxes	150	
Increase in other liabilities	50	
Total adjustments		605
Net cash provided by operating activities		1,365

For starters, refer to the $445 depreciation and amortization figure. This is sourced directly from the consolidated statement of income previously presented. This is reflected as an adjustment because this amount is included in the calculation of net income, however, it is not actually a cash outlay, but is noncash. Depreciation and amortization is simply a financial charge that is recorded to reflect the reduction in the value of an asset over time. It is not an actual reflection of a physical cash outlay for use of an asset. Remember, the goal of the statement of cash flows is to reflect the actual movement in cash, so noncash transaction must be carved out in order to isolate the activity down to only cash transactions. Because we are starting with net income (calculated on an accrual basis of accounting), we have to make adjustments to essentially reflect it on a cash basis.

The entity's gain on sale reflected above is another example of a transaction that affected net income, but did not affect cash. In this situation, a facility with a net book value of $520 was sold for $600 cash. In other words, a gain of $80 was recorded, however, this is purely a financial gain and not a cash gain. Now, as will be discussed later, the $600 in cash proceeds received will be reflected in the statement of cash flows, but not in the operating section.

Finally, provisions for losses on accounts receivables is another example of a transaction that affects net income, but does not affect cash. As a result, this is an adjustment that needs to be made to net income to arrive at cash flows from operating activities. This provision for accounts receivable was likely recorded within the entity's selling, general, and administrative expenses, which in turn, was reflected in net income. Because it is a non-cash item, we are carving it out of net income to arrive at just the actual cash flow of the entity.

The next section of the statement of cash flows is the cash flow from investing activities. Refer to the exhibit below for an overview of this section of the statement of cash flows.

Cash flows from investing activities:		
Proceeds from sale of facility	600	
Payment received on note for sale of plant	150	
Capital expenditures	(1,000)	
Payment for purchase of Entity B, net of cash acquired	(925)	
Net cash used in investing activities		(1,175)

Note the $600 proceeds from the sale of the facility as was discussed above. This is an excellent example of where one transaction can have multiple effects on an entity's statement of cash flows. The gain was adjusted within cash flows from operating activities discussed previously, whereas the actual proceeds from the sale is reflected in investing activities. The line item for the payment received on note for sale of a plant is another example of a transaction that is reflected in investing activities. Because the entity is not in the business of buying and selling properties (i.e. the entity is a manufacturing company), this receipt of cash is not reflected as an operating activity, but is instead an investing activity.

Another common line item in the investing activities section of the statement of cash flows relates to capital expenditures. In this particular example, the $1,000 relates to accumulated expenditures during the year for the construction of a new facility. The investing activities section also includes activity where the entity purchased another entity, the $925 amount noted in the exhibit above. For this transaction, the entity paid $950 for the entity, however, it received $25 in cash from the entity based on its current listing of assets and liabilities at the acquisition date. As a result, the net effect ($950-$25) is included within the investing section of the statement of cash flows.

The next section of the example statement of cash flows relates to financing activities. Refer below for an example of this section of the statement of cash flows.

Cash flows from financing activities:		
Net borrowings under line-of-credit agreement	300	
Principal payments under capital lease obligation	(125)	
Proceeds from issuance of long-term debt	400	
Proceeds from issuance of common stock	500	
Dividends paid	(200)	
Net cash provided by financing activities		875

As you can note from line item descriptions, this section relates to borrowings, dividends paid, and other financing type arrangements such as the issuance of long-term debt and common stock.

The final section of the statement of cash flows is illustrated below. This is the section where it all comes together. The aggregate of the operating, investing, and financing sections is added to the beginning cash and cash equivalents balance at the beginning of the year to arrive at the balance at the end of the year. You will note that the beginning and ending balance amounts tie directly to the balance sheet previously presented.

Net increase in cash and cash equivalents	1,065
Cash and cash equivalents at beginning of year	600
Cash and cash equivalents at end of year	$1,665

Review Questions

9. Which of the following transactions is required to be classified within an entity's operating activities of its statement of cash flows?
    a. Proceeds received from derivative instruments that include financing elements at inception.
    b. Receipts from sales of property, plant, and equipment.
    c. Principal payments to creditors who have extended long-term credit.
    d. Payments to acquire materials for manufacturing of goods for resale.

10. Which of the following transactions is required to be classified within an entity's investing activities of its statement of cash flows?
    a. Payments to governments for taxes, fines, duties, and other penalties.
    b. Proceeds from issuing equity instruments.
    c. Proceeds from sales of machinery and equipment.

    d. Payments of dividends to the entity's stockholders.

11. Which of the following transactions is required to be classified within an entity's financing activities of its statement of cash flows?
    a. Payments related to debt issuance costs.
    b. Payments to suppliers and employees for goods and services.
    c. Proceeds from collections of loans made by the entity.
    d. Receipts from sales of loans that were not specifically acquired for resale.

Notes to Financial Statements

Financial statement footnotes are supplemental notes that accompany the financial statements issued by an entity. Simply put, footnotes are an integral part of the financial statements and are extremely valuable to users of financial statements, who can discern from the footnotes how various accounting policies used by an entity are impacting its reported financial position and results of operations.

Given that the accounting policies adopted by an entity can significantly affect the presentation of the entity's financial position, cash flows, and results of operations, it is critical that the entity ensure that users making economic decisions about the entity have a good understanding of the accounting policies by the entity. The accounting policies that an entity adopts should be most appropriate in the circumstances to present fairly the financial position, cash flows, and results of operations in accordance with GAAP (ASC 235-10-05-3). As a result, entities are required to provide a description of all significant accounting policies within the notes to financial statements, with the exception of interim (i.e. unaudited) period if the entity has not changed its accounting policies since the end of its preceding fiscal year (ASC 235-10-50-2).

Required Accounting Policy Disclosures

While we have laid out the principles with respect to accounting policy disclosures above, the next fundamental question is what is an entity specifically required to disclose? In short, the disclosures with respect to accounting policies should identify and describe the accounting principles followed by the entity and the methods of applying those principles that materially affect the determination of financial position, cash flows, or results of operations (ASC 235-10-50-3). Generally speaking, the disclosures should include important judgments regarding the appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods. Entities are also afforded flexibility as far as the formatting of these disclosures. While disclosure in a separate summary of significant accounting preceding the notes to the financial statements is preferred, it is not required (ASC 235-10-50-6). The FASB does prescribe that disclosures should include the accounting principles and methods that involve any of the following (ASC 235-10-50-3):

- A selection from existing accounting alternatives
- Principles and methods peculiar to the industry in which an entity operates, even if the principles and methods are predominantly followed in the entity's industry
- Unusual or innovative applications of GAAP

Further to the guidance prescribed above, the FASB also includes examples of common accounting policy disclosures entities should consider. These include the following (ASC 235-10-50-4):

- Basis of consolidation
- Depreciation methods
- Amortization of intangibles
- Inventory pricing
- Accounting for recognition of profit on long-term construction-type contracts
- Recognition of revenue from franchising and leasing operations

Example Accounting Policy Disclosures

The following sections provide examples from recent SEC filings of the accounting policy disclosure examples identified above. The majority of disclosures are sourced from current Dow Jones index companies. These examples are not meant to suggest these are best practices. Accordingly, these filings may be subject to SEC review and comment. These examples are merely presented to illustrate the application of the accounting policy disclosure noted above.

