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THE VEST POCKET GUIDE TO GAAP

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- Hundreds of supporting examples

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Steven Bragg, CPA, has been the chief financial officer or controller of four companies, as well as a consulting manager at Ernst & Young. He received a master's degree in finance from Bentley College, an MBA from Babson College, and a Bachelor's degree in Economics from the University of Maine. He has been the two-time President of the Colorado Mountain Club, and is an avid alpine skier, mountain biker, and certified master diver. Mr. Bragg resides in Centennial, Colorado. He has written the following books:

Accounting and Finance for Your Small Business
Accounting Best Practices
Accounting Control Best Practices
Accounting Policies and Procedures Manual
Advanced Accounting Systems
Billing and Collections Best Practices
Business Ratios and Formulas
Controller's Guide to Costing
Controller's Guide to Planning and Controlling Operations
Controller's Guide: Roles and Responsibilities for the New Controller
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Financial Analysis
GAAP Guide
GAAP Policies and Procedures Manual
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Treasury Management
Vest Pocket Controller
Vest Pocket GAAP
Vest Pocket IFRS Guide

WHAT THIS BOOK WILL DO FOR YOU

This is a handy pocket problem-solver for the accountant, controller, and chief financial officer. It provides broad coverage of generally accepted accounting principles (GAAP), using a question-and-answer format that provides concise explanations and hundreds of supporting examples for all GAAP topics. The layout is designed for quick comprehension of such questions as:

- Can I offset information in the balance sheet?
- What are the direct and indirect method layouts for the statement of cash flows?
- What are the thresholds for segment reporting?
- How do I calculate diluted earnings per share?
- Do I retrospectively adjust interim financial statements?
- What related party information should I disclose?
- How do I account for subsequent events after the reporting period?
- How do I measure losses from uncollectible receivables?
- How do I account for held-to-maturity investments?
- How do I use the equity method of accounting?
- What costs can I include in inventory?
- How do I account for preproduction costs?
- What depreciation method should I use?
- How do I assign goodwill to reporting units?
- How do I account for an asset retirement obligation?
- When do I recognize a loss contingency?
- What is the effective interest method?
- How do I account for treasury stock?
- When can I recognize revenue?
- How do I account for pension plans?
- How do I account for a share-based payment?
- What is a claims-made insurance contract?
- What is a research and development arrangement?
- How do I recognize a tax loss carryback?
- How do I disclose a change in accounting principle?
- How do I account for a business combination?
- What is hedging, and how do I account for it?

- When can I record assets and liabilities at their fair values?
- How do I determine an entity's functional currency, and how do I report transactions in that currency?
- When should I capitalize interest cost?
- How do I account for a capital lease?
- How do I account for a non-monetary exchange?

Vest Pocket GAAP is divided into sections, where each deals with four main categories of GAAP: the financial statements, assets and liabilities, revenue and expenses, and special transactions.

Part I, The Financial Statements (Chapters 1-6) addresses GAAP for the construction of financial statements. Part I is divided into separate chapters to address the basic form of the financial statements, how to consolidate them, and how to report on special situations. These special situations include the reporting of operating segments, earnings per share, and interim reporting, all of which are required for publicly-held entities. Other chapters address special disclosures, including related-party disclosures and the reporting of subsequent events.

Part II, Assets and Liabilities (Chapters 7-17) addresses GAAP for accounting issues related to assets, liabilities, and equity. There are separate chapters covering the accounting for receivables, investments, inventory, deferred costs, fixed assets, and intangible assets, as well as for asset retirement obligations, contingencies, debt, and equity.

Part III, Revenue and Expenses (Chapters 18-23) delves into a variety of revenue and expense topics. These include revenue recognition, employee benefits, stock compensation, research and development expenses, and income taxes.

Part IV, Broad Transactions (Chapters 24-32) addresses a broad range of accounting transactions. These include accounting changes, business combinations, derivatives, fair value accounting, foreign currency matters, and the appropriate handling of interest cost, as well as leases, non-monetary transactions, and not-for-profit entities.

Throughout, *Vest Pocket GAAP* has been structured to provide concise answers to the GAAP questions that an accountant is most likely to encounter during a typical business day. Keep it handy for easy reference and daily use.

Free On-Line Resources by Steve Bragg

Steve issues a free accounting best practices podcast. You can sign up for it at www.accountingtools.com, or access it through iTunes. The www.accountingtools.com Web site also contains hundreds of articles about a broad range of accounting topics.

PART I

THE FINANCIAL STATEMENTS

CHAPTER 1

FINANCIAL STATEMENTS PRESENTATION

What Is Profit or Loss?