<u>Basis of Consolidation</u>

Example 1 – HP Inc. (Form 10-K for the fiscal year ended October 31, 2015)

> "The Consolidated Financial Statements include the accounts of HP and its subsidiaries and affiliates in which HP has a controlling financial interest or is the primary beneficiary. HP accounts for investments in companies over which HP has the ability to exercise significant influence but does not hold a controlling interest under the equity method, and HP records its proportionate share of income or losses in Interest and other, net in the Consolidated Statements of Earnings. HP presents non-controlling interests as a separate component within Total stockholder's equity in the Consolidated Balance Sheets. Net earnings attributable to the non-controlling interests are eliminated within Interest and other, net in the Consolidated Statements of Earnings and are not presented separately as they were not material for any period presented."

Example 2 – American Express Company (Form 10-K for the fiscal year ended December 31, 2015)

> "The Consolidated Financial Statements of the Company are prepared in conformity with accounting principles generally accepted in the United States of America (GAAP). Significant intercompany transactions are eliminated. The Company consolidates entities in which it holds a "controlling financial interest." For voting interest entities, the Company is considered to hold a controlling financial interest when it is able to exercise control over the investees' operating and financial decisions. For variable interest entities (VIEs), the Company is considered to hold a controlling financial interest when it is determined to be the primary beneficiary. A primary beneficiary is the party that has both: (1) the power to direct the activities that most significantly impact that entity's economic performance, and (2) the obligation to absorb losses of, or the right to receive benefits from, the VIE that could potentially be significant to the VIE. The determination of whether an entity is a VIE is based on the amount and characteristics of the entity's equity. Entities in which the Company's voting interest in common equity does not provide it with control, but allows the Company to exert significant influence over the operating and financial decisions, are accounted for under the equity method. All other investments in equity securities, to the extent they are not considered marketable securities, are accounted for under the cost method."

<u>Depreciation Methods</u>

Example 1 – General Electric Company (Form 10-K for the fiscal year ended December 31, 2015)

> "The cost of GE manufacturing plant and equipment is depreciated over its estimated economic life. In 2015, we changed the method of depreciating its U.S. assets from an accelerated method based on a sum-of-the-years digits formula to a straight-line basis in order to align and harmonize our methodology for manufacturing plant and equipment. This change in estimate was made prospectively as of October 1, 2015, and had an immaterial impact for 2015. As a result, as of October 1, 2015, GE manufacturing plant and equipment is generally depreciated on a straight-line basis. The cost of GE Capital equipment leased to others on operating leases is depreciated on a straight-line basis to estimated residual value over the lease term or over the estimated economic life of the equipment."

Example 2 – The Home Depot, Inc. (Form 10-K for the fiscal year ended January 31, 2016)

> "The Company's Buildings, Furniture, Fixtures and Equipment are recorded at cost and depreciated using the straight-line method over the estimated useful lives of the assets. Leasehold Improvements

are amortized using the straight-line method over the original term of the lease or the useful life of the improvement, whichever is shorter."

Amortization of Intangibles

Example 1 – Microsoft Corporation (Form 10-K for the fiscal year ended June 30, 2015)

> "All of our intangible assets are subject to amortization and are amortized using the straight-line method over their estimated period of benefit, ranging from one to 15 years. We evaluate the recoverability of intangible assets periodically by taking into account events or circumstances that may warrant revised estimates of useful lives or that indicate the asset may be impaired."

Example 2 – Visa Inc. (Form 10-K for the fiscal year ended September 30, 2015)

> "Indefinite-lived intangible assets consist of trade name, customer relationships and the Visa Europe franchise right acquired in the October 2007 reorganization. Intangible assets with indefinite useful lives are not amortized but are evaluated for impairment annually or more frequently if events or changes in circumstances indicate that impairment may exist. The Company first assesses qualitative factors to determine whether it is necessary to perform a quantitative impairment test for indefinite-lived intangible assets. The Company assesses each category of indefinite-lived intangible assets for impairment on an aggregate basis, which may require the allocation of cash flows and/or an estimate of fair value to the assets or asset group. Impairment exists if the fair value of the indefinite-lived intangible asset is less than the carrying value. The Company relies on a number of factors when completing impairment assessments, including a review of discounted net future cash flows, business plans and the use of present value techniques."

Inventory Pricing

Example 1 – Best Buy Co., Inc. (Form 10-K for the fiscal year ended January 30, 2015)

> "Merchandise inventories are recorded at the lower of cost, using the average cost, or market. In-bound freight-related costs from our vendors are included as part of the net cost of merchandise inventories. Also included in the cost of inventory are certain vendor allowances that are not a reimbursement of specific, incremental and identifiable costs to promote a vendor's products. Other costs associated with acquiring, storing and transporting merchandise inventories to our retail stores are expensed as incurred and included in cost of goods sold. Our inventory valuation reflects adjustments for anticipated physical inventory losses (e.g., theft) that have occurred since the last physical inventory. Physical inventory counts are taken on a regular basis to ensure that the inventory reported in our consolidated financial statements is properly stated. Our inventory valuation also reflects markdowns for the excess of the cost over the amount we expect to realize from the ultimate sale or other disposal of the inventory. Markdowns establish a new cost basis for our inventory. Subsequent changes in facts or circumstances do not result in the reversal of previously recorded markdowns or an increase in the newly established cost basis."

Example 2 – Apple Inc. (Form 10-K for the fiscal year ended September 26, 2015)

> "The Company must purchase components and build inventory in advance of product shipments and has invested in manufacturing-related assets, including capital assets held at its suppliers' facilities. In addition, the Company has made prepayments to certain of its suppliers associated with long-term supply agreements to secure supply of inventory components. The Company records a write-down for inventories of components and products, including third-party products held for resale, which have become obsolete or are in excess of anticipated demand or net realizable value. The Company performs a detailed review of inventory that considers multiple factors including demand forecasts, product life cycle status, product development plans, current sales levels and component cost trends. The Company also reviews its manufacturing-related capital assets and inventory prepayments for impairment whenever events or circumstances indicate the carrying amount of such assets may not be recoverable.

If the Company determines that an asset is not recoverable, it records an impairment loss equal to the amount by which the carrying value of such an asset exceeds its fair value.

The industries in which the Company competes are subject to a rapid and unpredictable pace of product and component obsolescence and demand changes. In certain circumstances the Company may be required to record additional write-downs of inventory and/or manufacturing-related assets. These circumstances include future demand or market conditions for the Company's products being less favorable than forecasted, unforeseen technological changes or changes to the Company's product development plans that negatively impact the utility of any of these assets, or significant deterioration in the financial condition of one or more of the Company's suppliers that hold any of the Company's manufacturing-related assets or to whom the Company has made an inventory prepayment. Such write-downs would adversely affect the Company's financial condition and operating results in the period when the write-downs were recorded.

The Company accrues for estimated cancellation fees related to inventory orders that have been cancelled or are expected to be cancelled. Consistent with industry practice, the Company acquires components through a combination of purchase orders, supplier contracts, and open orders in each case based on projected demand. Where appropriate, the purchases are applied to inventory component prepayments that are outstanding with the respective supplier. Purchase commitments typically cover the Company's forecasted component and manufacturing requirements for periods up to 150 days. If there is an abrupt and substantial decline in demand for one or more of the Company's products, a change in the Company's product development plans, or an unanticipated change in technological requirements for any of the Company's products, the Company may be required to record additional accruals for cancellation fees that would adversely affect its results of operations in the period when the cancellation fees are identified and recorded."