Profit or loss is the total of an entity's revenues and expenses, not including any components of other comprehensive income (see the next question). It is also known as *net income*.

Total comprehensive income is the combination of profit or loss and other comprehensive income.

What Is Other Comprehensive Income?

Other comprehensive income contains all changes including financial items that are not permitted in profit or loss. Items that you should insert in other comprehensive income include:

- Available-for-sale securities fair value changes that were previously written down as impaired
- Available-for-sale securities unrealized gains and losses
- Cash flow hedge derivative instrument gains and losses
- Debt security unrealized gains and losses arising from a transfer from the available-for-sale category to the held-to-maturity category
- Foreign currency gains and losses on intra-entity currency transactions where settlement is not planned or anticipated in the foreseeable future
- Foreign currency transaction gains and losses that are hedges of an investment in a foreign entity
- Foreign currency translation adjustments
- Pension or post-retirement benefit plan gains or losses
- Pension or post-retirement benefit plan prior service costs or credits

- Pension or post-retirement benefit plan transition assets or obligations that are not recognized as a component of the net periodic benefit or cost

It is acceptable to either report components of other comprehensive income net of related tax effects, or before related tax effects with a single aggregate income tax expense or benefit shown that relates to all of the other comprehensive income items.

An example of a possible format for reporting other comprehensive income in the income statement is:

EXAMPLE 1.1

GUTTERING CANDLE COMPANY STATEMENT OF INCOME AND COMPREHENSIVE INCOME FOR THE YEAR ENDED DECEMBER 31, 20X1

Revenues		$1,000,000
Expenses		800,000
Net income		200,000
Other comprehensive income, net of tax:		
Foreign currency translation adjustments		10,000
Unrealized gains on securities:		
Unrealized holding gains arising during the period	$12,000	
Less: reclassification of gains included in net income	(3,000)	
		9,000
Defined benefit pension plans:		
Net loss arising during the period	(2,000)	
Prior service cost arising during the period	(4,000)	
Less: amortization of prior service cost included in net periodic pension cost	1,000	
		(5,000)
Other comprehensive income		14,000
Comprehensive income		$ 214,000

You should list the total of other comprehensive income for each reporting period to a component of equity that is displayed separately from retained earnings and additional paid-in capital in the balance sheet, and call it *accumulated other comprehensive income*. An example showing the placement of this line item within the equity section of an entity's balance sheet follows:

EXAMPLE 1.2

Equity:	
Common stock	$1,000,000
Paid-in capital	10,000
Retained earnings	450,000
Accumulated other comprehensive income	25,000
Total equity	$1,485,000

If an item listed in other comprehensive income becomes a realized gain or loss, you then shift it out of other comprehensive income and into net income or loss. This can happen, for example, when you sell an investment security for which you already recorded an unrealized gain in other comprehensive income. At the point of sale, this is now a realized gain, which shifts into net income. You can display this reclassification adjustment either on the face of the financial statements, or in the accompanying notes.

Total comprehensive income is the combination of profit or loss and other comprehensive income.

What Information Is Included in a Complete Set of Financial Statements?

All of the following financial reports should be included in a complete set of financial statements for a reporting period:

Statement	Description
Balance sheet (Statement of financial position)	Contains all asset, liability, and equity items
Statement of comprehensive income	Contains all income and expense items
Statement of changes in equity	Reconciles changes in equity for the presented periods
Statement of cash flows	Displays all cash inflows and outflows from operating, financing, and investing activities
Notes	Summarizes accounting policies and explanatory information

You should clearly identify these financial statements and distinguish them from other information presented in the same report, so that users will be more likely to understand which documents within the report adhere to specific accounting standards.

You should include in the financial statements a prominent display of the name of the reporting entity (and note any change in it from the preceding reporting period), whether the statements are for a single entity or group of entities, the period covered by the statements, and the level of rounding used to present amounts. This information is usually most easily presented in column and page headers.

What Line Items Do I Include in the Balance Sheet?

There is no specific requirement for the line items to be included in the balance sheet. The following line items, at a minimum, are normally included in the balance sheet:

Assets

- Cash and cash equivalents
- Trade and other receivables
- Investments
- Inventories
- Property, plant, and equipment
- Intangible assets
- Assets held for sale

Liabilities

- Trade and other payables
- Accrued expenses
- Current tax liabilities
- Other financial liabilities
- Liabilities held for sale

Equity

- Capital stock
- Additional paid-in capital
- Retained earnings

You should add headings and subtotals to this minimum set of information if it will improve a user's understanding of the financial statements. You should add other line items when their size, nature, or function makes separate presentation relevant to the user.