<u>Revenue Recognition</u>

Example 1 – The Coca Cola Company (Form 10-K for the fiscal year ended December 31, 2015)

"We recognize revenue when persuasive evidence of an arrangement exists, delivery of products has occurred, the sales price is fixed or determinable and collectibility is reasonably assured. For our Company, this generally means that we recognize revenue when title to our products is transferred to our bottling partners, resellers or other customers. Title usually transfers upon shipment to or receipt at our customers' locations, as determined by the specific sales terms of each transaction. Our sales terms do not allow for a right of return except for matters related to any manufacturing defects on our part.

Our customers can earn certain incentives which are included in deductions from revenue, a component of net operating revenues in our consolidated statements of income. These incentives include, but are not limited to, cash discounts, funds for promotional and marketing activities, volume-based incentive programs and support for infrastructure programs. Refer to Note 1 of Notes to Consolidated Financial Statements. The aggregate deductions from revenue recorded by the Company in relation to these programs, including amortization expense on infrastructure programs, were $6.8 billion, $7.0 billion and $6.9 billion in 2015, 2014 and 2013, respectively. In preparing the financial statements, management must make estimates related to the contractual terms, customer performance and sales volume to determine the total amounts recorded as deductions from revenue. Management also considers past results in making such estimates. The actual amounts ultimately paid may be different from our estimates. Such differences are recorded once they have been determined and have historically not been significant."

Example 2 – McDonald's Corporation (Form 10-K for the fiscal year ended December 31, 2015)

"The Company's revenues consist of sales by Company-operated restaurants and fees from franchised restaurants operated by conventional franchisees, developmental licensees and foreign affiliates. Sales by Company-operated restaurants are recognized on a cash basis. The Company presents sales net of sales tax and other sales-related taxes. Revenues from conventional franchised restaurants include rent and royalties based on a percent of sales with minimum rent payments, and initial fees. Revenues from restaurants licensed to foreign affiliates and developmental licensees include a royalty based on a percent of sales, and may include initial fees. Continuing rent and royalties are recognized in the period earned. Initial fees are recognized upon opening of a restaurant or granting of a new franchise term, which is when the Company has performed substantially all initial services required by the franchise arrangement."

Changes in Accounting Principles

In the preceding section, we discussed the various accounting policy noted disclosures entities are required to present within the notes to the financial statements. In this final section of the course, we'll review the considerations and address the requirements with respect to changes in accounting principles.

A change in accounting principle is a situation where an entity changes from reporting from one GAAP principle to another GAAP principle. For example, this could be a situation where an entity changes its inventory method from First-In First-Out (FIFO) to Last-In First-Out (LIFO). Both of these types of inventory methods are accepted accounting principles so as a result, the change is considered a change in accounting principle (as opposed to a correction of an error which would be the case if an entity changes from a non GAAP principle to a GAAP principle). The distinction between error corrections and changes in accounting principles is important to keep in mind.

ASC 250-10-45-1 notes that a presumption exists that an accounting principle, once adopted shall not be changed in accounting for events and transactions of a similar type. Furthermore, consistent use of the same accounting principle from one accounting period to another enhances the utility of financial statements for users by facilitating analysis and understanding of comparative accounting data. In addition, ASC 250 also notes that neither of the following would be considered a change in accounting principle:

- Initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or that previously were immaterial in their effect;
- Adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring;

Given that the initial adoption of an accounting principle is not considered a change, nor is an adoption or modification of an accounting principle based on changes in transaction or events, what is considered a change in accounting principle? In this situation, the FASB provides specific guidance on exactly what is considered a change in accounting principle. This includes each of the following (ASC 250-10-45-2):

- The change is required by a newly issued Codification update;
- The entity can justify the use of an allowable alternative accounting principle on the basis that it is preferable;

The first situation above is pretty straight forward and generally results when the FASB releases ASUs from time to time. This would not be considered voluntary, but instead, would be required by all entities who are subject to certain ASC scope requirements. In some cases, entities may consider changing an accounting principle to conform with a proposed amendment to the ASC. However, it should be noted that a proposed amendment to the ASC does not provide sufficient support for a change in accounting principle. As a result, such a proposed amendment to the ASC should not be used as the basis for a voluntary change in accounting principle because proposed amendments to the ASC remain subject to change in the process of developing and approving the update.

The second bullet though relates to more voluntary changes made by an entity. For example, this could be case where an entity does any of the following:

- Changes its measurement date for conducting its annual goodwill impairment test;
- Changes its method of amortizing actuarial gains and losses of retirement benefits;

- Changes its inventory valuation method (i.e., from LIFO to FIFO, retail inventory method to weighted average cost, etc.);

The key point related to voluntary changes in accounting principles is that the entity must justify that the change is preferable. In other words, the entity cannot simply change back and forth between accounting principles.

How to Account for Change in Accounting Principle

ASC 250 requires that entities report a change in accounting principle using retrospective application of the new accounting principle to all prior periods. However, this is not required if the entity determines it is impracticable to do so (ASC 250-10-45-5). However, what is meant by retrospective application and how does an entity justify whether it is impractical to do so?

Retrospective application of a change in accounting principle requires the following:

- The cumulative effect of the change to the new accounting principle on periods prior to those presented is reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented
- An offsetting adjustment, if any, is made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period;
- Financial statements for each individual prior period presented are adjusted to reflect the period specific effects of applying the new accounting principle;

It is also important to note the distinction between retrospective application and a restatement. The distinction within the ASC Master Glossary when these two terms are compared is intended to reflect the conclusion that it is preferable to use the same terms as International Financial Reporting Standards (IFRS) whenever possible to reduce the potential for inconsistent application of accounting principles. As a result, the terminology change would better distinguish changes in amounts reported for prior periods related to a voluntary change in accounting principle from those changes related to the correction of an error. The difference in terminology assists in eliminating the negative implication associated with changes to prior period financial statements as a result of a change in accounting principle, compared to the term restatement which results from a correction of an error.

The use of the retrospective application yields greater consistency of financial information reported across different periods because it reflects the financial statements as if a newly adopted accounting principle had always been used historically. Further to this point, with respect to recognizing the cumulative effect of a change in accounting principle in opening retained earnings, the FASB concluded that it would be inappropriate to record the cumulative effects on prior periods in net income of the period of change because none of the effects relate directly to that period. As a result, while new ASUs may require recognizing a cumulative effect as of a specific date as the transition method, the cumulative effect will be recognized in retained earnings as opposed to net income in the period of the change.

ASC 250 also requires that retrospective application only include the direct effects of a change in accounting principle. Said another way, this would include any related income tax effects in prior period financial statements. However, if as a result of retrospective application, indirect effects of a change in accounting principle result, these indirect effects should be recognized in the period in which the accounting change is implemented. As a result, any indirect effects are required to be recognized in the period of the accounting change and not in the prior period that is affected by the retrospective application.

As noted above, ASC 250 affords entities an impracticability exception to retrospective application. There are two situations described in ASC 250-10-45-6 and 45-7 that affect an entity's ability to retrospectively apply a change in accounting principle. This includes the following:

- The cumulative effect of applying a change in accounting principle to all prior periods can be determined, but it is impracticable to determine the period-specific effects of that change on all prior periods presented;

- It is impracticable to determine the cumulative effect of applying a change in accounting principle to any prior period.

As you can infer, there are rigorous requirements that an entity must meet before concluding that it is impractical to reflect a change in accounting principle on a retrospective basis. This includes the following requirements/conditions (ASC 250-10-45-9):

- After making every reasonable effort to do so, the entity is unable to apply the requirement;
- Retrospective application requires assumptions about management's intent in a prior period that cannot be independently substantiated;
- Retrospective application requires significant estimates of amounts, and it is impossible to distinguish objectively information about those estimates that both:
  - Provides evidence of circumstances that existed on the date(s) at which those amounts would be recognized, measured, or disclosed under retrospective application, and
  - Would have been available when the financial statements for that prior period were issued.

One of the key judgments relates to the interpretation of what constitutes an entity making every reasonable effort to apply the change in accounting principle on a retroactive basis. As a result, this will require judgment on the part of management and the independent auditors, after considering all relevant facts and circumstances of each specific situation.

One of the important questions an entity should consider is whether appropriate and sufficient data was collected in prior periods in a way that would retrospective application from a change in accounting principle. If this data was not collected in prior periods, is it impracticable to attempt to recreate the data in such a manner that would sufficiently support retrospective application of the change in accounting principle? Furthermore, the entity should also consider the relevance of hindsight on the part of management. In other words, can it reliably make assumptions about what management's intentions would have been in a prior period or estimate the amounts recognized, measured, or disclosed? Finally, the entity should also consider the costs and benefits of performing a full retrospective application from the change in accounting principle. In other words, would trying to recreate history with a different accounting principle be so costly that the perceived benefits would not be worth it?

Justifying a Change in Accounting Principle

ASC 250 presumes that once an accounting policy is adopted and applied, it is used consistently in accounting for similar events or transactions by the entity. However, an entity may voluntarily change an accounting principle only if it justifies the use of an allowable alternative accounting principle if it is in fact preferable. As a result, preferability is the key consideration. Preferability among accounting principles should also be determined on the basis of whether the new principle constitutes an improvement in financial reporting and not on the basis of the income tax effect alone (ASC 250-10-55-1).

A decision by an entity to make a voluntary change of an accounting principle requires management, as well as the entity's independent auditor, to make an assessment of the preferability of the change. The PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, states that the auditor should evaluate a change in accounting principle to determine whether:

- The newly adopted accounting principle is a generally accepted accounting principle;
- The method of accounting for the effect of the change is in conformity with generally accepted accounting principles;
- The disclosures related to the accounting change are adequate;
- The company has justified that the alternative accounting principle is preferable;

While there is specific guidance for auditors to use in assessing changes in accounting principles, very little guidance in the accounting literature exists for evaluating the reasonableness of management's justification for a voluntary change in accounting principle. One of the few examples is included within ASC 330-10-30-14 which discusses methods of costing inventory which states that "although selection of the method should be made on the basis of the individual circumstances, it is obvious that financial statements will be more useful if uniform methods of inventory pricing are adopted by all companies within a given industry."

While there is limited guidance as noted above within the accounting literature, the SEC does provide additional interpretive guidance with respect to preferability changes. These questions and interpretive responses are included within ASC 250-10-S99-4. This interpretive guidance is included below.

Facts
Rule 10-01(b)(6) of Regulation S-X requires that a registrant who makes a material change in its method of accounting shall indicate the date of and the reason for the change. The registrant also must include as an exhibit in the first Form 10-Q filed subsequent to the date of an accounting change, a letter from the registrant's independent accountants indicating whether or not the change is to an alternative principle which in his judgment is preferable under the circumstances. A letter from the independent accountant is not required when the change is made in response to a standard adopted by the Financial Accounting Standards Board which requires such a change.

Question 1
For some alternative accounting principles, authoritative bodies have specified when one alternative is preferable to another. However, for other alternative accounting principles, no authoritative body has specified criteria for determining the preferability of one alternative over another. In such situations, how should preferability be determined?

Interpretive Response
In such cases, where objective criteria for determining the preferability among alternative accounting principles have not been established by authoritative bodies, the determination of preferability should be based on the particular circumstances described by and discussed with the registrant. In addition, the independent accountant should consider other significant information of which he is aware.

Question 2
Management may offer, as justification for a change in accounting principle, circumstances such as: their expectation as to the effect of general economic trends on their business (e. g., the impact of inflation), their expectation regarding expanding consumer demand for the company's products, or plans for change in marketing methods. Are these circumstances which enter into the determination of preferability?

Interpretive Response
Yes. Those circumstances are examples of business judgment and planning and should be evaluated in determining preferability. In the case of changes for which objective criteria for determining preferability have not been established by authoritative bodies, business judgment and business planning often are major considerations in determining that the change is to a preferable method because the change results in improved financial reporting.

Question 3
What responsibility does the independent accountant have for evaluating the business judgment and business planning of the registrant?

Interpretive Response
Business judgment and business planning are within the province of the registrant. Thus, the independent accountant may accept the registrant's business judgment and business planning and express reliance thereon in his letter. However, if either the plans or judgment appear to be unreasonable to the independent accountant, he should not accept them as justification. For example, an independent accountant should not accept a registrant's plans for a major expansion if he believes the registrant does not have the means of obtaining the funds necessary for the expansion program.

Question 4
If a registrant, who has changed to an accounting method which was preferable under the circumstances, later finds that it must abandon its business plans or change its business judgment because of economic or other factors, is the registrant's justification nullified?

Interpretive Response
No. A registrant must in good faith justify a change in its method of accounting under the circumstances which exist at the time of the change. The existence of different circumstances at a later time does not nullify the previous justification for the change.

Question 5
If a registrant justified a change in accounting method as preferable under the circumstances, and the circumstances change, may the registrant revert to the method of accounting used before the change?

Interpretive Response
Any time a registrant makes a change in accounting method, the change must be justified as preferable under the circumstances. Thus, a registrant may not change back to a principle previously used unless it can justify that the previously used principle is preferable in the circumstances as they currently exist.

Question 6
If one client of an independent accounting firm changes its method of accounting and the accountant submits the required letter stating his view of the preferability of the principle in the circumstances, does this mean that all clients of that firm are constrained from making the converse change in accounting (e. g., if one client changes from FIFO to LIFO, can no other client change from LIFO to FIFO)?

Interpretive Response
No. Each registrant must justify a change in accounting method on the basis that the method is preferable under the circumstances of that registrant. In addition, a registrant must furnish a letter from its independent accountant stating that in the judgment of the independent accountant the change in method is preferable under the circumstances of that registrant. If registrants in apparently similar circumstances make changes in opposite directions, the staff has a responsibility to inquire as to the factors which were considered in arriving at the determination by each registrant and its independent accountant that the change was preferable under the circumstances because it resulted in improved financial reporting. The staff recognizes the importance, in many circumstances, of the judgments and plans of management and recognizes that such management judgments may, in good faith, differ. As indicated above, the concern relates to registrants in apparently similar circumstances, no matter who their independent accountants may be.