Example 1.3

Holystone Dental Corporation presents its balance sheet in the following format:

HOLYSTONE DENTAL CORP. STATEMENT OF FINANCIAL POSITION

(000s)	**as of 12/31/x2**	**as of 12/31/x1**
ASSETS		
Current assets		
Cash and cash equivalents	$ 270,000	$ 215,000
Trade receivables	147,000	139,000
Inventories	139,000	128,000
Other current assets	15,000	27,000
	571,000	509,000
Non-current assets		
Property, plant, and equipment	551,000	529,000
Goodwill	82,000	82,000
Other intangible assets	143,000	143,000
	776,000	754,000
Total assets	$1,347,000	$1,263,000
LIABILITIES AND EQUITY		
Current liabilities		
Trade and other payables	$ 217,000	$ 198,000
Short-term borrowings	133,000	202,000
Current portion of long-term borrowings	5,000	5,000
Current tax payable	26,000	23,000
Accrued expenses	9,000	13,000
Total current liabilities	390,000	441,000
Non-current liabilities		
Long-term debt	85,000	65,000
Deferred taxes	19,000	17,000
Total non-current liabilities	104,000	82,000
Total liabilities	494,000	523,000
Shareholders' Equity		
Capital	$ 100,000	$ 100,000
Additional paid-in capital	15,000	15,000
Retained earnings	738,000	625,000
Total equity	853,000	740,000
Total liabilities and equity	$1,347,000	$1,263,000

When Do I Present Information as Current or Non-Current?

You should classify all of the following as current assets:

- *Cash.* Cash that is available for current operations, and any short-term, highly liquid investments that are readily convertible to known amounts of cash and which are so near their maturities that they present an insignificant risk of value changes. Do not include cash whose withdrawal is restricted, to be used for other than current operations, or segregated for the liquidation of long-term debts.
- *Inventory.* Includes merchandise, raw materials, goods in process, finished goods, operating supplies, and maintenance parts.
- *Accounts receivable.* Includes trade accounts, notes, and acceptances that are receivable. Also include receivables from officers, employees, affiliates, and others, if they are collectible within a year. Do not include any receivable that you do not expect to collect within 12 months.
- *Marketable securities.* Includes those securities representing the investment of cash available for current operations, including trading securities.
- *Prepaid expenses.* Includes prepayments for insurance, interest, rent, taxes, unused royalties, advertising services, and operating supplies.

You should classify an asset as current when an entity expects to sell or consume it during its normal operating cycle or within 12 months after the reporting period. If the operating cycle is longer than twelve months, then use the longer period to judge whether an asset can be classified as current. You should classify all other assets as non-current.

You should classify all of the following as current liabilities:

- *Payables.* All accounts payable incurred in the acquisition of materials and supplies that are used to produce goods or services.
- *Prepayments.* Amounts collected in advance of the delivery of goods or services by the entity to the customer. Do not include a long-term prepayment in this category.
- *Accruals.* Accrued expenses for items directly related to the operating cycle, such as the accruals for compensation, rentals, royalties, and various taxes.
- *Short-term debts.* Debts maturing within the next 12 months.

You should classify a liability as current when the entity expects to settle it during its normal operating cycle or within 12 months after the reporting period, or if it is scheduled for settlement within 12 months. You should classify all other liabilities as non-current.

Current liabilities include accruals for amounts that can only be determined approximately, such as bonuses, and where the payee to whom payment will be made cannot initially be designated, such as a warranty accrual.

Can I Offset Information in the Balance Sheet?

Offsetting involves reporting only the net amount of an asset and a liability in the balance sheet. Generally, it is improper to do so unless there is a *right of setoff*. A right of setoff is a debtor's legal right to discharge all or some portion of the debt owed by another party by applying the debt against an amount that the other party owes to the debtor. If a right of setoff exists, generally accepted accounting principles (GAAP) generally allows offsetting in the balance sheet only if there are just two parties involved.

There is a right of setoff when each party owes the other party a determinable amount, the reporting party has the right to set off the amount owed with the amount owed by the other party, the reporting party intends to set off the amounts, and the reporting party's setoff right is legally enforceable.

What Line Items Do I Include in the Income Statement?

You should present all items of income and expense for the reporting period in a statement of comprehensive income. Alternatively, you can split this information into an income statement and a statement of comprehensive income.