Question 7
If a registrant changes its accounting to one of two methods specifically approved by the FASB in the Accounting Standards Codification, need the independent accountant express his view as to the preferability of the method selected?

Interpretive Response
If a registrant was formerly using a method of accounting no longer deemed acceptable, a change to either method approved by the FASB may be presumed to be a change to a preferable method and no letter will be required from the independent accountant. If, however, the registrant was formerly using one of the methods approved by the FASB for current use and wishes to change to an alternative approved method, then the registrant must justify its change as being one to a preferable method in the circumstances and the independent accountant must submit a letter stating that in his view the change is to a principle that is preferable in the circumstances.

As you can note from the guidance above, when an SEC registrant makes a voluntary change in accounting principle, it generally is required to include a preferability letter issued by its independent registered public accounting firm as Exhibit 18 to its first periodic report filed subsequent to the accounting change. As a result, this would either be through its Quarterly Report on Form 10-Q if the change is made in an interim period other than the fourth quarter or the entity's Annual Report on Form 10-K if the change is made in the fourth quarter. ASC 250 has no effect on this requirement. The SEC staff has taken the position that a preferability letter is needed for each situation in which a registrant discloses a voluntary change in accounting principle, even though the auditors may consider the change to not be material and do not comment thereon in their report.

One specific example the SEC cites as example of a situation where a preferability would be required relates to an entity's goodwill impairment testing date. Further to this point, in a December 2014 speech at the AICPA Conference on Current SEC and PCAOB Developments, Carlton Tartar, Associate Chief Accountant, Office of the Chief Accountant, an SEC staff member, stated the following:

> "…the staff has observed that some registrants may view a change in goodwill impairment testing date to not represent a material change to a method of applying an accounting principle, even if goodwill is material to the financial statements, because the change in impairment testing date is not viewed to have a material effect on the financial statements in light of the registrant's internal controls and requirements under Topic 350 to assess goodwill impairment upon certain triggering events. The staff acknowledges that judgment is required when assessing materiality and the assessment of whether a change in accounting principle is material may include considerations beyond the quantitative significance of the financial statement line items. Accordingly, if a registrant determines that a change in goodwill impairment testing date does not represent a material change to its method of applying an accounting principle, the staff will no longer request a preferability letter to be obtained and filed, provided that such change is prominently disclosed in the registrant's financial statements. The staff also reserves the right to ask questions based on the registrant's specific facts and circumstances, which may include situations where it appears that a registrant's goodwill impairment testing date is frequently changed."

Review Questions

12. Which of the following identifies an example of a change in accounting principle?
    a. A change in the estimated useful life of an entity's long-lived assets.
    b. A change in the estimate of uncollectible accounts receivable balances.
    c. A change in the valuation method of an entity's inventory.
    d. A change in the estimated future liability for warranty obligations on an entity's products sold.

Glossary of Terms

Business Interruption Insurance

Insurance that provides coverage if business operations are suspended due to the loss of use of property and equipment resulting from a covered cause of loss.

Component of an Entity

Comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. May be a reportable segment or an operating segment, a reporting unit, a subsidiary, or an asset group.

Financing Activities

Financing activities include obtaining resources from owners and providing them with a return on, and a return of, their investment; receiving restricted resources that by donor stipulation must be used for long-term purposes; borrowing money and repaying amounts borrowed, or otherwise settling the obligation; and obtaining and paying for other resources obtained from creditors on long-term credit.

Investing Activities

Investing activities include making and collecting loans and acquiring and disposing of debt or equity instruments and property, plant, and equipment and other productive assets, that is, assets held for or used in the production of goods or services by the entity (other than materials that are part of the entity's inventory). Investing activities exclude acquiring and disposing of certain loans or other debt or equity instruments that are acquired specifically for resale.

Liquidation

The process by which an entity converts its assets to cash or other assets and settles its obligations with creditors in anticipation of the entity ceasing all activities. Upon cessation of the entity’s activities, any remaining cash or other assets are distributed to the entity’s investors or other claimants (albeit sometimes indirectly). Liquidation may be compulsory or voluntary. Dissolution of an entity as a result of that entity being acquired by another entity or merged into another entity in its entirety and with the expectation of continuing its business does not qualify as liquidation.

Operating Activities

Operating activities include all transactions and other events that are not defined as investing or financing activities. Operating activities generally involve producing and delivering goods and providing services. Cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income.

Repurchase Agreement

A transaction in which a seller-borrower of securities sells those securities to a buyer-lender with an agreement to repurchase them at a stated price plus interest at a specified date or in specified circumstances

Reverse Repurchase Agreement

A transaction that is accounted for as a collateralized lending in which a buyer-lender buys securities with an agreement to resell them to the seller-borrower at a stated price plus interest at a specified date or in specified circumstances.

Right of Setoff

A debtor’s legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor.

Final Examination

1. Which of the following FASB ASC topics prescribe requirements with respect to a reporting entity's notes to its financial statements?
    a. ASC Topic 210.
    b. ASC Topic 220.
    c. ASC Topic 235.
    d. ASC Topic 250.

2. Discontinued operations should ordinarily be reported by entities when the disposal represents which of the following?
    a. A strategic shift in its continuing operations.
    b. A material change in future net income.
    c. A significant loss on disposal.
    d. A group of the entity's low value revenue-generating assets.

3. A disposal transaction by sale qualifies for reporting as a discontinued operation if each of the following criteria are met, except?
    a. The disposal group is a component of an entity.
    b. The disposal meets the held for sale requirements.
    c. The disposal represents a strategic shift.
    d. The disposal will result in a material gain.

4. In order for a disposal transaction to meet the held for sale criteria, the sale must be probable and occur within what period of time?
    a. 3 months.
    b. 6 months.
    c. 12 months.
    d. 24 months.

5. In order for a disposal transaction to meet the held for sale criteria, the asset must be marketed at a price that is reasonable in relation to its
    a. Fair market value.
    b. Net book value.
    c. Replacement cost.
    d. Original acquisition cost.

6. In general, an entity should prepare its financial statements on the liquidation basis of accounting if liquidation of the entity is
    a. Probable.
    b. Likely.
    c. Imminent.
    d. Reasonably possible.

7. If an entity prepares its financial statements using the liquidation basis of accounting, then the entity should measure its assets at which of the following?
    a. Their fair market value.
    b. The cost to replace the assets
    c. The original cost less accumulated depreciation.
    d. The amount of cash the entity expects to receive.

8. Which of the following identifies a statement that presents a liquidating entity's net assets available for distribution to investors and other claimants as of the end of the reporting period?
   a. Statement of net assets in liquidation.
   b. Statement of changes in net assets in liquidation.
   c. Statement of expected cash flows from liquidation.
   d. Statement of net assets at fair market value.

9. Which of the following FASB ASU's prescribed that certain disclosures be made by an entity in situations when substantial doubt exists about the entity's ability to continue as a going concern?
   a. ASU 2014-14.
   b. ASU 2014-15.
   c. ASU 2015-06.
   d. ASU 2016-02.

10. Each of the following identifies an example of an adverse condition or event that may give rise to substantial doubt about an entity's ability to continue as a going concern, except?
    a. Working capital deficiencies.
    b. Noncompliance with statutory capital requirements.
    c. Substantial dependence on the success of a particular project.
    d. Revised estimates of asset useful lives.

11. Which of the following is a required condition for a right of setoff to exist?
    a. One of the two parties owes the other a determinable amount.
    b. The reporting entity may elect to setoff.
    c. The reporting entity has a right of setoff enforceable by law.
    d. One of the parties is subject to a reverse repurchase agreement.

12. The FASB ASU which eliminated the extraordinary concept within GAAP is effective for public business entities for fiscal years, and interim periods within those years, beginning after what date?
    a. December 15, 2015.
    b. December 31, 2015.
    c. December 15, 2016.
    d. December 31, 2016.

13. The FASB ASU related to comprehensive income prescribed that all non-owner changes in stockholder's equity be presented in a single continuous statement of comprehensive income or in which of the following?
    a. Within the entity's statement of financial position.
    b. Within two separate but consecutive statements.
    c. Within the statement of shareholder's equity.
    d. Within the income statement as a reconciling item.

14. Which of the following sections of the statement of cash flows relates to obtaining resources from owners and providing them with a return on their investments?
    a. Operating activities.
    b. Investing activities.
    c. Financing activities.
    d. Capital activities.

15. Which of the following sections of the statement of cash flows relates to making and collecting loans and disposing of debt or equity instruments?
    a. Financing activities.
    b. Investing activities.
    c. Equity activities.
    d. Operating activities.

16. Cash receipts from returns on loans, other debt instruments of other entities, and equity securities should be classified as which of the following activities on an entity's statement of cash flows?
    a. Operating activities.
    b. Investing activities.
    c. Financing activities.
    d. Equity activities.

17. Which of the following identifies the FASB's preferred method of presentation of an entity's statement of cash flows?
    a. Indirect method.
    b. Cash receipts method.
    c. Direct method.
    d. Cash movement method.

18. Which of the following methods of presentation of an entity's statement of cash flows presents reconciliation of net income to net cash flow from operating activities?
    a. Indirect method.
    b. Cash receipts method.
    c. Direct method.
    d. Cash movement method.

19. When an entity elects the use of the direct method of presenting its statement of cash flows, the entity is required to disclose each of the following, except?
    a. Interest and dividends received.
    b. Cash collected from customers.
    c. Income taxes paid.
    d. Cash movements among the entity's business units or subsidiaries.

20. Reporting entities are required to provide which of the following within the notes to their financial statements?
    a. Description of their significant accounting policies.
    b. Description of their significant contracts with major customers.
    c. Identification of their material accounting estimates compared to actual results.
    d. Identification of the countries where their cash and cash equivalents are maintained.

21. Which of the following identifies an example of a change in accounting principle?
    a. Initial adoption of an accounting principle for events occurring for the first time.
    b. Modification of an accounting principle required by events that are different in substance than those previously occurring.
    c. Adoption of a new accounting principle required by a newly issued ASU.
    d. A change from a non-GAAP accounting principle to a GAAP accounting principle.

22. In order for a reporting entity to implement a change in accounting principle to an allowable alternative, the entity is first required to do which of the following?
    a. Evidence that the accounting alternative is preferable.
    b. Obtain a preferability letter from its independent auditor.
    c. Restate its financial statements for all prior periods presented.
    d. Disclose the change in the accounting principle through an SEC Form 8-K.

23. GAAP requires a change in accounting principle be applied using which of the following transition methods, unless it is impractical to do so?
    a. Prospective.
    b. Modified prospective.
    c. Retrospective.
    d. Modified retrospective.

24. Which of the following PCAOB Standards requires an auditor evaluate a change in accounting principle to determine, among other factors, whether the disclosures related to the accounting change are adequate?
    a. PCAOB Auditing Standard No. 1
    b. PCAOB Auditing Standard No. 3
    c. PCAOB Auditing Standard No. 4
    d. PCAOB Auditing Standard No. 6

25. Which of the following FASB ASC topics prescribe requirements with respect to accounting and reporting of discontinued operations?
    a. ASC Topic 205.
    b. ASC Topic 210.
    c. ASC Topic 410.
    d. ASC Topic 425.

26. If an entity concludes that a change in accounting principle is preferable, then the entity should review the related disclosure requirements regarding the change within which of the following ASC Topics?
    a. ASC Topic 280.
    b. ASC Topic 250.
    c. ASC Topic 205
    d. ASC Topic 815.

27. Results of discontinued operations should be presented below which of the following line items in an entity's income statement?
    a. Income from continuing operations before income taxes.
    b. Net income.
    c. Comprehensive income.
    d. Income from continuing operations.

28. Additional financial statement disclosures for a discontinued operations are required if which of the following related to the discontinued operation is applicable?
    a. The entity retains an equity method investment in the discontinued operation.
    b. The entity classified the discontinued operation as held for sale.
    c. The disposal represents a strategic shift.
    d. The disposal proceeds were received in cash.

29. Which of the following adverse conditions related to an entity's going concern relates to an internal matter?
    a. Loss of a key franchise.
    b. Loss of a principal supplier.
    c. Uninsured catastrophe.
    d. Uneconomic long-term commitments.

30. Which of the following identifies a transaction that is accounted for as a collateralized lending in which a buyer-lender buys securities with an agreement to resell them to the seller-borrower at a stated price plus interest at a specified date?
    a. Reverse repurchase agreement.
    b. Repurchase agreement.
    c. Leveraged lease.
    d. Derivative.

31. Which of the following types of insurance coverage generally provides for reimbursement of certain costs and loss incurred during a reasonable period of time required to rebuild or repair damaged property used in an entity's business?
    a. Umbrella insurance.
    b. Property insurance.
    c. Business interruption insurance.
    d. Contingency insurance.

32. Cash paid to settle asset retirement obligations should be classified within which of the following sections of the statement of cash flows?
    a. Operating activities.
    b. Financing activities.
    c. Investing activities.
    d. Noncash activity.

33. With respect to an entity's notes to its financial statements, the FASB prescribes each of the following as common accounting policy disclosures?
    a. Basis of consolidation.
    b. Depreciation methods.
    c. Inventory pricing.
    d. Goodwill impairment.

34. Retrospective application of a change in accounting principle requires an offsetting adjustment, if any, be made to the opening balance of which of the following?
    a. Retained earnings.
    b. Stockholders equity.
    c. Other income.
    d. Comprehensive income.

35. Which of the following type of changes was noted by the SEC to not represent a change in accounting principle if the change does not materially affect the method with which the accounting principle is applied?
    a. Change in useful lives of long-lived assets.
    b. Change in goodwill impairment testing date.
    c. Change in amortization method of intangibles.
    d. Change in method of valuing inventory.