There are no specific requirements for which line items are included in the income statement, but the following line items are typically used, based on general practice:

- Revenue
- Tax expense
- Post-tax profit or loss for discontinued operations and for the disposal of these operations
- Profit or loss
- Extraordinary gains or losses
- Other comprehensive income, subdivided into each component thereof
- Total comprehensive income

A key additional item is to present an analysis of the expenses in profit or loss, using a classification based on their nature or functional area, maximizing the relevance and reliability of presented information. If you elect to present expenses by their nature, the format looks similar to the following:

Revenue		XXX
Expenses:		
Change in finished goods inventories	XXX	
Raw materials used	XXX	
Employee benefits expense	XXX	
Depreciation expense	XXX	
Telephone expense	XXX	
Other expenses	XXX	
Total expenses		XXX
Profit before tax		XXX

Alternatively, if you present expenses by their functional area, the format looks similar to the following:

Revenue	XXX
Cost of sales	XXX
Gross profit	XXX
Administrative expenses	XXX
Distribution expenses	XXX
Research and development expenses	XXX
Other expenses	XXX
Total expenses	XXX
Profit before tax	XXX

Of the two methods, presenting expenses by their nature is easier, since it requires no allocation of expenses between functional areas. Conversely, the functional area presentation may be more relevant to users of the information, who can more easily see where resources are being consumed.

You should add additional headings, subtotals, and line items to the items noted above if doing so will increase a user's understanding of the entity's financial performance.

Example 1.4

Plasma Storage Devices presents its statement of financial position in two statements by their nature, resulting in the following format, beginning with the income statement:

PLASMA STORAGE DEVICES INCOME STATEMENT FOR THE YEARS ENDED DECEMBER 31

(000s)	20x2	20x1
Revenue	$ 900,000	$ 850,000
Other income	25,000	20,000
Changes in finished goods inventories	(270,000)	(255,000)
Raw materials used	(90,000)	(85,000)
Employee benefits expense	(180,000)	(170,000)
Depreciation and amortization expense	(135,000)	(125,000)
Impairment of property, plant, and equipment	0	(50,000)
Other expenses	(75,000)	(72,000)
Finance costs	(29,000)	(23,000)
Profit before tax	146,000	90,000
Income tax expense	(58,000)	(32,000)
Profit for the year from continuing operations	88,000	58,000
Loss for the year from discontinued operations	(42,000)	0
Profit for the Year	$ 46,000	$ 58,000
Earnings per share:		
Basic	$ 0.13	$ 0.16
Diluted	0.09	0.10

Plasma Storage Devices then continues with the following statement of comprehensive income:

PLASMA STORAGE DEVICES STATEMENT OF COMPREHENSIVE INCOME

(000s)	20x2	20x1
Profit for the year	$ 46,000	$ 58,000
Other comprehensive income:		
Exchange differences on translating foreign operations	5,000	9,000
Available-for-sale financial assets	10,000	(2,000)
Actuarial losses on defined benefit pension plan	(2,000)	(2,000)
Other comprehensive income, net of tax	13,000	5,000
TOTAL COMPREHENSIVE INCOME	59,000	63,000

How Do I Account for Extraordinary Items?

An extraordinary item is an event or transaction that is distinguished by both its unusual nature and the infrequency of its occurrence. Something is considered to be unusual if it represents a high degree of abnormality and is unrelated to an entity's typical activities. Something occurs infrequently if you do not reasonably expect it to recur in the foreseeable future.

Examples of extraordinary items are:

- A tornado destroys crops in an area where tornado damage is rare.
- An earthquake destroys a building.
- A hurricane destroys a business in an area where there is no record of hurricane damage.

Items that are *not* considered to be extraordinary are:

- Adjustments to accruals on long-term contracts
- Asset disposal gains or losses
- Effects of a strike
- Foreign currency transaction gains or losses (including currency devaluations and revaluations)
- Remaining excess of the fair value of acquired net assets over cost
- Write-downs of accounts receivable, inventory, deferred research and development costs, and other intangible assets

The following are examples of events that are not extraordinary:

- A farmer's grapes are destroyed by frost in an area where frost damage is relatively common.
- A company is unable to complete a public equity registration.
- A company incurs costs to defend itself from a hostile takeover.

If you classify an item as extraordinary, then classify it separately in the income statement if it is material in relation to the income before extraordinary items, or to the trend of annual earnings before extraordinary items. You should make this decision for individual items, and not in aggregate for multiple items.

Extraordinary items should be segregated from the results of ordinary operations and shown separately in the income statement, using the following format:

Income before extraordinary items	$XXX,XXX
Extraordinary items (less applicable taxes of $___) (Note XX)	X,XXX
Net income	$XXX,XXX

In the accompanying notes to the financial statements, disclose the nature of the extraordinary event and the principal items entering into its determination as an extraordinary item, as well as the related amount of income taxes. Also, if earnings per share disclosure are required, then separately disclose the earnings per share for extraordinary items.