Solutions to Review Questions

1. Which of the following FASB ASC topics prescribe the overall financial statement presentation requirements for reporting entities?
    a. ASC Topic 205.
    Correct. ASC Topic 205 prescribes the primary requirements with respect to presentation of financial statements. Additionally, this ASC topic is further broken down into various subtopics to include subtopic 20 (Discontinued Operations), subtopic 30 (Liquidation Basis of Accounting), and subtopic 40 (Going Concern). Like other FASB ASC topics, there are additional subtopics that are specific to certain industries (i.e. financial services, health care, not-for-profit, etc.).
    b. ASC Topic 210.
    Incorrect. ASC Topic 210 prescribes the requirements with respect to balance sheet presentation. This topic includes an overall subtopic (subtopic 10) along with a subtopic dedicated to balance sheet offsetting (subtopic 20). Similar to other FASB ASC topics, there are additional subtopics that are specific to certain industries such as contractors and financial services.
    c. ASC Topic 230.
    Incorrect. ASC Topic 230 prescribes the requirements with respect to statements of cash flow. This topic is limited to the overall subtopic (subtopic 10), but also includes cash flow considerations related to foreign currency, development stage entities, entertainment-films, real estate, etc.
    d. ASC Topic 250.
    Incorrect. ASC Topic 250 prescribes the requirements with respect to accounting changes and error corrections. This includes discussions with respect to changes in accounting principles, changes in accounting estimates, along with accounting and reporting requirements of corrections of errors.

2. Which of the following ASUs resulted in less asset disposals qualifying for discontinued operations recognition?
    a. ASU 2014-05.
    Incorrect. ASU 2014-05 prescribes amendments for service concession arrangements (ASC Topic 852) based on a consensus of the FASB's Emerging Issues Task Force (EITF). It did not relate to discontinued operations.
    b. ASU 2014-08.
    Correct. ASU 2014-08, released in April 2014, resulted in less asset disposals qualifying for discontinued operations recognition. The provisions within the ASU amended the requirements for reporting asset disposals as discontinued operations and are effective for public business entities for assets disposals that occur within annual periods beginning on or after December 15, 2014, including interim periods within those years.
    c. ASU 2015-01.
    Incorrect. ASU 2015-01 does not include amendments and provisions within respect to asset disposals qualifying as discontinued operations. This ASU simplified income statement presentation by eliminating the concept of extraordinary items.
    d. ASU 2016-02.
    Incorrect. ASU 2016-02 does not include amendments and provisions with respect to assets disposals qualifying as discontinued operations. This ASU prescribed sweeping changes for the way in which lease transactions are accounted for and reflected on lessee's balance sheets. Primarily, these amendments will result in lessee's including a lease liability and right-of-use asset on their balance sheet for operating leases.

3. Each of the following is a criteria for a disposal meeting the held for sale criteria, except?
    a. Management commits to a plan to sell the asset.
       Incorrect. Management committing to a plan to sell the asset is a criteria that must be met in order for an asset disposal to qualify as held for sale. Ordinarily, the commitment to sale should be evidenced by appropriate documentation and approved by the appropriate level of authority within the entity. In other words, if given the magnitude of the sale it would require CEO approval, the criteria would not be met until the CEO approves the sale.
    b. The asset is available for immediate sale in its present condition.
       Incorrect. An asset being available for immediate sale in its present condition is a criteria that must be met in order for an asset disposal to qualify as held for sale. In order for an asset to be available for immediate sale, an entity must have both the intent and ability to sell the component in its present condition. Said another way, if an entity imposes a delay in the actual transfer of the component, this would call into question whether the component is actually available for immediate sale in its present condition.
    c. An active program to locate a buyer will commence within 6 months.
       Correct. While an active program to locate a buyer is a requirement of an asset disposal meeting the held for sale criteria, it should have already commenced. The FASB does not provide additional guidance with respect to this criteria, so entities are afforded some additional flexibility in justifying that this criteria has been met. However, the key point to note here is that the entity should be making progress in identifying a buyer related to the disposal transaction.
    d. The sale of the asset is probable and expected to be completed within one year.
       Incorrect. The sale of the asset being probable and expected to be completed within one year is a criteria that must be met in order for an asset disposal to qualify as held for sale. This criteria should be viewed as two separate requirements. The first requirement is that the sale must be probable. Next, it must be completed within a year (subject to limited exceptions). While the conclusion with respect to this criteria can be subjective, the FASB does include implementation guidance that assists entities in understanding how the assessment of this criteria can be applied.

4. Which of the following schedules/statements is a reporting entity required to prepare if it is using the liquidation basis of accounting?
    a. Statement of cash flows.
       Incorrect. An entity using the liquidation basis of accounting is not required to prepare a statement of cash flows. Requirements for the statement of cash flows are prescribed within ASC Topic 230.
    b. Statement of financial position.
       Incorrect. An entity using the liquidation basis of accounting is not required to prepare a statement of financial position (i.e. a balance sheet). Requirements for balance sheets are prescribed within ASC Topic 210.
    c. Statement of net assets held for sale.
       Incorrect. A statement of net assets held for sale is not a recognized financial statement. Instead, an entity using the liquidation basis of accounting is required to prepare a statement of net assets in liquidation. This is a statement that presents a liquidating entity's net assets available for distribution to investors and other claimants as of the end of the reporting period.
    d. Statement of changes in net assets in liquidation.
       Correct. The statement of changes in net assets in liquidation is a required financial statement of an entity applying the liquidation basis of accounting. This is a statement that presents the changes during the period in net assets available for distribution to investors and other claimants during liquidation.

5. If management determines that its plans do not alleviate the substantial doubt about the entity's ability to continue as a going concern, the entity is required to do which of the following?
    a. Present its financial statements using the liquidation basis of accounting.
    Incorrect. An entity would not present its financial statements using the liquidation basis of accounting if there continues to be a going concern even when considering management's plans to alleviate the substantial doubts. An entity would only use the liquidation basis of accounting if liquidation is imminent.
    b. Disclose the principle conditions/events that raised the substantial doubt.
    Correct. If management's plans do not alleviate the substantial doubt, the entity is required to disclose the principle conditions/events that raised the substantial doubt. Additionally, the entity is required to disclose management's evaluation of the significance of those conditions or events in relation to the entity's ability to meet its obligations.
    c. Re-measure assets and liabilities at fair market value.
    Incorrect. An entity would not re-measure its assets and liabilities at fair market value if management's plans do not alleviate a substantial doubt about the entity's going concern. The entity is required to make certain disclosures including management's evaluation of the significance of the conditions or events giving rise to the substantial doubt.
    d. Restate its financial statements on a cash basis.
    Incorrect. An entity would not restate its financial statements if management's plans do not alleviate a substantial doubt about the entity's going concern. The entity is required to make certain disclosures though, including disclosure of the plans management developed to alleviate the substantial doubt.

6. Which of the following terms identify a debtor's legal right to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor?
    a. Right of setoff.
    Correct. The right of setoff relates to a debtor's legal right to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor. A right of setoff exists when each of two parties owes the other determinable amounts, the reporting party has the right to setoff the amount owed with the amount owed by the other party, the reporting party intends to setoff, and the right of setoff is enforceable by law.
    b. Securities custodian.
    Incorrect. Based on the FASB ASC Master Glossary, the securities custodian for a securities transfer system may be the bank or financial institution that executes securities transfers over the securities transfer system, and book entry securities exist only in electronic form on the records of the transfer system operator for each entity that has a security account with the transfer system operator. It does not relate to a debtor's legal right to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor.
    c. Leveraged lease
    Incorrect. A leveraged lease is a lease that involves at least three parties (a lessee, a long-term creditor, and a lessor) and the financing provided by the long-term creditor is nonrecourse as to the general credit of the lessor (although the creditor may have recourse to the specific property leased and the unremitted rentals relating to it). It does not relate to a debtor's legal right to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor.
    d. Repurchase agreement accounted for as collateralized borrowing.
    Incorrect. A repurchase agreement refers to a transaction in which a seller-borrower of securities sells those securities to a buyer-lender with an agreement to repurchase them at a stated price plus interest at a specified date or in specified circumstances. A repurchase agreement accounted for as a collateralized borrowing is a repo that does not qualify for sale accounting. It does not relate to a debtor's legal right to discharge all or a portion of the debt owed to another party by

applying against the debt an amount that the other party owes to the debtor.