What Line Items Do I Include in the Statement of Changes in Equity?

You should include the following line items in the statement of changes in equity:

- Total comprehensive income (with separate presentation of the amounts attributable to the owners of the parent entity and to non-controlling interests)
- Effects of retrospective applications or restatements on each component of equity (which are usually adjustments to the opening balance of retained earnings)
- Reconciliation of changes during the period for each component of equity resulting from profit or loss, each item of other comprehensive income, and transactions with owners (including contributions by and distributions to them)
- Dividends recognized, and the related amount per share (this item can alternatively be presented in the associated notes)

What Are the Main Components of the Statement of Cash Flows?

The statement of cash flows contains information about activities that generate and use cash. The primary activities are:

- *Operating activities.* These are an entity's primary revenue-producing activities. Examples of operating activities are cash receipts from the sale of goods, as

Example 1.5

Musical Heritage Company presents its statement of changes in equity as follows to reflect changes in its equity over a two-year period:

	Share Capital	Retained Earnings	Total	Non-Controlling Interests	Total Equity
Balance at Jan. 01, 20x1	$350,000	$50,000	$400,000	$40,000	$440,000
Accounting policy change	–	(3,000)	(3,000)	–	(3,000)
Restated balance	350,000	47,000	397,000	40,000	437,000
Changes in equity for 20x1					
Dividends	–	(25,000)	(25,000)	–	(25,000)
Total comprehensive income	–	42,000	42,000	4,000	46,000
Balance at Dec. 31, 20x1	350,000	64,000	414,000	44,000	458,000
Changes in equity for 20x2					
Dividends	–	(18,000)	(18,000)	–	(18,000)
Issue of share capital	125,000	–	125,000	–	125,000
Total comprehensive income	–	37,000	37,000	4,000	41,000
Balance at Dec. 31, 20x2	$475,000	$83,000	$558,000	$48,000	$606,000

well as from royalties and commissions, amounts received or paid to settle lawsuits, fines, payments to employees and suppliers, cash payments to lenders for interest, contributions to charity, and the settlement of asset retirement obligations.

- *Investing activities.* These involve the acquisition and disposal of long-term assets. Examples of investing activities are cash receipts from the sale of property, the sale of debt or equity instruments of other entities, and repayment of loans made to other entities. Examples of cash payments that are investment activities include the acquisition of property, plant, and equipment, and purchases of the debt or equity of other entities.
- *Financing activities.* This refers to those activities resulting in alterations to the amount of contributed equity and the entity's borrowings. Examples of financing activities include cash receipts from the sale of the entity's own equity instruments or from issuing debt, proceeds received from derivative instruments, as well as cash payments to buy back shares, pay dividends, and to pay off outstanding debt.

The statement of cash flows also incorporates the concept of *cash and cash equivalents*. A cash equivalent is a short-term, very liquid investment that is easily convertible into a known amount of cash, and which is so near its maturity that it presents an insignificant risk of changes in value because of changes in interest rates.

What Are the Direct and Indirect Method Layouts for the Statement of Cash Flows?

You can use the *direct method* or the *indirect method* to present the statement of cash flows. The direct method presents the specific cash flows associated with items that affect cash flow. Items typically affecting cash flow include:

- Cash collected from customers
- Interest and dividends received
- Cash paid to employees
- Cash paid to suppliers
- Interest paid
- Income taxes paid

Under the indirect method, 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 cash provided by operating activities.

Examples of both methods are located in the answer to the next question.

What Line Items Should I Include in the Statement of Cash Flows?

The statement of cash flows reports cash activities during a reporting period, subdivided into operating, investing, and financing activities. The information you should include in these activities is as follows:

- *Operating activities.* Use either the direct method (disclosing major classes of gross cash receipts and payments) or the indirect method (adjusting profit or loss for changes in inventories, receivables, payables, and a variety of non-cash items).
- *Investing activities.* Separately report the major classes of gross cash receipts and payments caused by investing activities. You should separately report investing cash inflows and outflows; for example, a payment for property, plant, and equipment is reported separately from a receipt from the sale of property, plant, and equipment.
- *Financing activities.* Separately report the major classes of gross cash receipts and payments caused by financing activities.

Examples of the direct method and indirect method of presenting a statement of cash flow follow.

Example 1.6

Ajax Machining Company constructs the following statement of cash flows using the direct method:

AJAX MACHINING COMPANY STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 12/31/X1

Cash flows from operating activities	
Cash receipts from customers	$45,800,000
Cash paid to suppliers	(29,800,000)
Cash paid to employees	(11,200,000)
Cash generated from operations	4,800,000