7. Which of the following FASB ASU's eliminated the concept of extraordinary items?
   a. ASU 2014-09.
      Incorrect. ASU 2014-09 did not eliminate the concept of extraordinary items. Instead, this ASU prescribed extensive amendments to the revenue recognition standards. As a result, it created a new FASB ASC Topic 606 – Revenue from Contracts with Customers. The amendments within this ASU are effective for public business entities for annual reporting periods beginning after December 15, 2016.
   b. ASU 2014-10.
      Incorrect. ASU 2014-10 did not eliminate the concept of extraordinary items. Instead, this ASU eliminated certain financial reporting requirements, including amendments to variable interest entities, for development stage entities. The amendments within this ASU are effective for public business entities for annual reporting periods beginning after December 15, 2014.
   c. ASU 2015-01.
      Correct. This ASU eliminated the concept of extraordinary items. Historically, if an event or transaction met the criteria for extraordinary classification (i.e. unusual in nature and infrequent in occurrence), an entity was required to segregate the extraordinary item from the results of ordinary operations and present the item separately in the income statement, net of tax, after income from continuing operations. In addition, an entity was also required to disclose the applicable income taxes and either present or disclose earnings per share data that was applicable to the extraordinary item.
   d. ASU 2015-02.
      Incorrect. ASU did not eliminate the concept of extraordinary items. Instead, this ASU amended the consolidation analysis prescribed within ASC Topic 810. The amendments within this ASU are effective for public business entities for annual reporting periods beginning after December 15, 2016.

8. When used in conjunction with other financial statements, an entity's statement of cash flows should assist stakeholders in assessing each of the following, except?
   a. The entity's ability to generate sufficient future cash flows.
      Incorrect. An entity's statement of cash flows do assist stakeholders in assessing the entity's ability to generate sufficient future cash flows. This is due in part to the fact that a stakeholder can quickly identify how much cash the entity is generating from its operating activities. This is compared to net income which includes many noncash transactions.
   b. The entity's anticipated comprehensive income.
      Correct. An entity's statement of cash flows do not assist stakeholders in understanding an entity's comprehensive income. Comprehensive income is the change in equity of an entity from non-owner sources in addition plus net income. These changes attributed to non-owner sources is commonly referred to as other comprehensive income.
   c. The primary reasons for differences between net income and cash receipts/payments.
      Incorrect. An entity's statement of cash flows assists stakeholders in identifying the primary reasons for differences in net income and cash receipts/payments. This is due in part to the fact that most entities prepare their statement of cash flows using the indirect method, which provides for a reconciliation of net income to operating cash flow.
   d. The entity's ability to meet its future financial obligations.
      Incorrect. An entity's statement of cash flows assists stakeholders in assessing the entity's ability to meet its future financial obligation. In addition, it also assists stakeholders in assessing the effects on an entity's financial position of both its cash and noncash investing and financing transactions during the period.

9. Which of the following transactions is required to be classified within an entity's operating activities of its statement of cash flows?
    a. Proceeds received from derivative instruments that include financing elements at inception.
    Incorrect. Proceeds received from derivative instruments that include financing elements at inception should be classified within financing activities, not operating activities.
    b. Receipts from sales of property, plant, and equipment.
    Incorrect. Receipts from sales of property, plant, and equipment should be classified within investing activities, not operating activities.
    c. Principal payments to creditors who have extended long-term credit.
    Incorrect. Principal payments to creditors who have extended long-term credit should be classified within financing activities, not operating activities.
    d. Payments to acquire materials for manufacturing of goods for resale.
    Correct. Payments to acquire materials for manufacturing of goods for resale should be classified as operating activities. Operating activities also include cash receipts from loans, other debt instruments of other entities, and equity securities.

10. Which of the following transactions is required to be classified within an entity's investing activities of its statement of cash flows?
    a. Payments to governments for taxes, fines, duties, and other penalties.
    Incorrect. Payments to governments for taxes, fines, duties, and other penalties should be classified as operating activities, not investing activities.
    b. Proceeds from issuing equity instruments.
    Incorrect. Proceeds from issuing equity instruments should be classified as financing activities, not investing activities.
    c. Proceeds from sales of machinery and equipment.
    Correct. Proceeds from sales of machinery and equipment should be classified as investing activities. An additional example of investing activities is receipts from sales of equipment instruments of other entities.
    d. Payments of dividends to the entity's stockholders.
    Incorrect. Payments of dividends to the entity's stockholders should be classified as financing activities, not operating activities.

11. Which of the following transactions is required to be classified within an entity's financing activities of its statement of cash flows?
    a. Payments related to debt issuance costs.
    Correct. Payments related to debt issuance costs should be classified as financing activities. An additional example of financing activities include proceeds from issuing bonds, mortgages, notes, and from other short- or long-term borrowing.
    b. Payments to suppliers and employees for goods and services.
    Incorrect. Payments to suppliers and employees for goods and services should be classified as operating activities, not financing activities.
    c. Proceeds from collections of loans made by the entity.
    Incorrect. Proceeds from collections of loans made by the entity should be classified as investing activities, not financing activities.
    d. Receipts from sales of loans that were not specifically acquired for resale.
    Incorrect. Receipts from sales of loans that were not specifically acquired for resale should be classified as investing activities, not financing activities.

12. Which of the following identifies an example of a change in accounting principle?
    a. A change in the estimated useful life of an entity's long-lived assets.
       Incorrect. A change in the estimated useful life of an entity's long-lived assets is an example of a change in accounting estimate, not a change in accounting principle.
    b. A change in the estimate of uncollectible accounts receivable balances.
       Incorrect. A change in the estimated of uncollectible accounts receivable balances is an example of a change in accounting estimate, not a change in accounting principle.
    c. A change in the valuation method of an entity's inventory.
       Correct. A change in the valuation method of an entity's inventory is an example of a change in accounting principle. A change in accounting principle is a situation where an entity changes from reporting from one GAAP principle to another GAAP principle. For example, this could be a situation where an entity changes its inventory valuation method from FIFO to LIFO.
    d. A change in the estimated future liability for warranty obligations on an entity's products sold.
       Incorrect. A change in the estimate future liability for warranty obligation on products sold by an entity is a change in accounting estimate, not a change in accounting principle.

Course Evaluation Form

Program Title: ____

Program Date: ____

Participant Name: ____

Please indicate your agreement with the following statements:	Agree	Disagree	Don't Know
1. Stated Learning Objectives were met	______	______	________
2. Stated prerequisite requirements were appropriate and sufficient	______	______	________
3. Program materials were relevant and contributed to the achievement of the learning objectives	______	______	________
4. Time allotted to the learning activity was appropriate	______	______	________
5. If applicable, individual instructors were effective	______	______	________

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Additional Comments:

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Thank you for your comments!